Morley **Insights**

Money market reform

What we'll discuss

- Risk / return evaluation
- Comparisons of capital preservation options
- Background on money market reform

October 2018

Capital preservation fund options in defined contribution plans

As the dust has settled on the US Securities and Exchange Commission's (SEC) money market reform, it has become apparent that defined contribution (DC) plan sponsors and fiduciaries are evaluating implications for their capital preservation investment options and, in many cases, considering alternatives.

Given that many plans include only one capital preservation fund in their investment line up, it seems appropriate for plans that have previously selected money market funds (MMFs) as the capital preservation option, over half of DC plans[1], to use this opportunity to revisit that decision.

What is important for you to know?

Money market reforms were fully implemented in October 2016. Providers made changes to MMFs that may impact your plan or client.

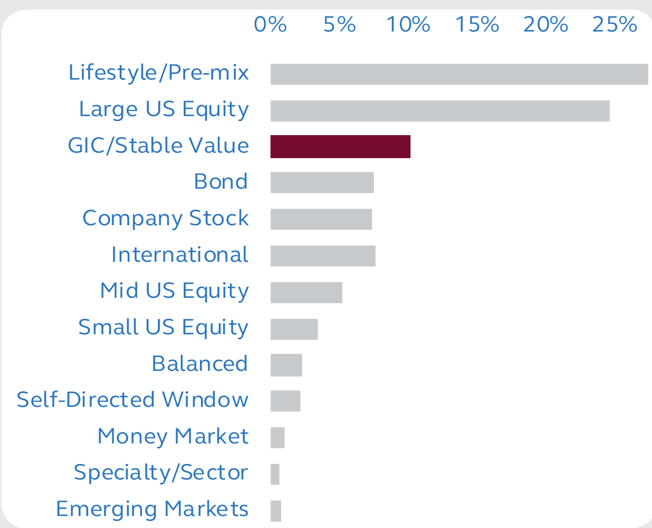
Three significant considerations stemming from the reform are:

- Floating net asset value (NAV) on prime institutional MMFs
- Liquidity fees and/or redemption gates
- Investment constraints on government MMFs

The largest capital preservation option, as measured by assets, within the DC market continues to be stable value. In a 2017 survey released by MetLife[2], over 80% of advisors and stable value fund providers favor stable value as a MMF replacement.

Stable value investment vehicles represent more than 10% of the $7.09 trillion total DC assets.[3]

Exhibit 1



[1] The Brightscope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2014, published December 2016
[2] MetLife 2017 Stable Value Study
[3] Stable Value Investment Association 2Q2018 Quarterly Characteristics Survey and Exhibit 1 courtesy of Alight Solutions 401(k) IndexTM as of June 30, 2018

The risk/return history of stable value, validated across a wide range of market cycles, has provided a combination of low risk (as measured by standard deviation) and returns similar to short bond funds. In Exhibit 2, we've examined 10 years of data to compare risk/return profiles of three capital preservation options. It is evident that stable value risk has been similar to that of MMFs with performance that over time has been higher. Returns for stable value and short bond funds may be similar after 10 years, however, stable value can offer lower risk. Participants who use stable value in place of a similar duration bond fund may reduce the risk profile of their retirement portfolio and participants who use stable value in place of MMFs may increase the return on their portfolio.

Exhibit 2

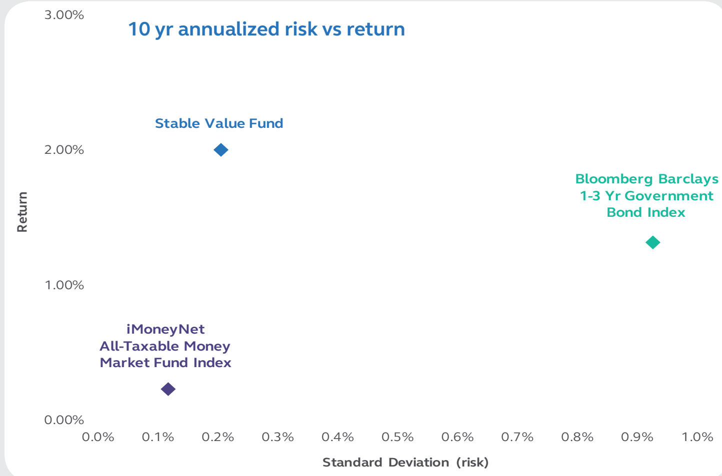
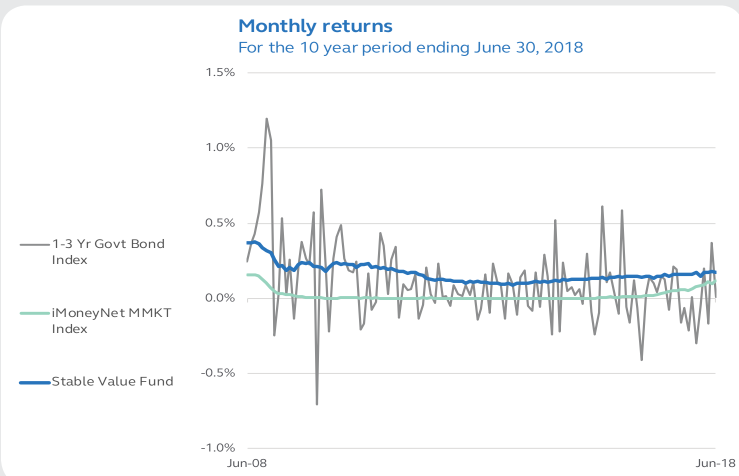


Exhibit 3



Let's look a little closer at the performance of these capital preservation options. A fundamental difference is the return volatility experienced by bond funds compared to the consistency in returns of stable value. Exhibit 3 compares monthly returns of the same three capital preservation options over 10 years. As noted above, after 10 years, stable value outperformed MMFs by an average of 15 basis points per month or 1.77% annualized. An even more vivid comparison is that of stable value to short bonds represented by the grey line. While total return may be similar after 10 years, you can see the path is more volatile in bonds. A participant seeking capital preservation may not be best served by an asset class where volatility may cause loss of principal.

We've compared a few key characteristics, post-reform, of traditional capital preservation options for your consideration.

Investment option	Current yield	Net Asset Value	Participant withdrawals
Morley Stable Value Fund	2.13%*	Book value	Daily at book value
Government Money Market Funds – Institutional	1.56%**	Fixed NAV	Daily at Fixed NAV, though can be subject to liquidity fees and redemption gates depending upon fund liquidity
Prime Money Market Funds – Institutional	1.86%**	Floating NAV	Daily at Floating NAV, though required to impose liquidity fee/ redemption gates depending upon fund liquidity
1-3 Yr Government Bond Index	2.53%	Market value, exposed to price volatility	Daily at market value

Data is as of June 30, 2018
* Represents the Crediting Rate
** Source: iMoneyNet Fund Averages, June 27, 2018

How can Morley help you?

We have a long and successful history of providing stable value collective investment trusts (CITs) and creating innovative solutions for clients that desire a tailored stable value fund. The Morley Stable Value Fund is offered through over 30 platforms and over 200 TPAs and recordkeepers.

Give us a call or send us an email to find out how our team of seasoned investment and service professionals can partner with you to provide a stable value solution best suited for you or your clients' capital preservation needs.

Background

The SEC actions were a response by regulators to risks associated with MMFs during the financial crisis of 2008. At that time the Reserve Fund, a MMF, experienced asset defaults and a liquidity run resulting in its fixed NAV falling below its stated value, also referred to as breaking the dollar, the traditional value reported by MMFs.

Regulators, who were grappling with a wide range of historic financial market crises, addressed the liquidity risk in MMFs by having the Treasury implement a temporary insurance, or liquidity, facility for MMFs to help calm the markets and dampen the threat of a broad run on money market assets.

The reforms approved in July 2014 are aimed at limiting the run risk in MMFs and providing investors with greater pricing transparency. However, these reforms pose some challenges for DC plans that have historically used MMFs as a capital preservation investment option.

The MMF reforms appear to raise significant questions to DC plan sponsors, some of which are:

1. Is it a reasonable and prudent time to evaluate alternative capital preservation vehicles due to the conversion from a fixed to a floating NAV that could result in a negative return?

2. Would a plan fiduciary be comfortable using a prime MMF as a capital preservation vehicle that could, on short notice, impose a liquidity fee and/or a redemption gate depending upon the liquidity profile of the fund?

3. Given the revised government MMF investment constraints, does the reduction in the return profile for such funds make them less attractive as a long term, capital preservation option?

As a reminder, the SEC reforms identify two primary types of MMFs (prime/municipal or government) and two types of investors (institutional or retail). Retail investors are characterized by the owner being a natural person. The SEC has confirmed that DC plans are considered beneficially owned by a natural person and are eligible to access a MMF offered to retail investors in addition to institutional MMFs.

All prime/municipal MMFs, whether offered to an institutional or retail investor, must impose a liquidity fee and are permitted to impose redemption gates depending upon the liquidity condition of the fund.

Institutional prime/municipal MMFs are required to report a floating NAV, while retail MMFs can report a fixed NAV ($1). Government-only MMFs will continue to report a fixed NAV and can impose liquidity fees and redemption gates, though they are not required to impose such restrictions.

The SEC did require material changes in government MMFs asset strategies; requiring funds to now hold 99.5% of assets in government securities, up from the current 80% minimum. These strategy requirements might compress government security yields and reduce the long term return profile of government MMFs.

Reforms were fully implemented in October 2016. Not unexpectedly, there does not appear to be one common approach in the marketplace to address the reforms. A number of firms converted prime MMFs to government MMFs, enabling the funds to maintain a fixed NAV. Some of these firms have also indicated they will not be imposing any liquidity fees or redemption gates on government MMFs, as allowed under the new regulation.

It has been interesting to see some managers closing MMFs and returning assets to investors due to the low yield environment which had already created a situation where many managers were waiving fees to avoid creating negative rates of return for investors. The Investment Company Institute reported that money fund fee waivers topped $6 billion in 2014.

Even though many MMFs are currently earning no more than 0.50%, it would appear the reforms may make the continued use of MMFs even less appealing from a risk/return perspective when fully implemented.

We look forward to hearing from you and determining the best stable value solution for your capital preservation investment option.

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Glossary of terms

Basis Point – One hundredth of a percent (0.01%). One hundred basis points equal 1.00%.

Book Value – The value of an original investment plus accrued interest minus withdrawals and expenses.

Capital Preservation – An investment strategy where the primary goal is to prevent loss of invested principal, or capital.

Crediting Rate – In the context of stable value, it is the rate of return credited to the book value of an investment contract or stable value fund. A typical formula used within a wrap investment contract is:

Crediting Rate = (1 + Yield) * (Market Value/Book Value)^(1/Duration) -1 - Fees

Current Yield – A rate determined by dividing the annual income by the current price of a security. The current yield on a security trading at par, or 100, would be equal to its stated coupon rate. The current yield on a security trading below par would exceed its stated coupon rate.

Government Money Market Fund – A money market fund that invests in short-term securities that are primarily backed by the US government and its agencies.

Market Value – The value of a security determined by the price at which the asset can be sold or bought in an open market.

Net Asset Value (NAV) – The price per share at which a fund trades. A fixed NAV is a set value that is unchanging, e.g. $1.00; income earned is used to purchase new shares at the fixed NAV. A floating NAV can change and is calculated by subtracting the fund's liabilities from its assets and dividing the result by the number of outstanding shares.

Prime Money Market Fund – A money market fund that invests in high-quality, short-term assets such as certificates of deposit, banker's acceptance notes, commercial paper and US government securities.

Redemption Gate – A measure imposed by a fund to temporarily suspend redemptions. Designed to help control losses in a fund in certain situations such as the occurrence market disruptions or excessive withdrawal requests from a fund.

Standard Deviation – A measure of dispersion, or amount of variation, of a set of values from its mean. The mean represents the average of a set of values, determined by dividing the sum of all values by the number of values summed.

Volatility – A measure of dispersion, or amount of variation, of a set of returns. Volatility can also be measured using standard deviation. Generally, higher volatility implies greater risk.

Disclosures

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Past performance is not a guarantee of future results. Performance returns assume the reinvestment of dividends and other earnings. Returns for periods less than one year are not annualized. Gross returns are presented net of Fund Level Expenses which includes Stable Value Investment Contract Fees, Sub-Adviser Fees, Acquired Fund Fees and Other Expenses. Net returns are presented net of 0.25% annualized Trustee/Adviser Fee and 0.00% annualized Service Provider Offset. Fees charged by varying share classes including the Service Provider Offset may differ and as a result, investors in other share classes may obtain higher or lower net returns if multiple share classes are available. Performance information for share class options available after the original Fund inception date are based on the performance of the Morley Stable Value Fund, adjusted to reflect estimated fees for the respective share class option. The Fund's inception date is December 1993.

Performance (as of 6/30/18)	3 Month	YTD	1 Year	3 Years	5 Years	10 years
Morley Stable Value Fund Gross	0.52%	1.01%	1.99%	1.80%	1.60%	2.00%
Morley Stable Value Fund Net 25	0.46%	0.89%	1.73%	1.55%	1.35%	1.75%
iMoneyNetAll Taxable	0.33%	0.58%	0.92%	0.41%	0.25%	0.23%
Bloomberg Barclays 1-3 Yr Govt	0.21%	0.06%	0.03%	0.42%	0.59%	1.32%

The Morley Stable Value Fund (Fund) is a collective investment trust maintained by Principal Global Investors Trust Company, (the Trust Company). The Trust Company has retained Morley Capital Management (Morley), a specialized investment boutique of Principal Global Investors, LLC (the Adviser), to serve as investment adviser with respect to the Fund, subject to the Trust Company's supervision and review. The Adviser is an indirect wholly owned subsidiary of Principal Financial Group, Inc.® and is under common control with the Trust Company. The Fund is not a mutual fund and is not registered with the Securities and Exchange Commission, the State of Oregon, or any other regulatory body. Units of the Fund are not deposits or obligations of, guaranteed by, or insured by the Trust Company or any affiliate, and are not insured by the FDIC or any other federal or state government agency. The value of the Fund will fluctuate so that when redeemed, units may be worth more or less than the original cost. The declaration of trust, participation agreement, and disclosure documents contain important information about investment objectives, risks, fees and expenses associated with investment in the Fund and should be read carefully before investing.

Market indices have been provided for comparison purposes only. Indices are unmanaged and do not reflect the deduction of fees and other expenses. Individuals cannot invest directly in an index. The iMoneyNet All-Taxable Money Market Fund Index measures the equally weighted returns of the largest taxable money market funds. The Bloomberg Barclays 1-3 Year Government Bond Index measures the returns of investment grade, fixed-rate dollar-denominated bonds publicly issued by the U.S. Government, with a maturity of over 1 year, and less than 3 years.

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