
The Short Answer

For Safety-First Savers, Stable-Value Funds Are Tough to Beat

By [Adam Zoll](#) | 04-16-13 | 06:00 AM | [Email Article](#)

Question: My employer's 401(k) plan offers a stable-value fund that seems to offer better returns than any money market I've come across. Are these plans the same as cash?

Answer: For savers in search of a low-risk investment vehicle with a little more income than one might get from a bank or money market mutual fund, stable-value funds are a great choice. Unfortunately, they are only available through employer-sponsored retirement plans, such as 401(k), 403(b), and 457 plans and through some 529 college-savings plans.

In a sense, stable-value funds serve a similar role in a 401(k) as that played by a money market fund in a taxable account. It's a safe place to keep cash that is waiting to be invested or as a long-term, low-risk holding. Stable-value funds don't provide much in the way of returns these days. They paid 2.6% on average in 2012, according to a survey by the [Stable Value Investment Association](#), which represents the industry. But that's still much better than the 0.03% paid out by the average money market fund during the same period.

About half of all 401(k) plans offer stable-value funds, according to the SVIA, and 11% of all 401(k) assets were invested in stable-value funds at the end of 2011, according to the Investment Company Institute.

What They Invest In

Stable-value funds typically hold diversified portfolios of high-quality fixed-income securities, including Treasuries, corporate bonds, and mortgage-backed securities. A look at the underlying portfolios of stable-value funds at the end of 2011 shows that 26% of assets were held in mortgage-backed securities, 24% in publicly traded corporate bonds, 16% in Treasuries, and the remainder in other low-risk investment vehicles, including cash.

Because they invest in both short- and intermediate-term bonds, stable-value funds can offer higher returns than money market funds, which invest only in very short-term securities. Stable-value fund portfolios averaged 3.7 years duration, a measure of interest-rate sensitivity, at the end of 2012, with an average credit rating of around AA, according to the SVIA.

Structural Differences

To help ensure that they live up to the first part of their name, stable-value funds are protected from interest-rate volatility through contracts with banks or insurance companies in which the financial institution agrees to protect the fund's principal and guarantees a rate of return over a given time period even if the underlying portfolio of investments loses money. These are sometimes referred to as wrap contracts or wrappers. This guarantee allows the fund to use the book value (the value of its principal plus interest) rather than the more volatile market value of its holdings in calculating what the fund's assets are worth.

Some stable-value funds use a Guaranteed Interest Contract structure, in which

the fund enters into a contract with an insurance company that provides a guaranteed rate of return while taking ownership of fund assets and adding them to its general account, which is used to back its guarantee. A synthetic GIC works in a similar fashion but with the retirement plan retaining ownership of fund assets while entering into a contract with a bank or insurance company. A third structure, called a separate account contract, offers either a fixed rate or a periodic rate of return based on the performance of the fund's portfolio, with assets owned by the insurance company but set aside in an account specifically designated for the plan.

Not Completely Risk-Free

The protections afforded by these contracts mean that if the fund's underlying portfolio loses value, the bank or insurance company will step in to cover the shortfall. It is possible, however, for stable-value fund investors to lose money, and that's why the securities can't be considered as safe as true cash instruments. One way is if securities in the fund's portfolio experience a default or downgrade, in which case the contract's guarantees may not apply. That's why stable-value funds typically have strict quality guidelines regarding the securities in which they invest. There also is a risk that the insurance company defaults on its obligations, which is why stable-value funds typically contract with more than one financial institution and might also use more than one contract structure.

Yet another risk involves the employer that sponsors the plan. If the employer declares bankruptcy or has mass layoffs that precipitate large withdrawals from its plan's stable-value fund, the fund could be forced to sell securities to meet redemptions, thus incurring losses. Those losses may not be covered by the contracts. Such was the case with the Lehman Brothers bankruptcy in 2008, when the company abruptly laid off half of its workforce. The firm's stable-value fund lost 1.7% that December, though it still managed a 2% gain for the year. In less extreme cases when there is more time to prepare for potential problems, the employer and the stable-value fund may make arrangements to anticipate strong outflows from the fund without investors losing the book value of their holdings.

Despite these real but unlikely risks, stable-value funds have a well-earned reputation as a safe investment vehicle. They are strictly regulated, with many falling under the purview of the Employee Benefits Security Administration and subject to the Employee Retirement Income Security Act. Stable-value funds in state and local government retirement plans are regulated at the state level.

Have a personal finance question you'd like answered? Send it to TheShortAnswer@morningstar.com.

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