Defined contribution (DC) plan fiduciaries are required to periodically review their fund offerings to ensure that their plans provide participants with a variety of prudent investment options.

Although stable value funds have historically outperformed most other principal preservation alternatives, fiduciaries must determine whether these funds are suitable for their participants.

This brief compares the benefits and risks of the principal preservation options typically available to plan participants. It also highlights considerations for sponsors as they evaluate these options.
Why offer a principal preservation option to plan participants?

Under U.S. Department of Labor regulations issued under Section 404(c) of the Employee Retirement Income Security Act, DC plan fiduciaries will not be liable for losses resulting directly from participants’ exercise of control over their accounts if, among other requirements, the plan provides an investment menu that includes diversified funds from a range of asset classes (equity and fixed income) and a low-risk capital preservation option. Capital preservation typically includes both money market and stable value funds.

As reported in *How America Saves 2019*, approximately 98% of all DC plans for which Vanguard provided recordkeeping services in 2018 offered either a money market fund, a stable value fund, or both. Over 99.5% of all participants had access to these principal preservation options.

Although money market funds and stable value funds both seek to provide current income and preserve investors’ principal by maintaining a net asset value (NAV) of $1 per share, they achieve this through very different means.

Stable value and money market funds: A closer look

Money market mutual funds are Securities and Exchange Commission-registered funds that invest in very short-term, high-quality securities. The amount of income a shareholder may receive from these securities largely depends on the current interest rate environment for such investments. The funds are designed to provide maximum liquidity to investors and thus are considered one of the most conservative investment options.

In contrast, stable value funds, which are not SEC-registered, invest directly or indirectly in high-quality short-to intermediate-term fixed income investments. These investments typically provide more income than money market investments, but unlike the very short-term investments held by money market funds, their daily value can fluctuate significantly. As a result, stable value funds must purchase insurance (for instance, through a group annuity contract) against daily market fluctuations that allows the funds to use book-value, rather than market-value, accounting so the funds can maintain the $1 per share NAV.

Stable value fund structures

Stable value funds come in a variety of forms, including:

Separately/individually managed. This structure is typically plan- or sponsor-specific, with access limited to participants of a single sponsor and managed under a single investment management and fee agreement, which may be customized. These are generally cost-effective only in the large-market segment. In this structure, plan-specific risks are isolated, but plans are subject to individual underwriting review by insurers. In certain instances, the risk profile of a plan may limit an insurer’s willingness to provide insurance to the plan or at least result in higher fees for the insurance coverage (known as benefit-responsive/wrap fees), regardless of size.

Collective/commingled trust. This structure “pools,” or combines, the assets of multiple sponsors’ plans (for example, Vanguard Retirement Savings Trust III). It makes stable value funds accessible to smaller plans that may be unable to offer a separately managed fund. These funds may offer pricing flexibility but typically cannot be customized.

Guaranteed investment contract (GIC). At a high level, these come in two forms: a general account contract and a separate account contract.

General account. Also referred to as a “traditional” GIC, this is the simplest form of GIC. It is a pure contractual arrangement with the issuing insurance company. The plan receives a fixed rate of return, which can be set for the life of the contract or reset periodically as specified in the contract (for example, quarterly). The contract is backed solely by the financial strength of the issuing insurer. As a result, if the issuer becomes insolvent, the plan, along with other annuity policy holders, will have to wait for the resolution of the insololvency proceedings.

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1 Money market securities typically have a dollar-weighted average maturity of 60 days or less.
2 Money market funds do not have competing fund restrictions on participant trades or exit provisions for plan sponsors (for example, because of plan lineup changes).
3 This is often a point of confusion among plan fiduciaries. Some suggest that the insurance component makes stable value funds “safer” than money market funds, which is not correct. The insurance component is simply an inherent requirement of being able to maintain a stable NAV.
**Separate account.** This GIC is supported primarily by associated assets in a segregated account held by the issuing insurance company. If the separate account assets are inadequate to cover the benefits owed under the contract, the insurer’s general account assets and surplus are used. The securities in this account are owned by the insurance company but are held for the exclusive benefit of the plan or plans participating in the separate account. If stipulated in the investment contract, the separate account assets may not be used to satisfy any of the insurer’s other liabilities if it becomes insolvent. Any shortfall relative to the contract value would have to be recovered via the insolvency proceedings (similar to a general account contract).

Each option may have different cost structures, risk characteristics, and contractual restrictions (see the “risks and restrictions” section on page 4). Fiduciaries should consider all of these factors before making a decision.

**Performance expectations and fees**

Because stable value funds invest in longer-duration securities, these funds are generally expected to provide returns that exceed those of money market funds over the long term, consistent with returns of short- to intermediate-term bonds. In managing performance expectations, plan fiduciaries must be aware that past performance is not a guarantee of future results. In addition, as suggested in our last review of this topic (Dorfler, 2016), the performance gap between stable value and money market funds has narrowed since the latest Federal Reserve tightening cycle began in 2015 (see Figure 1). Because of their comparatively short-duration investments, money market funds will reflect rate changes much more quickly than will stable value funds, which have longer-duration portfolios. But ultimately, stable value fund yields will migrate toward current market yields and over the long term should deliver performance that is in line with expectations. Importantly, although stable value funds have historically outperformed inflation, this is typically not a stated objective of the fund.

**Figure 1. Vanguard Retirement Savings Trust III 30-day SEC yield versus Vanguard Prime Money Market Fund 7-day SEC yield**

The performance data shown represent past performance, which is not a guarantee of future results. Investment returns will fluctuate. Current performance may be lower or higher than the performance data cited. There may be other material differences between products that must be considered prior to investing.

**Note:** Data are from December 2003 through May 2019.

**Source:** Vanguard.
However, current yield is not the whole story. Fiduciaries must consider the costs and risks associated with the various options. Stable value fund expenses typically include the investment management fee, costs associated with the underlying investments, and benefit-responsive charges. Additional costs may include trustee, record-keeping, and subadvisory fees, depending on the structure of the product and the degree of customization, if any.

Different stable value structures provide different levels of fee transparency as well. Individually managed and commingled/collective trusts tend to be fairly transparent on management fees and costs, but insurance contract fees may be more difficult to understand. For example, fees on general account contracts are not explicitly disclosed. Plan sponsors must consider a product’s direct and indirect costs to ensure that they are consistent with performance objectives.

Risks and restrictions

As with all investing, there is no “free lunch” in pursuit of higher returns. There are trade-offs between offering stable value funds in a DC plan compared with investing in a less restrictive money market fund or other fixed income alternative.

Although a stable value fund is designed to be a low-risk investment, participants could lose money by investing in it. Stable value funds are neither insured nor guaranteed by the U.S. government, and there is no assurance that the fund will be able to maintain a stable net asset value per share.

The primary risk of investing in a stable value fund is “plan event” risk. This is the risk that the plan will experience an event that is not covered under its insurance contract(s). A stable value fund typically provides for payment at $1 per share only for daily participant transactions. Plan-level transactions (such as a reenrollment or change to the plan lineup and participant transactions in response to large corporate events, layoffs, divisional sales, and voluntary reductions in force) typically are not covered and may be paid out at less than $1 per share.

In contrast, money market funds are not subject to this risk because they do not rely on insurance coverage to maintain a stable NAV. Instead, a money market fund’s stable NAV is simply a function of its focus on very short-duration, high-grade securities.

Stable value funds are also subject to restrictions that are not applicable to money market funds. In addition to plan event risk, fiduciaries should consider these common restrictions:

- Advance notice is required for plan-level transactions if the plan wants to receive the full book value. As a result, plan fiduciaries must thoughtfully consider how to exit a stable value fund if the fiduciary decides that a different stable value manager or a different type of principal-protection fund would be more suitable for the plan. Plan-level transactions in stable value collective funds generally require at least 12 months’ notice to the manager. For some types of stable value options (such as traditional and separate account GICs, or other stable value contracts that are directly sold to sponsors), plan transactions may even have to be paid out over a period of several years or longer, or the plan’s withdrawal might be subject to a market-value adjustment or other redemption fee, regardless of advance notice.

- Certain plan communications with participants, as well as plan changes, must be reviewed by contract providers to ensure that they do not materially cause transfers out of the stable value option or otherwise influence participants to reduce their allocations to stable value. These communications may also cause participant withdrawals to be paid out at less than book value.

- Stable value funds require a more in-depth review by the plan fiduciaries than do money market funds. It’s not enough to understand investment strategy alone; stable value funds are principally a product of legal agreements. Consequently, legal counsel is often needed to review fund documents to understand fully the limits of when the fund will— and won’t— provide stable value for participants.

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4 Insurance company compensation is the difference between the yield of the contract and the earnings of the assets in the company’s general account.

5 Prime money market funds can be subject to fees and withdrawal restrictions (“fees and gates”) under certain circumstances, but these are generally limited to extreme market situations. In contrast, stable value funds are designed not to pay out at a stable value for certain investor-specific reasons, even if the financial markets and the fund itself are otherwise functioning normally.
Why consider stable value?

The primary reason to consider a stable value fund is its yield advantage relative to other principal preservation alternatives. Stable value fund returns are driven primarily by the performance of their underlying investments. Thus, their results are generally more comparable to those of short- to intermediate-term bond funds, which are generally higher than those of money market funds over the long term—a characteristic that has continued to draw investors to the asset class (see Figure 2).

Conclusion

Plan fiduciaries are not required to offer any particular type of investment as the protected-principal option. In reviewing money market versus stable value funds in this regard, fiduciaries should undertake a prudent process to understand and evaluate the benefits and risks of each and then make a reasoned choice. Either vehicle may be an appropriate investment option.

Stable value funds offer bond-like performance with much lower volatility than traditional bond funds. By contrast, money market funds had little return for several years after the global financial crisis, as a result of the zero-interest-rate environment. In recent years the performance gap has closed considerably, reflecting money market funds’ much greater sensitivity to interest rates.

Plan fiduciaries considering stable value funds should look at more than just their attractive performance record compared with other principal preservation options. In particular, the fiduciaries should scrutinize their plan’s design, participant demographics, and the likelihood of plan events that could limit the funds’ principal protection for some or all of their participants.

It is important to note that past performance is not a guarantee of future results. Although the performance of stable value and money market funds has converged (on a net basis) over the past few years, the advantage of stable value funds is likely to widen again. However, plan fiduciaries must weigh that potential advantage against the funds’ unique risks.

References


All investing is subject to risk, including the possible loss of the money you invest.

For more information about Vanguard funds, visit vanguard.com or call 800-662-2739 to obtain a prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

*For Vanguard Prime Money Market Fund: You could lose money by investing in the fund. Although the fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. The fund may impose a fee upon the sale of your shares or may temporarily suspend your ability to sell shares if the fund’s liquidity falls below required minimums because of market conditions or other factors. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The fund’s sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.

†For Vanguard Retirement Savings Trusts: An investment in the fund is neither insured nor guaranteed by the U.S. government. There is no assurance that the fund will be able to maintain a stable net asset value, and it is possible to lose money by investing in the fund.

For additional information about stable value investing, visit the Stable Value Investment Association at stablevalue.org.

Vanguard Retirement Savings Trust III is not a mutual fund. It is a collective trust available only to tax-qualified plans and their eligible participants. Investment objectives, risks, charges, expenses, and other important information should be considered carefully before investing. The collective trust mandates are managed by Vanguard Fiduciary Trust Company, a wholly owned subsidiary of The Vanguard Group, Inc.