



Stable Value Funds... how safe are they?

Executive Summary

Stable value funds are widely used throughout the 401(k) retirement plan market place. It is estimated that at least 80% of 401(k) plans have them as an investment option. They are very often selected by plan participants as the cash-equivalent investment that offers safety of principal; *especially* since recent market declines have been so devastating to account balances. In response, even more employees are directing their investment dollars to the stable value option.

The cause for concern?

The credit and housing crisis, which began in 2008, has created conditions which have brought into question the true safety and liquidity of these funds. As fixed income securities have lost "market value", the underlying value for most of these funds have fallen noticeably below their "book value"; meaning the true value for some of these funds are worth as little as 85 cents on the dollar. In addition, the liquidity provisions employed by stable value funds, which allow "employer-initiated" withdrawals to be delayed by up to twelve months, have ostensibly turned these "cash-equivalent" investments into illiquid assets for some plans. "Employee-initiated" transactions are still generally liquid in order to meet the plan's benefit provisions. Astute fiduciaries need to take note and educate themselves on this topic in order to appropriately evaluate the risks associated with these funds for the benefit of their employees.

In the long run, PrimeTRUST Advisors believes that most stable value funds will find their footing again as the bond markets recover. However, we believe that stable value funds which are currently "underwater" will provide reduced rates of return to investors and, in many cases, may prove to be illiquid should the employer attempt to change to a different cash-equivalent fund option for the plan.

Additionally, there are some longer-term questions about what stable value funds will look like in the future. It is questionable whether insurance companies will issue "wrappers" for these funds as easily as they had in recent years. It is also questionable whether these managers will continue to build their diversified bond portfolios to include some of the riskier assets many currently hold, which ultimately calls into question what reasonable return expectations for these funds will be. Unfortunately these questions cannot be fully assessed until credit markets normalize and financial institutions resume normal business operations. Like everyone, we hope this will take place sooner than later.

Overview

Traditionally, stable value funds invested in Guaranteed Insurance Contracts (GICs) which offered cash equivalent-like returns with relatively high safety of principal. The



investment objective for most stable value funds is to attempt to generate annual returns 0.50% to 1.00% greater than traditional money market accounts.

In attempting to achieve the higher returns expectations, stable value funds have evolved into diversified bond portfolios “wrapped” with contractual “book-value” guarantees issued by insurance companies. As such, these funds *generally* invest in high-quality bonds with short- to long-term maturities. Given the corporate bond market decline that occurred at the height of the fear permeating the credit crisis, most stable value funds find themselves “underwater”.

But... cash equivalent type funds are supposed to be “stable” and not experience volatility in their values.

Stable value funds seek to manage this “stability” in two ways. First, investment returns are smoothed over time considering existing cash flows and “crediting rates”. Second, stable value funds seek to achieve safety of principal by purchasing “wrappers” from insurance companies that guarantee the principal value of the fund. The well-managed stable value fund can then protect the principal and smooth the investment returns over time. However, as the market value of the underlying bond portfolio rises and falls, the insurance company may be on the hook for the difference... and it could be called upon at an inopportune time.

Accordingly, the ultimate safety of a stable value fund hinges on the contracting insurance company's ability to meet its guarantees. Related to this, however, is the issue of the *quality* of the stable value fund's underlying fixed income investments. Those stable value fund managers holding riskier fixed income securities (*in an effort to boost returns*) have potentially created an even wider gap between the portfolios' market value and its book value; potentially exposing insurance companies to greater liability. This could be problematic for troubled insurers.

Current Concerns

We all understand that the capital markets are on shaky ground.

To combat the gap between the market value and book value, many stable value funds are utilizing several methods to shore up their funds. First, they are modifying their current “crediting rate”. The “crediting rate” is the calculated interest rate that investors receive each month. The “gap” between market value and book value is incorporated into the calculation and so current investor's credited returns are being “reduced” from the actual yield to make up for losses on bond holdings. Second, many stable value funds are also exercising a “twelve-month put option”, which allows the fund to delay “plan level” distributions by up to twelve-months. This is a typical contractual provision of the fund designed to protect *existing* investors in the fund from realizing market losses due to the “forced selling” of distressed assets. Third, as we mentioned earlier, these funds are realizing significant cash inflows; these current positive cash inflows help the funds improve their market value to book value ratios. Many critics, however, have begun sensationalizing this fact by to comparing these funds to “ponzi schemes”, since,



in theory, it will be the “last investor” remaining who will ultimately be holding any unrealized capital losses.

The impact of all this may turn out for the common good, as most insurance companies are now executing their business operations much more conservatively. As such, they are not issuing as many “wrappers”; meaning stable value funds may not be able to obtain the “guaranteed” provisions they were looking for unless they invest the underlying portfolios much more conservatively. Of course, this likely means investors will see reduced rates of return in the future, but the integrity of the preservation of principal concept will be much more in tact.

Conclusion

Not all stable funds will be exposed to the risks we discussed in this article. Some funds still invest in traditional GICs while others have ventured into all aspects of the fixed income markets. As such, it is important to understand each stable value fund’s strategy, allowable investments, current portfolio holdings, changes in policy and credit rates, operational requirements, and whether the fund can get new “wrappers” to assess its true safety of principal and future.

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