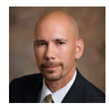
Simplifying Stable Value

Revisiting 90-day equity wash rules for self-directed brokerage.

November 2019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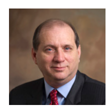
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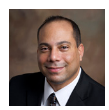
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One of the more challenging aspects of stable value investing are the wrap provider's contract terms and conditions—in particular, the competing fund definition, which prevents participants from transferring money from their stable value funds directly into other fixed income investment vehicles with average durations under three years, such as money market, ultra short-term bond, and short-term bond strategies.

Competing fund restrictions date back to the early 1980s when runaway inflation caused the Federal Reserve to increase short-term rates aggressively, producing a major inversion in the yield curve. This led some defined contribution (DC) plan participants to arbitrage from intermediate-term insurance company products to short-term investments, resulting in significant investment losses for the insurers.

To curb direct transfers from stable value to competing short-term funds, DC plans are required to impose a provision called a 90-day equity wash, which requires participants to transfer their money first to a noncompeting investment vehicle, such as an equity fund, for at least a 90-day period before they can move it to a competing fund. Today, most recordkeepers have the technology in place to implement an equity wash, but it still can be a daunting task for a plan to implement and monitor.

Many plan sponsors may not be aware that many wrap providers also include self-directed brokerage windows (SDBWs) in their definition of a "competing fund." SDBWs are included because they typically feature a money market fund in the investment lineup inside the brokerage window.

History has shown that most participants who move money into an SDBW will park their investments in the money market fund before redeploying it to other investment options, such as equities or bonds. Moreover, when participants sell their SDBW investments, they also tend to park the proceeds in the money market fund at least temporarily. Because of this investor behavior and a lack of transparency inside the brokerage window, wrap providers typically regard the entire brokerage window as a competing fund for the purposes of the 90-day equity wash rule.

Brokerage Balances Tend to Be Modest

Our experience has been that most DC plans have relatively modest SDBW balances and that those balances tend to be stable. Essentially, most participants use SDBWs with the intention of purchasing equities or other long-term assets, and any money market balances largely are a result of not yet having completed those investments. We find it quite frustrating that all participants, nonetheless, are restricted in their ability to use this investment option.

We have been looking at the competing fund definition and the treatment of SDBWs for some time. In recent years, we have shared our observations about investor behavior with a number of wrap providers and discussed the possibility of removing brokerage windows from their competing fund definitions.

In these conversations, we have found that providers are more focused on the overall percentage of participants who use SDBWs than they are on the actual share of plan assets invested in the money market fund options within those windows. This reflects the typical lack of transparency about how participants are allocating their funds within SDBWs.

In cases where overall participant usage of the brokerage window is low, we hope to get some wrap providers comfortable with the idea of eliminating SDBWs from their competing fund definitions. In the coming quarters, we hope to be able to persuade our wrap providers to eliminate SDBWs from the competing fund definition for our stable value portfolios on a case-by-case basis.

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