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Managing Stable Value in an Environment of Heightened Risk, Uncertainty

Over the past six months, the COVID-19 pandemic has brought unprecedented uncertainty to capital markets and the economy, including consequential impacts in the credit markets.

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Over the past six months, the COVID-19 pandemic has brought unprecedented uncertainty to capital markets and the economy, including consequential impacts in the credit markets.

As plan sponsors — and plan participants — have sought safety and stability, they're paying more attention to the stable value component of their portfolios, and they're finding a market that holds plenty of opportunity, although it's not immune to broader economic woes.

"We feel the stable value industry is healthy, as measured by favorable market-to-book value ratios," said David Starr, managing director, head of stable value investments, at

MetLife Investment Management. “And from a competitive perspective, the level of current yields remains significantly higher than traditional capital preservation alternatives such as money market funds.”

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That may make stable value more attractive for plan sponsors for whom capital preservation and decreased volatility remain top priorities. Stable value strategies may also offer a refuge for plan participants anxious about when the next market drop could hit. Still, stable value can hold its own set of risks, especially due to ratings downgrades, which could drift even further into defaults for many issuers in this market.

Uncertainty ahead

The economic path forward remains uncertain, even as the Federal Reserve has clearly communicated its intention and ability to continue purchasing securities and balloon its balance sheet.

“We saw an incredibly swift reaction from the Fed, taking the risk-free rate effectively to zero and messaging to the market that it’s going to leave that there for an extended period of time to bridge the gap to a more normal inflationary environment and avoid widespread deflationary impacts,” said Brian Funk, managing director, head of credit research, at MetLife Investment Management. “That had a dramatic impact on the market, and it’s a theme that we are paying quite a bit of attention to.”

Despite the Fed’s clear messaging, uncertainty remains high, and with so much at stake, it’s more important than ever that plan sponsors choose the right stable value managers to navigate this market.

“We have a difficult business cycle and challenges with corporate balance sheets to work our way through,” Funk said. “There is the scenario where we have further ratings migration, most likely skewed toward the negative. So we are really focused on how

individual sectors, and how the issuers within those sectors, will be impacted going forward."

That includes sectors, such as technology, that may be benefiting from the impact of COVID-19; as well as sectors, such as hospitality, that have experienced a negative impact. Sectors that fall into the latter camp require more detailed research by investment managers into the businesses themselves.

"We're looking for issuers that we believe can deal with the challenges and have ample liquidity to get them through to a more normalized global growth environment or domestic growth environment — whenever that may be," Funk said. "We believe that they can get there with a reasonable capital structure and a fundamental backdrop where they can create organic revenue growth [and] naturally free cash flow, and [then] de-lever the incremental facilities they've relied on to get through this time."

Choose your risk

In this market, it's a matter of what type of risk you're willing to accept.

"We aim to build stable value and other investment-grade portfolios by accepting more credit risk toward the front end of the curve, where we can use fundamental research to judge business and balance-sheet considerations," Starr said. "At the front end of the curve, spread assets yield a multiple of comparable duration Treasuries, so our approach to bottom-up security selection is centered on finding a specific role for each bond in the portfolio."

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Careful evaluation becomes crucial in this market, where the potential for mistakes is higher. With the potential for default rates to climb to 8% or higher — according to MetLife Investment Management, sell-side institutions, and rating agency estimates — the market could get one in 12 credits wrong, Funk said.

Further, each of those mistakes can have an outsized impact on a portfolio — an unacceptable result in stable value — because default recoveries in COVID-affected sectors have been challenged during this cycle.

“How many downgrades can you sustain in an investment-grade portfolio and earn that back with a sub-2% all-in yield?” Funk asked.

Perhaps more prevalent for stable value performance is the potential for spread-widening related to rating agency downgrade risk. So getting ahead of high-profile downgrades is key. In this volatile and challenging investment environment, MetLife Investment Management believes investors should be seeking managers that have a defined track record in security selection and the expertise in portfolio construction to help mitigate some of this uncertainty, all underpinned by a fundamental research platform.

“When unexpected outcomes occur, resulting in difficult credit situations, we believe that our assessment of the issuer’s underlying quality and intrinsic value will be a critical driver of success during challenging time periods” Funk said.

Potential opportunities

That said, there may be more opportunity today, as markets have truly dispersed for the first time in a decade.

“We tend to think that volatility can be your friend if you’re resourced properly with the right people doing the right jobs,” Funk said. “Analyzing credit the right way is getting bad ideas out of client portfolios and good ideas into portfolios. We welcome the dispersion.”

Among the potential opportunities are fallen angels in the oil sector and some well-positioned consumer businesses, he said.

Regardless of sector, in every case, Starr, Funk and their teams look not only at a company's fundamentals, but at the financial policy decisions that management is making. Such decisions might include how they're dealing with historic dividend payout ratios or go-forward share buybacks, or what they're doing as far as acquisition versus asset disposition.

"We think that's where we can add a lot of value for our clients," Funk said. "In some circumstances, management teams still control the fate of their outcomes, the fate of their balance sheet and the fate of their corporate credit rating. We tend to like those names."

The approach considers continuously evolving business models that further complicate the landscape.

"We believe the need to generate safe and attractive income in a stable value portfolio places a significant premium on a process that features extensive fundamental credit research and is enhanced by building portfolios bond by bond from the ground up," Starr said.

Funk agreed and added that he and his team are seeking to take advantage of investment opportunities even as the fundamental business outlook remains cloudy. "We're excited about our ability to navigate these types of markets regardless of where we sit on rates, yields and spreads," he said. ▪

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