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Seeking to enhance the stability of stable value with traditional GICs

Traditional guaranteed investment contracts (GICs) can enhance the diversification, liquidity, and flexibility of stable value portfolios.

Stable value strategies can pursue greater diversification by balancing exposures to traditional GICs and the bonds underlying synthetic structures.

Traditional GICs can help lower crediting-rate volatility in stable value strategies, particularly in rising-rate environments.

While not always used in stable value strategies, we believe traditional GICs possess characteristics that act as diversifiers to the underlying securities of the synthetic components used in many stable value portfolios. Positioned at the top of the insurance company capital structure, traditional GICs may offer attractive structural positioning, full customization of the timing of cash flows, and a desirable level of stability to the overall crediting rate of stable value portfolios.

Diversifying with traditional GICs

Stable value strategies can include a range of underlying vehicles, including traditional GICs, insurance separate accounts, and synthetic GICs that rely on wrap contracts for book value accounting. While all of these vehicles can play important roles in a diversified stable value portfolio, only two of them — separate accounts and synthetic GICs — enjoy widespread usage. In our view, the frequent omission of traditional GICs limits the degree of diversification and flexibility of many stable value strategies.

The potential advantages of traditional GICs

GICs can provide a number of advantages to stable value portfolios. They offer stability and flexibility in the areas of credit risk and term structure risk, and, more importantly, they possess critical characteristics of liquidity, diversification, and crediting-rate enhancement. In what follows, we summarize these advantages and then explore key areas in greater depth to substantiate the potential benefits to investors.

Attractive structural credit risk

A GIC is a senior security in an insurance company’s capital structure whereas a corporate bond typically is not. In other words, GICs sit at the top of the payment waterfall alongside life insurance policyholders, while corporate bonds generally come behind any first- or second-lien bank loans. If the comparison is between a corporate A or AA rated issuer and a similarly rated insurance company, the credit risk is improved in the GIC due to its structural advantage of being first in the payment hierarchy.

Customizable term structure

Investors are able to select principal, interest, and maturity payment dates for each GIC they purchase. This may be highly advantageous, particularly if the manager prizes liquidity as a key component of the overall stable

value strategy. The ability to customize the term structure of the contract is attractive in order to structure cash flows at the time needed, e.g., a plan event or liquidation. The funding can be made available on designated dates of the manager’s choice at the time the contract is negotiated.

Liquidity provisions

Traditional GICs are not able to be sold on a secondary market, but that does not render them illiquid. Indeed, for the purpose of funding activity, traditional GICs are fully liquid due to their contractual provisions, which allow them to be “sold” back to the issuer at par.

Diversification potential

Traditional GICs offer exposure to a relatively stable investment vehicle backed by a long-tenured group of major U.S. insurance companies. With robust capacity parameters guiding their traditional GIC issuance, even modest GIC exposures can offer diversification benefits to investors.

Crediting-rate stability

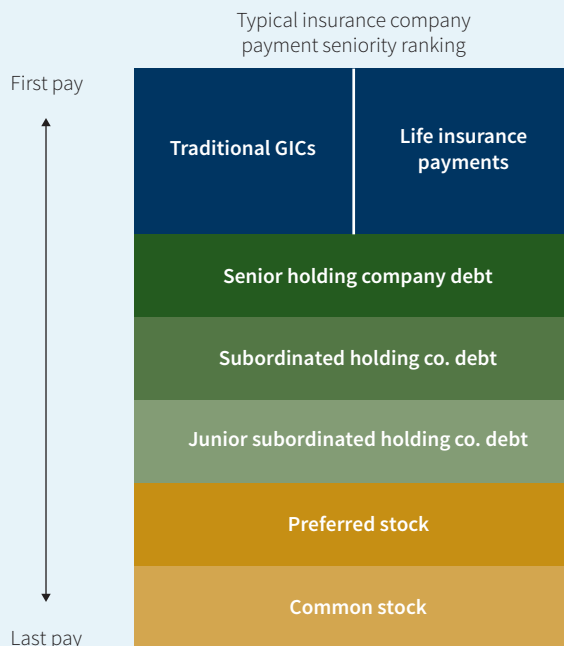
Because traditional GICs do not fluctuate in price, they are insulated from duration risk. In this respect, traditional GICs are excellent crediting-rate stabilizers for synthetic GICs, which can fluctuate in value due to interest-rate changes and other factors.

What is a traditional GIC?

A traditional guaranteed investment contract (GIC) is an investment contract issued by a AA or A rated insurance company, or its affiliate. The buyer, or contractholder, pays the insurance company/issuer for the contract, which then invests those proceeds in its general account.

The interest rate — known as the crediting rate in the stable value context — may be fixed or floating and is based on the assets available for investment by the issuer as well as that issuer’s assessment of the risk associated with the plan(s) and the specific investment manager purchasing the contract.

The “guaranteed” portion of the name indicates that principal and interest are guaranteed by the insurance company. In other words, the guarantee is as good as the credit risk of the issuer. Stable value funds using GICs typically develop a diversified exposure employing a number of issuers.



For illustrative purposes only. Diversification does not assure a profit or protect against loss. It is possible to lose money in a diversified portfolio.

Assessing the liquidity of traditional GICs

It is a common belief that because traditional GICs are not able to be sold on a secondary market, that means they are largely illiquid. While it is true that the private placement, customized nature of traditional GICs has made it challenging to develop a secondary market for these vehicles, traditional GICs are, in fact, liquid due to contractual provisions, which effectively allow these instruments to be put back to the issuer at par.

- *GICs are benefit responsive* — This means that the investor may approach the issuer to refund a portion, or all, of the contract in order to satisfy investor activity. Defined another way, the manager owns what is essentially a contingent put option at par value.
- *GIC liquidity can be tied to the health of the issuer* — If an issuer's credit is deteriorating, GIC provisions may allow for full or partial liquidation.

As a result, for the purpose of funding participant activity, GICs are fully liquid and have liquidity provisions related to credit quality.

An offset to lower levels of liquidity is typically additional premium, or spread, resulting in a higher crediting rate. Because of the perceived liquidity challenges of a traditional GIC, investors commonly expect an additional premium to be built into the crediting rate of the typical traditional contract. If a GIC is completely illiquid, the premium expectation is much higher compared with that of a corporate bond. However, there is a measure of liquidity available to the manager that reduces the level of expected liquidity premium as a result of the put feature embedded in a GIC. Determining a reasonably precise level of premium continues to be a debate in the market for GICs and is an issue that experienced stable value managers consider in their credit and relative value analysis.

Assessing the diversifying power of traditional GICs

Another major misconception is that GICs generally fail to offer a robust form of diversification. The concern here is that there aren't enough GIC issuers to create adequate diversification, or, if the manager's portfolio is quite large, that existing GIC issuers do not have enough capacity.

However, if we understand traditional GICs as components of a larger asset allocation strategy, it becomes easier to see that they can, in fact, carry diversification benefits.

- *Even modest GIC exposures can provide meaningful diversification* — A stable value portfolio that invests 3%–6% of its net exposure in a single traditional GIC issuer can potentially enhance overall portfolio diversification.
- *GIC issuers maintain strict capacity goals* — The issuers of these vehicles have historically had exposure limitations for each manager they contract with as well as an overarching capacity goal.

The number of GIC issuers has ebbed and flowed over the years, but there is a core group of insurance companies that have remained significantly involved in the traditional GIC business. This includes large, well-known companies such as MetLife, Principal Life, and Prudential, among others. This group has demonstrated a long-term commitment to the traditional GIC business through all market environments.

Additionally, managers who use traditional GICs typically construct a diversified portfolio including both synthetic strategies of wrapped bonds and GICs. Building a portfolio using 100% GICs is definitely a challenge from a diversification perspective as roughly six to eight insurance issuers compose the market. With only a portion of the total portfolio invested in GICs, a manager may have a modest exposure to a single insurer — on the order of 3% to 6% of the portfolio — which can enhance the overall level of diversification.

The capacity concern related to traditional GIC issuers should be thought of as a risk mitigation measure on the part of the issuers rather than as a problem of having enough issuing capacity. GIC issuers have historically had an overall capacity goal for their traditional GICs in total, as well as individual exposure limitations for each manager investing in GICs. Depending on the GIC issuer's view of the risk of the stable value portfolio, its associated plan(s), as well as the manager's investment style, this risk assessment directly impacts the level of exposure to a single manager or portfolio the issuer is willing undertake. The riskier the manager's style or the portfolio characteristics, the less capacity is made available.

Diversification does not assure a profit or protect against loss. It is possible to lose money in a diversified portfolio.

Traditional GICs as potential enhancers of crediting-rate stability

GICs are priced at par at issuance as well as going forward, given the private placement nature of the contracts and the par put embedded in the contract. With no fluctuation in price, that portion of the portfolio is immune to duration effects as interest rates rise and fall. This lends stability to the traditional GIC’s crediting rate, which may help smooth the overall portfolio’s crediting rate.

For comparison, consider a synthetic strategy (underlying bonds with a derivative wrap contract) with a 3-year duration (see illustration below). Unlike a traditional GIC, a synthetic strategy’s crediting rate is based on book value as well as any market value gains or losses, which are amortized over the duration of the securities being wrapped. This effectively smooths out market volatility. If interest rates rise 2%, the strategy’s 3-year duration will cause the portfolio market value to fall 6%. With a market value lower than book value (an unrealized loss), the market-to-book value ratio declines, which reduces the crediting rate of the synthetic strategy. In this example, the crediting rate on the synthetic strategy falls from 1.81% to 1.72%. If, however, the stable value strategy were made up of a 50/50 allocation to the synthetic strategy and traditional GICs, the overall crediting rate on the portfolio would decrease from 1.91% to 1.86%, a reduction of only 5 basis points.

When a stable value portfolio solely consists of a synthetic strategy with a cash buffer — one common stable value structure — the crediting rate of the portfolio as a whole is impacted to a greater degree by fluctuations in market value due to changes in interest rates. In a portfolio that combines cash, traditional GICs, and synthetic strategies, the traditional GIC portion can help to stabilize the overall crediting rate of the portfolio because only the synthetic portion of the portfolio will fluctuate in value. This is more easily observable in an environment of rapidly rising interest rates.

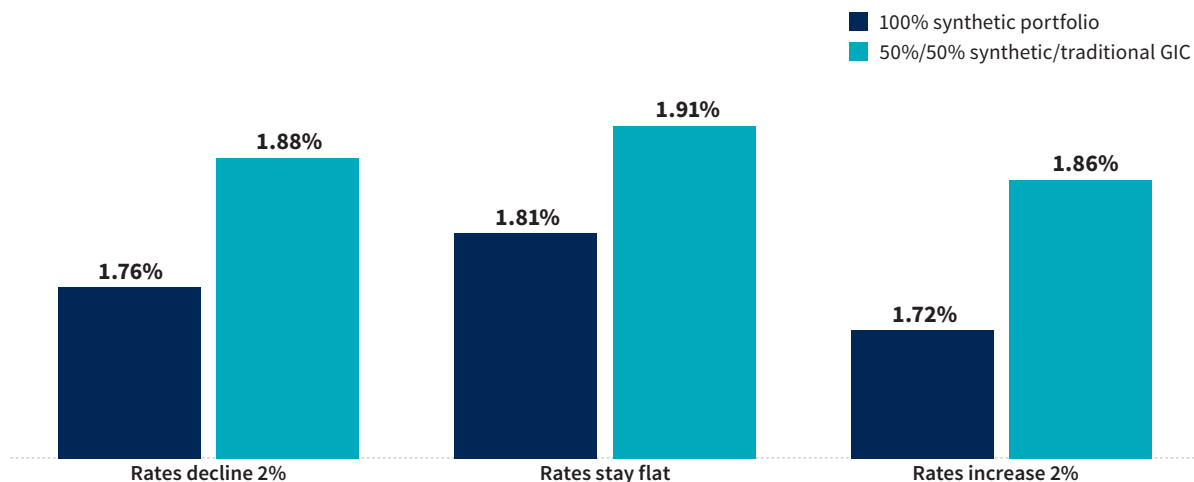
Traditional GICs: Sources of liquidity, diversification, and crediting-rate stability

While traditional GICs were historically a fixture in many stable value portfolios, more recently the range of usage has varied. Citing liquidity concerns and other challenges, many managers have tended to steer clear of traditional GICs altogether, while others have invested episodically.

We believe the use of multiple traditional GIC contracts within a broader, diversified stable value portfolio is a more prudent way to invest — and the best way to make the most of what traditional GICs have to offer, particularly as potential enhancers of portfolio liquidity, flexibility, and crediting-rate stability.

Traditional GICs can smooth the crediting rate

Portfolio crediting-rate comparison under different rate scenarios



Source: Putnam. For illustrative purposes only and should not be considered a recommendation to purchase or sell any security. Illustration assumes a 3-year duration, an initial 2% bond equivalent yield, and a 0.20% wrap fee for the synthetic GIC component; a 2.0% increase in interest rates; a constant 2% crediting rate of traditional GIC component; and no cash.

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Risk considerations: A GIC represents the issuer's agreement to make interest and principal payments in the amounts and at the times specified by the contract. Investment contracts typically pay an interest rate (also referred to as the crediting rate) that adjusts periodically on a specified schedule. These contracts allow a constant valuation of the contract at book value, but the crediting rate will increase or decrease based on changes in the market value of the underlying securities and the interest paid on the securities. The payment of principal and interest of a GIC contract is dependent on the creditworthiness of the issuer. In the event of a default on its obligations by a GIC issuer, the owner could incur a loss of principal. The creditworthiness of investment contracts is dependent on the financial health of the relevant wrap providers or investment contract issuers. The contract reserves for GICs are held in the insurer's general account, and the ability of the insurer to meet its contractual obligations ultimately depends on its financial stability. GICs are not insured by any federal agency.

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