Impact of Rising Rates on Stable Value

Stable value industry on firm footing amid rate hikes.

September 2022

KEY INSIGHTS

- While higher interest rates can be a short-term headwind for stable value, the industry is approaching this market environment from a position of strength.
- Whether the effect of rising rates has been priced into the market is debatable, but wrap capacity remains strong and has not been impacted by falling market-to-book ratios.
- Compared with other low-duration strategies, stable value has performed well on a relative basis.

Antonio L. Luna, CFA
Head of Stable Value, Portfolio Manager

Xin Zhou, CFA
Portfolio Manager, Stable Value

Bob Madore
Portfolio Manager, Stable Value

Ben Gugliotta, CFA
Portfolio Manager, Stable Value

Whitney H. Reid
Portfolio Specialist, Stable Value

Stable value weathered the 2020 coronavirus pandemic remarkably well. Market-to-book ratios and wrap capacity held up during the COVID crisis and performed as expected. Since the 2008 global financial crisis (GFC), the stable value industry has undergone significant reforms with improved risk disciplines from all the industry practitioners, which have contributed to the resilience of this asset class.

In 2021, stable value once again came into focus primarily as a viable alternative to money market funds as the Federal Reserve (Fed) was forced to implement a near zero interest rate policy for the second time in a little more than 10 years. In many instances, it was stable value's strong performance at the height of the COVID crisis and increased product flexibility that convinced plan sponsors to take a second look at and revisit stable value after some left the asset class during the GFC. So how might stable value perform during the current inflation-driven rate hike cycle?

Wrap Capacity Remains Robust for the Stable Value Industry

Among the stable value industry practitioners, the wrap providers play a vital role in the overall health of the stable value asset class. Since the GFC, the wrap providers have enhanced their risk management through appropriate investment guidelines and asset surveillance. Today, bank and insurance company wrap providers are financially strong with ample wrap capacity, which should fuel not only continued growth in the asset class, but also lower wrap fees.

In 2020, the stable value industry saw record year-over-year growth in the total amount of assets wrapped. In 2021, total cash flows into stable value slowed while assets became more diversified among the universe of wrap providers.

In 2021, we also saw insurance company Great-West offer its first wrap contract that did not require utilizing its affiliated fixed income manager for the underlying assets, bringing the total number of active wrap providers in the industry to 17, according to Valerian Capital.

We are hopeful that Great-West's entry into the wrap industry with additional flexibility will pave the way for new market entrants.

Rising Rates Present Both Challenges and Opportunities for Stable Value

Today, stable value faces many headwinds in the form of rising rates and higher inflation that the asset class has not seen in over 40 years. In addition, we are coming off historically low interest rates, where meaningfully higher rates could have a significant impact to stable value cash flows and market-to-book value ratios. However, it is important to remember that rising rates also means eventually higher crediting rates for stable value products. For older retirement investors looking for capital preservation, stable value may offer shelter from market volatility while potentially providing an attractive income.

In the first half of 2022, shorter-term Treasury yields rose sharply as the market reacted to elevated inflation, supply and demand imbalances, and a hawkish Fed focused on combating surging inflation.

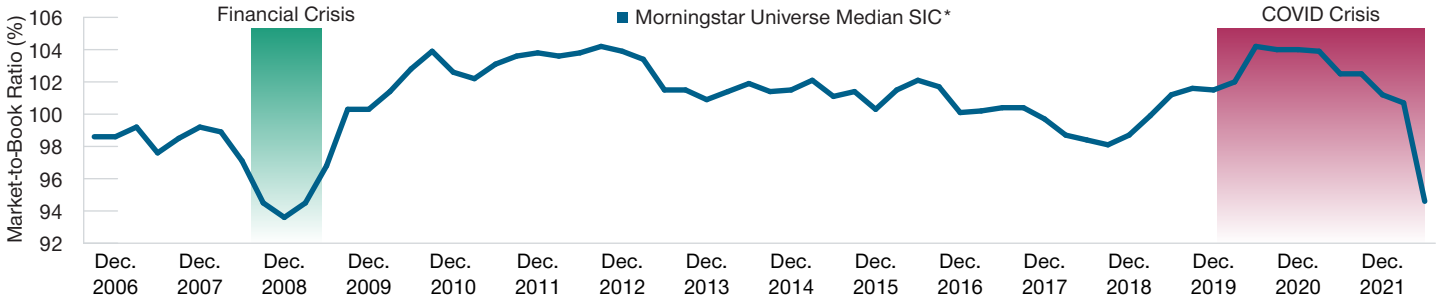
As expected, higher rates negatively impacted the market-to-book value ratios across the industry as the value of the underlying fixed income assets declined. In general, the average market-to-book value ratios fell from around 101% at the end of 2021 to around 95% at the end of June 2022 (Fig. 1). While the drop in market-to-book value ratios has been abrupt, we believe that the industry is on more solid footing than during the GFC given a healthier industry today and a different market environment.

Where May Market-to-Book Value Ratios and Crediting Rates Go From Here?

Given the recent move in yields, we forecast rates along the yield curve over the next six months and modeled the impact to a hypothetical stable value portfolio. In our base-case rate scenario, we would expect that as the underlying portfolios reinvest in higher-yielding assets, the crediting rates of contracts would increase gradually over time. Under that scenario, we would also

Historical Market-to-Book Ratios

(Fig. 1) Market-to-book ratios were stronger heading into the COVID crisis.



As of June 30, 2022.

Past performance is not a reliable indicator of future performance.

*Data provided on this page include the historical information of the Hueler Pooled Fund Index through December 31, 2020, and the Morningstar US CIT Stable Value Index from January 31, 2021, to the current period ending date. The Morningstar US CIT Stable Value Index (Universe), formerly the Hueler Analytics Stable Value Pooled Fund Index, is provided by Morningstar, Inc., a financial services firm, and provides an array of investment research and investment management services. The Morningstar US CIT Stable Value Index is an equal-weighted total return average across all participating funds in the Universe and represents approximately 75% of the stable value pooled funds available to the marketplace. Universe rates of return are reported gross of management fees.
Chart presents the median market-to-book ratio of SICs for constituents of the Hueler Pooled Fund Universe (the Universe).
Source: Morningstar US CIT Stable Value Index (formerly a Hueler index). Please see Additional Disclosures page for information about this Morningstar information.

expect that market-to-book ratios in the industry would begin to rise as well.

Lastly, our base-case interest rate and yield curve scenarios do not take into consideration the impacts from participant cash flows. It has been our experience that participants have sought the safety of stable value during periods of extended market volatility. Positive cash flows into stable value would further help improve market-to-book ratios and provide managers with dry powder to invest at attractive yields.

Historical Yield Premium Over Money Markets

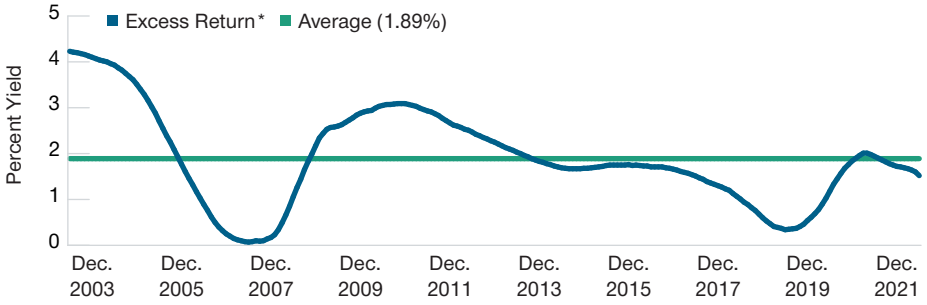
Historically, stable value offered a yield premium over money market funds even in periods where the Fed was hiking rates and the yield curve flattened. In the past, even during rising rate environments, stable value outyielded money market funds. Figure 2 represents the one-year rolling monthly excess returns of the Morningstar CIT Stable Value Index over the Lipper Money Market Index, and stable value has outperformed money markets in 100% of monthly periods rolling annually over the past 20 years. While the current environment is different from the previous cycles, and history may not repeat itself, it often rhymes. In the current environment, money market funds may outyield stable value for the shorter term. However, like past cycles, such inversion could prove to be temporary. With the advantages of the stable value asset class, we believe stable value should outperform money markets funds over longer periods.

As highlighted previously, we believe the stable value industry continues to be on firm footing and is coming off another strong year of positive cash flows and expanding wrap capacity. Stable value faces a challenging road ahead with rising rates and higher inflation, but participants could benefit from higher crediting rates and improved participant income because of the current rate environment. While traditional thinking may lead away from considering stable value as the Fed is committed to tightening monetary policy, we believe that plan sponsors and investment professionals should continue to evaluate stable value product offerings

> ...stable value has outperformed money markets in 100% of monthly periods rolling annually over the past 20 years.

Stable Value Offers Yield Premium

(Fig. 2) Historically, money market yields look relatively unappealing.



As of June 30, 2022.

*Excess return represents the difference between the Morningstar CIT Stable Value Index and the Lipper Money Market Index.

Past performance is not a reliable indicator of future performance.

Figures are calculated using monthly index data and are gross of fees. Returns would have been lower as the result of the deduction of applicable fees, and the results could differ.

Money market and stable value have different risks. It is important that you carefully review the legal documents for each type of vehicle prior to investment to determine if it is appropriate for you.

Source for Lipper data: Lipper Inc. Please see Additional Disclosures page for information about this Lipper information.

Source for Morningstar Index data: Please see Additional Disclosures page for information about this Morningstar information.

for their potentially attractive long-term risk/return attributes and consider adding stable value to their plan lineups as appropriate.

Past Rising Rate Environments Display Stable Value's Potential

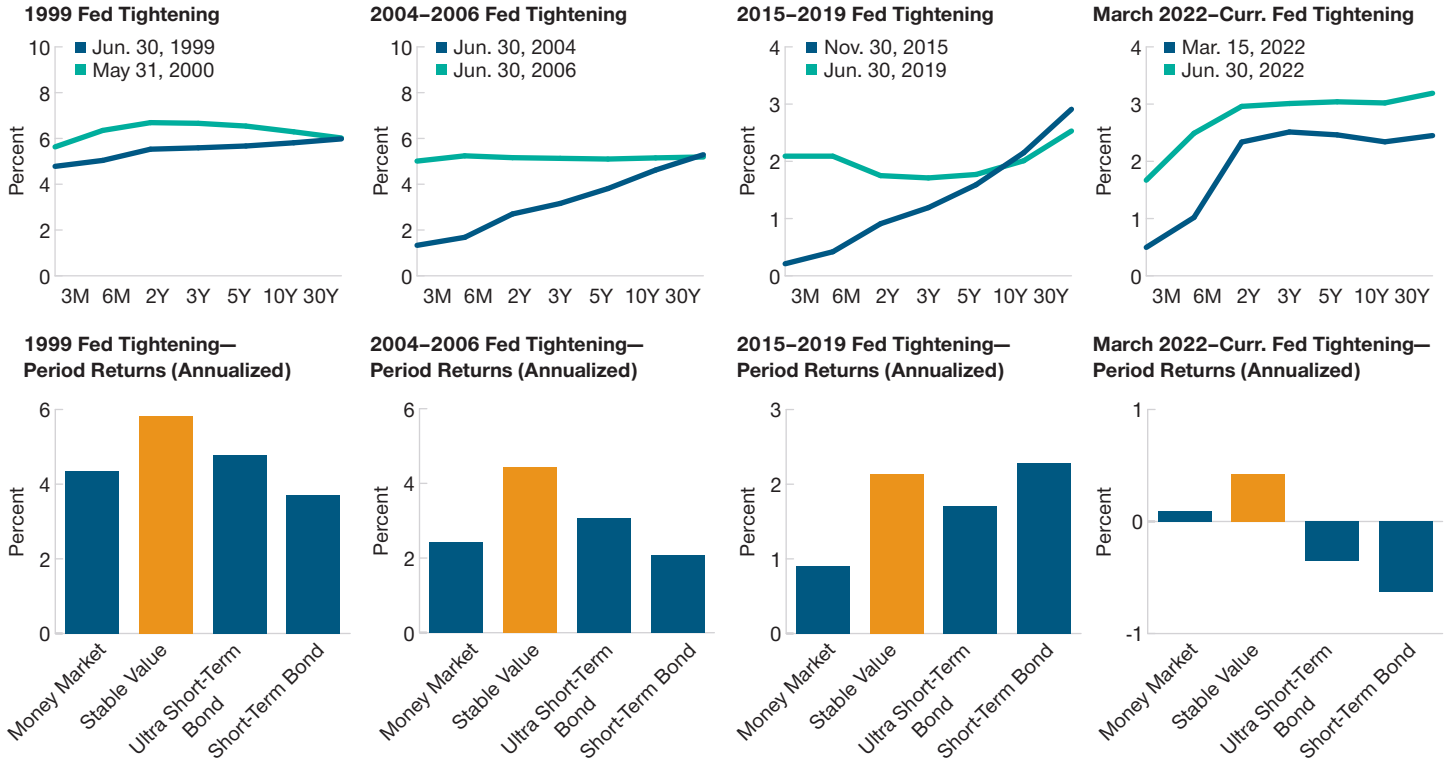
Many investors are apprehensive about the effect of rising rates on a stable value portfolio. But how has stable value performed in prior rising rate environments? As highlighted in Figure 3, stable value performed well relative to money market funds and comparable low-duration fixed income during prior rate hike cycles under a variety of yield curve scenarios. The top charts display the shape of the Treasury yield curve during recent Fed tightening periods, and the corresponding lower charts show stable value's annualized returns relative to a similar asset class during those respective tightening cycles.

Conclusion

Stable value remains an attractive capital preservation investment option during periods of rising interest rates. Stable

Stable Value Delivered as Rates Rose

(Fig. 3) Stable value has done well while the Fed hikes rates.



As of June 30, 2022.

Past performance is not a reliable indicator of future performance.

Money market, stable value, ultra short-term bond, and short-term bond have different risks, in addition to the possible loss of principal. In addition, vehicles can include trusts, separate accounts, and mutual funds. It is important that you carefully review the legal documents for each type of vehicle to determine if it is appropriate for you prior to investment.

Money Market is represented by the Lipper U.S. Treasury Money Market Index; Ultra Short-Term Bond is represented by the Bloomberg 9–12 Month T-Bill Index; Short-Term Bond is represented by the Bloomberg U.S. 1-3 Year Government/Credit Bond Index; Stable Value is represented by the Morningstar US CIT Stable Value Index. The Fed's target rate rose 175 bps over the 1999–2000 tightening cycle; 425 bps over the 2004–2006 tightening cycle; 225 bps over the 2015–2019 tightening cycle; and 150 bps over the current tightening cycle.

Sources: Morningstar, Lipper Inc., U.S. Department of the Treasury, and T. Rowe Price.

Source for Bloomberg index data: Bloomberg Index Services Limited. Please see Additional Disclosures page for information about this Bloomberg information.

Source for Morningstar data: Please see Additional Disclosures page for information about this Morningstar information.

Data provided on this page includes the historical information of the Hueler Pooled Fund Index through December 31, 2020, and the Morningstar US CIT Stable Value GR USD from January 31, 2021, to the current period ending date.

value has continued to be on firm footing and is coming off a strong year of positive cash flows and increased wrap capacity.

Despite that stable value market-to-book ratios face many headwinds in the form of rising rates and higher inflation, we believe that access to higher crediting rates and potentially improved participant income could make stable value an attractive liquidity option for retirement investors through all interest rate environments.

Compared with money market funds, stable value has performed well on a relative basis and historically has performed well during rising rate environments. Lastly, we believe plan sponsors and investment professionals should continue to evaluate stable value product offerings on attractive long-term risk/return attributes and consider adding stable value to their plan lineups as appropriate.

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T.RowePrice®

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

This material was prepared for use in the United States for U.S.-based plan sponsors, consultants, and advisors, and the material reflects the current retirement environment in the U.S. It is also available to Canadian-based plan sponsors, consultants and advisors for reference. There are many differences between the two nations' retirement plan offerings and structures. Therefore, this material is offered to accredited investors in Canada for educational purposes only and does not constitute a solicitation or offer of any product or service.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

USA—Issued in the USA by T. Rowe Price Associates, Inc. and T. Rowe Price Investment Management, Inc.,100 East Pratt Street, Baltimore, MD, 21202, which are regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

ID0005275 (08/2022)
202208-2383139