Moving Away From Guaranteed Investment Contracts

Stable value managers are finding better opportunities in cash bonds.

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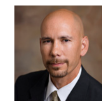
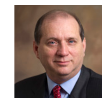
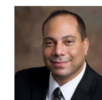


Antonio L. Luna, CFA
Head of Stable Value, Portfolio Manager



Robert A. Madore
Portfolio Manager, Stable Value



Whitney H. Reid, CFA
Portfolio Specialist, Stable Value

During the 1980s and 1990s, traditional guaranteed investment contracts (GICs) were heavily used in stable value funds and, at times, made up 100% of the assets of several such funds. More recently, however, GICs have not been as widely used. According to Hueler Analytics, they currently make up 5.5% of the assets in the stable value funds that are included in the Hueler Pooled Fund Index. Many funds do not use them at all. Moreover, as the popularity of GICs has declined, so has the number of high-quality issuers.

Traditional GICs vs. Comparable Fixed Income Securities

In the current market, stable value managers are finding better opportunities in cash bonds as compared to traditional GICs. Traditional GICs typically have very tight spreads as well as greater investment concentration and single-creditor or counterparty risk. In a rising interest rate environment, long-dated, fixed rate investments such as traditional GICs also stand at a disadvantage as they will not track rates as they move higher. In addition, given the limited competition described above, the spreads currently available on GICs generally are not compelling, in our view.

Liquidity and Price Stability

Moreover, just like a typical bank certificate of deposit, traditional GICs require an investor to lock up their investment for several years. While traditional GICs are "benefit responsive" and offer stable value managers some liquidity and the ability to withdraw a portion of the contract if needed to accommodate participant withdrawals, those features come at the cost of lower yields compared to similar cash bonds.

Lastly, if events such as a credit downgrade or run on the bank unfold, leading the manager to desire to terminate a GIC prior to maturity, the termination formulas are typically very onerous, with any gains retained by the GIC issuer. Many traditional GICs do not have a termination option at all.

Stable value managers that do use GICs often cite their performance and stability benefits, such as enhanced crediting rates and better and/or more stable market-to-book value ratios. While there is some truth to these arguments, GICs still pose greater investment concentration risk and single-creditor risk, as well as lower liquidity compared with diversified cash bond investments that can be sold in the open market.

Because traditional GICs are valued at a constant USD 1 per share, they can provide some additional stability to market-to-book value ratios and crediting rates in an overall portfolio as their prices and allocation weights within the portfolio will not fluctuate as interest rates rise and fall. This is attractive when market values fall below book values in a traditional

bond portfolio, but less so when market values are above book values.

From our perspective, the constant USD 1 share valuation feature ultimately masks the market value and volatility of the underlying fixed income investments in the insurance company's general account that back up a traditional GIC, as well as the management fees imposed by the insurer.

Conclusions

Traditional GICs remain a unique alternative investment available to stable value managers. However, over the years they largely have been replaced by more liquid and transparent cash bonds and by synthetic investment contracts. From our perspective, traditional GICs pose higher levels of investment concentration risk and single-creditor counterparty risk relative to comparable cash bonds. They are certainly less liquid given the restrictions on early contract termination. In general, we see the use of traditional GICs as an opportunistic decision by the stable value manager.

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