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Stable value: A better complement to equities in diversified portfolios

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Executive summary

As an asset class, stable value can be a more attractive alternative than other fixed-income options as a complement to equities. The returns are similar to bonds, but principal protection, far less volatility, and lower correlations with equities make for a better risk-adjusted outcome.

The diversification built into a balanced portfolio of 60% equities/40% fixed income works well most of the time. However, during difficult periods when markets declined and interest rates rose sharply, such as 1994 and 2022, using a fixed-income alternative such as stable value would have reduced portfolio losses.

In more complex asset allocation scenarios containing a range of asset classes:

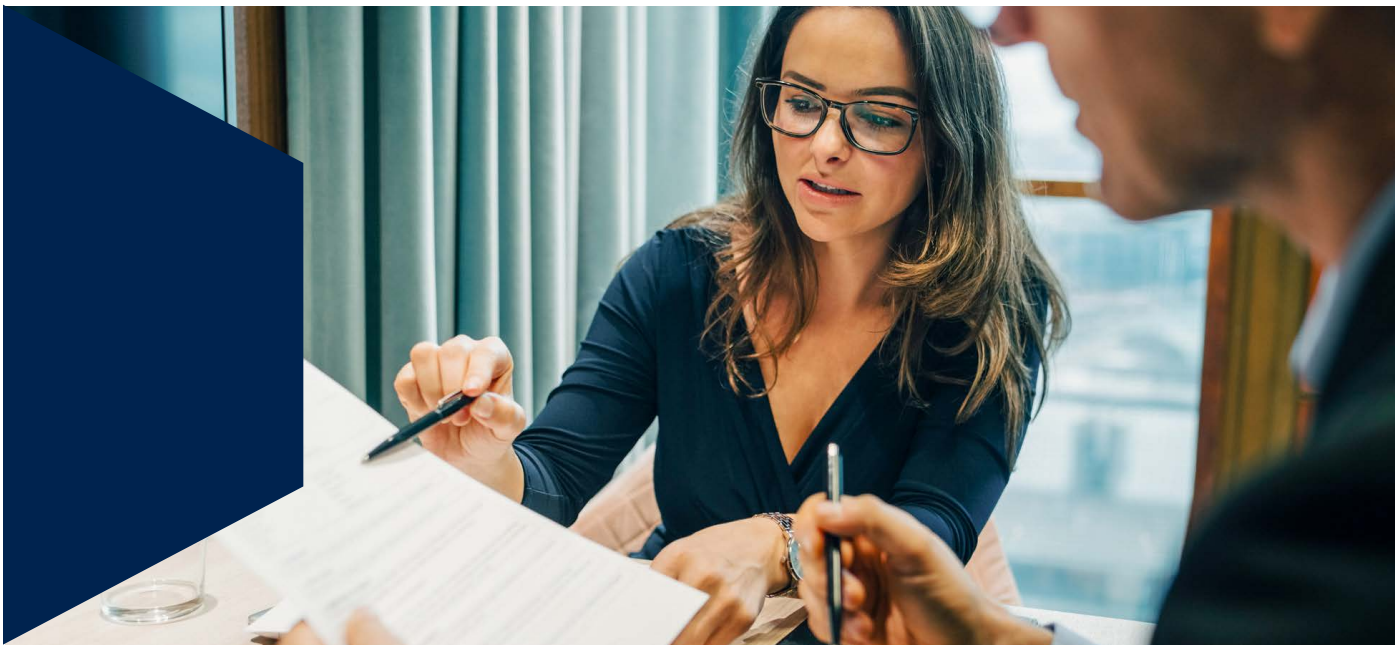
- Even though money market funds and stable value have very similar overall standard deviations and correlations with other assets, there is a large advantage for stable value in terms of long-term average return.
- Relative to bonds, stable value has dramatically lower volatility and correlations with equity assets, which more than offsets slightly lower long-term average return. When stable value is introduced to a multi-asset class opportunity set, it is better than other bond assets on the efficient frontier, and also produces portfolios with lower standard deviation.

Why include stable value alongside equities

Among the characteristics that make stable value attractive is a similar return profile to that of short- to intermediate-term bonds and a risk profile similar to money market funds, but with a key principal protection feature. Its return profile leads to lower correlations with other portfolio investments typically used as part of diversified portfolio, as well as a superior risk-adjusted return profile relative to fixed-income options. These benefits are evident across market phases and interest rate environments.

Higher and more consistent crediting rates over time are another reason stable value may be considered over money market funds. Even though the stable value options are generally backed by diversified fixed income-oriented investments, the crediting rate is less volatile than the capital gains and losses experienced in the underlying insurer portfolio.

A typical fixed-income portfolio can fluctuate substantially as interest rates change because it's often marked-to-market daily. That is not the case with an equivalent stable value option. The difference is especially clear in a rising-rate environment. In these circumstances, capital losses can significantly overwhelm the interest income earned on a traditional bond fund or index, while the stable value option has downside protection. Even in a declining-rate environment, the higher return-to-risk efficiency and lower correlation with equities relative to bonds still favors stable value.



Key elements: Volatility and correlation

Understandably, investment performance is measured primarily by gains and losses. However, when building diversified portfolios, allocations to specific asset classes focus on volatility and correlation.

- Volatility is the variation in return from one period to another.
- Correlation is how different asset returns typically move in relation to each other.

A lower correlation coefficient between two assets is preferred because there's less common movement between them. In a portfolio context, when selecting an asset for inclusion versus alternatives, a higher return coupled with less volatility and lower correlation with other existing portfolio assets is more efficient by improving performance while taking on as little risk as possible.

Figure 1: Performance, volatility and correlation comparisons (3/31/87 to 12/31/24)

				Correlation with Equity Indices		
Fixed Income Benchmarks	**Annual Return**	**Standard Deviation**	**Return-to-risk Ratio**	**MSCI USA**	**MSCI EAFE**	**Russell 2000**
Morningstar US CIT Stable Value GR USD	**4.65%**	**0.64%**	**7.22**	**-0.02**	**-0.01**	**-0.02**
Money Market Fund Average	2.94%	0.72%	4.05	0.02	-0.01	-0.03
Bloomberg US Agg Bond TR USD	5.24%	4.26%	1.23	0.19	0.15	0.09

Source: MPI Stylus, Mesirow Calculations and Morningstar. Past performance is not a guarantee of future results. It is not possible to invest directly in an index. The performance shown does not reflect the deduction of all fees and expenses that a client or investor would have paid if invested in investable instruments based on the indices shown during the time period displayed.

While money market and stable value have very similar overall standard deviations and correlations with other common equity assets, there is a large average return advantage for stable value, which is the reason stable value beats money market funds in an asset-allocation portfolio.

Compared to bond assets, stable value's volatility and correlations with equity assets are dramatically lower, with only a slight dip in returns.

A portfolio would need either stable value or money market allocations to achieve a portfolio standard deviation less than the bond standard deviation (4.26%) when combined with equities.

Stable value within a 60/40 balanced portfolio

The favorable return-to-risk ratio of stable value, therefore, will tend to be better than fixed-income alternatives in any portfolio framework. The simplest way to visualize this advantage is a traditional 60/40 balanced portfolio, consisting of 60% equities and 40% bonds. This combination has long been considered capable of weathering different macroeconomic and capital market environments. While the diversification built into a 60/40 portfolio structure usually works well most of the time, it can fail when it is needed most.

There have been noticeably difficult periods, such as the years 1994 and 2022, when interest rates sharply rose. As seen below in **Figure 2**, rising rates in these years led to below-average returns and even sharp capital losses for both equities and nominal bond assets, meaning that even this portfolio construction is not insulated from downturns.

- In 1994, the Bloomberg Aggregate Bond Index was down 2.92% and the S&P 500 Index returned an anemic 1.32%, so a 60/40 portfolio fell by 0.37%.
- In 2022, the results were far worse, as the Bloomberg Aggregate Bond Index dropped 13.01% and the S&P 500 Index plummeted 18.11%, leading to a combined portfolio result of negative 16.07%.

One potential alternative is to replace bond assets with other assets such as money market funds or stable value options.. **Figure 2** shows the long-term return and downside volatility of 60/40 portfolios with each of these different fixed-income alternatives, as well as showing the returns for the calendar years 1994 and 2022. In this instance, we are focusing on the variation in returns that is only below zero – in other words, when the portfolio is losing money. Those approaching retirement, or drawing down assets in retirement, would have been drastically affected. Even conservative investors with a longer time horizon might abandon the portfolio strategy in such times of severe stress, losing the chance at recovery of their losses.

Figure 2: Investment mix comparisons

Portfolio Allocations (Based on Benchmarks)	Average Annual Return (1988-2024)	Semi-standard Deviation (<0, 1988-2024)	One-year Performance	
			Calendar Year 1994	Calendar Year 2022
60% S&P 500 / 40% Bloomberg US Aggregate Bond	9.26%	7.83%	-0.37%	-16.07%
60% S&P 500 / 40% Money Market Fund Avg	8.27%	7.26%	2.29%	-10.32%
60% S&P 500 / 40% Morningstar US CIT Stable Value	**8.96%**	**6.96%**	**3.26%**	**-10.11%**

Source: MPI Stylus, Mesirow Calculations and Morningstar. Past performance is not a guarantee of future results. It is not possible to invest directly in an index. The performance shown does not reflect the deduction of all fees and expenses that a client or investor would have paid if invested in investable instruments based on the indices shown during the time period displayed.

Neither stable value nor money market funds suffered losses in 1994 or 2022, providing a cushion against overall portfolio losses caused by equities.

Stable value options are more attractive because the return is very similar to bonds, but with far less volatility due to the stability of the crediting rates and protection of principal.

The long-term drawback of using money market funds over bond funds would be the substantial drag on long-term return which might be considered worse than an occasional sharp downturn.

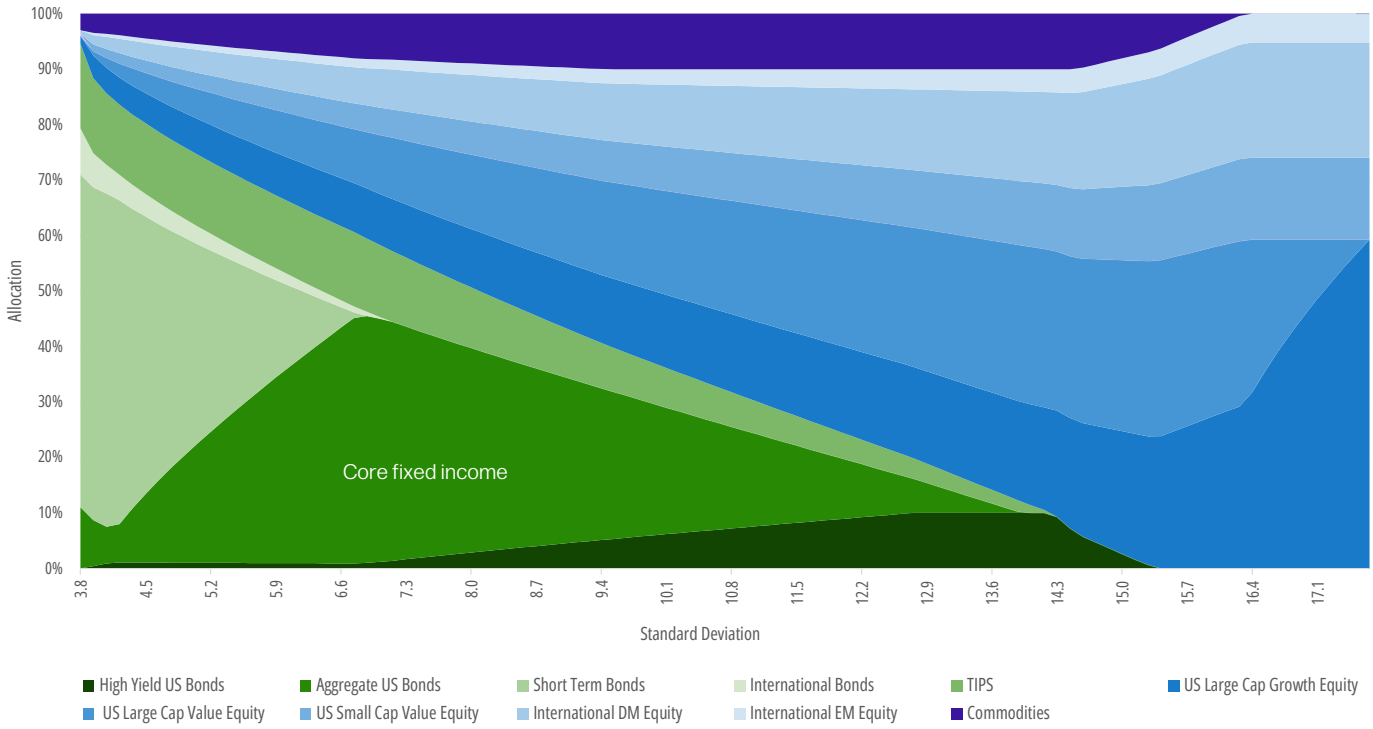
MVO analysis: Efficient portfolios are more than just returns

While a simple, two-asset balanced portfolio is a useful example, most investors diversify across a broader range of asset classes. In these cases, looking at assets along an efficient frontier is helpful for evaluation. Depending on the horizon used – one year, for example – it determines the full spectrum of risk-level options that are efficient. Efficient means that it produces the highest possible return for a given level of risk.

Traditional mean variance optimization (MVO) is an example of one-period asset allocation modeling. It is used to determine efficient frontier allocations to different asset classes, ranging from minimum to maximum standard deviation levels. The key inputs for MVO are return, risk (standard deviation or variance), and correlation.

Figure 3 shows an MVO asset mix from lower risk on the left to higher risk on the right. From a fixed-income perspective, allocations transition from short-term bonds, to aggregate bonds and then high yield.

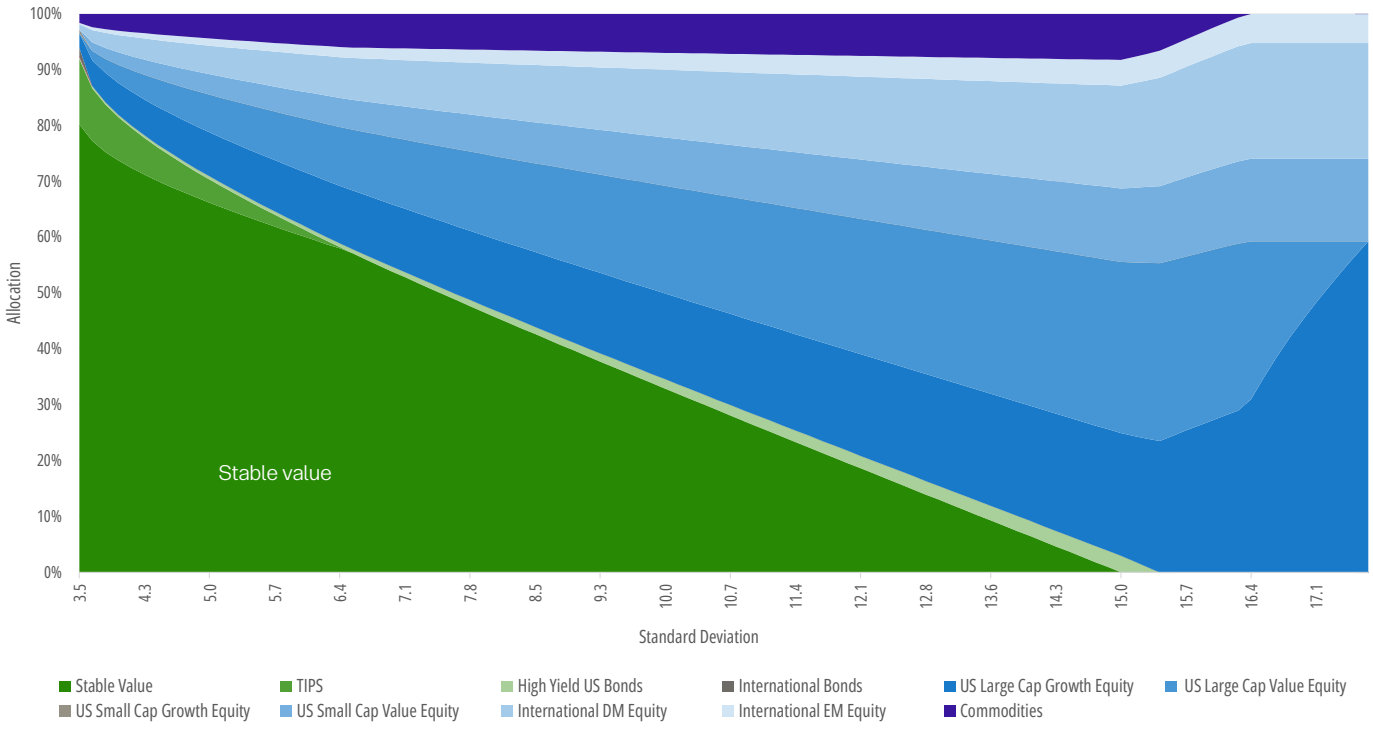
Figure 3: MVO with traditional fixed income allocation



Source: MPI Stylus, Mesirow Calculations and Morningstar Direct Asset Allocation Software. Results based on forward-looking data assumptions that incorporate Mesirow 2024 capital market assumptions. Capital market assumptions are based on current data like inflation and market yields and long-term historical derived data.

In **Figure 4**, allocating predominately to stable value as the fixed income component creates a more efficient portfolio and achieves a lower overall standard deviation than the investments used in **Figure 3**.

Figure 4: MVO with stable value allocation



Source: MPI Stylus, Mesirow Calculations and Morningstar Direct Asset Allocation Software. Results based on forward-looking data assumptions that incorporate Mesirow 2024 capital market assumptions. Capital market assumptions are based on current data like inflation and market yields and long-term historical derived data.

Conclusions when comparing Figures 3 and 4:

There's no difference between the two when comparing the highest risk levels. As the fixed income/stable value allocations fade out to all-equity allocations at higher standard deviation, the two analyses become identical.

All portfolios that include fixed income are more efficient with stable value than with traditional fixed income, meaning that the either the return is higher for a similar level of risk or that it is lower risk for similar return.

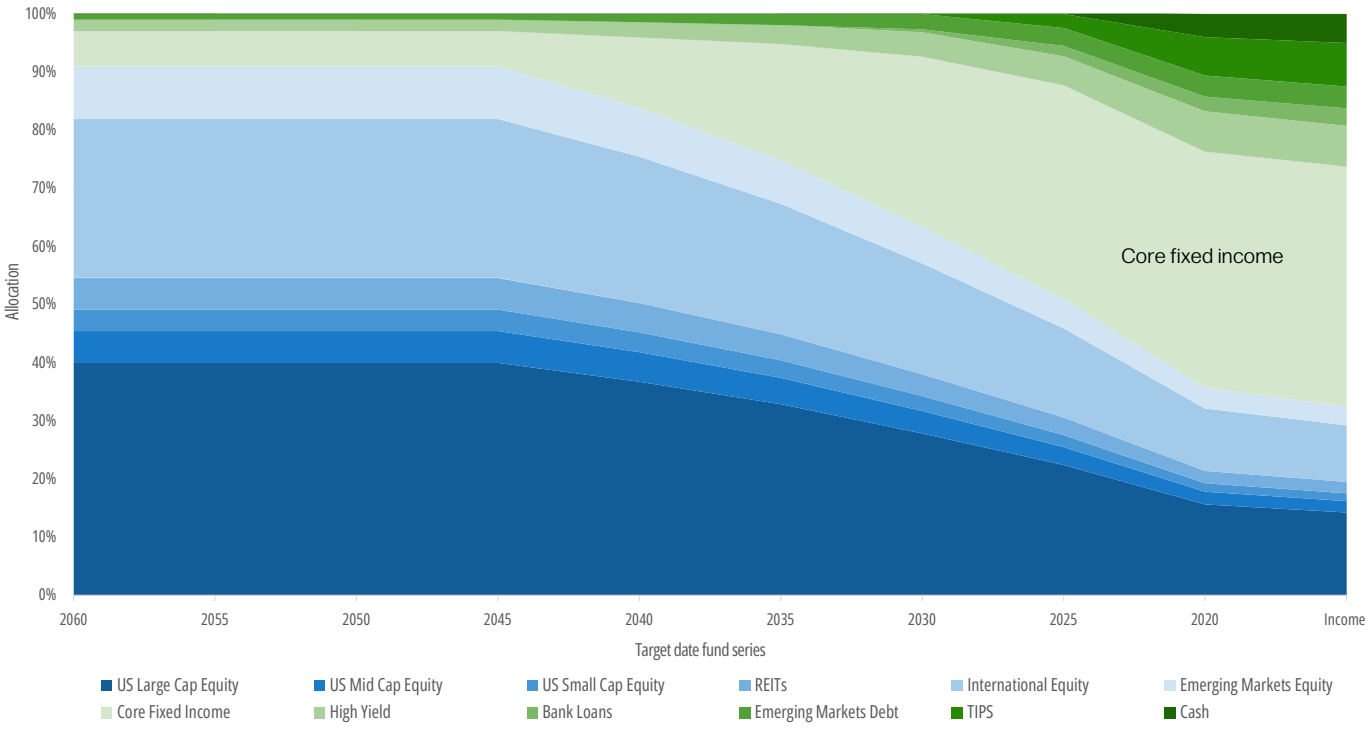
At the lowest level of risk that is comprised of almost all fixed income, the risk is substantially lower with stable value than with traditional fixed income.

Glide path analysis: Stable value versus fixed-income alternatives

Whereas Mean Variance Optimization showed how the asset allocation mix changes as the desired risk level changes for one particular time frame, glide path construction models vary the risk level with different time horizons. This approach is designed to convey appropriate allocations for various time horizons and a particular risk tolerance. Just as an MVO increases in equities at higher risk levels and bond equivalents at lower risk levels, a glide path increases in equity levels as time horizons increase and bond equivalents when time horizons are shorter. Rather than lower risk at the left as shown with MVO analysis, higher equity and higher risk allocations are at the left in visual glide path displays.

Figure 5 shows a sample Mesirow glide path for different equity and fixed-income mixes, with longer horizon portfolios at the left and shorter horizon portfolios at the right, terminating at a retirement/income portfolio mix.

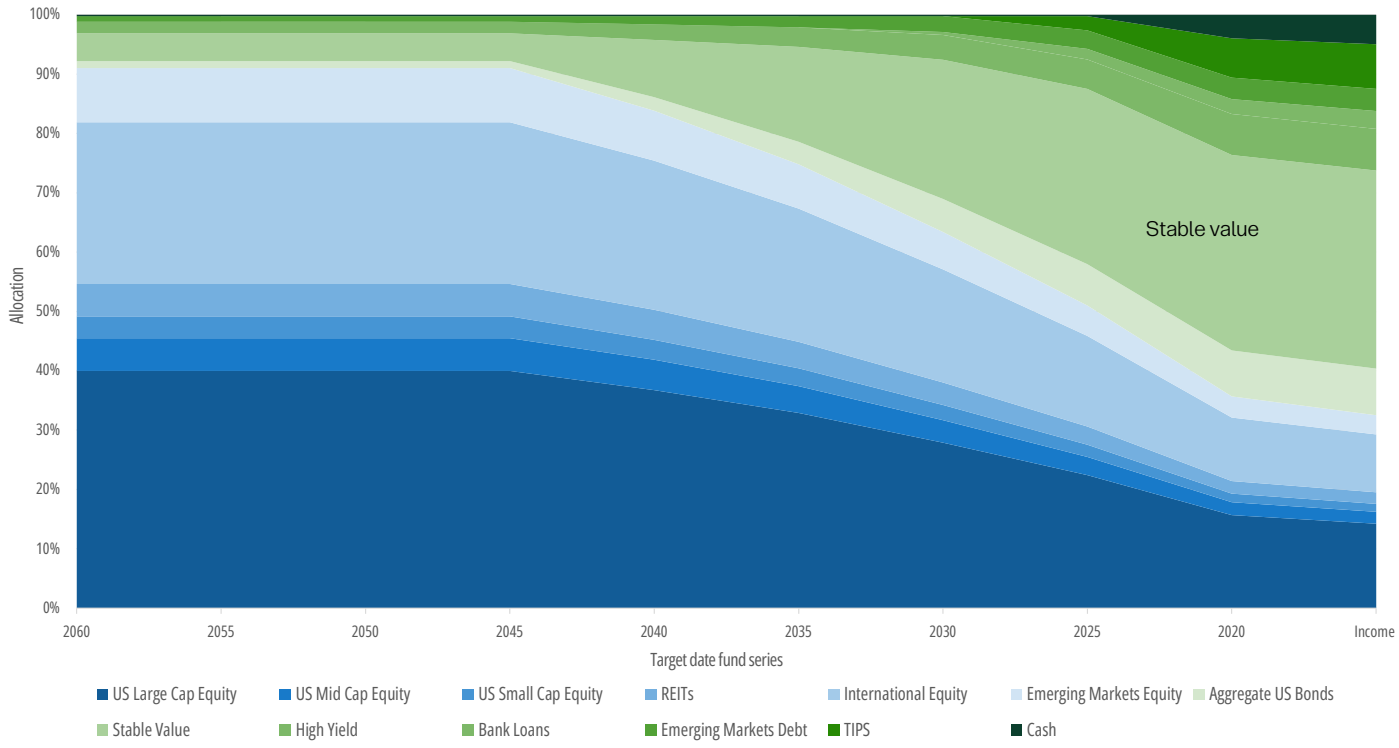
Figure 5: Sample glide path with traditional fixed income allocations



Source: Mesirow Fiduciary Solutions, utilizing MPI Stylus, Mesirow Calculations and Morningstar Direct Asset Allocation Software.

Figure 6 shows a similar sample glide path when stable value is available as an investment option. Much as was the case in the MVO framework, stable value is better in the glide path framework. Mesirow's detailed methodology for glide path construction includes time-varying inputs and robust optimization for certain broad asset classes. Their approach to stable value is based on analyzing a Sharpe Ratio of an integrated asset portfolio and finding the maximum value based on different carveouts to stable value from the broad fixed-income bucket. The Sharpe Ratio is a risk-adjusted return that essentially conveys the efficiency of an asset in producing return from the risk level used to generate that return.

Figure 6: Sample glide path with stable value allocation



Source: Mesirow Fiduciary Solutions, utilizing MPI Stylus, Mesirow Calculations and Morningstar Direct Asset Allocation Software.

Mesirow finds that the optimal carveout from fixed income to stable value assets is greater than 80%. In fact, some of the residual fixed-income allocation in a portfolio is largely for liquidity purposes or periodic required portfolio rebalancing. That's because the stable value allocation may not be drawn down to reallocate elsewhere in the portfolio, so the residual fixed-income allocation can fluctuate up and down to serve that purpose. While this analysis is for an overall integrated portfolio, the return-to-risk ratios viewed earlier in **Figure 2** give an indication of the standalone return-to-risk efficiency of stable value relative to bonds.

Conclusion

As we've seen, the principal protection, predictable returns, and low volatility found in stable value options make them a compelling investment option on their own. However, these same benefits also result in lower standard deviations relative to fixed income alternatives, and lower correlations to equities – which are highly desirable attributes in building diversified portfolios. This is demonstrated in both an analysis of simple 60/40 balanced portfolios – including certain years when stocks and bond assets were in distress – and in more diversified portfolio settings like target date funds where an expanded investment mix is used.

Any reference to a specific index or security does not constitute a recommendation to buy, sell, hold or invest directly in such index or securities. It is not possible to invest directly in an index.

Investing involves risk including the risk of loss of capital. Past performance is not a guarantee of future results.

All Transamerica companies identified are affiliated, but are not affiliated with Mesirow Financial Investment Management, Inc, Morningstar, or any other organization referenced.

Benchmark Descriptions for MVO Analysis:

Aggregate Bonds: Bloomberg US Aggregate Bond Index: The index is a composite of four major sub-indexes: US Government Index; US Credit Index; US Mortgage Back Securities Index and US Asset Backed Securities Index. The index holds investment grade bonds. The ratings are based on S&P, Moody and Fitch bond ratings. The index does not include High Yield Bonds, Municipal Bonds, Inflation Indexed Treasury Bonds or Foreign Currency Bonds.

Short-Term Bonds: Bloomberg 1-3 Year Treasury Bond Index: The Bloomberg U.S. 1-3 Year Treasury Bond Index measures the performance of the US government bond market and includes public obligations of the U.S. Treasury with a maturity between 1 and up to (but not including) 3 years.

International Bonds: Bloomberg Global Aggregate TR Hdg USD Index: Measures global investment grade debt from twenty-four local currency markets. This multi-currency benchmark is US dollar-hedged and includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

High Yield Bonds: Bloomberg US Corporate High Yield Bond Index: measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

TIPS: Bloomberg 1-10 Year U.S. Government Inflation-Linked Bond Index: designed to measure the performance of the inflation protected public obligations of the U.S. Treasury commonly known as "TIPS" that have a remaining maturity greater than or equal to 1 year and less than 10 years.

Stable Value: Morningstar US CIT Stable Value Index: An equally-weighted, monthly rebalanced index measuring the performance of approximately 75% of the U.S. collective investment trust stable value fund pooled universe. The underlying stable value fund returns are gross of investment management fees but net of contract fees.

Commodities: Bloomberg Commodity Index: a benchmark index that tracks the performance of a broad range of commodity futures contracts across energy, precious metals, industrial metals, livestock, and agricultural commodities.

International DM Equity: MSCI ACWI Ex USA Index: Captures large and mid-cap representation across 22 of 23 developed markets countries (excluding the US) and 27 emerging markets countries. With more than 2,300 constituents, the index covers approximately 85% of the global equity opportunity set outside the US..

International EM Equity: MSCI Emerging Markets Index: a free-float-adjusted, market-cap-weighted index that tracks the performance of large and mid-cap companies in 24 emerging markets, covering approximately 85% of the readily available shares in each country.

Large Cap Growth Equity: Russell 1000® Growth Index: Measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000 companies with higher price-to book ratios and higher forecasted growth values.

Large Cap Value Equity: Russell 1000® Value Index: Measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

Small Cap Growth Equity: Russell 2000® Growth Index: Measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 2000 companies with higher price-to book ratios and higher forecasted growth values.

Small Cap Value Equity: Russell 2000® Value Index: Measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower expected growth values.

Additional Benchmark Descriptions Utilized in Mesirow Representative Glide path:

Bank Loan: Credit Suisse Leveraged Loan USD Index: Measures the performance of the investable market of the U.S. dollar-denominated leveraged loans. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+.

Small Cap Equity: Russell 2000® Index: Measures the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

Mid Cap Equity: Russell Mid Cap® Index: Measures the performance of the mid-cap segment of the US equity universe and is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap Index rep- resents approximately 31% of the total market capitalization of the Russell 1000 companies.

Large Cap Equity: Russell Top 200 Index: A market capitalization weighted index of the 200 largest companies in the Russell 3000 index.

Cash Equivalents: 30-Day US T Bill Index: This index data in the paper measures the monthly return from the FRED database of the St. Louis Federal Reserve Bank for a constant maturity treasury bill.

REITs: FTSE NAREIT Equity REITs TR USD Index: A free-float adjusted, capitalization-weighted index that comprises all Equity REITs not designated as Timber REITs or Infrastructure REITs. Equity REITs are defined as REITs with 75% or greater of their gross invested book assets invested directly or indirectly in the equity ownership of real estate.

Emerging Markets Debt: JPM EMBI Plus TR USD Index: A traditional, market capitalization-weighted USD-denominated sovereign emerging markets index with a unique liquidity ranking methodology to provide investors with the most liquid set of issues within the asset class.

Additional Benchmark Descriptions Utilized in Table Displays:

Money Market Fund Average: This benchmark data in the paper measures the category average for all taxable money market mutual funds in the Morningstar universe obtained through MPI Stylus and with Mesirow calculations.

S&P 500 Index: The index measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation.

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