BEACON POINTE ADVISORS

BEACON POINTE RESEARCH
WHITE PAPER

STABLE VALUE FUNDS – MUCH ADO ABOUT NOTHING?

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Stable Value Funds – Introduction

Stable value investments are fixed income investment vehicles offered through tax-deferred plans such as defined contribution savings accounts, mutual funds, and IRAs. Stable value funds are touted as an alternative for bonds and equities for those investors primarily interested in preservation of capital with the added advantage of dampened volatility. As a result of poor performance in the equity markets in recent times, stable value funds have gained tremendous popularity amongst investors, growing 300% in 2002 to $261 billion at the end of the year. Currently, total assets in stable value funds exceed $315 billion according to the Stable Value Industry Association.

Stable Value Funds – What is Being Touted……..

Stable value funds have gained significant traction as they have been proclaimed the investment vehicle of choice for those investors seeking capital preservation without taking market risk. In a stable value fund, the investors' principal and accumulated earnings are preserved because an insurer, bank, or other financial institution agree to maintain the net asset value (NAV). In contrast, the NAV of a bond fund varies as the interest rates fluctuate. The NAV of a mutual fund varies as the share prices of the holdings fluctuate. In other words, when the NAV declines, the banks or other financial institution absorb the losses.

Although money markets may preserve your capital, the low yields offered by these funds are not enough to offset the ravaging effect of inflation that will slowly eat away at the value of your money. By the time an investor retires, money parked in the money market funds is likely to buy much less than the investor foresees. In addition, for investors seeking bond funds as a safe haven at this time, in a rising interest rate environment, higher interest rates are likely to result in losses for these funds, as higher interest rates lower the value of the bonds. This can happen as investors might pursue higher yielding instruments forcing the funds to sell securities if they don't have enough cash on hand to meet redemptions. If interest rates fall, investors are likely to deposit more funds than expected causing capacity issues in that the fund managers will have to secure enough capacity for insurance coverage to catch up with asset growth. Insurance providers would then respond by asking for higher premiums making the contracts less attractive thus causing a drag in returns.

In contrast, stable value funds offer unique risk/return characteristics because they have some sense of certainty in preservation of capital and accumulated interest earnings. Stable value fund investors receive interest income comparable to that on investment grade corporate bonds, but without the associated market risks. Stable value funds also have similar stability as money market funds but significantly higher average interest rates.

The assets in a stable value fund are a mix of high quality, intermediate-term bonds, and guaranteed-interest contracts (GICs) from insurance companies. A stable value fund's portfolio is protected against interest rate risk by a bank or an insurance company through a wrap. Stable value funds use a broad array of fixed income investments to reduce risk and achieve appropriate investment returns. Stable value investments are typically purchased from financial institutions such as insurance companies, banks, investment management firms, or mutual funds.

In summary, advocates of stable value funds say that these funds incorporate the best features of bonds and money markets, while stripping the negative features of each. These funds have the higher returns of bonds with the stability and daily liquidity of money markets. However, when interest rates go back up, money markets will respond faster than the stable value funds because of the way these funds amortize gains and losses.

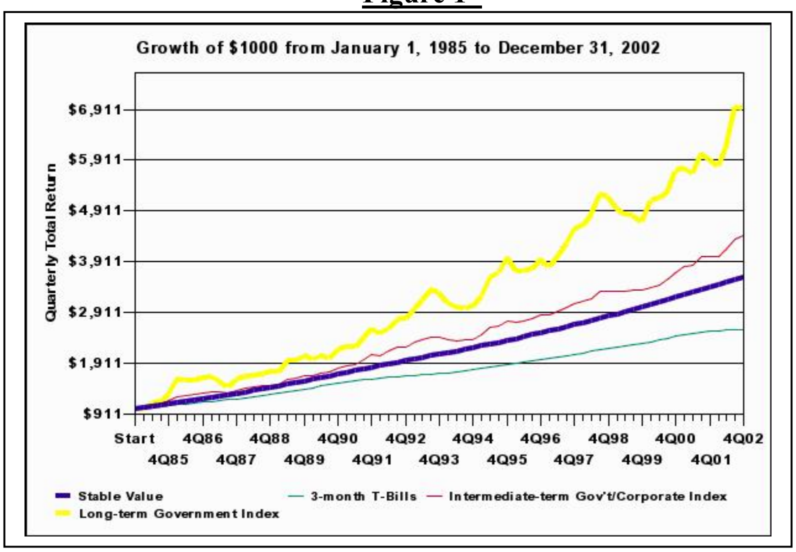
Stable value funds are available through employer-sponsored tax-deferred savings plans such as a 401(k). Stable value funds are also found in other tax-deferred savings vehicles such as 529 college savings plans and Individual Retirement Accounts (IRAs). In general, stable value funds have no withdrawal restrictions. However, since they are purchased with retirement plans, the restrictions imposed by the plan itself may prevent access to the stable value funds. Unlike a certificate of deposit, no penalties are incurred when you withdraw before maturity.

Since stable value funds are generally offered as part of a company's traditional defined contribution plan, their fees tend to be lower. The average stable value fund fee is 41 basis points. However, some of the funds charge as much as 100 basis points.

Stable Value Funds – What Is Not Very Well Known………

Although stable value funds are being touted as an alternative to bonds and equities, especially in an uncertain environment, long-term performance of stable value funds, when compared to bonds and equities, are certainly not stellar.

Figure 1*



$6930 – Long-term Govt. Index
$4424 – Inter Govt./Corporate
$3605 – Stable value funds
$2584 – 3-month T-bills

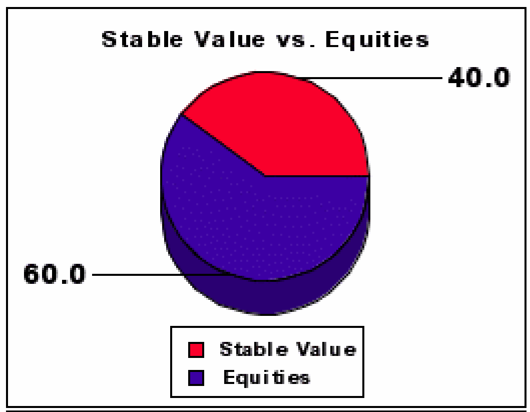
Source: Stable Value Investment Association, http://www.stablevalue.org

As seen from Figure 1, long-term results show the superiority of long-term government bonds and intermediate government /corporate bond funds despite short-term gyrations. Stable value is decidedly superior to the 3-month T-bills suggesting that they are a better alternative compared to money market funds.

An interesting tool that is available on the Stable Value Investment Association website (http://www.stablevalue.org) enables one to compare the reward/ risk characteristics of the portfolio considering allocations that include stable value funds and one that does not. As seen from Figure 2-4 on the following pages adapted from the Stable Value Investment Association website, on a reward/risk basis, an allocation of 60% to equities and 40% split between the various major subsectors in the fixed income world, shows a superior profile compared to the same allocation scenario but with the allocation in fixed income substituted by a 40% allocation to the stable value funds. In addition, a mix of 60% equities and 40% in various fixed income securities has a better annual performance than a mix of 60% equities and 40% stable value.

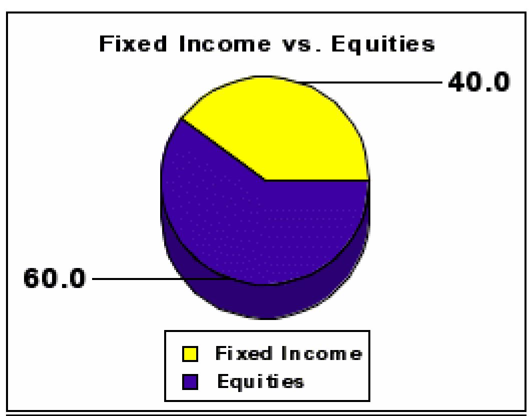
Moreover, the highest quarterly return for the stable value mix is lower, and the lowest quarterly return is even worse off than the corresponding metrics for the traditional asset allocation mix. So, for all their advantages and the risk/reward profile of stable value funds, these investments aren't without potential problems. The earnings from these investments *can* be outpaced by inflation, the yields typically lag the market, and these investments are not immune from credit blow-ups among the issuers of the bonds they hold.

Figure 2*



**Source: Stable Value Investment Association, http://www.stablevalue.org*

Figure 3*



**Source: Stable Value Investment Association, http://www.stablevalue.org*

Figure 4*

Equity Allocations:	**Fixed Income Allocations:**
60 % Stocks	5 % 3-month T-Bills
	10 % Intermediate-term Government/Corporate Index
	25 % Long-term Government Index

	Portfolio with Stable Value	**Portfolio with Fixed Income**
Annualized Total Returns:		
Highest quarterly return:	13.63%	14.50%
Average quarterly return:	2.73%	3.01%
Lowest quarterly return:	-12.67%	-10.57%
Annualized compound return:	10.83%	11.99%
Measures of Investment Risk:		
Number of quarters with negative returns:	15	17
Variability[1]:	5.09%	5.29%
Reward to risk ratio[2]:	0.536	0.569
What This Means in Dollars:		
Ending value of a $10,000 lump-sum investment:	$63,697	$76,738
Maximum loss on a $10,000 lump-sum investment:	$0	$0
Maximum gain on a $10,000 lump-sum investment:	$68,884	$80,239

**Source: Stable Value Investment Association, http://www.stablevalue.org*

In addition to the risk-to-reward profiles, investors need to be cautious regarding several rules that may affect them adversely and also be cognizant of hidden interest rate risks. As stable value funds were designed for retirement plans and as such as are available only in 401(k) and IRAs, investors are limited by the rules governing those investments regarding how much they can invest each year. Similarly, withdrawals are also governed by each plan's particular rules and virtually all of the mutual funds have redemption fees that vary from fund to fund.

For example, as illustrated in a recent Wall Street Journal article, Oppenheimer Capital Preservation Fund charges a 2% redemption fee for investors who withdraw their money within a year. Another fund, Scudder Preservation Plus Income Fund has an "interest-rate trigger" that imposes a redemption fee in a rising interest-rate environment. This trigger is activated when the yield on a particular daily bond index benchmark is higher than the fund's annual yield by 1.55% or more.

Although institutions guarantee against the loss of principal, industry professionals are wary that investors could flee these stable value funds in pursuit of higher yielding money market funds in a rising interest rate environment. In such a case, a massive outflow could cause the yield to drop for the remaining investors.

Stable Value Funds - Summary

- Stable value funds were created for retirement plans and indeed have grown to a significant 28% of all assets in the 401(k) marketplace. These funds are best suited for retirees with conservative investment needs, although younger investors may use them to replace or augment the conservative portion of a diversified portfolio. It can be used as a volatility dampener when wild market swing on the downside may cause concerns for investors.

- However, for investors with long-term investment horizons and who can withstand short-term gyrations in the fixed income market, stable value funds are not a very attractive investment vehicles. Various restrictions, redemption fees, and a possible flight from these funds in a rising interest-rate environment, causing a decline in returns for stable value funds, should make investors wary of investing in these funds.

- Beacon Pointe believes that stable value funds are suitable mainly for retirees with conservative investment income needs. Most investors are better off with traditional fixed income investment vehicles such as intermediate government/corporate and/or long-term government bonds.

- Please contact your Beacon Pointe consultant should you have any questions.