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529 PLANS: ASSESSING THE STABLE VALUE OPTION

Why are an increasing number of states making stable value the conservative investment option in their 529 plans?

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EXECUTIVE SUMMARY

Should your 529 plan offer a principal-preservation investment option to plan participants?

Almost certainly.

Should that option be a stable value fund?

Again, almost certainly.

For years, many 529 plans offered money market funds as their conservative investment option. Now, they're increasingly replacing them with stable value funds. At least 35 of the nation's 102 plans currently include a stable value fund on their investment menu.¹ Among the recent converts are Iowa's College Savings Iowa plan and Connecticut's CHET Advisor plan, both of which jettisoned money market funds in favor of stable value offerings in 2017. Indiana's CollegeChoice 529 Direct Savings Plan made the same change to stable value in late 2016.

This trend prompts two important questions. First, why are so many states adding stable value funds to their 529 plans? And second, why are more than half still without them?

The answer to the first question is actually fairly simple: Stable value funds historically have delivered significantly higher returns than money market funds (their most common competitor), with little to no added volatility, as shown in Figure 2. And during the extended period following the 2008 financial crisis, when most money market funds were offering 0 percent returns, stable value funds looked all the more attractive. (Money market funds seek to earn interest for investors while maintaining a consistent net asset value of \$1 per share, although that value is not guaranteed and can fluctuate. Money market funds generally invest in a diversified portfolio of high-quality, short-term securities.)

The second question is a bit more complicated. Its answer revolves primarily around a lack of familiarity with the asset class on the part of some plan administrators, along with concerns about perceived challenges that, in the end, actually help account for stable value's unique appeal to many plan participants.

¹ College Savings Plans Network website, March 2018

WHAT IS STABLE VALUE?

Stable value is a conservative investment option built for safety and liquidity. It has been highly popular for decades in the defined contribution retirement plan market, where it is offered in about 167,000 plans² and accounts for more than \$700 billion in total retirement plan assets.³

When first introduced in the 1970s, stable value funds generally took the form of guaranteed investment contracts, or GICs. Issued by insurance companies, they were structured as group annuities and sold to defined benefit pension plans. GICs guarantee the return of principal and accumulated interest to their investors. Often, they guarantee the rate of interest for a specified period of time, too, after which it is reset. The rate reflects what the insurer is earning on its general investment account, less some margin of profit for the insurance company. The creditworthiness of a GIC is inextricably linked to the creditworthiness of the issuer, since the guarantees of the products are backed by the claims-paying ability of the guaranteeing insurance company.

While a number of insurers still offer these “general account” products, many more stable value funds today are structured as synthetic GICs, which were developed in the 1990s to provide more safeguards for investors. At a high level, they do so by separating the investment guarantees of the GIC from the ownership and management of the underlying financial assets, and by splitting responsibility for the investment guarantees among multiple insurers.

Rather than investing in the issuer’s general account, this newer type of stable value fund invests in its own separate portfolio of investment-grade, intermediate-term fixed-income securities. These securities are owned by the retirement plan rather than the insurance company, and managed by one or more independent investment managers who market the fund to plan sponsors. Finally, the portfolio is “wrapped” by one or more stable value investment contracts issued by insurance companies and, in some cases, banks. These wrap contracts guarantee “benefit responsive” withdrawals for the fund’s investors, meaning that, subject to certain restrictions, investors making withdrawals in the normal course of the fund’s operation will have access to their

principal and accumulated interest at book value—regardless of how the fund’s underlying securities are performing.

To minimize the risks associated with providing these guarantees, wrap issuers typically set investment guidelines for stable value asset managers specifying the types of investments they can buy. Wrap issuers also may set some limits on the ability of plan participants to transfer money directly out of a stable value fund and into a competing fund, such as a money market fund or short-term bond fund. Instead, investors must first transfer their money to an equity fund and leave it there for a prescribed period of time—usually 90 days. These “equity wash” rules are designed to reduce arbitrage opportunities between stable value funds and competing funds during periods of extreme market volatility, helping to minimize the possibility that stable value funds might be forced to sell assets at depressed prices to meet investor redemptions.

The return that a modern stable value fund delivers to investors is determined primarily by the performance of its underlying investment portfolio and is expressed as the fund’s “crediting rate.” The crediting rate is often guaranteed for a fixed period of time, such as one year, and then reset. It is calculated using a formula that amortizes differences between the book value and market value of the fund’s underlying investment portfolio over time. This mechanism smooths stable value returns, causing the crediting rate to fall more slowly than interest rates in a falling rate environment, and to rise more slowly in a rising rate environment.

With modern stable value funds, then, plan sponsors enjoy the security of retaining ownership of their stable value fund’s assets, and are no longer dependent on the creditworthiness of a single insurance company. They also enjoy the diversification benefits of having multiple guarantors (wrap issuers) and investment managers, as well as full transparency into the makeup of their fund’s investment portfolio.

Within a 529 plan, a stable value fund can be offered as a stand-alone investment option or as one of several underlying investments in an age-based or target-risk fund. When used

² “Stable Value at a Glance,” Stable Value Investment Association website, May 22, 2018

³ “Stable Value at a Glance,” Stable Value Investment Association website, May 22, 2018

as a stand-alone investment option, plan participants decide what percentage of their contributions they wish to allocate to the stable value fund. When used as a component of an age-based or target-risk fund, the manager of that fund

decides how much to allocate to stable value. In general, the shorter the fund’s investment horizon, or the smaller its appetite for risk, the higher the allocation to stable value.

HOW HAVE STABLE VALUE FUNDS PERFORMED

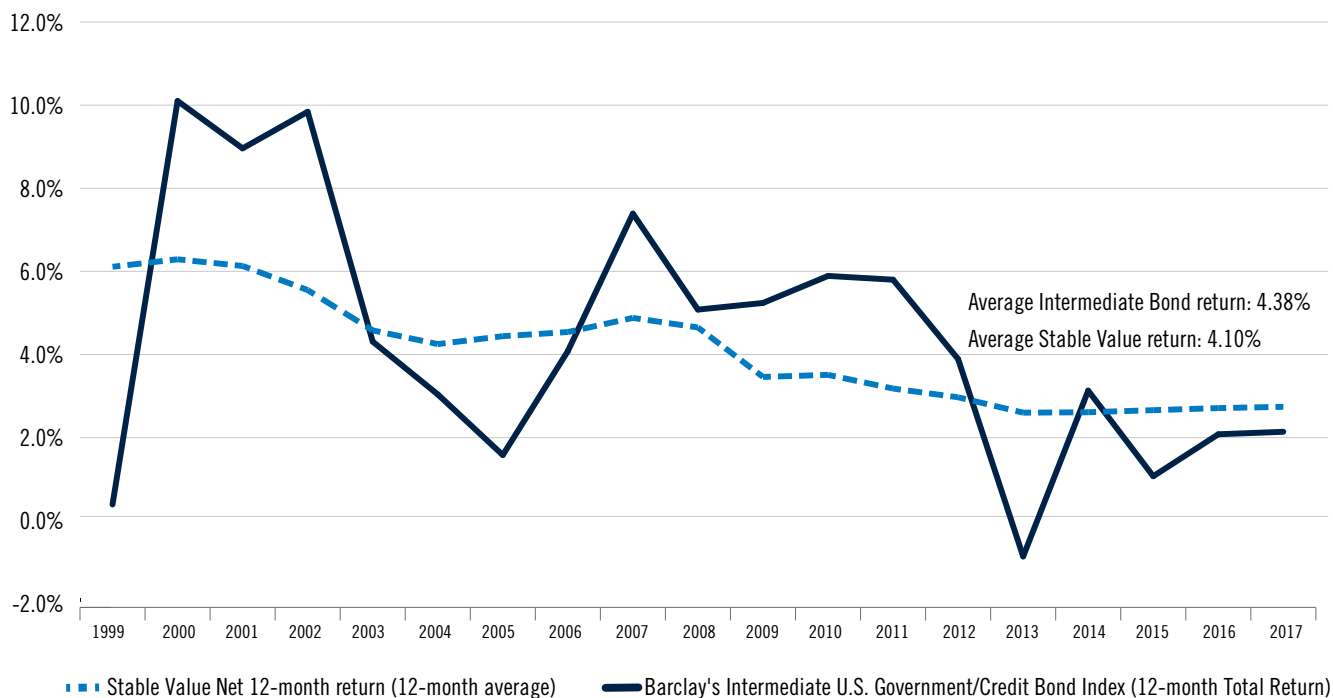
Stable value funds could be viewed as a best-of-both-worlds hybrid of investment-grade intermediate-term bond funds and money market funds. Their absolute returns have largely tracked those of the former asset class. (See Figure 1.) Meanwhile, thanks to their book-value accounting and crediting-rate mechanisms, they have largely mirrored or improved upon the low volatility characteristics of money market funds. (See Figure 2.) The happy result is that their long-term performance trends align neatly with the investment objectives of many 529 plan participants, who typically have much shorter investment horizons than retirement plan participants and an overarching concern for safety of principal.

Like investment-grade intermediate-term bonds, stable value funds have outperformed money market funds over time. It’s

worth noting that this performance advantage can be eroded during periods of rapidly rising interest rates, since money market funds invest exclusively in very short-term securities that react more rapidly to rate changes. In practice, however, such reversals have been rare. Meanwhile, unlike money market funds, stable value returns also have outpaced inflation over time, meaning they have done a better job preserving the purchasing power of their investors. (See Figure 2.)

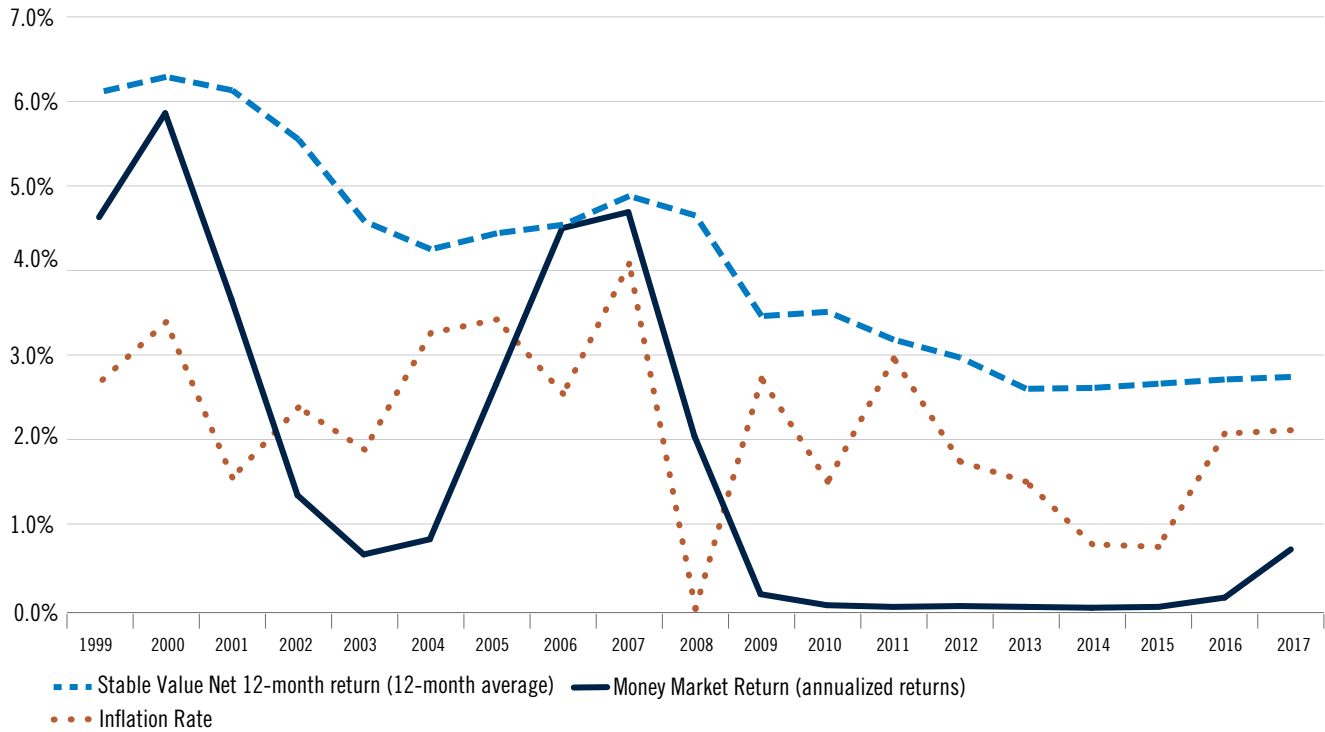
Finally, stable value funds have delivered consistent performance through a wide variety of investment environments, including periods of rising interest rates and the 2008 financial crisis. Figure 3 compares stable value performance with the trend in the federal funds rate from 1999 through 2017.

Figure 1: Stable Value Returns Track Intermediate-Term Bonds, but with Less Volatility



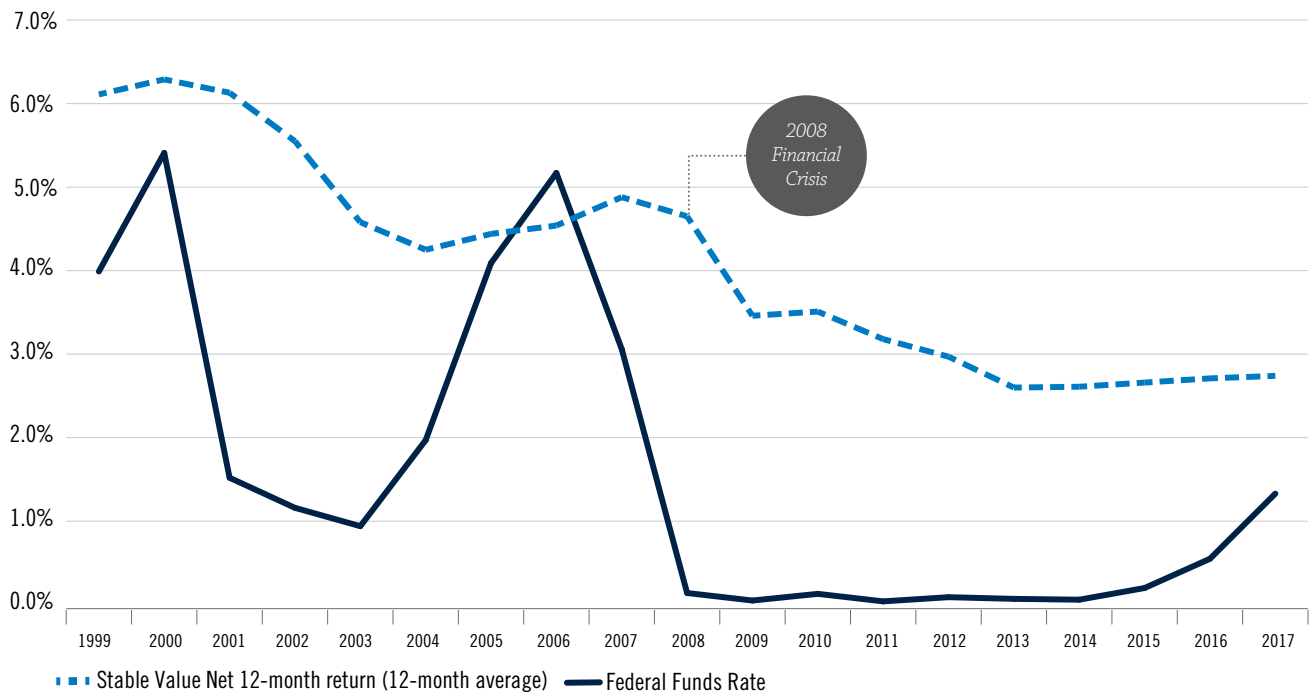
Source: Stable Value Returns: “SVIA 19th Annual Stable Value Investment & Policy Survey”, 1999-2017. Net 12-month return. Intermediate Bond Returns: “Barclays Intermediate Government/Credit Bond Index”, 1999-2017. Returns illustrated are gross before any fees.

Figure 2: Stable Value Crediting Rates Versus Money Market Returns and Inflation Rates



Source: Stable Value Returns: "SVIA 19th Annual Stable Value Investment & Policy Survey", 1999-2017. Net 12-month return.
 Money Market Returns: "iMoneyNet MFR Money Funds Index", 1999-2017. Returns illustrated are gross before any fees.
 Inflation Rates: Bloomberg, 1999-2017.

Figure 3: Stable Value Has Delivered on its Promise Across Multiple Investment Environments



Source: Stable Value Returns: "SVIA 19th Annual Stable Value Investment & Policy Survey", 1999-2017. Net 12-month return.
 Federal Funds Rates: Macrotrends, 1999-2017.

Figure 4 below shows how stable value compares with money market funds and investment-grade intermediate-term bonds in terms of their investment objectives, their

underlying investments, the behavior of their yields and their protections for an investor's principal.

Figure 4: Asset Class Comparison

	STABLE VALUE	MONEY MARKET	INVESTMENT GRADE INTERMEDIATE-TERM BOND
OBJECTIVE	Safety of principal while providing intermediate-term fixed income returns	Safety of principal while providing short and ultra-short-term fixed income returns	Safety of principal while providing intermediate-term fixed income returns
UNDERLYING INVESTMENT	High quality intermediate-term fixed income securities	High quality liquid securities such as government securities, CDs and commercial paper	High quality intermediate-term fixed income securities
YIELDS	Rate may be fixed for a period of time, with many stable value products providing a guarantee for a minimum rate of return	Rates fluctuate with short-term interest rates	Rates fluctuate with intermediate-term interest rates
SAFETY OF PRINCIPAL	Book value and accumulated earnings guaranteed by the issuer	Net asset value generally stays constant	Market value fluctuates based on bond prices and exposure to credit risk within the portfolio

WHY MORE 529 PLANS ARE TURNING TO STABLE VALUE

The growing interest in stable value funds among 529 plan sponsors is attributable in large part to the tight alignment between the benefits they offer and the needs of their investors. With their relatively short investment horizons, many participants in 529 plans place a premium on protecting their principal. They want to be sure their money is available when they need it. At the same time, they appreciate seeing their account grow in value. Stable value addresses these twin priorities with:

- Book-value guarantees that help assure access to principal and accumulated interest, regardless of financial market conditions.

- Crediting-rate formulas that can smooth out the impact of market volatility on investment returns.
- Returns that historically have outperformed those of the most common conservative investment option, money market funds, helping put 529 plan participants closer to achieving their investment goals.

The growing interest in stable value also may be explained by the fact that some administrators of 529 plans are familiar with its use in state-sponsored 403(b) and 457 retirement savings plans. Over time, this may have made it easier for them to support the introduction of stable value funds in 529 plans, too.

WHY HAVE SOME STATES NOT EMBRACED STABLE VALUE IN THEIR 529 PLANS?

Many of the same factors that have prompted some plan sponsors to embrace stable value factor into why others have not—but in reverse. Some plan administrators, for example, are not involved in their state’s 403(b) or 457 plans, and as a consequence may not be familiar with stable value. In other cases, their 403(b) or 457 plans simply may not offer stable value, again making it an unfamiliar asset class.

Meanwhile, some plan administrators likely remember that the stable value industry’s wrap capacity was challenged in the immediate aftermath of the 2008 finance crisis, when market turmoil prompted a number of wrap issuers to exit the market. What they may not know is that several new wrap

issuers entered the market shortly after the crisis.⁴ Since then, wrap capacity has expanded greatly and generally is no longer a constraint on the asset class.⁵

Finally, plan administrators with only passing familiarity with stable value may consider it more complicated, less transparent and more expensive than other investment options—without fully appreciating that these are tradeoffs that may often make sense for 529 plan participants. In fact, the widespread use of stable value suggests that many plan sponsors and plan participants have concluded that the benefits of the asset class justify its costs and distinctive characteristics. Let’s take a closer look.

INSIDE THE TRADEOFFS: ASSESSING STABLE VALUE’S PERCEIVED BENEFITS AND CHALLENGES

The perceived challenges some plan administrators associate with stable value are in many cases critical to delivering the benefits that make the asset class so appealing, not only to their peers who may have already adopted it but also to the administrators of the more than 160,000 retirement savings plans that offer stable value to their plan participants.⁶ Let’s look at some of the more commonly cited challenges, and the benefits they deliver:

- **Contractual restrictions.** Equity wash rules relating to competing funds discourage arbitrage and minimize the chance that a stable value fund will have to liquidate assets when their values are depressed. This helps create a stronger, more sustainable asset class that protects the interests of the vast majority of stable value investors who do not try to benefit from arbitrage. Even so, this is primarily an issue for retirement savings plans, not college savings plans. Why? First, many 529 plans that offer stable value funds do not offer money market funds, which are the most common type of competing fund. Second, most 529 plans

permit participants to make exchanges among investments only twice each calendar year—quite a contrast to the daily trading permitted in most retirement savings plans. This, too, makes arbitrage—and the competing fund restrictions aimed at preventing it—less of an issue in the 529 plan market.

- **Expenses.** While the all-in expense ratio for a stable value fund may be higher than it is for traditional stock and bond funds, expenses are never the sole measure of an investment’s value and should always be considered against the benefits it offers. Stable value delivers unique book-value guarantees that generally aren’t available with other investment options.
- **Transparency.** This is less of an issue today than it was in the past. Many wrapped stable value funds now offer investors a direct view of their underlying investment portfolios. General account products may not offer the same level of transparency, but they may offer offsetting benefits, such as higher crediting rates and return guarantees in excess of 0 percent.

⁴ “New Wrap Capacity Offers More Opportunity for Growth . . . and Competition,” by Randy Myers, *Stable Value Times*, Stable Value Investment Association, First Half 2014

⁵ “Wrap Availability Puts Stable Value Back on Map,” by Robert Steyer, *Pensions & Investments*, April 28, 2014

⁶ “Stable Value at a Glance,” Stable Value Investment Association website, May 2, 2018 - <https://stablevalue.org/knowledge/stable-value-at-a-glance/>

THE OUTLOOK: IS STABLE VALUE RIGHT FOR MY STATE'S 529 PLAN?

More so than in the retirement plan market, where plan participants may have an investment horizon that stretches out four or more decades, administrators of 529 plans may be concerned about how the current investment climate impacts the decision of whether and when to add a stable value fund to their investment lineup—either as a stand-alone investment option, or as a component of their plan's age-based or target-risk offerings.

Given that stable value has been tested through a wide variety of investment climates—including both rising and falling interest-rate environments and the 2008 financial crisis—concerns about the investment outlook should not be the determining factor in deciding whether or when to introduce stable value to a 529 plan. Rather, plan

administrators should consider how doing so would impact plan participants. Among the questions to be considered:

- Would our plan participants benefit from a conservative investment option that guarantees access to principal and accumulated interest at book value?
- Would our plan participants benefit from a conservative investment option that historically has delivered returns similar to investment-grade intermediate-term bond funds, but with the liquidity and low volatility more commonly associated with money market funds?
- Would the managers of our age-based or target-risk investment options appreciate access to an asset class that can serve as the conservative anchor of a well-diversified investment portfolio—especially for those funds whose investors share the shortest investment horizons or the lowest threshold for risk?

COMPETITIVE PRESSURES MAY DRIVE FURTHER DEMAND FOR STABLE VALUE

As 529 plans become increasingly popular, many plan administrators may find adding a stable value option to their investment lineup a competitive necessity—especially in the wake of recent tax law changes.

College savings plans had already been growing in popularity heading into 2018 as college costs continued to soar, with many elite private universities now charging \$70,000 or more for a year of tuition, room, board and fees.⁷ Assuming a 3 percent inflation rate, parents could be looking at half a million dollars in college costs for today's newborns. And the closer those children get to starting college, the more concerned their parents will become with preserving what they've already saved and earned—while still generating a return on their investment.

Stable value funds, of course, offer a unique combination of principal preservation and steady growth. Now, though, some parents may find they have an even greater incentive to focus on stable value's benefits. Under the Tax Cuts and Jobs Act of 2017, qualified uses for 529 plan assets have been expanded to include not just postsecondary education but also qualified K-12 expenses—up to \$10,000 per year. With that change, some parents may find themselves tapping their 529 assets sooner than anticipated. If so, their keen focus on principal guarantees—and the appeal of stable value funds—may only be heightened.

Although seldom couched in these terms, the 529 plan market is competitive, with parents free to choose plans outside the state in which they reside. Already, most states make more than one 529 plan available, with some sponsored by states themselves, others by higher education entities and still others by financial services firms.

Strategic Insight, a financial research firm, has reported that over the three years ended December 31, 2017, assets in 529 plans grew to \$319 billion from \$247.9 billion. As those plans continue to grow in popularity, competition to attract investors is sure to heat up. Offering a stable value investment option is one way for 529 plans to enhance their appeal.

⁷ "Several Colleges in New England Now Cost \$70,000—or More," by Jaclyn Reiss, Boston Globe, February 22, 2018

CONCLUSION

Investors in 529 plans generally have much shorter investment horizons, on average, than investors in retirement savings programs. Most 529 plan participants will likely need to tap their accounts in 18 years or less, with some needing to access their entire balance with their first withdrawal. The net result is that while some 529 plan participants certainly want the ability to invest in higher-risk, growth-oriented assets, many, at some point, also want access to a

conservative investment option that can better safeguard their principal. Stable value funds offer a combination of returns and principal preservation guarantees that generally aren't available from other asset classes. Given these advantages, it seems likely that the number of 529 plan participants who view stable value as an attractive college savings tool will only continue to grow. Plans that fail to make it available to them may be doing plan participants a disservice.

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