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Stable-Value Funds are Looking More Stable These Days

By Daisy Maxey (reprinted with permission)

With the outlook improving for some of the fixed-income investments held by these funds, the possibility of a stable-value fund failing -- a prospect that was raised just months ago -- now looks unlikely.

Stable-value funds, which are an option in about two-thirds of defined-contribution plans like 401(k)s, invest in a diversified portfolio of fixed-income instruments. They typically invest in highly rated corporate debt and highly rated structured securities, such as asset-backed securities, commercial mortgage-backed securities, and residential mortgage-backed securities.

They back up these bonds with contracts, known as wrappers, from banks, insurers or other financial companies. Finding providers of those wrappers became a challenge for some funds earlier in the year.

Wrappers on the Rise

Now, insurers and others are becoming more willing to provide the wrappers, although the cost of the contracts has risen and cut into funds' returns.

Still, stable-value funds are returning one to two percentage points more than money-market funds, according to the Stable Value Investment Association. It says the funds held $642 billion in assets at the end of 2008.

A key measure of the funds' health -- the ratio of the actual market value of their underlying holdings to the funds' book value -- has improved. The average stable-value fund tracked by Hueler Cos. has a market value that is about 97.5% of its book value, up from about 95% earlier this year. It is still down from 99% at the end of last year.

Kelly Hueler, president and chief executive of Hueler, said she sees that gap continuing to close.

Previously, David Merkel, chief economist and director of research at brokerage firm Finacorp Securities, had said he wouldn't be surprised to see a stable-value fund fail this year.

Mr. Merkel now says he doesn't expect a failure. Stable-value funds' typical holdings have been faring better lately, except for commercial mortgage-backed securities, he noted.

Money had flooded from stocks into stable-value funds as investors shied away from risk. It began to trickle out as markets recovered in the second quarter, though some money flowed into them again on a net basis last month.

With higher fees and tighter investment guidelines, the contracts for wrappers now cost from 0.15% to 0.20% of assets annually, up from 0.08% to 0.12%, according to Betsy Vary, director of investment consulting for Buck Consultants LLC in New York.

Yields From 3% to 4%

Crediting rates -- essentially the yield investors receive from the funds -- are in the 3% to 4% range, Ms. Vary said.

Sue Walton, senior investment consultant at Watson Wyatt Worldwide, said a return to historical crediting rates of 5% isn't likely, because of the higher wrapper fees and new guidelines restricting bond portfolios in some cases.

While the funds' troubles haven't completely vanished, Ms. Walton said she doesn't expect any failures. "I think if we were going to see any problems, we would have seen that last year," she said.