Mesirow Financial Investment Strategies
April 17, 2020

Critical Thinking

Stable Value Market Update

The recent market turbulence caused by COVID-19 led to a rush for liquidity, dislocating the short end of the credit markets, particularly commercial paper and short duration structured securities. It also raised liquidity concerns on institutional prime money market funds triggering a government intervention, but the stable value market in general experienced healthy inflows as participants migrated away from equity market volatility.

How Does Stable Value Work?

The stable value asset class is available in corporate and governmental tax-qualified defined contribution plans as well as some tuition assistance plans. Stable value portfolios are generally backed by diversified fixed income securities coupled with an insurance wrap.

A typical fixed income portfolio of similar duration and credit risk fluctuates with changes in interest rates and credit spreads as the portfolio is marked-to-market on a daily basis. In a low yield environment, changes in the capital gains and losses can significantly overwhelm the income earned on the portfolio, leading to higher volatility. Using book value accounting, stable value products are uniquely structured to absorb some of this volatility by investing in a diversified pool of rate- and credit- sensitive fixed income products, and wrapped by highly-rated single or multiple insurance companies (depending on the fund's structure).

Book value accounting allows for amortization of the market-to-book value across the duration of the portfolio, smoothing out the marked-to-market impact. Under normal market conditions, stable value funds' long-term returns resemble an intermediate term bond portfolio with a volatility similar to money market funds.

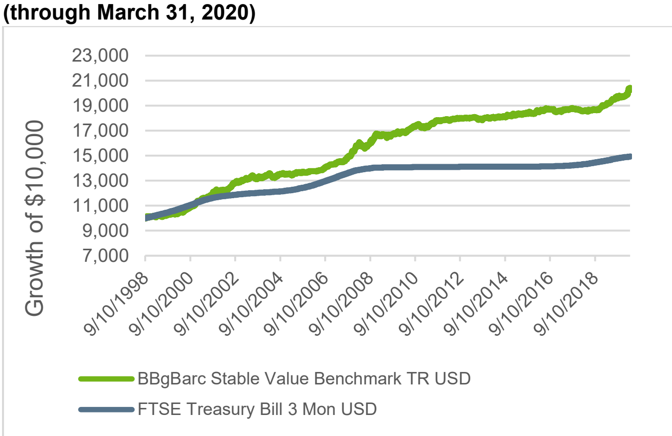
Do Interest Rates Matter?

The effect of interest rates on the relative attractiveness of stable value funds versus money market funds has certain complexities. In an environment where rates plummet, like they have over the past month, money market fund yields follow suit, reducing their relative attractiveness. In the opposite scenario, where the yields rapidly rise, stable value funds generally lag money market fund returns due to the same smoothing effect of book value accounting.

Since the financial crisis, predicting directional movements in rates has been notoriously difficult as rates have fluctuated in a narrow range. Stable value funds have consistently outperformed money market funds as seemingly rising rates have repeatedly reversed course back to all-time lows. Furthermore, the shape of the yield curve plays a role in the relative attractiveness of these funds. A steep yield curve is generally more favorable for stable value funds because their portfolios are longer in duration, taking advantage of the "term premium" imbedded in the yield and credit curves. A relatively rare inverted yield curve, on the other hand, is favored by money market funds, as all other longer duration fixed income securities are disadvantaged in that environment.

The chart below compares performance between a stable value asset class market index and the 3-month U.S. Treasury Bill (T-Bill). Note that there is no perfect benchmark for a stable value asset class due to unique structural features like the insurance wrap, book value accounting and other complexities associated with changes in the asset class mix and liquidity considerations. From September 1998 through March 2020, the stable value index returned 3.37%, outperforming 3-month T-Bills by 1.49%.

Bloomberg Barclays Stable Value / FTSE 3-Month U.S. T-Bills (through March 31, 2020)



Source: Morningstar Direct. Past performance is not indicative of future results. The indices are unmanaged and do not incur management fees, transaction costs or other expenses associated with investable products. It is not possible to directly invest in an index. Please see full disclosures at the end of this document for index definitions.

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Recent Market Environment

During the recent market turbulence, as expected, plan participants shifted some of their holdings from equity funds into stable value funds to mitigate market risk. It would be reasonable to assume that the capital rushing in during this market dislocation will likely stay with the stable value funds, given the uncertainty this pandemic exerts on the markets. This capital flow characteristic is generally favorable for a stable value fund, as long as the fund maintains a healthy amount of liquidity, as some of that capital may exit as the markets recover.

While market-to-book ratios have declined across the board in March 2020, the funds held up well in general. Declining rates were supportive, but the spread widening in corporate and securitized sectors reduced the total market value of the portfolios, offsetting the gains from the rate movements. The duration of the portfolios shortened somewhat due to cash inflows and rising (or expected to rise) mortgage prepayments, and the crediting rates will likely decline, albeit gradually, in the short run.

Stable value funds generally invest in high quality bonds with short duration exposure (around three years on average). However, when compared with government money market funds, for example, stable value funds can court higher credit risk and offer less liquidity. Stable value funds often invest in spread sectors in the fixed income markets such as asset backed securities (ABS), residential and commercial mortgage backed securities (MBS/CMBS), and corporate bonds. While in a spread-widening environment (recently), the capital losses in the credit-sensitive bonds reduce market-to-book ratio; under normal circumstances, wider spreads provide a more fertile ground for reinvesting cash flows from maturing debt, and new inflows.

The insurance wraps (principal protection) provided by highly-rated single or multiple insurance companies are structurally important for stable value funds to operate and carry certain assets at book value for tax-exempt vehicles. While certain stable value funds did run into challenges in 2008 as wrap providers exited the market, today's market dynamics have been generally favorable for this asset class through March 2020.

Summary

The short end of the credit market experienced an unusual liquidity event in March, but it reversed its course as the Fed and the U.S. Treasury intervened to inject unprecedented amounts of liquidity in the system. This was strongly supportive for the fixed income markets across the board. Stable value funds proved resilient throughout the dislocation, living up their promise of preserving capital in a rapidly developing market dislocation caused by the COVID-19 pandemic.

About Mesirow Financial

Mesirow Financial is an independent, employee-owned firm founded in 1937. As specialists in investment, risk management and advisory services, we are committed to helping our institutional, corporate and individual clients achieve their objectives. Our professionals are inspired by an entrepreneurial desire to develop tailored solutions designed to deliver measurable results. To learn more, please visit mesirowfinancial.com.

Bloomberg Barclays Stable Income Market Index: The index represents a low-risk blend of asset classes from within the Bloomberg Barclays U.S. Aggregate Bond Index, focusing on shorter maturities, and providing diversified exposure to debt from the government, credit and securitized sectors in order to better match the underlying investments of most stable value funds.
FTSE 3 Month US T Bill Index: This index measures monthly return equivalents of yield averages that are not marked to market. The Three-Month Treasury Bill Indexes consist of the last three 3-month Treasury bill issues.

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