Stable Value FAQ
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What is a stable value fund?

Stable value funds are capital preservation investment options available in 401(k) plans and other types of savings plans. They are invested in a high quality, diversified fixed income portfolio that are protected against interest rate volatility by contracts from banks and insurance companies. Stable value funds are designed to preserve capital while providing steady, positive returns. Stable value funds are considered a conservative and low risk investment compared to other investments offered in 401(k) plans.

How widely used are stable value funds?

Stable value funds are offered in approximately half of all 401(k) plans and some 529 tuition savings plans. Individuals have invested $701.3 billion in stable value funds through 189,000 defined contribution plans as of 12/31/2012, which include 457, 403(b) and 401(k) plans. Stable value funds are one of the most widely used investments by 401(k) investors. Investors on average allocate roughly 15 to 20 percent of their 401(k) assets to stable value funds.

How are stable value funds structured?

Stable value funds are structured in two ways: as a separately managed account, which is a stable value fund managed for one specific 401(k) plan; or as a commingled fund, which pools together assets from many 401(k) plans. Commingled funds offer the benefits of diversification and economies of scale for smaller plans.

Regardless of how stable value funds are structured, they are comprised of a diversified portfolio of fixed income securities that are insulated from interest rate movements by contracts from banks and insurance companies. The protection from interest rate volatility is universal to stable value funds. How this contract protection is delivered depends on the type of stable value fund investment purchased. The contract protection against interest rate volatility is provided through the following investment instruments:

- **A Guaranteed Interest Contract (GIC)** is a contract with an insurance company that provides principal preservation and a specified rate of return over a set period of time, regardless of the performance of the underlying invested assets. The invested assets are owned by the insurance company and held within the insurer’s general account.

- **A separate account contract** is an account held by an insurance company that holds a combination of fixed income securities and provides principal preservation and a specified rate of return over a set period of time. Separate accounts may provide either a fixed rate of return or a periodic rate of return based on the performance of the underlying assets. The assets are owned by the insurance company and are set aside in a separate account solely for the benefit of the specific contract holder.
A synthetic GIC is a diversified portfolio of fixed income securities that are insulated from interest rate volatility by contracts (wraps) from banks and insurance companies. In this arrangement, the 401(k) plan and its participants own the underlying invested assets—the portfolio of fixed income securities that support the stable value fund.

The typical stable value fund will diversify contract protection by investing in more than one instrument type and/or with more than one insurance company or bank.

What does protection against interest rate volatility mean?

The market value of all fixed income investments, including the underlying assets in a stable value fund, is volatile by nature. Translation: the market value of the assets moves inversely with the interest rate changes. As interest rates move up, the market value of the assets declines, and vice-versa. This volatility is not unusual.

Unlike other 401(k) investments, however, all stable value funds have protection against interest rate swings by way of protections made possible through insurance company and bank contracts. This means investors in stable value funds are able to transact (make deposits, withdrawals, transfers, etc.) at book or contract value. This is principal plus accrued interest.

Should the market value of the stable value fund’s underlying assets be insufficient to honor benefits for covered withdrawals at book value, the contractual protection kicks in to ensure that participants continue to transact at contract value. Contract value, or book value, is the value of all assets supporting the stable value fund plus the contractual protection against interest rate volatility.

Are there instances when book value or contract value does not apply?

There are a few, limited instances when participants do not get book value from a stable value fund. These limited instances are typically contractually defined. One such instance typically not covered is security defaults or downgrades. In order to protect the integrity of the stable value fund, most contracts incorporate investment guidelines establishing minimum credit quality requirements for the underlying securities. These contracts have established mechanisms to address downgraded or defaulted securities that fall outside the contractual guidelines.

Corporate-initiated events, which are employer-driven events such as an early retirement program, layoff, or bankruptcy, are also typically not covered. Corporate-initiated events generally cause withdrawals in masse from a stable value fund. These withdrawals can negatively impact investors and plans that choose to remain in the fund. Additionally, the cost for insurance against such events would be prohibitive. To treat stable value fund investors equitably and to maintain reasonable costs, employer-initiated events are not covered in most contracts. However, because these events are typically known in advance, the 401(k) plan sponsor and the
stable value fund generally have time to negotiate coverage of these events so that all
participants continue to transact at book value.

This did not occur in the Lehman Brothers bankruptcy due to a combination of extenuating
factors: the financial markets had undergone a historic adjustment, the scale of the Lehman
Brothers’ bankruptcy (it is the largest bankruptcy ever), the speed at which the bankruptcy
proceeded, and the veracity of the bankruptcy-half of Lehman Brothers’ workforce lost their jobs
immediately. The immediacy of the bankruptcy did not give the stable value fund time to work
out protections to keep the stable value returns positive. Consequently, Lehman Brothers stable
value fund investors had a negative return of 1.7 percent in December and an annual return for
2008 of 2 percent.

What happens in bankruptcy to a stable value fund?

There are several ways a stable value fund may be affected by bankruptcy. The 401(k) sponsor or
employer may go into bankruptcy. As stated above, bankruptcy is typically considered a
corporate or employer-initiated event and may not be covered by a stable value fund. However,
because there is a process for bankruptcy, the 401(k) sponsor and the stable value fund
generally have time to negotiate coverage during the bankruptcy so that all participants continue
to transact at book value.

A stable value fund may also be impacted by bankruptcy if an issuer of a stable value fund
investment becomes insolvent. In the event of an insurance company insolvency, a general
account GIC contract holder would have claim at the policyholder level, in front of the insurer’s
general creditors. For a separate account contract, the separate account assets are used solely
to satisfy the claims of the contract holder. Any shortfall would be subject to claim against the
insurer’s general account, alongside policyholders and ahead of general creditors.

If an issuer of a contract that wraps or covers a fixed income portfolio (synthetic GIC) became
insolvent, it is important to remember that the bulk of the assets—the portfolio of fixed income
securities that support the stable value fund—are already owned by the 401(k) plan and its
participants. In the event of any ultimate claim against the issuer for failure to meet any financial
obligation under the contract, such claim would be settled during the normal bankruptcy
process.

Insolvencies among stable value issuers have been rare. When this did occur in the late 1980’s,
participants were made whole. The assets affected by the failure of three issuers — Executive
Life, Confederated Life and Mutual Benefit—represented less than one percent of stable value
assets.
Are there waiting periods and other restrictions that affect withdrawals?

Stable value funds do not have waiting periods or surrender charges for participants. In fact, the accounting rules for stable value funds do not permit these types of restrictions on participant-driven transactions.

Most stable value funds have equity wash provisions that restrict transfers from stable value funds directly to competing funds. Competing funds are typically money market funds or short-duration bond funds.

The restriction requires transfers from stable value to sit in an equity fund for a set period of time, usually 90 days before the transfer is invested in a competing fund. Equity wash requirements serve to minimize arbitrage, which negatively impacts investors who choose to remain in the stable value fund.

In cases where a plan sponsor wishes to terminate its participation in a commingled stable value fund, a 12 month put or waiting period may be imposed to protect remaining investors by ensuring an orderly liquidation of the departing fund’s proportionate share of the stable value fund’s underlying assets. However, plan participants continue to transact at book/contract value.

Given its fixed rate nature, GIC contracts may impose a surrender charge if the stable value fund elects to terminate the contract prior to its stated maturity date.

What do I need to know about stable value funds?

The investment objective of stable value funds is to provide capital preservation and predictable steady, returns. During 2008, stable value funds were one of the few 401(k) investments that produced a positive return. Stable value fund returns generally ranged between 3 to 5 percent for 2008. Stable value funds are comprised of a diversified portfolio of fixed income securities that are insulated from interest rate movements by contracts from banks and insurance companies. The protection from interest rate volatility is universal and unique to stable value funds.

How are stable value funds regulated?

Stable value funds have multiple layers of government oversight, with the vast majority of fund regulated by the Department of Labor’s Employee Benefits Security Administration and must comply with federal pension law (Employee Retirement Security Act). Stable value funds in defined contribution plans for state and local governments — 457 plans — are state regulated.

Additionally, stable value investment structures provided by banks are regulated by the Office of the Comptroller of Currency, insurance companies are regulated by the various state insurance companies.
departments, and commingled investment funds are regulated by the Securities and Exchange Commission under the Investment Company Act.

Further, to qualify for contract value accounting and reporting, corporate defined contribution plans must comply with accounting regulations defined by the Financial Accounting Standards Board (FASB) while state and local defined contribution plans must comply with the Governmental Accounting Standards Board (GASB).

Both FASB and GASB have certain criteria that must be met by all stable value funds. Requirements include:

- The contract is effected directly between the fund and the issuer and prohibits the sale or assignment of the contract or its proceeds to another part without the consent of the issuer.

- The repayment of principal and interest credited to participate in the fund is a financial obligation of the issuer of the contract. Prospective interest-crediting rate adjustments are permitted as long as they are not less than zero, and the contract issuer must be a financially sound institution.

- The terms of the contract require all permitted participant-initiated transactions with the fund to occur at contract value.

- An event that limits the ability of the fund to transact at contract value with the issuer and limits the fund’s ability to transact at contract value with participants in the fund must not be probable of occurring.

- The fund itself must allow participants reasonable access to their funds.

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**Are stable value funds risk free?**

No. All investments have risks associated with them. Stable value funds are considered to be one of the lowest risk investments offered in 401(k) plans. They have return stability similar to a money market fund but generate higher returns. Because of their low risk and stable, consistent returns, they can help diversify 401(k) asset allocation. As an investor, you should evaluate your risk tolerance to make sure you are comfortable with the level of risk in your stable value fund and other investments.
Notes

1 Stable Value Investment Association 17th Annual Investment and Policy Survey.