Morley **Insights**

Morley
Capital Management

Capital preservation products: **a comparison**

Today's defined contribution marketplace offers multiple capital preservation products. The primary objective of these vehicles is to preserve capital and generate relatively stable returns while providing sufficient liquidity for participant benefit payments. Suitability for inclusion in a plan's investment lineup should be determined based on a wide range of factors. Evaluation of contract provisions is a key element in understanding these products and the differences between them. Many features may appear similar but upon further examination, important distinctions are present, such as the crediting rate calculation, contract termination, fee transparency and risk factors.

What we'll discuss

- Key features of insurance company general accounts and stable value funds
- How the crediting rate is determined
- Fee transparency

February 2017

What is important for you to know?

To equip you with basic knowledge of some key features, we've compared two types of vehicles: 1) Insurance company general account contracts: group annuity contracts pledging principal protection and participant benefit payments at book value that are backed by the general account of the issuing insurance company; and 2) Stable value funds: portfolios made up of bonds that are wrapped by investment contracts ("wraps") issued by financial institutions pledging principal protection and participant benefit payments at book value. The wraps are designed to amortize the gains and losses of the underlying bonds over time through the crediting rate.

Key features	Insurance company general account	Morley stable value funds
BENEFIT RESPONSIVE	Yes	Yes
CREDITING RATE	Reset periodically; typically quarterly, semi-annually, or annually. No formula stated in contract.	Crediting rate of fund changes daily based upon the crediting rates of investment contracts and cash equivalents held by the fund. Crediting rate of wrap contract is reset monthly, formula is stated in each contract.
MINIMUM GUARANTEED RATE	Varies, typically 1.00%+.	None stated, though wrap contract crediting rate cannot go below 0.00%.
OWNERSHIP STATUS	Policyholder of insurance company, general account assets are owned by the insurance company.	Plan/Fund owns wrap contracts and has direct or beneficial ownership of underlying assets.
DIVERSIFICATION	Plan owns one contract from a single insurance company.	Plan/Fund owns contracts from multiple wrap providers and directly or beneficially owns multiple underlying securities through multiple managers and mandates.
TERMINATION BY PLAN	Generally, lower of book value or market value if immediate liquidation, or option to take book value over multiple year payout period, typically 5 years. Some contracts may limit certain participant transactions during the payout period.	Assets in an individually managed account may be portable to new manager/provider. Plan Sponsors invested in a Morley collective investment trust (CIT) must provide 12 months advance notice, participant benefits continue to be paid and Fund's daily crediting rate is earned during waiting period.
SURRENDER PENALTY	Possible penalty and/or lower crediting rate over termination payout period.	None
FEE TRANSPARENCY	Insurance company earns a spread and is not required to disclose a fee.	Fees disclosed monthly as well as a comprehensive annual disclosure.

Answers to important questions

How is the crediting rate determined?

The formula by which the crediting rate is determined is not stated in an insurance company general account contract. An insurer has the discretion to set a crediting rate based upon several assumptions made by the insurer, including asset allocation, asset risk, market yields and future product cash flows. The amount earned by the insurer, generally referred to as the "spread", is dependent upon investment performance and product cash flows relative to the pricing assumptions. The spread is not revealed to the plan sponsor and will vary, making it difficult to define how future crediting rates will be determined.

The wrap contracts in a stable value fund identify the formula that will be used to establish the crediting rate, the elements of which are clearly defined. The formula is based upon the yield of the underlying bond fund and any gains or losses amortized over the duration of the bond portfolio. The crediting rates on the wrap contracts in the Morley products reset monthly, enhancing the ability of a stable value fund to track interest rate movements. The overall crediting rate on stable value funds may fluctuate slightly from day to day depending upon the allocation between cash holdings and wrapped assets.

Wrap CR = (1+Y) * (Market Value/Book Value) ^ (1/D) -1 - F

Represents the yield of underlying fixed income portfolio.

This shows whether the portfolio has a gain or loss based on current value of securities. A gain (MV>BV) increases the yield credited while a loss (MV<BV) lowers it over time.

Represents the yield of underlying fixed income portfolio.

What happens if the plan wants to change products?

If a plan is invested in an individually managed stable value account, the plan owns the assets, either directly or beneficially, making them portable and a transition to a new manager/provider relatively seamless. In many cases, a new manager simply assumes management of the current wrap contracts and underlying assets.

If a plan is invested in a CIT, in most cases, advance notice is required by the CIT, the length of which will vary by provider. Morley products have maintained a 12 month notice for plan sponsor withdrawals since its inception. The plan participants continue to earn the daily rate of their CIT share class during the waiting period, do not incur termination or surrender penalties, and will be paid book value upon withdrawal.

If a plan invested in an insurance company general account chooses to terminate the contract, surrender penalties may apply and will vary by provider. Generally, a plan sponsor can terminate the contract at the lesser of book or market value with proper notice. The market value of a contract will typically be lower than book value if current yields are higher than the contract's current crediting rate, which could occur in a rising rate environment. In this case, the contractholder may accept an immediate lump sum payment of the contract's market value or elect to have book value paid over a specified period of time, typically 5 years. If a book value payment period is selected, the crediting rate applied to participant accounts might be well under market rates until the final payment is made.

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CAPITAL MANAGEMENT

Are the fees clearly identified?

Recent regulations around fee transparency to plan participants have become an increasingly important component of fiduciary responsibility. Fees associated with Morley products are transparent through the detailed fee table provided on fact sheets. We also provide the annual ERISA 408(b)(2) disclosure that has information helpful to plans in completing their 404(a)(5) disclosure to participants.

Fees and expenses in a general account contract are not usually as transparent as stable value funds. The Department of Labor (DOL) excluded general account contracts from annual disclosure requirements which may limit a plan sponsor's ability to compare fees on similar products. As we mentioned, the insurer earns a spread which is not revealed to the plan sponsor, making it difficult to know the cost of buying the contract. The spread earned by the insurer is based upon on the general account in total and is not attributable to a specific liability, i.e., the contract.

Annualized Fees	
Stable Value Investment Contract Fees (Wrap Fees)	%
Sub-Adviser Fees	%
Acquired Fund Fees	%
Other Expenses	%
Total Fund Level Expenses	**%**
Trustee/Adviser Fee	%
Service Provider Offset	%
Total Fund Operating Expenses	**%**

SAMPLE

A word on risk

While capital preservation is generally considered a conservative investment option, these products do carry potential risks. Risks include, but are not limited to:

Credit risk – The risk that the book value guarantor will be unable to meet its obligations such as participant benefit payments. When a plan sponsor enters into a general account contract, they become a policyholder of the insurer and are subject to the credit risk of a single insurer. Fulfillment of participant withdrawal requests is tied to the creditworthiness of the issuer. CITs and individually managed accounts are also subject to credit risk, though generally have multiple wrap providers that pledge payments to participants, each with underlying portfolios that are well-diversified by sector, issuer and issue, further mitigating the risk profile of the product.

Stable value funds are bound by guidelines that set duration limits and generally permit the purchase of investment-grade assets only, thereby mitigating interest rate and credit risk. Most insurance companies invest the assets of their general accounts using a more broad set of guidelines that generally result in a longer duration and lower quality assets, including non-investment grade and illiquid assets, which may not be suitable for a capital preservation objective.

Interest rate risk – Characterized as what may happen to the value of a bond portfolio when interest rates change. We know that when interest rates rise, bond prices decrease, though the degree can vary based upon, among other factors, duration. We mentioned earlier that insurance company general accounts tend to have a longer duration than stable value funds. In the face of rising rates, a shorter duration portfolio may offer more protection from interest rate risk than a longer duration portfolio.

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 partner with you to provide a stable value solution best suited for you or your clients' capital preservation needs.

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