ExEcutivE Summary

The 2008 financial crisis and its aftermath have reshaped the environment for stable value investing. Plan sponsors should be aware that these changes may impact wrap contract capacity, increase wrap fees, and result in longer waiting periods for fund withdrawals at the plan level.

While capacity is returning to the market, wrap providers—the insurers and banks that attempt to shield stable value funds from short-term interest rate volatility—have grown more selective in their underwriting of both plans and pooled funds as well as investment managers.

Many wrap providers are demanding more conservative investment policies, including shorter duration, higher credit quality, and stricter limits on out-of-benchmark positions. Others are requiring that wrapped assets be sub-advised by them or their affiliates. The wrap provider universe is now dominated by insurers and well-capitalized banks.

Although the impact of post-crisis financial regulation remains unsettled, at this point it does not appear that wrap providers will be defined as swaps dealers. However, additional regulatory burdens on wrap providers could add to the upward pressure on wrap contract fees.

At a time when the Federal Reserve is holding short-term interest rates near zero, stable value funds have delivered attractive returns compared to alternatives such as money market funds and short-term bond funds. The Fed has indicated it expects to keep rates near zero at least through mid-2015.

Stable value remains a viable, attractive option for plan sponsors and participants. T. Rowe Price’s stable value strategy is well positioned for the new market environment, thanks to our global credit research capabilities, diversified portfolio structure, and strong relationships with wrap providers.
STABLE VALUE AND THE “NEW NORMAL”
For more than 30 years, stable value has been a popular choice for defined contribution (DC) plan participants. It remains so today, as participants seek to avoid both heightened market volatility and near-zero money market yields. Stable value is a uniquely attractive investment option that is only available through qualified retirement plans. The question for many plan sponsors, however, is whether stable value will remain a viable retirement plan option going forward.

We believe the answer is yes—but only if plan sponsors and asset managers can adapt to the post-2008 environment, one in which wrap capacity is less abundant and more expensive, risk-aware asset management is paramount, and book value withdrawals may be limited by increasingly restrictive contract terms.

Some constraints—the scarcity of wrap capacity, for example—are already easing, but others are structural and likely to persist. Clearly, the administration of stable value offerings is now a more challenging enterprise for both plan sponsors and their asset managers.

STATE OF THE STABLE VALUE MARKET
Perhaps the most significant recent trend in stable value has been the resurgence in wrap capacity. Although some existing wrap providers continue to exit the market, others have resumed or expanded their contract issuance. Meanwhile, a number of new providers—including Aviva, TIAA-CREF, Reinsurance Group of America, Bank of Tokyo, and Mutual of Omaha—have entered since 2009. These moves have restored much, though not all, of the capacity lost in the aftermath of the financial crisis.

A February 2012 survey of current and potential wrap providers by the Stable Value Investment Association (SVIA), for example, found that 67% of them plan to initiate or increase wrap coverage this year or in 2013. Another 19% said they plan to maintain their current book of business. Only 15% said they plan to reduce their exposure. The SVIA estimates that the firms entering or expanding their presence in the market could add between $67.5 billion and $100 billion in new capacity. The survey also reported that at least $27.5 billion in coverage reductions were planned to begin in 2012.1

The firms that have entered the wrap provider market over the past three years have tilted more heavily toward insurers and reinsurers, as well as better-capitalized banks, compared to the pre-crisis mix of providers. These providers tend to have considerable experience underwriting the relevant risk factors, such as participant cash flows.

Continued strong demand and a limited supply of wrap capacity have resulted in an increase in wrap costs. According to Russell Investments, wrap fees have more than doubled from pre-2008 levels, rising from less than 10 basis points to approximately 15-25 basis points, and continue to creep upwards.2

Sobered by their experience during the 2008 crisis—when market value fell well below book value at many stable value funds, especially those with exposure to subprime debt—wrap providers are insisting that managers adopt more conservative investment policies to help limit portfolio risk. These restrictions may include:

- Higher average credit quality and tighter windows for selling securities that lose their investment-grade ratings,
- shorter average duration (i.e., reduced exposure to interest rate risk),
- new constraints on sector and security positions, and much tighter limits on out-of-benchmark exposure.

Wrap providers also have grown more selective about offering coverage to pooled vehicles given their unique cash flow risks. Some providers have sought to extend fund-level withdrawal waiting periods or offer immediate fund-level withdrawals only at market, not book, value. However, this has not been a serious problem for most major fund managers, including T. Rowe Price. The list of offerings defined as competing products has been expanded in some cases.

CHANGE IN THE ASSET MANAGEMENT INDUSTRY
The changed environment has forced many asset managers to rethink their commitment to stable value. Some have exited the market or merged with competitors. Others are struggling to find enough wrap capacity to remain viable. Russell predicts this consolidation trend will continue, as

1 Stable Value Investment Association, “SVIA Issuers’ Outlook on Capacity,” April 2012.
smaller managers and those with weak performance records find it hard to compete in an era of higher costs and reduced profit margins.\(^3\)

The relationship between asset managers and wrap providers is also evolving. In their effort to limit risk exposure, wrap providers have become more selective about the managers they underwrite. In addition, some are requiring that the investment management of wrapped assets be delegated to them or to their affiliates in a sub-advisory arrangement. They may offer more attractive terms on wrap contracts—such as lower fees or fewer restrictions—for such deals. Careful analysis is needed to determine whether the benefits outweigh the additional costs.

**REGULATORY ISSUES**

While the wrap market is steadily recovering from the 2008 financial crisis, some analysts worry that another product of that crisis—tighter regulation of swaps and other financial derivatives—could reverse that progress. The Dodd-Frank Act, passed by Congress in 2010, requires the Commodity Futures Trading Commission (CTFC) and the Securities and Exchange Commission (SEC) to draft a variety of rules for the swaps markets, covering dealer registration, price reporting, collateral requirements, and other issues.

As regulators draft rules for implementing the Dodd-Frank Act, there is a risk that they might decide that wrap providers themselves qualify as swap dealers. Under the Employment Retirement Income Security Act (ERISA), this would raise serious conflict-of-interest issues, potentially forcing providers from the market.

Most industry observers, however, see that as an unlikely outcome. The Dodd-Frank Act specifically exempts wrap contracts from being regulated as swaps while the CTFC and the SEC conduct a joint study of the issue. The wording of the law also seems to invite the two agencies to confirm that exemption. Still, the issue bears watching.

**WRAP MARKET OUTLOOK**

The wrap market appears likely to continue its gradual recovery from the 2008 financial crisis, as new and expanded capacity is making it possible for well-positioned managers to accommodate participant inflows. The new wrap providers now entering the market are generally better capitalized and more experienced at managing underwriting risks.

Wrap fees are unlikely to return to the low levels seen in the years leading up to the crisis, and this potentially could result in lower net yields to participants going forward. However, higher premiums are also helping attract new capacity to the market, and making it possible for wrap providers to invest in their investment staffs, portfolio compliance functions, and technology infrastructures. Some new providers entering the market are engaging financial consultants to aid them in the manager due diligence process.

The more conservative investment policies now required by many wrap providers could be a potential drag on performance, especially for managers who in the past have pursued more aggressive strategies. However, we are optimistic that the trade off for higher fees and more conservative investment policies may be a steadier and more predictable wrap market.

**POTENTIAL IMPACT OF RISING INTEREST RATES**

Given the sluggish economic conditions in the U.S. and most other developed countries, markets appear to expect that short-term interest rates will remain pegged close to zero for some time. But it is likely that this interest rate cycle, like all previous ones, eventually will turn. Some sponsors may worry that future rate hikes will usher in a period of stable value underperformance.

When interest rates rise dramatically, stable value crediting rates typically do not react as quickly as money market yields. This can lead to short-term underperformance and put downward pressure on market values, since the underlying portfolios, like all bond funds, are exposed to movements in interest rates.

Under normal market conditions, intermediate-term bond yields are higher than short-term interest rates—giving stable value funds a natural yield advantage over money market funds, even in a rising rate environment. The exception is when the yield curve inverts—that is, when short-term rates move higher than longer-term rates.

Yield curve inversions, however, are relatively rare. From the end of 1981 through June 2012, the spread between 90-day Treasury bills and five-year Treasury notes was inverted for only 26 months—or 7.1% of the time. The average yield inversion over those 26 months was just -31 basis points, creating a relatively ephemeral performance advantage for money funds. Stable value (as represented

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\(^3\) Russell, ibid.
by the Hueler Analytics Stable Value Pooled Fund Index) outperformed the Lipper Money Market Funds Index in every 12-month rolling period from the end of 1985 through June 2012.

EXAMINING ALTERNATIVES TO STABLE VALUE
Given the changing environment for stable value investing, some plan sponsors may have considered replacing their stable value funds with other low-volatility offerings—money market funds and ultra-short and short duration bond funds, in particular. Plan sponsors should carefully consider the potential drawbacks to making such changes.

There is little question that higher wrap fees, more conservative management of the bond portfolios underlying wrap contracts, and possible future interest rate increases all have the potential to reduce stable value fund returns. Russell Investments estimates that the forward-looking excess return—that is, the return premium for stable value versus the low-volatility alternatives—has fallen to between 50 and 150 basis points per year, from a historic average of 200 to 250 basis points.4

But in an investment environment where yield is hard to find, even this modest premium has considerable appeal (Figure 1, below). What’s more, stable value offers a combination of characteristics that cannot be replicated easily with other strategies:

- Excess returns—and thus a better hedge against inflation compared to money market funds and short-term bond funds,
- average portfolio duration comparable to intermediate bond funds,
- relatively low volatility of returns, thanks to the wrap feature.

The result is an attractive risk-reward profile, relative both to the main low-volatility alternatives and the broad equity market (Figure 2, below).

Some plan sponsors may also be considering another potential alternative to stable value—so-called stable interest funds. These vehicles combine wrapped with unwrapped assets, typically short-term bonds. The unwrapped assets typically sit ahead of the wrapped portfolio in the fund’s withdrawal order.

While this hybrid structure reduces the need for wrap capacity, it also introduces market volatility into the fund’s net asset value (NAV), which can and probably will fluctuate daily. In our view, a floating NAV eliminates the primary attraction of stable value for many, if not most, participants and is not worth the incremental gain in yield. Investors with a tolerance for market risk may be better off in a short- or intermediate-term bond fund.

Figure 1: Stable Value Yields vs. Yields of Common Alternatives
Annualized Yields* Through June 30, 2012

Figure 2: Stable Value Has a Strong Risk-Adjusted Profile
10-Year Risk and Return Results, Through June 30, 2012

Sources: Hueler Analytics, Barclays, Lipper Inc.

* Monthly return data for the Hueler and Lipper indices have been converted to annualized yields by T. Rowe Price. Past performance is no guarantee of future results. The above chart is for illustrative purposes only and not meant to represent the performance of any specific investment option.
Stable value clearly demonstrated its value during the 2008 financial crisis. While the average market value to book value ratio (MV/BV) for the funds in the Hueler Stable Value Pooled Fund Universe fell below 96%—and for some funds, below 90%—those funds without exception continued to pay out at book value. The Hueler Stable Value Pooled Fund Index posted positive returns through the crisis, even as money fund yields plunged toward zero and short-term bond funds experienced unprecedented volatility. The favorable fixed income market conditions of the past three years have helped MV/BV ratios to rebound sharply (Figure 3, below).

Participants certainly seem to appreciate this performance. After some fund outflows during the initial recovery from the crisis, net flows more recently have turned strongly positive. According to Aon Hewitt, stable value funds and standalone guaranteed investment contracts attracted $1.35 billion in new assets last year, up from $355 million in 2010.

**BENEFITS OF T. ROE PRICE’S APPROACH**

Manager selection is always important, but in the current environment it is particularly critical for stable value mandates. Wrap providers have grown cautious and may be willing to work only with managers that have the scale and scope to be stable business partners. Wrap providers are also paying closer attention to investment personnel and process. Managers who pass these tests may have a better chance of obtaining adequate and diverse wrap capacity.

Active management skill also has become even more essential—a point driven home during the financial crisis, when return dispersion soared (Figure 4, below). With benchmark yields at unprecedented lows, the incremental returns that potentially can be generated through active management are more valuable than ever.

T. Rowe Price’s investment platform gives our stable value managers—and their clients—a number of crucial advantages in the current environment. These benefits include:

- **Global research capabilities**: Our managers understand the role that fundamental credit analysis can and should play in stable value investing. This includes screening and monitoring wrap providers (all providers must maintain a rating of A+ or above in our proprietary credit evaluation system), as well as security selection—a critical safeguard, since wrap contracts typically do not cover losses from defaults or downgrades.
A well-diversified fund structure: T. Rowe Price’s pooled fund features five discrete fixed income strategies: aggregate, short term, intermediate term, fixed maturity, and an allocation to traditional guaranteed investment contracts. We believe this structure provides more efficient exposure to the entire investment opportunity set relative to conventional core aggregate or government-credit portfolios.

A risk-aware investment process: Unlike some stable value managers, T. Rowe Price largely avoided subprime and collateralized debt during the credit bubble—and the performance meltdown that followed. The use of derivatives remains minimal, and risk management tools include clearly defined position limits on security, sector, and out-of-benchmark exposures. We rely on bottom-up fundamental research, informed by top-down analysis, to generate alpha. This conservative approach has allowed us to conform to new wrap provider investment guidelines with minimal disruptions.

Strong wrap provider relationships: As one of the world’s leading asset management firms and a sizable player in the stable value market (with almost $19 billion in assets under management and more than 900 plan clients7), T. Rowe Price has been able to acquire wrap coverage without sacrificing our quality standards. Since the end of 2009, we have obtained more than $2 billion in new coverage. Our priority in managing capacity is to serve our existing clients while selectively accommodating new account growth.

These features have helped our managers compile an impressive performance track record—especially since the credit crisis erupted. Based on the Hueler Analytics peer universe, our Stable Value Common Trust Fund has finished in the top performance quartile of the Hueler Stable Value Pooled Fund Universe in every year since 2008.

“Our approach to stable value has worked well in the turbulent markets of recent years. A disciplined investment process has enabled us to deliver consistent, measured return enhancement, without adding significantly to portfolio volatility.”

Ted Wiese, CFA
Head of Stable Value

Figure 5: Relative Performance of T. Rowe Price Stable Value Common Trust Fund

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<th>1 Year</th>
<th>5 Years Annualized</th>
<th>10 Years Annualized</th>
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<tr>
<td>T. Rowe Price Stable Value Common Trust Fund</td>
<td>2.81%</td>
<td>4.08%</td>
<td>4.36%</td>
</tr>
<tr>
<td>Hueler Stable Value Pooled Fund Index</td>
<td>2.36%</td>
<td>3.29%</td>
<td>3.97%</td>
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Figure 6: Percentile and Fund Rankings for the T. Rowe Price Stable Value Common Trust Fund In the Hueler Stable Value Pooled Fund Universe for the 12 Months Ending:

<table>
<thead>
<tr>
<th>Percentile</th>
<th>6/30/12</th>
<th>6/30/11</th>
<th>6/30/10</th>
<th>6/30/09</th>
<th>6/30/08</th>
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<tbody>
<tr>
<td>20.0%</td>
<td>20.0%</td>
<td>5.6%</td>
<td>0.0%</td>
<td>8.3%</td>
<td>40.0%</td>
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<tr>
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<td>1</td>
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<td>11</td>
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<td>Number of Funds in Universe</td>
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<td>18</td>
<td>23</td>
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Source: Hueler Analytics

7 As of June 30, 2012.
Conclusions: Stable Value Remains A Viable, Attractive Plan Offering

In the wake of the financial crisis and the market volatility of the past few years, stable value remains a compelling investment option for millions of retirement plan participants. With wrap capacity returning to the market, and stable value funds, on average, still generating attractive excess returns, fund inflows are likely to remain positive.

For plan sponsors, these trends should be reassuring. While some issues, such as the impact of regulation, are not yet resolved, plan sponsors with stable value in their plans should not feel compelled to replace it with other offerings—such as money funds or short-term bond funds. These alternatives do not offer the same risk-and-return proposition as stable value.

T. Rowe Price remains committed to stable value. Our strategy benefits from the size and global reach of our investment platform, the quality of our research, and the skill and stability of our management team. We have ample capacity for asset growth but continue to prioritize our existing clients ahead of new business. At T. Rowe Price, we currently employ in-house management of wrap assets, but we are examining possible alternatives—such as sub-advisory arrangements with providers—that could help diversify our wrap coverage. However, as with all aspects of our business, we will only consider such investment opportunities if the terms are right and the benefits to clients outweigh the costs.

If you would like to learn more about stable value, please contact your T. Rowe Price account representative or visit rps.troweprice.com.
T. ROWE PRICE AT A GLANCE

Established in 1937 by Thomas Rowe Price, Jr., T. Rowe Price is headquartered in Baltimore, MD, with offices located in the Americas, Asia, Australia, and Europe. It has nearly 5,000 associates worldwide, including 379 investment professionals. T. Rowe Price is a publicly traded firm (TROW) and is one of the few independent investment management firms included in the S&P 500 Index.