Stable value, rising interest rates, and inflation: why plan sponsors should stay the course

Introduction

Many plan sponsors have turned to stable value funds as a preferred capital preservation option to offer their participants. Stable value funds seek to offer a higher yield than money market funds, short to intermediate bond-like performance, and an insurance backed guarantee. With nearly $907 billion in assets in the third quarter of 2021, stable value funds continue to represent roughly 10% of the total defined contribution market.[1] Approximately 63% of all participants have access to a stable value fund through their plan's investment lineup.[2]

Last year's rise in inflation, and the general consensus that it will continue in 2022, have some plan sponsors and fiduciaries wondering if stable value is still a suitable choice for their participants. They're concerned that inflation could lead to a rise in interest rates, which could affect the performance of stable value investments, given the inverse relationship between bond yields and prices. When interest rates go up, the market value of traditional bond portfolios typically decreases.

In 2021, inflation was driven largely by sectors tied closely to the pandemic such as travel and transportation. However, high prices aren't specific to those sectors.

Food, shelter and energy prices have increased as well due to continuous supply chain bottlenecks and fiscal spending. For these reasons, we expect inflation to be a headwind in 2022.

The U.S. Federal Reserve's plan to accelerate the end of its bond purchase program is a sign that higher interest rates are on the horizon. Increases to the federal funds rate could begin as soon as March. Many industry professionals are expecting three or even four rate hikes this year to help fight inflation.

Despite the rise in inflation, staying the course with stable value may be the best course of action for plan sponsors.

The structure of stable value funds, including the insurance guarantees, crediting rate formula, and duration profile, may help position these funds to weather the current environment and continue to deliver consistent returns in most economic cycles.

Crediting rate formula helps reduce volatility

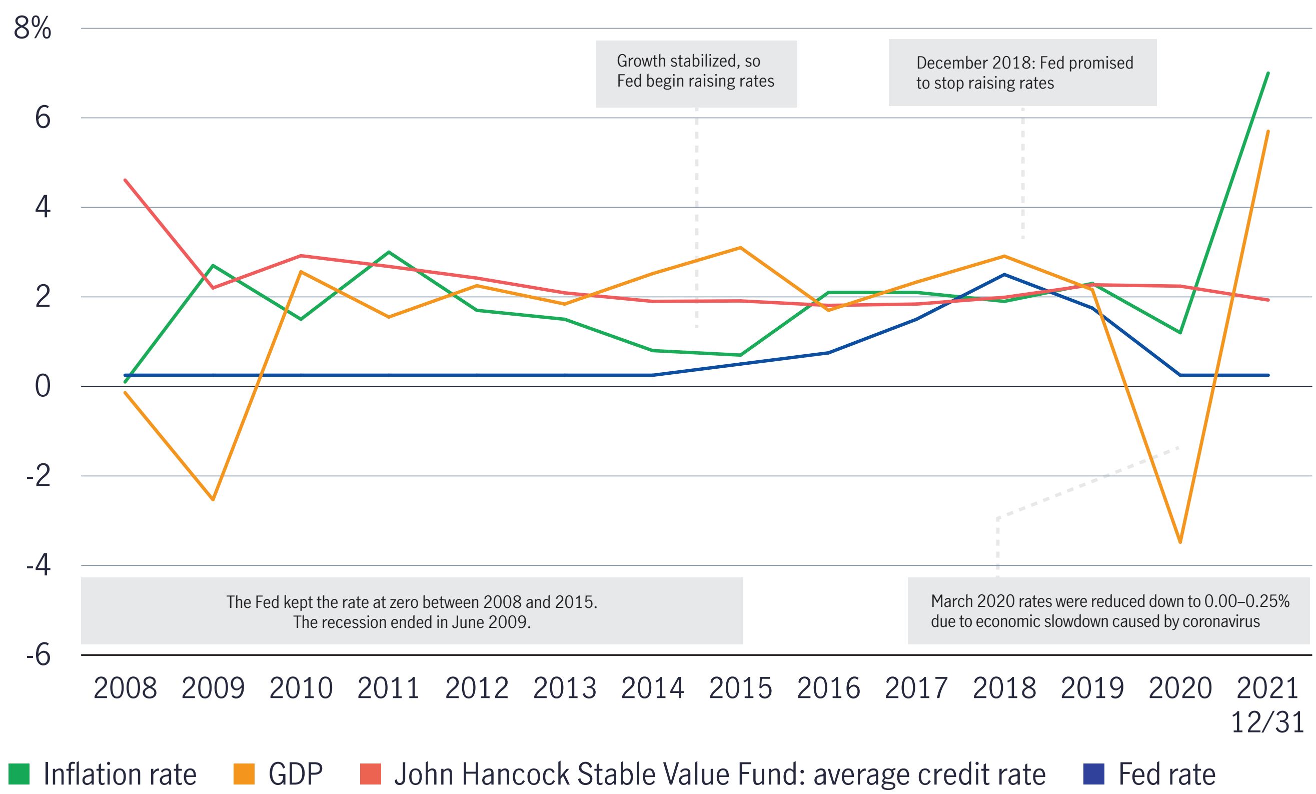
Insurance (wrap) contracts issued by insurance companies and banks are one of the distinct differences between stable value and other capital preservation funds. This insurance guarantees the investor's contract value, which is based on the investor's principal (total deposits), plus interest, minus expenses. The interest portion of the equation comes from the crediting rate of the stable value fund, which is calculated monthly, quarterly, semiannually, or annually, and is often expressed as the effective annual yield of the fund.

The crediting rate for pooled stable value funds is typically determined using an industry-standard formula that takes inputs directly from the underlying portfolio (including yield, duration, and market value) to determine the rate provided to retirement plans invested in the fund. An additional benefit of the crediting rate formula is the ability to amortize portfolio gains and losses over the duration of the fund, which smooths out the return volatility for investors.

Traditional bond portfolios that are marked to market daily will typically experience more pronounced volatility in their returns during periods of inflation or hyperinflation and rising interest rates.

The crediting rate formula is a key differentiator between stable value funds and traditional bond portfolios as it's designed to help mitigate the effects that increased volatility may have on the investment experience of retirement plans and their participants.

John Hancock Stable Value Fund crediting rate vs. U.S. year-over-year GDP vs. U.S. Fed rate vs. Consumer Price Index (inflation metric)



This example is based on the historical values of John Hancock Stable Value Fund and may not be representative of the experience for all customers.

John Hancock Stable Value Fund Class R6 crediting rate: average rate for the given year. Inflation—CPI-U as reported by U.S. Bureau of Labor Statistics. GDP—year-over-year (YOY) change in GDP as reported by the U.S. Bureau of Economic Analysis (note: Q3 2021 was the YOY form Q3 2020). Fed rate—average rate for the year as reported by the U.S. Federal Reserve.

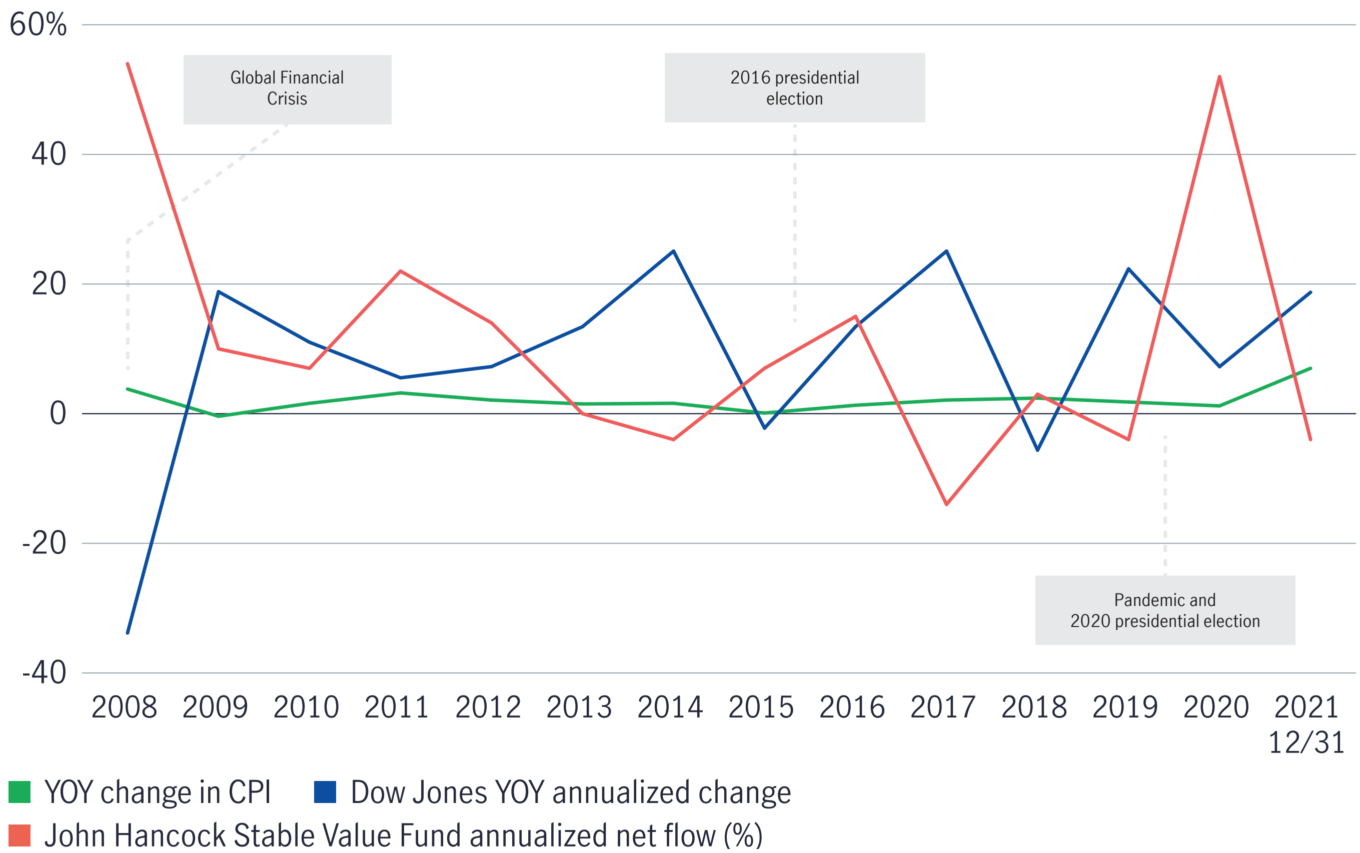
Increased cash flows lead to higher crediting rates

Typically in risk-off environments (periods of inflation and higher rates), retirement plan participants—and investors in general—tend to shift their assets from risk assets such as stocks to safer investments such as money market and stable value funds to lock in their gains or prepare for retirement. This influx of cash into stable value, coupled with maturing bonds, allows stable value fund managers to purchase higher-yielding fixed-income securities, which, in turn, typically results in higher crediting rates for stable value investors.

How quickly participants may experience the benefit of these higher-yielding bond purchases depends on the stable value fund's crediting rate reset frequency, which can be monthly, quarterly, semiannually, or annually in some cases.

Stable value crediting rates don't change until the reset date, so participants invested in a stable value fund with a monthly reset will see their crediting rate increase a month after the higher-yielding bonds are purchased. Participants in a stable value fund with quarterly or semiannual resets will have to wait three to six months to see their crediting rate go up.

January 2008 to December 2021: John Hancock Stable Value Fund net flows vs. Dow Jones annualized year-over-year change vs. Consumer Price Index (inflationary metric)



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Source: "Dow Jones—DJIA—100 Year Historical Chart," Macrotrends LLC.

Duration makes stable value less sensitive to interest-rate changes

Duration is another key factor plan sponsors should consider when assessing how their stable value fund may perform during inflationary periods. Duration is a term that describes how a bond portfolio will respond to changes in interest rates. Typically, securities with shorter duration profiles will react less in a rising interest-rate environment and are therefore better equipped to handle volatile market conditions compared with securities with longer duration profiles.

Pooled and general account are the two primary stable value categories, and each has its own duration profile.

A pooled, or commingled, stable value fund consists of a bond portfolio with wrappers from insurance companies or banks. These funds tend to have a target duration of two to four years.

A general account stable value fund is offered and guaranteed by a single insurance company. It's also known as a guaranteed insurance contract and has a target duration of four to seven years.

As of June 30, 2021, pooled stable value funds had an average duration of 2.94 years, and general account stable value funds had an average duration of 6.80 years.[1]

Conclusion

The selection and monitoring of plan investments is one of a plan sponsor's primary fiduciary responsibilities. As such, the decision to replace or remove an investment requires careful thought and deliberation and should follow a documented process. That process involves looking at many factors, including the fund's long-term performance, the role it plays in your lineup, and how it compares with alternative investments in the same and similar asset categories.

The current economic and interest-rate environment can be seen to favor stable value over other capital preservation funds. Even though the U.S. Federal Reserve is likely to increase its policy rate, short-term interest rates should remain relatively low through the first half of 2022. Low short-term rates mean stable value funds should continue to outperform money market funds over the short to intermediate term. Additionally, the structure of stable value funds should help insulate investors from much of the expected volatility in the bond market when rates do increase.

Amid rising inflation, plan sponsors should feel confident in their decision to offer their participants a stable value fund. This investment seeks to provide consistent performance and can help preserve retirement assets through this market cycle and beyond.

For more information, please contact your local John Hancock representative, or visit retirement.johnhancock.com.

For complete information about a particular investment option, please refer to the fund sheet and prospectus or offering memorandum/trust document. Investors should carefully consider the objectives, risks, charges, and expenses before investing. The prospectus or offering memorandum/trust document contains important information about the investment option and investment company. These documents may only be available in English.

1 "SVIA Stable Value Quarterly Characteristics Survey for 3Q2021," Stable Value Investment Association, 12/1/21. **2** "Who Invests in Stable Value and Why?", Stable Value Investment Association, 2/12/21. Data is as of the fourth quarter of 2019. **3** Q4 2021 Global Macro Outlook, Manulife Investment Management.

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