The Capital Preservation Trilemma: Implications and Potential Solutions for DC Plans

New Regulations, New Considerations for DC Plans

Beginning in October 2016, the new US money market fund regulation announced by the Securities and Exchange Commission (SEC) in 2014 will go into effect. In preparation for those changes, sponsors of Defined Contribution (DC) plans have begun to assess the impact of the reform and re-evaluate capital preservation options they offer to plan participants.

The capital preservation asset class is important for plan participants who are seeking modest growth of their nest eggs, particularly as they get closer to retirement. The three most important goals of capital preservation solutions may be characterized as: stability of principal (maintenance of the initial amount invested), liquidity (access to cash at the plan level) and yield (competitive market returns).

Meanwhile, other changes in the market are impacting the ability of capital preservation solutions to offer the same historical benefits. For instance, banks’ issuance of short-term debt has declined amid the adoption of the Basel III bank regulations, and the availability of government assets has become scarcer following quantitative easing measures by the Federal Reserve.

As implementation of the money market regulation comes into focus, this new market reality could create capacity concerns and further decline in government yields—increasing the importance of certain new fund features, such as the Fed Reverse Repo program—while creating return opportunities in longer-dated credit—making yield tradeoffs more notable.

Against this backdrop, capital preservation investors may now face what we call “the capital preservation trilemma,” where the three-part goals of stability, liquidity and yield may only be partially achieved and may not be fully captured in any one single investment. Specifically, investors may be able to pursue any two of those goals at one time, but generally only at the expense of the third goal.
New Money Market Fund Rule, New DC Plan Requirements
The new US money market requirements represent a substantial change for the industry and vary based by type of fund (i.e., prime, government, and tax-exempt) and by type of investor (i.e., retail and institutional).

- **Government money market funds** are generally unchanged under the new rules.
- By contrast, all non-government money market funds (prime and tax-exempt money market funds) will now be subject to potential liquidity fees and redemption gates ("fees and gates").
- **Retail prime money market funds**—those that are limited to “natural persons”—will be permitted to continue to use amortized cost accounting methodology and penny-rounding to maintain a stable $1.00 net asset value (NAV). DC plans are considered retail, and will be permitted to maintain stable NAV funds.
- **Institutional prime money market funds** will be required to use market-value based pricing, and move to a floating NAV calculated out to four decimal points ($1.0000). Defined benefit (DB) plans are considered institutional, and will be required to move to floating NAV funds.

In summary, under the new rules, DC plans are exempt from the any new floating NAV requirements, but will still be subject to potential fees and gates for non-government money market funds.

Navigating Potential Capital Preservation Options
Increasingly, capital preservation and conservative income options in the retirement market may broadly be demarcated by their primary two goals (that is, either stability and liquidity; or stability and yield; or yield and liquidity).

As a result of money market fund reform, DC plan sponsors who offer money market funds may seek different options in the capital preservation space. As an alternative, plans may wish to consider Stable Value Funds as a capital preservation option pursuing yield and stability, or expand the capital preservation space to also include conservative yield-focused options, such as conservative ultra-short duration funds that can take advantage of the new market landscape.

It is possible that the three primary capital preservation investment options evolving in DC plans may become:

1. **Government Money Market Funds** - offering potential stability and liquidity
2. **Stable Value Funds** - offering potential yield and stability
3. **Ultra-Short Duration Fixed Income Products** - offering potential yield and liquidity

Plan sponsors will need to consider the investment goals, risk tolerance and time horizons of the participant base when selecting investment options. Amid these considerations, the one certainty is that the changing regulatory landscape is forcing plan sponsors to re-think their capital preservation and conservative income strategies in light of a new, more challenging market environment.

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1 The new rule requires that a government money market fund invest at least 99.5% in government assets or cash.
2 This exemption also applies to retail tax-exempt money market funds, which are less common in DC plans.
3 A forfeiture account or other suspense account may not be eligible for investment in a retail fund unless all of the assets are owned by natural persons who have sole or shared voting and/or investment power over their investment. For example, money used to pay plan administrative expenses would not qualify.

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<td><strong>Potential Benefits</strong></td>
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<td>No tolerance for price fluctuations or principal loss</td>
<td>Seeks higher income with less volatility</td>
<td>Seeks higher income consistent with low volatility of principal</td>
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<td>Stable net asset value</td>
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<td>New SEC Rule 2a-7 Compliant</td>
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<td>GSAM’s Global Liquidity Management Team</td>
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<td>34 years of liquidity management experience</td>
<td>■ Over 30 years of stable value experience</td>
<td>■ Global expertise to navigate the entire short duration space and provide diversification across varying market conditions</td>
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<td>Remains a core capability within GSAM serving many of the world’s most discerning liquidity managers</td>
<td>■ Unique approach to stable value management designed to provide liquidity, competitive performance and mitigate interest rate volatility</td>
<td>■ Conservative investment approach</td>
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<td>GSAM’s Government MMF’s maintain access to Fed’s Reverse Repo Facility (RRP)</td>
<td>■ Access the depth and expertise of the GSAM Fixed Income team, credit and third-party manager platforms</td>
<td>■ Credit quality not compromised in search for yield</td>
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Source: GSAM. For illustrative purposes only. There is no guarantee that these objectives will be met.

*Under the new Rule 2a-7 requirements announced by the Securities and Exchange Commission in July 2014, a government money market fund may impose a fee or gate if the ability to do so is disclosed in the fund’s prospectus. Such amendments would require prior written notice to investors of at least 60 days. GSAM’s Government Money Market Funds WILL NOT be subject to the liquidity fees and redemption gates requirement.*

*Under new Rule 2a-7 Government funds will be defined as those that invest a minimum of 99.5% (formerly 80%) or more of their total assets in cash, government securities and/or repurchase agreements that are collateralized solely by government securities or cash. Effective December 17th 2014, GSAM’s Government Money Market Funds are officially in accordance with new Rule 2a-7 requirements.*

*Eligible to participate as counterparties in the Federal Reserve Bank of New York’s Reverse Repo Program (RRP).*
Investors should also consider the portfolio’s underlying asset classes, credit quality risk, interest rate risk, equity risk, currency risk, international risk, concentration risk, prepayment risk, and other risks. Bear in mind that all investing involves risk including the possible loss of principal. There is no assurance any investment strategy will be successful. Each fund or portfolio is subject to its own specific risks which are detailed in the prospectus, offering document or other information material. You should always read the prospectus, offering document or other information material for a more complete description of the risks associated with an investment in a particular product.

**Risk Considerations**

An investment in a money market portfolio is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market portfolio seeks to preserve the value of an investment at $1.00 per share, it is possible to lose money by investing in a money market portfolio.

There can be no assurance that any particular stable value will achieve its investment objective or, to the extent applicable, that it will be able to maintain a stable NAV of $1.00 per Unit. The value of investments and income derived from investments will fluctuate and can go down as well as up. A loss of principal may occur.

Stable value funds typically invest in “stable value contracts,” under which the insurance company or other financial institution contracts issuer agrees, subject to certain conditions, to make payments from the contract in connection with redemptions for plan participant-initiated benefit payments. Stable value contract risk includes credit risk with respect to the obligations of contract providers. Stable value contracts have terms that provide contract withdrawals relating to certain redemptions may not be paid at full contract value, and also define certain termination events that permit the provider to terminate the contract in which case the fund could be exposed to losses. These types of provisions could limit a stable value fund’s ability to maintain a stable NAV of $1.00 per Unit.

Participants in stable value funds are also exposed to risks associated with investing in the fixed income markets, including interest rate risk, credit risk and call/extension risk. For example, changes in interest rates will impact the return earned by the fund as well as the relative market value to book value ratio of a stable value fund.

**The Goldman Sachs Limited Maturity Obligations Fund** invests in a broad range of high quality, U.S. dollar-denominated money market and other fixed income instruments, including obligations issued or guaranteed by the U.S. Government, its agencies, authorities, instrumentalities or sponsored enterprises, obligations of U.S. banks, corporate notes, commercial paper and other short-term obligations of U.S. companies, states, municipalities and other entities, fixed and floating rate asset-backed securities and repurchase agreements. The Fund may also invest in U.S. dollar-denominated obligations issued or guaranteed by foreign banks, companies and governments or their agencies, authorities, instrumentalities or sponsored enterprises. The Fund is not a money market fund and does not attempt to maintain a stable net asset value. The Fund is subject to NAV risk, which means that the net asset value of the Fund and the value of investments in the Fund will fluctuate. The Fund’s investments in fixed income securities are subject to the risks associated with debt securities generally, including credit, liquidity and interest rate risk. Any guarantee on U.S. government securities applies only to the underlying securities of the Fund if held to maturity and not to the value of the Fund’s shares. Because the Fund may invest heavily in specific sectors (for example, the financial services sector), the Fund is subject to greater risk of loss as a result of adverse economic, business or other developments affecting such sectors. Foreign investments may be more volatile and less liquid than investments in U.S. securities and are subject to the risks of adverse economic or political developments. Investments in asset-backed and receivables-backed securities are subject to prepayment risk (i.e., the risk that in a declining interest rate environment, issuers may pay principal more quickly than expected, causing the Fund to reinvest proceeds at lower prevailing interest rates).

**The Goldman Sachs Enhanced Income Fund** invests primarily in a portfolio of U.S. dollar denominated fixed income securities, including non-mortgage U.S. government securities, corporate notes, commercial paper, fixed and floating rate asset-backed securities and foreign securities. The Fund’s investments in fixed income securities are subject to the risks associated with debt securities generally, including credit, liquidity and interest rate risk. Any guarantee on U.S. government securities applies only to the underlying securities of the Fund if held to maturity and not to the value of the Fund’s shares. Foreign investments may be more volatile and less liquid than investments in U.S. securities and are subject to the risks of adverse economic or political developments. Derivative instruments may involve a high degree of financial risk. These risks include the risk that a small movement in the price of the underlying security or benchmark may result in a disproportionately large movement, unfavorable or favorable, in the price of the derivative or benchmark. At times, the Fund may be unable to sell certain of its illiquid investments without a substantial drop in price, if at all.

**The Goldman Sachs High Quality Floating Rate Fund** invests primarily in high quality floating rate or variable rate obligations, and the Fund considers “high quality” obligations to be (i) those rated AAA or Aaa by a nationally recognized statistical rating organization at the time of purchase (or, if unrated, determined by the Investment Adviser to be of comparable quality), and (ii) U.S. government securities, including mortgage-backed securities, and repurchase agreements collateralized by U.S. government securities. The Fund’s investments in fixed income securities are subject to the risks associated with debt securities generally, including credit, liquidity and interest rate risk. Any guarantee on U.S. government securities applies only to the underlying securities of the Fund if held to maturity and not to the value of the Fund’s shares. Investments in mortgage-backed securities are also subject to prepayment risk (i.e., the risk that in a declining interest rate environment, issuers may pay principal more quickly than expected, causing the Fund to reinvest proceeds at lower prevailing interest rates). Foreign investments may be more volatile and less liquid than investments in U.S. securities and are subject to the risks of adverse economic or political developments. Derivative instruments may involve a high degree of financial risk. These risks include the risk that a small movement in the size of the underlying security or benchmark may result in a disproportionately large movement, unfavorable or favorable, in the price of the derivative or benchmark; the risk of default by a counterparty; and liquidity risk. At times, the Fund may be unable to sell certain of its illiquid investments without a substantial drop in price, if at all.

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