Why Investors Choose Stable Value

BY GINA MITCHELL

Editor’s Note: Gina Mitchell is president of the Stable Value Investment Association (SVIA), and this article confines itself to a discussion of stable value investments. It does not discuss other strategies that also can provide consistently positive returns in defined contribution plans.

Stable value is a popular investment in defined contribution plans today. The Hewitt 401(k) Index™ reports that stable value funds represent roughly 20–25 percent of all defined contribution plan assets, even though not all plans have a stable value option available. Hewitt reports that stable value’s share of 401(k) assets are in line with the amounts invested in U.S. equities and company stock.1

So why do stable value funds attract such a large share of defined contribution investors’ nest eggs? The answer is that investors today have to shoulder most of the burden for saving and investing for their retirements, and they are very concerned about the risk of losing money in the stock and bond markets. Because stable value funds provide the opportunity for consistently positive returns, these funds have become an important tool that retirement investors can use to build a more balanced and risk-controlled retirement.

Stable Value Fund Characteristics

For more than 30 years, stable value funds have provided consistent performance for defined contribution retirement plan investors in

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FIGURE 1 Stable Value Funds Earn Higher Returns than Money Markets

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public and private employer-sponsored retirement plans. By itself, this makes stable value funds very attractive to investors. But stable value funds provide the following other benefits as well:

- Returns that are generally higher over the long-term than money market funds and cash.
- Stable value funds outperform money market funds during most market environments, as shown in figure 1.
- Less risk to principal than bond funds.

Stable value funds provide higher returns because they hold intermediate-maturity investments plus companion wrapper agreements that provide protection of principal and accumulated earnings for investors. As a result, stable value funds tend to produce long-term returns that are comparable to intermediate-maturity bond funds. Unlike bond funds, however, stable value funds do not fluctuate in value with changes in interest rates, so their volatility or risk is substantially less than that of a bond fund.

These characteristics help explain why, when defined contribution plan investors have access to a stable value fund, they allocate 33 percent of their total 401(k) savings to stable value.²

What Is a Stable Value Fund?

A stable value fund is a conservative investment vehicle that is available in more than half of all defined contribution employee benefit plans. It is used by defined contribution plan investors to provide principal preservation and stable returns that are in line with the long-term returns of intermediate bonds.

Stable value funds invest primarily in diversified portfolios of intermediate-duration, investment-grade fixed-income securities. The average quality of these funds is typically AA+ or better. Stable value portfolios are covered by wrapper agreements that provide return stability and preservation of principal and accumulated earnings.

Why Investors Want Stable Value

In addition to the desirable investment characteristics that stable value funds offer, several societal trends fuel investors’ consistent commitment to stable value: the equity bear market, the aging of the population, the shift in responsibility for retirement savings, and investors’ awareness of investment risk.

The equity bear market made investors more cautious

The recent bear market in equities made many investors recognize the need for balanced portfolios to protect their nest eggs from equity-market volatility. Flows into stable value funds increased significantly in the past several years as investors recalibrated portfolios to include a higher percentage of conservative assets and bring risk exposures in line with true tolerances. The allocation to stable value funds of total defined contribution assets for plans participating in the SVIA survey grew from 23 percent in 1997 to 33 percent in 2002 and has stayed at that level since then.³
Stable value use increases as investors get older

Stable value is popular with investors of all ages, but, as Table 1 shows, it is most popular with older investors. Allocation to stable value by those in their 60s reaches 21 percent compared with 12.1 percent for all ages in the survey.4

Investors take on more responsibility for retirement savings

The U.S. retirement system once was like a “three-legged stool” comprised of Social Security, an employer-provided pension, and individual savings. For this system to work, all three legs need to be equally strong and balanced. However, with the enormous financial pressures on Social Security and defined-benefit pensions today, the U.S. retirement system is fundamentally out-of-balance.

Social Security is not sustainable under its current rules. Projections show that unless it is reformed, it will be able to cover only 74 percent of program costs after 2041 when the vast majority of baby boomers will be drawing benefits.5

Employer-provided pensions also have undergone a major transformation over the past 20 years. Increasingly, defined-benefit plans that promise a percentage of salary as a retirement benefit have been replaced with defined-contribution plans that provide a self-directed savings vehicle. This has shifted the investment risk from employers to workers who have little investment experience or training.

An increasingly mobile workforce also means that investors are tempted to spend rather than preserve retirement savings each time they change jobs. The Congressional Research Service reports that 14.3 million workers have been faced with the choice of spending or rolling over retirement savings at least once since 1998.6

Investors are more aware of investment risk

Many investors are hungry for investment vehicles that help to mitigate investment risk without sacrificing returns, as evidenced by the popularity of stable value funds in 401(k) plans and the rapid growth in stable value funds. The SVIA 2002 Conservative Investment Survey documented this sensitivity to risk.7 The survey found a surprisingly low tolerance for risk among 401(k) investors, with only 7 percent reporting that they were willing to take a substantial risk for a substantial gain. The majority (64 percent) of 401(k) investors said they were willing to take a moderate amount of risk in exchange for a moderate return. Twenty-eight percent said they would only take a small or minimum amount of risk, even if it reduced the money they would make on their investments.8

Not surprisingly, retirees are more risk-sensitive than 401(k) investors because they have fixed incomes and readily understand that a loss can mean a reduced standard of living. The majority (58 percent) of retirees said they preferred a retirement investment portfolio that allows them to take the least amount of risk necessary to achieve a steady stream of income. Only 37 percent of retirees said they were willing to take a moderate level of risk to receive moderate returns, and 1 percent reported a willingness to take a high level of risk in hopes of having high returns on investments.9

Stable value’s characteristics of principal protection, dependable

### TABLE 1 Average Assets of 401(k) Accounts by Participant Age, 2004

<table>
<thead>
<tr>
<th>AGE</th>
<th>EQUITY FUNDS</th>
<th>BALANCED FUNDS</th>
<th>BOND FUNDS</th>
<th>MONEY MARKET FUNDS</th>
<th>STABLE VALUE FUNDS</th>
<th>COMPANY STOCK</th>
<th>OTHER</th>
<th>UNKNOWN</th>
<th>TOTAL</th>
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<tr>
<td>20s</td>
<td>51.6</td>
<td>13.0</td>
<td>9.0</td>
<td>5.1</td>
<td>6.0</td>
<td>12.6</td>
<td>1.3</td>
<td>1.4</td>
<td>100</td>
</tr>
<tr>
<td>30s</td>
<td>56.1</td>
<td>10.3</td>
<td>8.3</td>
<td>3.6</td>
<td>5.4</td>
<td>13.5</td>
<td>1.5</td>
<td>1.3</td>
<td>100</td>
</tr>
<tr>
<td>40s</td>
<td>50.9</td>
<td>10.2</td>
<td>8.7</td>
<td>3.6</td>
<td>8.4</td>
<td>15.4</td>
<td>1.7</td>
<td>1.1</td>
<td>100</td>
</tr>
<tr>
<td>50s</td>
<td>43.8</td>
<td>10.3</td>
<td>10.3</td>
<td>4.1</td>
<td>13.3</td>
<td>15.1</td>
<td>1.9</td>
<td>1.2</td>
<td>100</td>
</tr>
<tr>
<td>60s</td>
<td>36.5</td>
<td>9.5</td>
<td>12.3</td>
<td>4.8</td>
<td>21.0</td>
<td>12.6</td>
<td>1.9</td>
<td>1.4</td>
<td>100</td>
</tr>
<tr>
<td>All</td>
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<td>10.1</td>
<td>9.8</td>
<td>4.0</td>
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<td>14.5</td>
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<td>1.3</td>
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</tbody>
</table>

Source: Holden and VanDerhei (2005)
income generation, and diversification struck a cord with the majority of retirees and 401(k) investors who responded to the survey, as shown in Table 2.10

**Can Stable Value Be a Wrong Choice for Investors?**

Despite the trends discussed, stable value can be a wrong choice for investors who are focused only upon return. Return-driven-only investors should avoid stable value funds and other conservative investments because stable value cannot provide the higher returns that higher-risk investments can provide.

Investors who want to market-time also should avoid stable value for two reasons. Stable value funds provide steady or “stable” returns, which means that as interest rates rise, stable value returns will rise, too. However, stable value funds can trail other conservative investments in a rapidly increasing interest rate environment. This characteristic also explains why stable value funds typically impose trading restrictions, which prevent arbitrage opportunities with competing conservative investments such as bonds or money markets.

**Conclusion: Why Choose Stable Value?**

Given our societal trend toward having workers bear the investment risk and responsibility for their retirement savings, an investment vehicle that provides bond-like returns, money-market-like volatility and liquidity, and low correlation with equities is a critical tool in helping investors provide for retirement security. These investment attributes are present in stable value funds, which defined-contribution investors have appreciated for more than 30 years. Clearly, stable value funds will continue to play an important role in helping Americans save for their retirements.

Gina Mitchell is president of the Stable Value Investment Association, a non-profit organization established in 1990 to educate plan sponsors and participants about the importance of saving for retirement and the contribution that stable value investments can make toward achieving retirement security. Contact her at gina@stablevalue.org.

**Endnotes**

3. Ibid., 3.
4. Sarah Holden and Jack VanDerhei, “401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2004,” Investment Company Institute (ICI) Perspective Web-Only Edition vol. 11, no. 4a (September 2005): 15, available on the World Wide Web at http://www.ici.org/pdf/per11-04.pdf. The data summarized covers 2004 and 16.3 million 401(k) investors in 45,783 plans with $926.2 billion in assets. Note that the ICI data about asset allocation to stable value differ from the SVIA survey data because the surveys cover different samples. The SVIA survey includes 97,854 plans, all of which have a stable value option with total assets. The ICI survey includes four investment plan types, only two of which contain a stable value option. ICI reported that allocation to stable value rose to 21.5 percent for plans that had equity, bond, money market, or balanced funds and stable value; and to 20.1 percent for plans that offered equity, bond, money market, and/or balanced funds, company stock, and stable value.
8. Ibid., 19.
9. Ibid., 42.
10. Ibid., 66.