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# Stable value funds: Considerations for plan sponsors

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**Executive summary.** The financial crisis of 2007–2009 has had a lingering effect in many asset classes, including stable value. Closures of some stable value funds and capacity restrictions in others have introduced uncertainties to stable value as an option for defined contribution plan participants. Higher fees for wrap insurance, constrained wrap availability, and more restrictive investment guidelines have furthermore led some plan sponsors to reassess their stable value offering.

Stable value's unique investment strategy and benefits over other fixed income alternatives, as well as a fund's portfolio characteristics and performance, are also important factors. Stable value's bondlike returns with lower volatility, along with its expectation of assurance (but not a guarantee) of principal protection, continue to make it an attractive option for both plan sponsors and participants.

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Therefore, although stable value remains a popular choice for plan participants, it may not be appropriate for every 401(k) plan. Stable value should be considered in light of the plan’s design, participant demographics, and likelihood of “plan events.” Plan sponsors should weigh these factors, along with ongoing market uncertainties and administrative challenges, against stable value’s attractive performance record and protection of book value.

The protracted effects of the 2007–2009 financial crisis continue to be felt in many asset classes, including the fixed income area known as stable value. Not only have some stable value funds closed permanently, but others have experienced capacity issues that restrict access to them.<sup>1</sup> Also, despite the lower returns of money market funds versus those of stable value funds, some plan sponsors are electing money markets over stable value for their plan portfolios (Myers, 2010). The reasons they give for dropping stable value have included concerns about the rising cost of wrap fees charged by providers, the future availability of wrap insurance, and “restrictions on certain investment choices required by wrap contracts”<sup>2</sup> (Steyer, 2011b). Other reasons cited have been wrap provider constraints on plan-sponsors’ communications with participants and the yet-unresolved Dodd-Frank<sup>3</sup> regulatory limbo as to “whether or not a stable value fund is considered a swap contract” (Gutner, 2011). These uncertainties and challenges have prompted some plan sponsors to take another look at stable value and to ask if the funds are still an appropriate offering for their participants.

### Is stable value the right fit for your plan?

Although stable value remains a popular choice for plan participants, it may not be appropriate for every 401(k) plan. Your plan’s design, participant demographics, and risk or frequency of “plan events”—for example, corporate activities such as employee layoffs, division sales, or M&A (mergers and acquisitions)—are important considerations in the stable value decision.

Although stable value’s investment strategies have remained largely the same, in recent years plan designs have often become more complex, sometimes conflicting with wrap providers’ more detailed and tighter contract terms when brokerage options, advice programs, and target-date funds have been added. Stable value is no longer permitted to serve as a qualified default investment alternative (QDIA) for contributions made after December 24, 2007, with the result that plans may re-enroll their participants to encourage use of funds with some equity exposure (McKay Hochman, 2012). Also, plans that decide to map assets to another fund may be required to wait 12 months or longer; or,

*Notes on risk: All investments are subject to risk. Investments in bond funds are subject to interest rate, credit, and inflation risk. Past performance is no guarantee of future returns.*

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1 At the same time, a positive trend may be emerging, in that rising fees for wrap insurance have induced more wrap providers to enter the market (Mercado, 2012); at least one new stable value fund has also been launched in 2012.

2 Steyer (2011a), described the Federal Reserve’s shift to a laddered bond approach from its guaranteed-investment-contract (GIC)-laden stable value fund.

3 This refers to the federal Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in 2010.

to get their assets sooner, participants may have to accept the lower of a fund's market versus book value (Mercado, 2012).

Another consideration is that if your plan has a large percentage of inactive (term-deferred) participants who are no longer making contributions, there is a higher probability of outflows than inflows for your stable value fund. This imbalance may have a negative impact on investors who remain in the fund.

One of the advantages of stable value funds is fund participants' ability to withdraw their funds at book value, rather than at the underlying market value of the assets, as is the case for unwrapped bond funds. However, this option does not extend to the plan as a whole. Keep in mind, also, that because plan events such as M&As may trigger larger-than-normal cash flows, most wrap contracts do not extend the right of immediate book-value withdrawals in such cases (Mercado, 2012).

### A checklist for your stable value fund

To evaluate the appropriateness of any plan offering, it's important for you, as plan sponsor, to examine all aspects of a fund. Understanding the fund's asset class and investment mandate—and, in the case of stable value, its contract terms—is critical. In general, transparency is key: A clear, written description of the primary characteristics of your stable value fund should be readily accessible to plan sponsors. The following rundown of stable value funds' distinctive characteristics should assist you in evaluating the asset class as an ongoing or potential plan offering. (See also appendix **Figure A-1** for a summary comparison of stable value fund characteristics and their advantages/disadvantages versus money market and short-term bond funds.)

- **Portfolio manager(s).** A consistent team dedicated to stable value is important. Numerous changes in the investment management may increase the probability of changes in a fund's investment strategy.

- **Investment objective.** Stable value funds seek to earn a return similar to that of a short-term bond fund and to maintain a constant \$1 net asset value.<sup>4</sup> Investors look to stable value to provide both "capital preservation and a steady, predictable return on their investment" (Myers, 2011; LaBarge, 2011).
- **Investment strategy.** Most stable value funds invest in an underlying diversified portfolio of high-quality, short- to intermediate-term fixed income investments "wrapped" with an insurance-like product by a bank or life insurance company; this pairing results in a synthetic guaranteed investment contract (GIC). The wrap contract allows the stable value fund to use book-value, rather than market-value, accounting, and has resulted in smoother returns over time. Given the challenges in securing sufficient high-quality wrap capacity, some funds are returning to traditional GICs, in which the investment management and the wrap contract are offered by the same insurance company (Laise, 2010).
- **Portfolio characteristics, including sector and credit-quality distribution, of the underlying fixed income investments.** Stable value funds are most often a diversified portfolio of U.S. Treasury and government-agency debt, short- to intermediate-term corporate bonds, asset-backed securities, and mortgage-backed debt securities.
- **The fund's market value to book value (MV/BV) ratio.** The MV/BV ratio is a measure of a fund's collateralization (that is, the fund's underlying assets). Rising interest rates cause the market value of a stable value fund's underlying fixed income assets to fall more rapidly than the fund's book value, resulting in a lower MV/BV ratio. When the ratio is less than 100%, the market value of the underlying securities has fallen below that of the fund's book value;<sup>5</sup> participants receive \$1 per share when they exchange from a stable value fund, but the fund may be getting less than \$1 per share from the sale of assets required to reimburse participants.<sup>6</sup>

4 Despite this similarity to a money market fund, a stable value fund should not be considered a cash-reserve fund with a higher yield.

5 During the credit crisis of 2007–2009, the market values of many stable value portfolios fell below their book value, and some MV/BV ratios dropped well below 100%, causing the wrap providers to reevaluate the risk profile of their business.

6 See Xia and Graef (2012) for a detailed analysis of the effects of rising interest rates and cash outflows on stable value funds.

To amortize the difference between book and market values, the fund's book-value crediting rate may need to be reset downward.<sup>7</sup> For instance, should interest rates rise sharply, money market funds' yields might be higher, over the short term, than those of stable value funds. This would happen because stable value funds' yields follow the trend in current market interest rates, but with a lag.<sup>8</sup>

- **The stable value contract.** Provisions of stable value wrap contracts—specifically, the competing fund rule<sup>9</sup>—may restrict participants' ability to exchange from a stable value fund to other investment options, and may have a resulting impact on a plan's design. A contract's terms also detail "plan events" that could negate the book-value guarantee. At the same time, the contract specifies that a sponsor's communications with participants generally should be limited to basic information on investing,<sup>10</sup> while also allowing the sharing of stable value fund data such as portfolio characteristics, the MV/BV ratio, fund performance, and names of a fund's wrap provider.
- **Credit quality of the wrap providers.** Knowing the credit rating and outlook of the wrap provider is important in evaluating a stable value fund's overall risk. As the MV/BV ratio falls below 100%, the differential is the potential amount that the wrap provider must make up,<sup>11</sup> and the fund's credit exposure to the wrap provider thus increases. It's important for plan sponsors to be

aware of this aspect when evaluating insurance-company products such as traditional GICs, which are backed by the company's general-account assets rather than using third-party wrap providers.

- **Fund performance.** Comparison of a stable value fund's short- and long-term returns against market benchmarks—such as the 3-month U.S. Treasury bill, the Hueler Analytics Stable Value Pooled Fund Index (hereafter, the Hueler Index), and the Barclays Stable Income Market Index (SIMI)<sup>12</sup>—is an important indicator of the consistency of the fund's positioning and investment strategy over time.

### Stable value's fixed income alternatives

Although returns for fixed income assets, including those of stable value funds, have trended down since the early 1990s, stable value has lived up to its name. As shown in **Figure 1**, stable value's ability to use book-value accounting has resulted in smoother performance over time versus not only money market instruments but short- and intermediate-term bond funds, a characteristic that has continued to draw investors to the asset class. Although stable value returns have at times lagged those of money market funds when short-term rates spiked up, stable value—as represented by the Hueler Index—has outperformed money market funds every year since 1990.

7 Stable value funds' use of book-value accounting smooths any difference between a fund's market value and its book value (amortized cost plus credited interest) over time. This smoothing occurs via the fund's crediting rate, also known as the book-value yield.

8 For example, when the yield curve was inverted in 2006–2007—that is, short-term yields were higher than long-term yields—money market funds yielded more than stable value funds. However, over the longer term, stable value funds typically outperform money market funds by capturing the higher relative performance of the short- to intermediate-term bond funds underlying the wrap contracts.

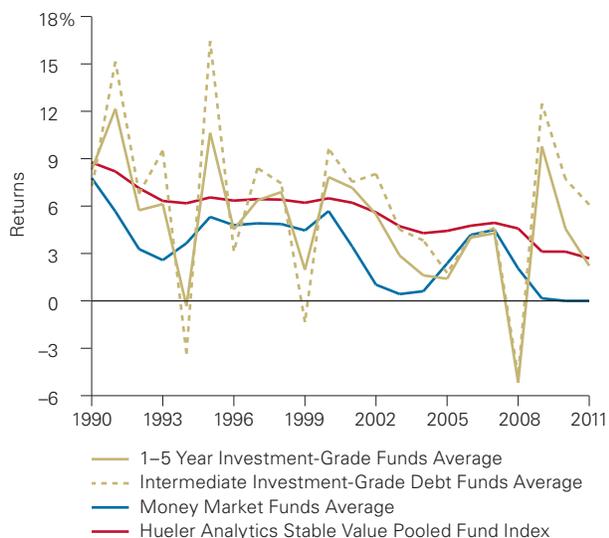
9 Traditionally, competing funds were most often fixed income funds such as money market or short-term bond funds. Some wrap providers now consider the self-directed brokerage account option in 401(k) plans as a "competing fund" (Myers, 2010).

10 Both the competing fund rule and restrictions limiting participant communications aim to constrain a fund's cash inflows and outflows. This is because stable value funds typically invest in short- to intermediate-term bonds while offering participants the ability to redeem at book value, irrespective of the underlying market value.

11 However, the wrap contract "issuer payment obligation is triggered only after the supporting assets are fully liquidated to pay plan benefits" (Mercier et al., 1988: 131).

12 The Barclays SIMI, launched in October 2010, was designed to be a diversified, short-term portfolio of fixed income securities that "fairly reflect[ed] the constraints imposed by wrap providers" (Barclays, 2010). However, the index is a market-value benchmark and does not measure the impact of the wrap contracts.

**Figure 1.** Stable value returns have been smoother over time than those of other fixed income alternatives: 1990–2011



Sources: Vanguard calculations, using average annual peer-group returns from Lipper Inc. and Hueler Analytics, Inc. Stable value funds are represented by the Hueler Index.

Over the long term, stable value fund returns have been a function of the returns of their underlying investments. Thus, as shown in **Figure 2**, their returns have generally been more comparable to short- to intermediate-term bond funds and higher than those of money market funds. Return smoothing from the book-value guarantee has resulted in low volatility, in line with that of money market funds.

**Figure 2.** Stable value has delivered bondlike returns with lower volatility: 1990–2011

	Hueler Index	Money Market Funds Average	1–5 Year Investment-Grade Funds Average	Intermediate Investment-Grade Debt Funds Average
Average annual returns	5.61%	3.26%	4.93%	6.13%
Standard deviation	1.56	2.20	3.88	5.23
Maximum returns	8.76	7.77	12.15	16.46
Minimum returns	2.69	0.00	-5.18	-4.76

Note: “Hueler Index” refers to the Hueler Analytics Stable Value Pooled Fund Index.

Sources: Vanguard calculations, using average annual peer-group returns from Lipper Inc. and Hueler Analytics, Inc.

Of course, to use book-value accounting, stable value relies on a wrap contract, which, as mentioned, includes various restrictions and constraints. Thus, there are trade-offs between using stable value and less restrictive, but more volatile, fixed income alternatives.

### Weighing the stable value decision

Stable value, along with other fixed income asset classes, continues to feel the effects of the 2007–2009 credit crisis. However, stable value funds’ unique investment strategy, which brings with it an assurance (but not a guarantee) of principal protection, as well as the funds’ potential for lower volatility, makes stable value a desirable option versus fixed income alternatives for plan sponsors and participants.

Stable value’s popularity notwithstanding, sponsors should be aware that stable value may not be an appropriate choice for every 401(k) plan. As detailed in this paper, a fund should be considered in light of a plan’s design, participant demographics, and the likelihood of “plan events.” Plan sponsors should weigh these factors, along with ongoing market uncertainties and administrative challenges, against stable value’s attractive performance record and book-value protection.

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## Appendix

**Figure A-1.** Comparison of characteristics and associated advantages (+) and disadvantages (–) for stable value, money market, and short-term bond funds

	Stable value funds (SV)	Money market funds (MM)	Short-term bond funds (S-T)
<b>Investment objectives</b>	Seek to maintain \$1 share price (NAV) and to generate current income.	Seek to maintain \$1 share price (NAV) while providing current income and liquidity.	Seek to provide current income while maintaining limited price volatility.
<b>Accounting method</b>	Contract/book value (BV).	Amortized cost.	Market-value (MV).
<b>Liquidity</b>	<ul style="list-style-type: none"> <li>+ Participant-directed withdrawals at BV, even when MV lower.</li> <li>– But, no BV protection for plan events.</li> <li>– Participant exchanges subject to competing fund rule.</li> <li>– Plan mapping to another fund may require 12+ months' wait.</li> </ul>	<ul style="list-style-type: none"> <li>+ Participant-directed withdrawals at NAV.</li> <li>+ As an open-ended mutual fund, can redeem shares at any time.</li> </ul>	<ul style="list-style-type: none"> <li>– Participant-directed withdrawals at MV.</li> <li>+ As an open-ended mutual fund, can redeem shares at any time.</li> </ul>
<b>Interest rate risk and duration/average maturity</b>	Weighted duration of about 1–4 years. Risk minimized by wrap contracts, which allow asset valuation at BV.	Minimal interest rate risk: weighted average maturity of less than 60 days.	Slight interest rate risk: weighted duration of about 1–4 years.
<b>Relative performance</b>	+ Generally outperform MM in most market environments.	+ May outperform SV when short-term rates rise quickly.	+ Generally outperform MM in most market environments.
<b>Volatility of returns</b>	+ Given the return smoothing via SV's crediting rate, changes in interest rates reflected more slowly than for bond funds.	+ Relatively low return volatility, comparable to SV.	Return volatility historically between that of MM and intermediate-term bond funds.
<b>Regulatory uncertainties</b>	– Unresolved: SEC and CFTC (Dodd-Frank Act) determination of SV wrap as a swap contract.	– Unresolved: SEC determination of fixed versus floating NAV or required capital buffer.	+ None.
<b>Additional considerations</b>	<ul style="list-style-type: none"> <li>– Higher fees for wrap contracts; wrap capacity improving but remains constrained.</li> <li>– Wrap providers place restrictions on plan design and plan sponsor communications with participants.</li> </ul>		

Notes: Money market funds' liquidity requirements are set by Securities and Exchange Commission (SEC) Rule 2a-7, which requires 30% of assets to be held in securities convertible into cash within five business days. Also, taxable money markets must hold at least 10% of their assets in securities convertible into cash by the next business day.

The stable value and money market "Regulatory uncertainties" mentioned here are scheduled to be resolved in the latter half of 2012. If wrap contracts are deemed to be swap contracts, an exemption could be created if the SEC and the U.S. Commodity Futures Trading Commission (CFTC) decide it would be in the public interest (*Pensions & Investments*, 2012).

Source: Vanguard.



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