

# "STABLE VALUE FUND RISK MANAGEMENT"

## Keynote Speech

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Stable Value Investment Association

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Good morning and thank you for the invitation to speak here today. While always important, risk management has taken center stage in recent months. In the aftermath of unprecedented losses, regulators and investors alike are asking a lot of questions about process. A recent fortune cookie

message says it all. “All things have a cause. Look into your past for answers.”

Many people blame black swans for the credit crisis and assorted financial meltdowns. Others suggest that the culprit was an absence of supervisory oversight or lack of familiarity with material investment risks or both. Understanding the root cause of what happened in the last few years is critical in order to effect positive change in the financial services industry.

In preparing for my talk today, I was struck by how little I found on the topic of stable value fund risk management, especially given the large size of the market at roughly \$700 billion and the widespread use of stable value vehicles in deferred compensation plans such as 401(k) plans.



What I did uncover about stable value fund risk management was general and vague with a few exceptions. One product profile provided some specifics under the heading of Risk Management as follows:

- “Focus on liquidity management to ensure preservation of principal in all market environments
- Utilize multi-factor risk system to stress test the portfolio relative to the benchmark. Proprietary risk model applies traditional fixed income analysis to stable value.”

## Slide 1:

Makings of a Storm?

- Accountability
- Accounting
- Asset Allocation
- Availability of Wraps
- Bank Capital
- Collateral
- Concentration
- Controls
- Correlation
- Diversification
- Fiduciary Liability
- Leverage
- Liquidity
- Litigation
- M&A
- Political Pressures
- Ratings
- Regulation
- Reputation
- Service Provider Due Diligence
- Style Drift
- Valuation
- Volatility



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Things have definitively changed in the financial industry. Some describe the perfect storm. A good test of your preparedness is to imagine answering questions as a witness who is being deposed about current risk practices. If that possibility makes you nervous, use your anxiety to spring into action and put comprehensive risk management policies and procedures in place.

Ask yourself what risk factors keep you up at night, what will cause you to lose business or worse. In addition to the imposition of new capital rules that could materially impact bank providers of investment products, an expansive fiduciary standard looms large. Add increased litigation and enforcement to the mix, along with political pressures to force change and it's clear that investment industry players find themselves in the spotlight as never before.

As a result, plan sponsors will likely spend more time on their due diligence efforts of service providers and products. Hidden leverage, the inability to liquidate a position, nasty surprises that will make headlines, bad and/or insufficient collateral and lax internal controls are only a few of the questions being asked by vigilant deferred

compensation plan investment committees. Transparency is another huge issue. In the case of a stable value fund, it's not clear if the various players are sharing enough information with each other to allow plan sponsors to thoroughly identify risk factors and then explain to participants how those risk factors are being measured and managed. Think about it this way. At a time when plan sponsors are jittery, is the black box approach going to allow plan sponsors to discharge their fiduciary duties in selecting and regularly monitoring a stable value fund(s)? It's doubtful.

Another big concern is valuation. A recent *Pensions and Investments* article talked about valuation concerns of the U.S. Department of Labor. Around the time that I testified on the topic of risk management and hard-to-value investing in 2008,

there was a lot of talk about regulatory sanctions of plan sponsors that did not take care to independently value instruments inside their portfolio.

Now there is talk of having appraisers, if used, classified as fiduciaries. This could discourage third parties from offering price assessment, thereby putting more pressure on already overworked plan sponsors to figure out how to check the value of what's inside their portfolio. It could further discourage plan sponsors from investing or recommending anything that has a "hard-to-value" component. Critics have pointed out that stable value funds sometimes invest in instruments that are not readily liquid and/or challenging to mark-to-market or mark-to-model.

## Slide 2:

### Bucket Theory of Risk Management

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The bucket theory of risk management suggests that there are asset managers and wrappers who practice good risk management and therefore get classified as "good players" (i.e. fall into the shiny green bucket). In stark contrast, there is "everyone else" who gets associated with having insufficient, inappropriate poor quality risk controls. Since so little is publicly known about how stable value fund providers manage risks, those who are doing

everything right may end up being classified as belonging to the dirty, leaky buckets. Plan sponsors want to avoid transacting with leaky bucket providers at all costs. To do otherwise means that their fiduciary liability goes up and that is not a good thing for their participants or for the committee members who are exposed to personal and professional liability.

## Slide 3:

Winning Clients With A New Paradigm

- Craig's Story
- Put Yourself In Others' Shoes
- Asymmetric Payoff
- Investing in Education
- Scorecards
- W2 Impact



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The good news is that education on the part of stable value fund providers about their risk management activities can help to differentiate firms and thereby allow organizations to win and/or keep business. However, client communication and education are key. Let me give you an example of what I mean. My colleague Craig reduced fees for his clients as a good faith gesture during tough markets. Without education about what he did and

why, his clients thought he was charging more elsewhere. His efforts did not go far enough from a client interface perspective.

Put yourself in the shoes of plan sponsors who need and want to have complete information about risk controls. Think about the positive contribution you can make to somebody's W2 by solving their problems of needing to know more about risk management.

The notion of asymmetry is important to consider as well. When you do something great, people seldom rave. Do something bad and the downside can be material. Informing clients helps to level out this seemingly unfair situation of doing what is right for your client and not immediately being able to reap the rewards. Stable value fund service

providers can provide concrete tools for their clients in the form of a best practices scorecard that explicitly lays out risk factors and how your organization benchmarks against prudent process. Email [susanm@fiduciaryleadership.com](mailto:susanm@fiduciaryleadership.com) if you want ideas about what a scorecard should look like and how to implement an effective client-centric education initiative for the plan sponsor community.

## Slide 4:

| Published Risk Factors<br>For "Low Volatility" Stable Value Trust* |  |
|--|--|
| ■ Accounts of Affiliates of the Investment Manager                 | ■ Management Risk  |
| ■ Active Trading Risk  | ■ Market Risk  |
| ■ Call Risk  | ■ Prepayment Risk  |
| ■ Credit Risk  | ■ Registration Risk (with CFTC, SEC)                           |
| ■ Crediting Rate Risk  | ■ Risks Associated With Investing in Comingled or Private Pool |
| ■ Derivatives Risk   | ■ Securities Lending Risk                                      |
| ■ General Investment Risk  | ■ Spread Risk  |
| ■ Inflation Risk   | ■ Wrapper Agreement Risk                                       |
| ■ Interest Rate Risk   |  |
| ■ Leverage Risk  |  |
| ■ Liquidity Risk   |  |



\* Taken from a product marketing brochure dated 9/30/10


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Stable value funds are sometimes referred to as “low risk.” As shown in Slide 4, a 2010 product marketing brochure for a stable value trust lists nineteen (19) risk factors though it does not address how the provider is mitigating any or all of the risks under their control. Citing these risks can scare a potential investment committee buyer unless they understand that those in charge are


facing those risks head on and dealing with them systematically.

## Slide 5:



ERISA Fiduciary Duties And Litigation

- Are Investment Managers Taking Too Much Risk?
- Is Collateral Being Properly Monitored?
- Are Stable Value Vehicles Superior To Money Market Funds In Context Of Diversification Duties Of Plan Administrators?
- Was A Prudent Process In Place With Respect To Investment Risk Mitigation?
- Are Fees Too High?
- Who Is Vetting Service Providers And On What Basis?



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It is noteworthy that more and more ERISA lawsuits allege fiduciary breach. Slide 5 offers a sampling of questions that are being asked in various lawsuits. Expect more legal queries about the role of various players in the pension investment eco-system, with a particular focus on process. The logo for my new

blog, to be launched shortly, is circular by design. That's because risk management is an ongoing process. Once policies and procedures are created, relevant decision-makers need to monitor when and how those policies and procedures might need to be “re-balanced” so to speak.

For those interested, the new blog URL is [goodriskgovernancepays.com](http://goodriskgovernancepays.com). Look for a launch in early December 2010. You might also want to check out [pensionriskmatters.com](http://pensionriskmatters.com) for over four years of archived articles and references about asset allocation, compliance, due diligence, fees, fiduciary liability, risk management, valuation and much more.

## Slide 6:

### Embedded Derivatives

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- **Stable Value Funds (“SVF”) = Diversified Fixed Income Portfolio + Wrap**
- **Contingent Performance (Embedded Option):**
  - If SVF falls < ROR set by wrapper, then insurer pays the difference
  - If SVF > ROR set by wrapper, SVF pays the insurer
- **Employer Initiated Withdrawals (Embedded Option)**
  - Delays up to 12 months render investments illiquid
  - Opportunity cost



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By their very design, stable value vehicles include embedded derivatives. Embedded derivatives are financial instruments that cannot be stripped out and sold separately in the marketplace. An investor in stable value funds may likewise encounter embedded derivatives by virtue of the structure of assets under management. Some stable value fund managers allocate monies to asset-backed securities and/or some type of instruments with

contingent or option-like price behavior. Notwithstanding the numerous accounting issues to consider, the use of derivatives can induce leverage. Leverage is neither good nor bad but it must be identified, measured and well managed. Even when derivatives are used for hedging purposes, there are economic issues relating to hedge effectiveness, economic leakage, costs of transacting, need to rebalance and counterparty risk. Provisions of the Dodd-Frank Act will further impact the costs and benefits of using derivatives.

According to a recent report published by the Bank for International Settlements, over-the-counter derivatives totaled nearly \$600 trillion or about forty (40) times the current level of U.S. national debt. The global market has grown significantly because of the flexibility that over-the-counter derivatives

can offer. However, there is no free lunch and the incremental risks, netted against expected benefits, associated with the use of derivatives should not be ignored.

## Slide 7:

Derivative Instruments:  
Sample Product Comparison

| <i>Instrument Class</i> | <i>Futures</i>   | <i>Over-the-counter Options</i><br>(subject to Dodd-Frank)  | <i>Swaps</i><br>(subject to Dodd-Frank)  |
|-------------------------|--|---|--|
| Credit Risk             | Lower because of clearinghouse and daily settlement  | Higher because of direct contracting with counterparty  | Higher because of direct contracting with counterparty   |
| Economic Risk           | Depends since standardized terms make it harder to hedge exact underlying exposure but easier to value derivative instrument | Depends since customized terms make it easier to hedge exact underlying exposure but harder to value derivative instrument                                  | Depends since customized terms make it easier to hedge exact underlying exposure but harder to value derivative instrument |
| Legal Risk              | Lower due to regulation  | Higher due to evolving case law   | Higher due to evolving case law  |
| Liquidity Risk          | Lower for most contracts because of standardized terms   | Higher especially for longer-term contracts   | Higher but partially reduced because of intervening cash settlements   |
| Operational Risk        | Depends on quality of staff and technology systems in place to track and make daily settlement cash flow transfers           | Depends on availability and knowledge of staff to monitor and possibly exercise options (Note: Systems may be required if many options are bought or sold.) | Depends on quality of staff and technology systems to track and make intervening settlement cash flow transfers            |

Source: *Risk Management for Pensions, Endowments, and Foundations* by Susan M. Mangiero (John Wiley & Sons, 2005)

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A simple derivative instrument matrix comparison such as the example shown in Slide 7 is a reminder that not all derivatives are created equal. The risk-return tradeoffs, not to mention operational and

legal issues, can differ. Those differences are critical to consider when stable value fund buyers are doing their homework. Investment committee members will want to drill down deep about the extent to which financial derivatives are embedded or used outright by stable value fund asset managers and the wrappers, strategies employed and related risk control policies and procedures.

## Slide 8:

### Working With External Money Managers

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**“If the plan is investing in a pooled fund which is managed by a party other than the plan fiduciary who has chosen the fund, then that plan fiduciary should obtain, among other things, sufficient information to determine the pooled fund's strategy with respect to use of derivatives in its portfolio, the extent of investment by the fund in derivatives, and such other information as would be appropriate under the circumstances.” (PWBA 1996 letter)**



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While a guideline letter from the then Pension and Welfare Benefits Administration, now called Employee Benefits Security Administration or EBSA, is dated 1996, its mandates regarding derivative instrument due diligence remain relevant today. The full letter goes on to describe suggested investigatory techniques such as stress testing. However, a plan sponsor cannot “obtain, among

other things, sufficient information to determine the pooled fund's strategy with respect to use of derivatives..." unless stable value fund providers are transparent in what they do (assuming they are hedging or otherwise using exchange-traded and/or over-the-counter instruments).


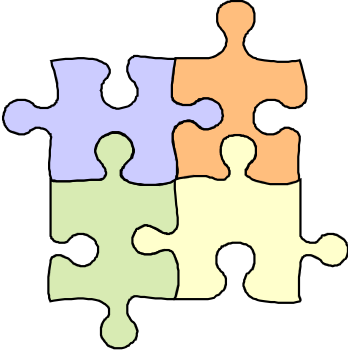
## Slide 9:

Valuation is Part of the Puzzle

Virginia C. Smith, director of enforcement for the DOL's Employee Benefits Security Administration, confirmed in a September 2008 hearing before the ERISA Advisory Council that the DOL was investigating how corporate pension plan fiduciaries were valuing alternative investments.

She said it would be "difficult, if not impossible," for a plan fiduciary to fulfill its prudence obligations if it lacked accurate information about the value of its alternative investments.

Source: *Pensions & Investments*



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As stated earlier, valuation is a critical piece of the puzzle. U.S. Department of Labor executive,

Virginia C. Smith, has questioned whether a plan sponsor can discharge his or her duties without “accurate information about the value of its alternative investments.”

While not all alternatives are hard to value and some "traditional" securities or funds are hard to value, there is a lot of attention being paid to valuation process. Valuation challenges will apply to some stable value fund products but not to others. However, for those for which valuation is an issue, investment committee members and their advisors absolutely must investigate who is conducting valuation checks, how often and on what basis.

## Slide 10:

### Valuation

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- **“Clearly Defined Responsibilities for the Valuation Roles, with Reporting Lines Independent of the Front Office**
- **Independent and Reliable Sources of Market Prices**
- **Regular Review of the Appropriateness and Frequency of Independent Valuations**
- **Clarity Concerning the Timing of Closing Prices and a Robust Adjustment Process for Detecting and Addressing Mis-Pricing Errors**
- **Robust End of Month and, Where Necessary Ad Hoc Verification Procedures”**

(Source:

[http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0316\\_dw.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0316_dw.shtml))



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Valuation best practice tools include the use of “independent and reliable” market prices. A plan sponsor has every right to expect transparency about the valuation process in place, who does what and when and with what model and data. Matrix pricing may not fully reflect the ability to convert a security(ies) inside a stable value vehicle to cash.

In summary, implementing excellent risk management and valuation policies and procedures should be a first step for stable value fund providers, both asset managers and wrappers. Conveying that information in the form of client education and transparency will help plan sponsors do their job. If you are a roadblock to their fulfillment of fiduciary duties, you may not get or keep clients. Putting business development issues aside, robust risk management activities should provide stable value fund providers with enhanced flexibility to refine a product, survive declining profit margins (if applicable) and avoid negative press.

Thank you.

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Susan Mangiero is an independent risk management and valuation consultant and founder of Investment Governance, Inc. Dr. Mangiero provides research, analysis and training in the areas of fiduciary investment risk management, valuation, fees, suitability, asset allocation and performance. Dr. Mangiero works with pension trustees, board members, C-level decision-makers and the attorneys, asset managers and consultants working with plan sponsors. With over twenty years of experience, including work on several trading desks, Dr. Mangiero is the author of the pension risk blog, [www.pensionriskmatters.com](http://www.pensionriskmatters.com).

A CFA charterholder, she is certified by the Global Association of Risk Professionals as a Financial Risk Manager. She holds a Ph.D. in finance (minor in math), an MBA in finance, an M.A. in economics and a B.A. in economics and has done post-graduate computational finance work at Carnegie Mellon University. She has written extensively about risk management and valuation for publications such as *Investment Lawyer*, *RISK*, *Risk Review*, *Valuation Strategies* and the *Expert Evidence Report*. Her book entitled *Risk Management for Pensions, Endowments and Foundations* for John Wiley & Sons, Inc. (2005) addresses financial risk management issues for investment fiduciaries. Dr. Mangiero can be reached by calling 203-261-5519 or by sending an email to [susanm@fiduciaryleadership.com](mailto:susanm@fiduciaryleadership.com).



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