Morley
CAPITAL MANAGEMENT

April 2020

State of stable value

Key observations on how the stable value market has responded to the COVID-19 pandemic.

Current state of the market

- **Stable value is doing what it should be doing**, providing book value stability and positive rates of return, typically most valued when markets are volatile like we are currently experiencing.

- **Participant cash flows were significantly positive** last month as participants tried to mitigate investment risk due to the equity market dislocation.

- **Money market fund yields have fallen** significantly given the interest rate cuts implemented by the Fed. Government MMF's yield has fallen below 1.0%, with Treasury rates 1 month to 1 year T-bills now ranging between 0.05% and 0.17%.

- **The Morley Stable Value Fund has continued to provide a positive crediting rate** and has increased the crediting rate premium it provides compared to money market funds due to the steepening of the yield curve and the increased spread offered in corporate and structured sectors, like ABS, CMBS and MBS.

- Fixed income markets were volatile during the first quarter. **A strong US Treasury rally during January and February led to positive returns for the major fixed income indices through February, boosting the market to book value ratios of stable value funds.** Beginning in late February the spreads of the non-Treasury sectors widened significantly leading to negative fixed income returns in March, causing a decline in market to book value ratios. Widening credit spreads have provided investment opportunities for our portfolio managers as they look to put money to work. In this market, as you might imagine, it has been beneficial to be a buyer of assets instead of a seller. The Fed intervention in the markets over the last week, restarting bond buying efforts across the Mortgage-Backed Securities and indicating an intention to buy corporate bonds, was tremendously beneficial in supporting bond prices and improving liquidity in the markets.

Cash flow experience over last month

- Cash flow experience over the last month, driven by participant activity, has been strongly positive.

- We've taken a balanced approach to maintaining a defensive cash position in anticipation of possible withdrawals if the equity market stabilizes or rebounds and prudently investing cash across our various investment strategies in the Fund.

- Duration of the Fund has fallen during March due to the increased cash holding and mortgage backed securities shortening, though our relative duration positioning in underlying fixed income mandates remains neutral to respective benchmarks.

Putting money to work in this market

- Liquidity in corporate and securitized sectors has been challenging for sellers of bonds. The significant cash inflows across all our stable value strategies has enabled us to be buyers on behalf of our clients.

- Specifically, given the spread widening in corporate and securitized sectors, we have been able to take advantage of attractive opportunities across the short to intermediate duration, investment grade fixed income market. Those sectors of the market have been appealing as other investors have needed to raise liquidity by selling those same types of securities. We have purchased Agency residential mortgage backed securities, high quality asset backed securities and investment grade corporate bonds at attractive levels in recent weeks. In many cases we have seen yields available on shorter duration bonds exceeding that of their longer duration counterparts because some investors have been selling their most liquid assets to generate liquidity. It's been a turbulent, volatile market in general, but what we like to invest in has been available at good relative prices.

- We are not tactically changing our duration positioning; staying neutral to our benchmarks. We are also not tactically altering our sector weightings, believing the diversified approach we have taken with regards to holding Treasuries and Agencies, Corporates, Mortgage Backed Securities and Asset Backed Securities continues to benefit and support the crediting rate of the Fund.

Frame stable value as historical capital preservation option

As defined by the Stable Value Investment Association:

> *Stable value is a unique asset class available only in corporate and governmental tax-qualified defined contribution plans, as well as some tuition assistance plans. When offered as an investment option in such a plan, stable value seeks to offer capital preservation, liquidity, and returns typically higher than other options focused on capital preservation, such as money market funds. Stable value investment options may be offered by investment managers, trust companies, or insurance companies in various structures, such as separately managed accounts, commingled funds or guaranteed insurance accounts. Sometimes a stable value investment option will be managed by a plan sponsor. While stable value investment options may be managed or structured in a variety of ways, the important similarity is the use of stable value investment contracts, issued by banks, insurance companies, and other financial institutions, which convey to the investment option the ability to carry certain assets at book value. These investment contracts are what enable a stable value investment option to maintain principal value and minimize return volatility. The investment options that typically purchase or offer stable value investment contracts are commonly named Fixed Income Fund, Capital Preservation Fund, GIC Fund, Interest Income Fund, Stable Interest Fund or Stable Value Fund, among others.*

- Stable value funds crediting rates track the overall direction in the general level of interest rates, but with a lag given the method for calculating individual crediting rates for stable value contracts. The nature of the crediting rate formula embedded in the contracts dampens the immediate impact of price movements, smoothing out the impact over, typically, the duration of the assets wrapped. That typically creates a smoother performance path than an unwrapped short term bond fund or a money market fund.

- Specific to today's COVID-19 financial and economic impact, even though Treasury yields have fallen, particularly on the short end of the yield curve, spread sectors have still been attractive. In fact, the yield curve has steepened as well, typically providing stable value funds both a spread and duration benefit over MMFs.

- Crediting rates for stable value funds will likely be trending down given the decline in the general level of interest rates, though we again anticipate that movement to be gradual compared to money market funds. Crediting rates will follow the general level of interest rates on a lagged basis.

Wrap issuer availability/Credit outlook

- Generally, we would all probably agree that investment outlooks are still uncertain regarding the breadth and depth of the anticipated worldwide recession and will certainly be tied to the global ability to contain and ultimately manage the spread of COVID-19. Issuers generally entered this period though in stronger financial position than in 2008.

- All issuers to the Morley Stable Value Fund continue to accept new deposits across a range of underlying fixed income mandates. We'd add as well that the overall market-to-book value ratios were much stronger so far through this pandemic crisis than we experienced in the Great Financial Crisis.

- Given regulatory changes brought about by the Great Financial Crisis in 2008, financial institution balance sheets are in better shape as we cope with the COVID-19 pandemic than we experienced over 10 years ago. That said, earnings across all industries will likely be under pressure for some time to come. We are continuing to evaluate our ratings outlook for the industry and specific issuers given changing market conditions.

- As we have previously shared, stable value is an asset class that is designed to provide capital preservation and stable returns regardless of market volatility. The structure of a typical stable value portfolio seeks price stability similar to a money market fund while providing the return potential of a short to intermediate term bond fund. Stable value strategies are managed to longer duration targets than money market funds and, compared to government money market funds, have a structural overweight to spread sectors, further enhancing the expected return premium.

Compared to 2008 and current outlook

- Though the market volatility is similar, the driving factors are unique to each period. The Great Financial Crisis was a confluence of issues driving risk exposures in the mortgage market that ultimately pervaded all corners of the US and global financial and housing markets. The resulting impact drove substantial regulation changes aimed at improving the capital markets and limiting the risk exposures of the major financial institutions supporting economic activities in all countries.

- The pandemic is a health crisis first, tipping over to a global market crisis and likely worldwide economic recession. Financial institutions are generally in better capital shape than they were a decade ago. The government responses around the globe, though perhaps halting to start, have coalesced around strong monetary and fiscal stimulus attempting to soften the impact of a pending recession and stabilize markets. The market reaction to the pandemic has also happened much more quickly than the GFC, which unfolded over a much longer period of time.

- Regarding our outlook, we'd share the following:

  > Stable value strategies are working as intended.

  > Morley continues to offer positive returns, generally tracking the level of interest rates with the price stability inherently provided through book value wrap contracts.

  > Issuers in our market have been providing investment capacity and also tend to have a stronger capital position in aggregate than issuers did 10 years ago.

  > Through February, stable value funds had built up positive market-to-book value ratios due to strong, positive underlying fixed income performance. Even though market returns were negative in March, most stable value strategies likely remain in a positive market-to-book value position.

  > Great time as well to revisit the risk/return benefits of stable value when compared to money market funds. We are likely headed to a period where Treasury yields might be lower for a longer period of time.

A market crisis always provides an interesting set of opportunities to evaluate capital preservation options on behalf of plans. It is a great time to engage managers like Morley to clearly understand how we manage the risk/return relationship based upon credit, liquidity and interest rate risks as well as any cash flow risks due to changing market conditions.

How can we help you?

We have a long and successful history of providing stable value 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 e-mail to find out how our team of seasoned investment and service professionals can work with you to provide a stable value solution best suited for you or your clients' capital preservation needs.

Contact us

Bill Gardner
Director
gardner.bill.f@morley.com
503-484-9313

Jim Pondel
Sr. Relationship Manager
pondel.jim@morley.com
312-541-4077

Brett Okamoto
Relationship Manager
okamoto.brett@morley.com
503-484-9360

Yolanda Reyes White
Relationship Manager
reyeswhite.yolanda@morley.com
503-484-9341

Morley Capital Management | 1300 SW Fifth Avenue, Suite 3300 | Portland, OR 97201
800-548-4806 | www.morley.com

114869-042020