

Stable Value Investments In A Challenging Market Environment

Retirement | Insights

June 2009

The financial crisis has changed the market environment in ways that could impact the performance and risks of stable value investments. We believe it is important for plan sponsors, consultants, and advisors to understand current market trends and how their stable value portfolios are performing in a challenging environment. While T. Rowe Price stable value investments are affected by market developments, we are pleased to report that our products are positioned to continue meeting your objectives by seeking to preserve principal and provide competitive returns for participants. In this update, we review the market environment, the impact on our stable value investments, and the changes that clients can expect.

DEVELOPMENTS IN THE STABLE VALUE MARKETPLACE

- **Declining synthetic investment contract (SIC) wrap insurance capacity.** A scarcity of capital in the insurance and banking sectors along with elevated market volatility have increased the sensitivity of SIC wrap providers to their risk exposure in the wrap market. Many insurers have limited new deposits to existing contracts, declined to bid on new contracts, or raised their fees. SIC wrap contracts typically account for a major portion of stable value investment allocations because they offer substantially higher crediting rates than alternative book value investments. SICs (also known as “wraps”) help smooth the volatility in underlying bond portfolios and are eligible for book value accounting, assuming certain requirements are met.
- **Higher cash allocations in stable value vehicles.** Market volatility has understandably driven retirement investors to seek more stable investments, causing cash inflows to rise dramatically in most stable value portfolios. Due to lower SIC capacity and the need for liquidity to address potential future increases in redemptions, cash levels are generally higher than normal in many stable value portfolios. With cash invested in high-quality, shorter-term investments offering lower yields, higher cash levels are expected to modestly reduce the interest yield paid to stable value investors.
- **Lower market-to-book value ratios.** The market-to-book value ratio is a critical metric to consider when evaluating a stable value portfolio. The ratio changes over time and measures the market value of the underlying bond portfolio as a percentage of the portfolio’s book (or contract) value. Market-to-book ratios for some stable value funds trended lower based on data through Dec 31, 2008, due to the decline in liquidity and asset prices in certain fixed-income sectors—although, ratios across the industry have recently improved as liquidity and confidence have returned to fixed-income markets. Stable value portfolios with declining market-to-book value ratios can expect their crediting rates to fall as bond portfolio losses are generally amortized over time to bring the market-to-book value ratio closer to 100%.
- **Lower crediting rates for stable value investors.** Several factors are likely to result in lower stable value yields through 2009, including above-average cash levels, limited SIC wrap capacity, increased wrap fees, lower market-to-book value ratios, and depressed interest rates for high-quality investments. The impact on interest income could be material for some stable value investors, depending on the circumstances of their particular investment. It is important to note, however, that many stable value portfolios continue

to offer substantially higher yields than money market funds. Over the past decade ended June 30, 2009, stable value funds represented by the Hueler Pooled Fund Universe have annually returned 5.07% versus 2.93% for the average money market fund represented by the Lipper Money Market Index.¹ Remember that money market funds typically have lower risk than stable value portfolios.

Although credit risk always exists in stable value funds, it is especially a concern in the current fragile financial environment. Under typical contract terms, SIC issuers do not reimburse the fund for defaults of underlying securities and may have the right to require that the book value of their contracts be immediately reduced by any loss from a security default. In addition, an underlying security may decline in price and have to be sold at a loss due to a decline in the creditworthiness of its issuer, resulting in a reduction in future crediting rates. Also, the insolvency of a guaranteed investment contract or SIC issuer (or other significant issuer credit event) could result in losses to investors due to the failure to make a required payment and/or the inability to account for assets of the fund at book value.

T. ROWE PRICE STABLE VALUE PORTFOLIOS

Although market developments pose challenges for the industry, T. Rowe Price's risk-conscious portfolio management continues to emphasize seeking safety of principal and competitive returns.

- **Constrained SIC wrap capacity impacts all stable value providers.** Market conditions causing reduced SIC wrap capacity and lower crediting rates are impacting all stable value investment providers. Currently, most of our wrap providers are not accepting additional deposits. However, wrap providers in the T. Rowe Price portfolios are currently well capitalized, with credit ratings between A and AAA. Wrap market conditions remain uncertain, and capacity is unlikely to expand in the near term. However, T. Rowe Price continues to explore potential opportunities for additional wrap capacity. While wrap capacity is constrained, our stable value portfolio managers will seek prudent alternatives to lower-yielding cash investments.

¹ The Lipper Money Market Funds Index is an equally weighted performance index of the largest qualifying funds in the Lipper category. Lipper index gross of fees performance data is not available. Source: Lipper Inc.

² The Hueler Analytics Pooled Fund Universe ("Universe") is provided by Hueler Analytics, a stable value data and research firm, which has developed the Universe for use as a comparative database to evaluate collective trust funds and other pooled vehicles with investments in GICs and other stable value instruments. The Universe is comprised of pooled stable value funds with common investment objectives of stability of principal; the number of participating funds in the Universe may vary over the different historic periods. The Hueler Universe SIC data is provided for informational purposes only. Any further dissemination, distribution, or copying of the Hueler Universe Median SIC data is strictly prohibited.

Data as of June 30, 2009



- **Higher cash levels provide a beneficial hedge in illiquid markets.** Our portfolio managers are comfortable with the temporary increase in cash allocations until market conditions improve. Cash levels in T. Rowe Price stable value portfolios currently range between 3% and 10%, compared with historical levels in the 3% to 7% range. As a result, our stable value portfolios are expected to show modest declines in the income yield paid to participants. However, higher cash allocations can help provide a cushion against increased participant redemptions as equity markets recover. The cash allocation insulates SICs and reduces the potential risk of having to sell bonds in an unfavorable market. Further, we believe increasing liquidity in the current market environment is prudent and supports stable value's primary goal of preserving capital.
- **Market-to-book value ratios in our SIC wrap contracts exceed the industry average.** As a key measure of our risk management, market-to-book value ratios across all our SIC contracts averaged 100.8%, as of June 30, 2009. Our ratio is significantly higher than the 96.8% average for the Hueler Analytics Pooled Fund Universe² (described further below) as of June 30, 2009. Our superior market-to-book value ratio reflects our commitment to a disciplined investment process with a primary objective of preserving capital, rather than taking additional risk to boost yields. We believe the stable value management team's access to T. Rowe Price proprietary credit research has been a key factor in our success. A higher market-to-book value ratio can support higher crediting rates in the future and help to offset the impact of higher cash levels and wrap fees.

T. Rowe Price remains committed to a portfolio management process that seeks to preserve the safety of principal and promote efficient liquidity management as primary goals of our stable value investments. We remain focused on avoiding inappropriate risks through proprietary credit research, while striving to deliver competitive crediting rates. If you have additional questions, please do not hesitate to contact your relationship manager.