PAVILION

THE STATE OF STABLE VALUE

2016 UPDATE

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Recently, Pavilion Advisory Group Inc. interviewed four stable value managers (Galliard, JPMorgan, New York Life and Putnam) on the current state of the marketplace. Key questions asked were:

- What major trends did you notice in 2015?
- What are the largest anticipated challenges for stable value funds?
- What trends do you see in terms of fees, duration, market value-to-book value ratios, wrap capacity and type of wrap (such as global)?
- Do you expect increased usage of stable value within target date funds or retirement income solutions?

Below we provide some background information and a summary of the managers' views. We have also provided the verbatim questions and responses as an appendix to our analysis.

Reasons for including stable value funds in DC plan menus

Historically plan sponsors included stable value funds in their investment menus because of their more attractive return profiles (between 1% and 3% over the past several years) relative to money market funds. The underlying portfolio within a stable value fund is a short- to intermediate-term bond portfolio, therefore over most periods the fund will provide a term premium over a money market fund. The use of insurance wrappers to create a stable net asset value (NAV) makes the vehicle attractive for plan participants. Many plan participants are partial to investments with a stable market value where the variable is the interest rate earned.

Key reasons for not including stable value as an investment option generally have been that some products impose strict exit provisions (related to plan sponsor-initiated events), restrictions on the addition of certain other fixed income funds (i.e., competing funds) to the plan menu, equity wash rules and lack of transparency.

Prudential and MetLife each released a study in 2015 which polled plan sponsors, managers and consultants on the topic of stable value[1]. Both studies found that the key reason plan sponsors offer stable value is capital preservation. Other important reasons for offering stable value include steady returns, guaranteed returns (if applicable), and higher returns than money market funds. MetLife found that the main reason for not offering a stable value option was that the plan sponsor's advisor had not recommended it. Secondary reasons were the perceived complexity, strict contract terms and lack of transparency.

Market Trends

Money market reforms. Money market mutual funds have been popular options in DC plans. Near zero short-term interest rates and recent Securities Exchange Commission (SEC) money market reforms, however, have plan sponsors reviewing the role of money market funds in a DC plan menu. In 2015, the SEC released new requirements for money market (MM) mutual funds. Only retail MM mutual funds classified as government funds will be able to maintain a stable NAV and be exempt from liquidation restrictions. Non-government retail MM mutual funds may be subject to liquidation restrictions but will have a stable NAV. Institutional MM mutual funds will have a floating NAV and be subject to liquidation restrictions.

Improved wrap capacity. Wrap capacity for stable value funds continued to improve in 2015. Stable value asset growth has been flat to down, so demand for insurance wrappers has dropped. At the same time, wrap providers have sought to grow their businesses. Wrap providers that had previously demanded managing a part of a stable value portfolio as a condition of providing wrap insurance, are now open to

[1] Prudential polled more than 400 plan sponsors and 300 advisors/consultants, while MetLife surveyed 205 plan sponsors, 20 stable value managers and nine consultants.

wrap-only business. The improved capacity has provided greater leverage for wrap fee negotiations. Expectations are that wrap fees will decline up to 0.05% from the current level of approximately 0.25%. Managers generally believe that it is unlikely for wrap fees to drop to the pre-2008 level of around 0.15%.

Litigation. There is an increase in the number of lawsuits involving DC plans overall and stable value funds are not immune.

1. On December 11, 2015, a lawsuit was filed against Fidelity Management Trust Company (Fidelity). The lawsuit involves Fidelity's stable value fund called the Fidelity Group Employee Benefit Plan Managed Income Portfolio Commingled Pool (MIP). The suit alleges that:

- Fidelity's actions led to low returns and high fees for MIP; following the market crisis of 2009, Fidelity positioned the portfolio in an overly conservative manner and agreed to allow wrap providers to charge high fees; and
- Fidelity attempted 'to conceal' MIP's conservative strategy and low returns by using an improper benchmark (money market), which made MIP's relative returns look better.

On January 20, 2016, Fidelity filed a motion to dismiss the lawsuit. In support of its motion to dismiss the suit, Fidelity claims that MIP met Employee Retirement Income Security Act (ERISA) and Department of Labor's (DOL) 'safe' option criteria as MIP was diversified, preserved capital and provided consistent returns. In responding to the allegations about paying high wrap fees, Fidelity states that it paid the market rate for wrap fees and did not breach its fiduciary duty. Fidelity cited that effective December 2010, the DOL selected the 3-Month U.S Treasuries Bill Index as the model benchmark for stable value funds. The firm claims that there was nothing improper about its use of the 3-Month U.S Treasuries Bill Index as the usage was consistent with DOL guidance.

2. On December 29, 2015, a lawsuit, Bell et al. v. Anthem Inc. et al., was filed in the U.S. District Court for the Southern District of Indiana, Indianapolis division. This lawsuit involves the Anthem, Inc. 401(k) Plan, which has about $5 billion in plan assets. While the lawsuit is centered on not using lower-cost CITs over mutual funds, it also alleges that in 2006, the plan replaced the stable value product with a money market fund which cost participants $65 million in lost earnings from 2010 through September 30, 2015.

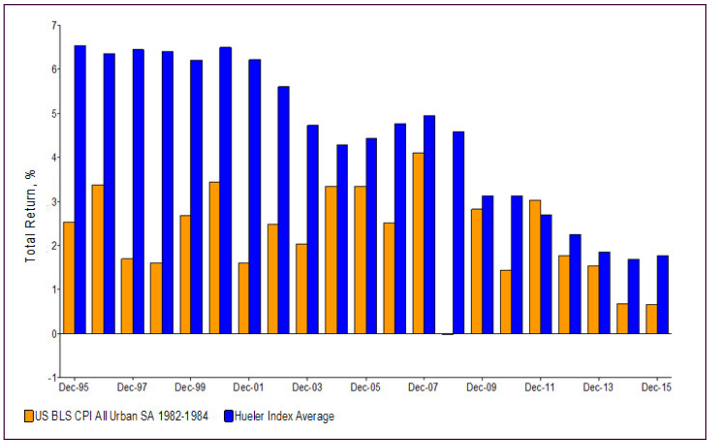
Largest challenges for stable value funds

Stable value fund managers summarized their largest challenges as relating to the potential for rising interest rates and aging demographics. The concern is that in a rising rate environment, market-to-book ratios could dip below par. While stable value products are designed to withstand decreases in market value below par, the ability of managers to navigate a rising interest rate environment will depend on how much interest rates rise and how quickly. Small and gradual interest rate increases are manageable with lower crediting rates. Sharp interest rate increases could drop market values below book values quickly. If market-to-book ratios fall below par, it will be more challenging for plan sponsors to execute large scale plan events, including re-enrollments. Managers also expressed concern about managing cash outflows related to aging participants who may need to withdraw funds for retirement or withdraw from their company's plan at retirement.

Inflation protection

Plan sponsors have questioned whether stable value funds provide inflation protection. Historically, stable value returns have outpaced inflation. The charts below compare the annual and the rolling three-year performance of stable value funds (Hueler Index Average[2]) with inflation (U.S. BLS CPI All Urban Seasonally Adjusted). Stable value has been consistent in producing positive real returns. However, we note that fixed income returns historically were much higher while inflation remained low. The gap between stable value returns and inflation has shrunk considerably.

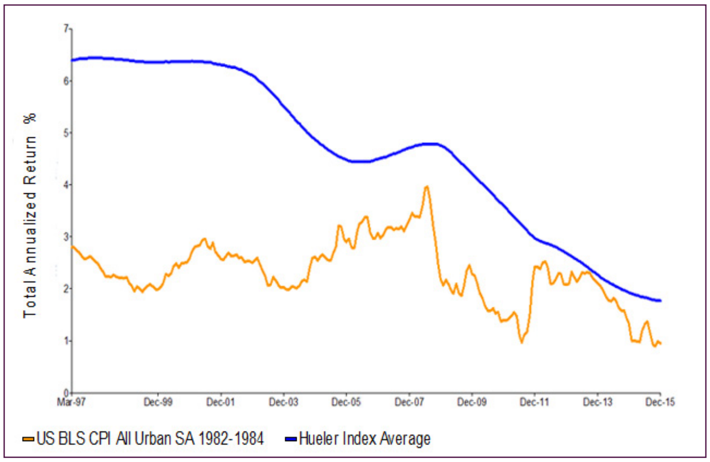
Annual Performance—December 1995 to December 2015



Data: Morningstar & Hueler

[2] Hueler takes a straight average of the monthly book value returns of the funds participating in the Hueler Analytics Stable Value Pooled Fund Universe for the month identified. The monthly indeces are linked to calculate the index values for the designated periods. The Hueler Universe currently represents the investment strategies across 15 stable value pooled funds.

36 Month Rolling Performance—March 1997 to December 2015



Data: Morningstar & Hueler

Stable value in target date funds

Many stable value managers view target date funds (TDF) as a potential growth engine, hoping that stable value will be included within a TDF. Some of the leading TDF managers we interviewed were less receptive to using stable value funds. Logistical and legislative hurdles pose barriers for including stable value in off-the-shelf TDFs. Many TDF managers believe that the cost of using stable value in TDFs outweigh the benefits. For example, they believe that short-term bond funds likely will generate returns similar to stable value and having principal protection on just that portion of a target date sleeve is of less value when the TDF is exposed to fluctuations in the equity market. Custom target date fund solutions were most likely to incorporate a stable value fund.

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APPENDIX—PAVILION QUESTIONS AND MANAGER RESPONSES

Pavilion Advisory Group Inc. (Pavilion) interviewed four leading stable value managers on their views on the industry. Managers' responses are presented in alphabetical order.

Pavilion: What major trends did you notice in 2015?

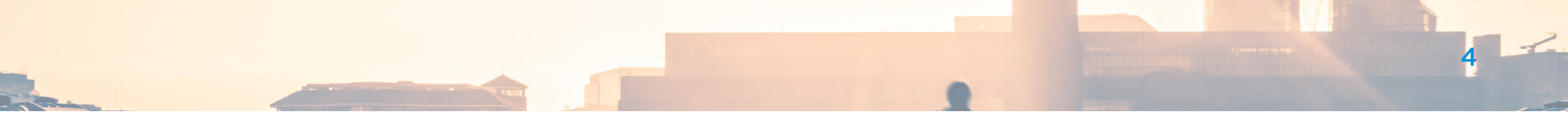
Galliard: In the last year, we have continued to see ample supply of capacity for stable value contracts [wrap contracts] available through the contract issuers with whom we maintain relationships. We believe that this is a result of a combination of factors, including new contract issuers entering the market (replacing the supply from issuers that exited the market or sought to reduce their books of business), flat to negative stable value cash flows during the first half of 2015, and the ability and interest of most providers to grow their books of business. Due to these improved supply/demand dynamics, we have seen an increased competition in the market for stable value contracts. As a result of this and the total size of the stable value assets we manage, we believe we have the leverage to negotiate improved contract legal terms, increased investment guideline flexibility and lower pricing, especially from issuers priced at the higher end of current market rates.

The finalization of the SEC's new money market mutual fund requirements has also had a significant impact on the stable value industry. Due to the changes and the increased attention on money market funds, we have seen numerous opportunities for new business from plan sponsors who are reconsidering stable value as a better alternative to the money market funds currently offered within their plans.

J.P. Morgan: Stable value funds have experienced modest but steady cash outflows since 2009 as participants moved back into equities. The first half of 2015 was no exception, but we've seen a reversal as volatility in the markets, most notably around China, has led some participants to rethink their risk appetite, driving flows back into stable value. The overarching theme of 2015 was a much improved wrap market—good wrap capacity was readily available, issuers demonstrated a willingness to revisit investment guidelines and contract terms, and even in some cases lowered fees.

New York Life: One industry trend that we noticed in 2015 is the adoption of stable value solutions outside of normal qualified plans, such as 529 plans. Also in late 2015, we observed cash flows begin to return to stable value vehicles after going toward equities for several years.

Putnam: The biggest trends we saw were the continued movement of integrating stable value into target date/Lifestyle funds, negative cashflow at the participant level, and stable value being involved in several retirement plan lawsuits.



Pavilion: What do you anticipate to be the biggest challenge for stable value?

Galliard: With an increased risk of rising interest rates and a potentially difficult credit cycle ahead of us, we are entering a period where investment performance becomes more important than ever. The success of a plan's stable value manager in navigating this difficult investment environment will have an impact on overall performance in the future.

J.P. Morgan: With the Fed on a path to normalization, market-to-book ratios may dip below par, which would be the first occurrence in over five years. Higher interest rates could ultimately be a good thing for plan participants, and if it plays out gradually as we expect, stable value funds should weather the shift very well. The yield on stable value (crediting rates) should track the rise in interest rates, albeit on a lagged basis. Less evident to participants, the market-to-book ratio will likely fall, but within a normal operating range. However, if market-to-book ratios fall below par, it may be a little trickier for plan sponsors to execute large scale plan events such as re-enrollments.

New York Life: New York Life believes that the biggest challenge facing stable value in 2016 will be higher out-flows than in-flows due to the aging demographics of participants and the advent of asset allocation funds as a qualified default investment alternative (QDIA) from the Pension Protection Act of 2006 (PPA).

Putnam: Managing cashflow in a rising rate environment where liquidity is at a premium.

Pavilion: What trends do you see in terms of fees, duration, MV/BV, wrap capacity and type of wrap (such as global)?

Galliard: We expect wrap fees to continue to experience downward pressure over the year, especially for separate accounts with attractive participant cash flow history.

With the Fed poised to continue raising rates in 2016, we would expect total returns to be negative in 2016, which will likely push some market-to-book ratios below 100%. It's important to note that MV/BV ratios below 100% are an expected occurrence over a market cycle in a stable value portfolio and that the lower MV/BV ratio should be offset by higher yielding underlying portfolios, which would ultimately lead to higher participant credited rates of interest.

We would anticipate [wrap] capacity remaining abundant during the year, especially for plans with attractive demographics and participant cash flow history. We do not anticipate significant changes to the way in which we structure our stable value contracts but are constantly working with issuers to develop contracts that improve flexibility and reduce risk within our stable value portfolios.

J.P. Morgan: Wrap capacity is very robust, driven primarily by large insurance companies. This has resulted in modest fee concessions. Synthetic contracts should prevail as the bulk of issuance. We do not anticipate major shifts on the duration front, where limits are generally longer for separately managed accounts than pooled funds, which are typically three years as a result of the "put" feature. Market-to-book ratios have been above par for approximately five years, which is a pretty impressive run. If the Fed is successful in normalizing interest rates this will likely lead to lower market-to-book ratios in 2016. However, given the gradual pace and potential for a flatter yield curve, we do not anticipate a significant decrease in ratios.

New York Life: Regarding market value, we do expect to see some downward pressure as rates rise, however, given our outlook that interest rates will continue to rise along with the shorter duration nature of our stable value funds, we don't expect rising rates to be an issue for our clients.

Putnam: We see fees remaining relatively flat for 2015; duration we see as likely neutral to slightly lower; MV/BV ratios may decline; wrap capacity should remain plentiful and the type of wraps will likely be stand alone with little global wrap availability.

Pavilion: Do you expect increased usage of stable value within target date funds, or retirement income solutions?

Galliard: Galliard-managed stable value portfolios have for years been included in the asset allocation models for many of our clients' managed account programs and customized target date solutions. Given stable value's attractive combination of low risk and risk-adjusted returns and its correlation relative to other assets classes utilized in target date solutions, we believe stable value will continue to be utilized as professional asset management is made available to retirement plan participants. Additionally, the principal preservation objectives of stable value portfolios make them ideally suited to play a significant role for plan participants in the decumulation phase of their lives. As such, we expect them to continue to be valuable components in retirement income solutions that seek to appropriately balance flexibility and longevity risk for retirees.

J.P. Morgan: Yes, certainly with custom target date funds. If a stable value fund is already in the line-up it seems like a no brainer to add it to a custom target date series. Usage in prepackaged commingled target date funds and retirement income solutions is more difficult to implement, and therefore much less prevalent. We definitely see an opportunity for stable value in these types of products, especially those focused on an older demographic, were there is much less appetite for volatility, and a desire for income.

New York Life: New York Life has seen some interest but little increased usage of stable value within target date funds. Retirement income is an important topic that has been getting a lot of attention lately. Insurance companies play an important role is this market and New York Life is a leader in providing guaranteed retirement income to retirees and pre-retirees. However, the current retirement income solutions are mostly provided outside of qualified defined contribution retirement plans, where stable value is most prevalent.

Putnam: As mentioned above, yes. Should be a potential growth engine for stable value especially with money market reform in 2016.

Pavilion: Do you anticipate simplification of stable value products (such as easing the equity wash provisions, narrowing down the list of plan sponsor events)?

Galliard: We continue to see a push across the industry —led primarily by stable value managers—to simplify and standardize the requirements of stable value funds, as well as to ensure that stable value is compatible with trends in the retirement savings plan marketplace. Examples of this evolution include the modernization of stable value contracts' competing fund definitions to better accommodate target date funds, multi-sector "go anywhere" fixed income funds, and brokerage windows; the development of terms to accommodate the use of stable value within managed account or custom asset allocation funds; and terms designed to reduce the amount of notification or reporting required of plan sponsors. We view these changes as improving the experience for plan sponsors and participants by reducing restrictions and administrative requirements and evolving stable value to better accommodate modern plan design trends. In the coming years, we expect the industry to continue to simplify the stable value product, while maintaining the attractive combination of principal preservation and attractive credited rates of interest in comparison to other principal protection options.

J.P. Morgan: Yes, there is definitely an effort underway to make the product more user-friendly. A prime example of that is the equity wash rule. Historically, a money market fund, or short-term bond fund was deemed competing. Post financial crisis, some issuers expanded their list to include TIPS, self-directed brokerage accounts, and even certain asset-allocation and target date funds. It was really extreme. Sensibility is returning and wraps are reverting back to money market and short-term bond funds. There are even discussions in the industry about limiting it to just capital preservation options.

New York Life: The stable value asset class must contain certain contractual provisions in order to achieve the objective of principal preservation. Some stable value providers and products may have different provisions that are more/less restrictive, but we are not seeing a trend toward removing or easing these existing provisions in the near future.

Putnam: We have heard some rumors about changes like this but view it as a long term process.

Pavilion: What impact will the increasing interest in re-enrollment have on the stable value industry, and how do you anticipate providers will react?

Galliard: Re-enrollments, depending upon how they are executed, can pose unique challenges for stable value portfolios. Specifically, the investment contracts that provide a stable value fund's principal protection may not provide contract coverage for plan sponsor-initiated withdrawals. Because they are guaranteeing withdrawals at contract value regardless of the market value of the underlying assets, stable value contract issuers have been unwilling to extend their guarantee to withdrawals that are the result of a plan sponsor's actions, which would include the large withdrawals that often result from an "opt out" re-enrollment. Due to this, plan sponsors and their consultants must work closely with their stable value manager when considering a re-enrollment.

The particulars of a plan sponsor's re-enrollment strategy are critical to determining the potential impact on the plan's stable value option. For example, the QDIA into which participant balances are being defaulted is an important consideration. Custom asset allocation funds (e.g. custom target date funds) and managed account programs that reallocate participant assets to the plan's existing options (including stable value) typically will have a less adverse impact on the stable value option than reallocating to "off the shelf" products (e.g. target date mutual funds).

J.P. Morgan: Re-enrollment has been a hot topic over the last several years, and the Stable Value industry has responded with flexible solutions to accommodate those plans that elected to hit the reset button. Coincident with re-enrollment, we observed a trend where sponsors moved from separately managed stable value funds to pooled stable value funds due to size and convenience factors. Certainly if market-to-book ratios fall below par, re-enrollment discussions may become quite tricky.

New York Life: New York Life has not seen a large trend in re-enrollments, but several of our clients have undertaken the exercise. Our experience is that a majority of a plan's assets tend to move out of the core investment options and into a QDIA option, which is usually a target date fund. In effect, stable value assets are typically lower after the re-enrollment, but it is a major decision for the plan sponsor and very few plans have elected a full re-enrollment. Plan sponsors should be aware of the potential implications of a re-enrollment as some stable value funds might consider them a plan-initiated event which may be subject to restrictions and/or adjustment.

Putnam: This may well be negative at the margin and lead to some negative cash flow; how a given provider will react is dependent on their structure and how they value liquidity, return and client relationships.