PLAN STABILITY MEETS PLAN GROWTH

Stable Value for Secure 529 Savings

Prudential

Executive Summary

An increasing number of states have made Stable Value the conservative investment option in their 529 plans.

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 the conservative investment option. In recent years, 529 plans have increasingly replaced money market funds with Stable Value funds. At least 51 of the nation's 104 plans currently include a Stable Value fund on their investment menu.[1] Among the most recent converts are Utah's my529 plan, Colorado's CollegeInvest Direct Portfolio College Savings Plan, and Ohio's CollegeAdvantage Direct 529 Savings Plan. These plans join Virginia, Rhode Island, New York, Nevada, and others who have offered Stable Value for years. This trend prompts two important questions.

First, why are so many states adding Stable Value funds to their 529 plans?

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 1. During the extended period following the 2008 financial crisis and the COVID-19 pandemic crisis when most money market funds were offering near-zero percent returns, Stable Value funds' returns looked all the more attractive.

And second, why are some plans still without Stable Value funds?

This answer revolves primarily around a lack of familiarity with the asset class in the 529 market, along with concerns about perceived challenges that, in the end, actually help account for Stable Value's unique appeal to many plan participants.

WHAT IS STABLE VALUE?

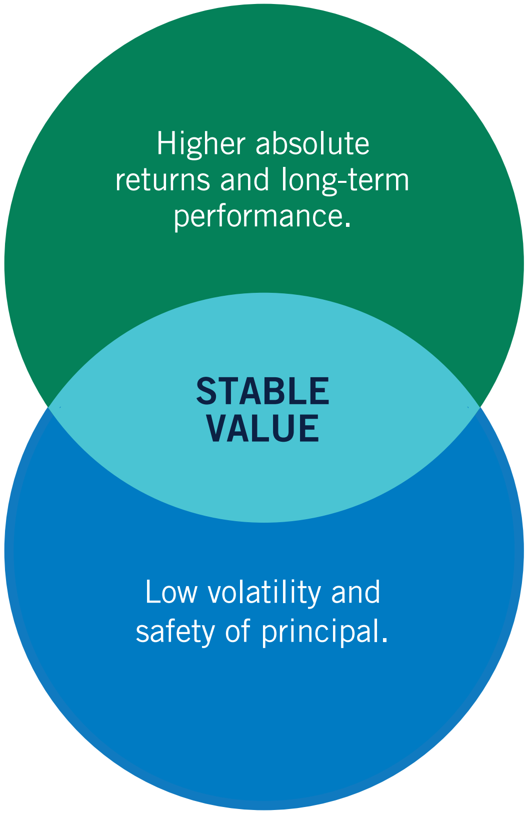
Stable Value is a conservative investment option built for safety and liquidity. It has been highly popular for decades in the defined contribution retirement plan market, is offered in approximately three out of four defined contribution plans, and accounts[2] for more than $812 billion in total retirement plan assets.[3]

How is it structured?

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 529 plan or the retirement plan, rather than the insurance company, and managed by one or more independent investment managers at the direction of the plan.

Finally, the portfolio is guaranteed or "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. This means that, subject to certain restrictions, investors making withdrawals in the normal course of the plan's operation will have access to their guaranteed principal and accumulated interest, regardless of how the fund's underlying securities are performing.

What about returns and security?

The returns that these modern Stable Value funds deliver to investors is determined primarily by the performance of its underlying investment portfolio and then is expressed as the fund's "crediting rate."

The crediting rate is 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 guaranteed value and the market value of the fund's underlying investment portfolio over time. This mechanism smooths Stable Value returns, typically causing the crediting rate to gradually shift as the market moves up and down.

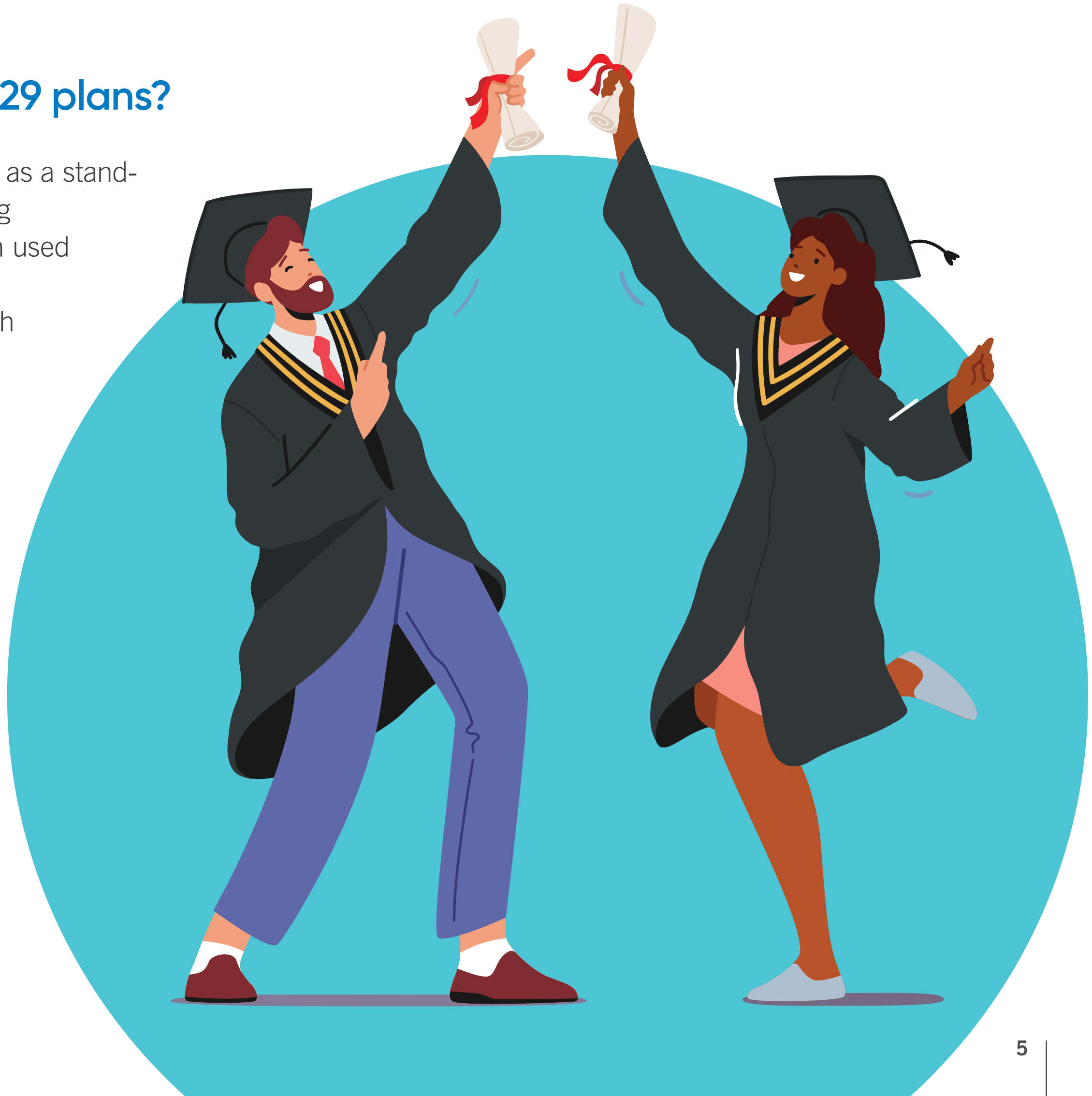
While the investors are earning these returns going forward, they are also assured that the guarantees in the fund protect their principal and earned interest from declining—potentially an attractive attribute for the conservative 529 investor or for those in the tuition payment mode.

With modern Stable Value funds, plan sponsors also 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. The assets are held by the plan—not the insurance companies.

Plan sponsors also enjoy the diversification benefits of having multiple guarantors (wrap issuers) and investment strategies or managers, as well as full transparency into the composition of their fund's investment portfolio.

How can Stable Value be used in 529 plans?

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 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 2). Meanwhile, thanks to their guarantees and crediting-rate mechanisms, they have largely mirrored or improved upon the low-volatility characteristics of money market funds (see Figure 3). 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.

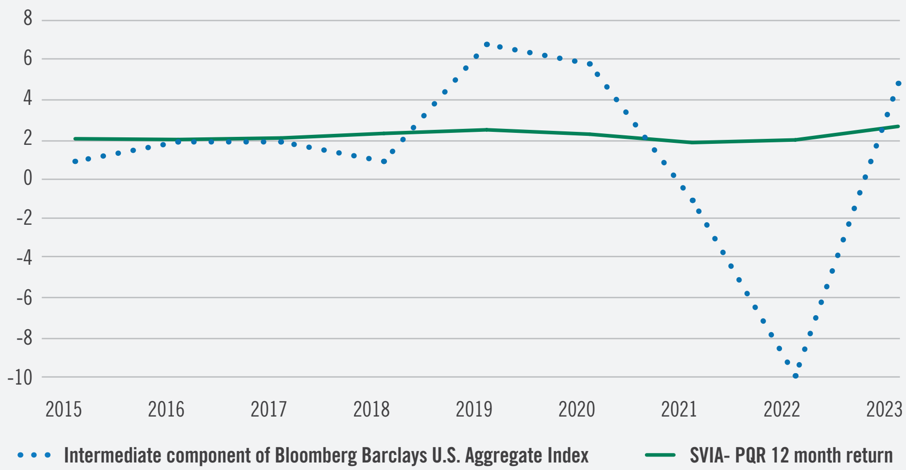
Stable Value against other conservative options

Before we take a look at performance, let's first define Stable Value, money markets, and intermediate term bonds.

Figure 1: Asset Class Comparison

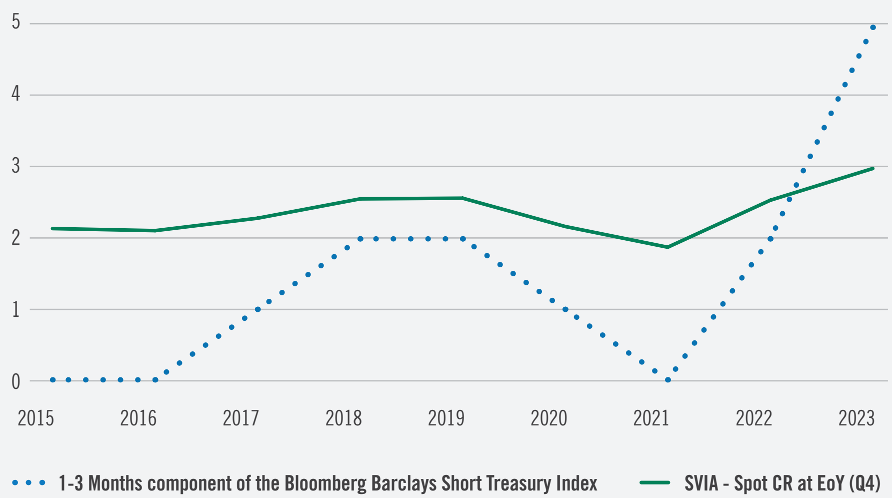
	Stable Value	Money Market	Investment Grade Intermediate-Term Bond
Objective	Safety of principal while providing intermediate-term fixed income returns	Safety of principal while providing short and ultra-short-term fixed income returns	Safety of principal while providing intermediate-term fixed income 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

Figure 2: Stable Value Returns Track Intermediate-Term Bonds, but with Less Volatility



Source: Stable Value Returns: SVIA Stable Value Quarterly Characteristics Survey for 1Q2024, 2015-2023. Net 12-month return.
Intermediate Bond Returns: Barclays Intermediate U.S. Aggregate Index, 2015-2023. Returns illustrated are gross before any fees.

Figure 3: Stable Value Crediting Rates Versus Money Market Returns



Source: Stable Value Returns: SVIA Stable Value Quarterly Characteristics Survey for 1Q2024, 2015-2023. Net 12 month return.
Money Market Returns: Bloomberg Barclays Short Treasury Index, 2015-2023. Returns illustrated are gross before any fees.

Like investment-grade intermediate-term bonds, Stable Value funds have outperformed money market funds over time.[2] It's worth noting that this performance advantage can be muted 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 and short-lived. 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.

Finally, Stable Value funds have delivered consistent performance through a wide variety of investment environments, including periods of rising interest rates, the 2008 financial crisis, and the recent pandemic-driven economic challenges.

Figure 1 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.

Why 529 plans are embracing 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 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 priorities with:

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 may also be explained by the fact that some state sponsors of 529 plans are familiar with its use in state-sponsored 457 Governmental and 403(b) retirement savings plans.

Why have some states not embraced Stable Value in their 529 plans yet?

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 529 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 financial crisis when market turmoil prompted many wrap issuers to exit the market. What they may not know is that several new wrap issuers entered the market shortly after the crisis. Since then, wrap capacity has expanded greatly and generally is no longer a constraint on the asset class.

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 trade-offs 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.

Navigating the balance: exploring Stable Value's unique advantages and opportunities

The perceived challenges that 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 three out of four defined contribution plans that offer Stable Value to their participants.[2]

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 lessens the opportunity to arbitrage and makes the competing fund restrictions aimed at preventing it unnecessary 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 guarantees that generally aren't available with other investment options.

Transparency

This is not typically an issue with modern, multi-guarantor Stable Value funds. Wrapped Stable Value funds offer 529 plan sponsors a direct view of their underlying investment portfolios. General account products (the earlier type of funds offered) 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%.

Exploring the potential: choosing Stable Value 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, sponsors 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 standalone 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–the 2008 financial crisis, and COVID-19 pandemic 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 sponsors should consider how doing so would impact plan participants. Among the questions to be considered:

- Would plan participants benefit from a conservative investment option that guarantees access to principal and accumulated interest at book value?
- Would 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 an 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 of 2024, the SECURE 2.0 Act allows 529 assets—up to a lifetime limit of $35,000—to be rolled into the account beneficiary's Roth IRA, without incurring the usual 10% penalty for non-qualified withdrawals or generating any taxable income. So, for anyone who is concerned about funding a 529 plan, but then either over-funding or having a child not attend college, at least a portion of the funds can be moved into a Roth IRA, which may help to encourage more people to utilize 529 plans.[4]

Passed in late 2019, the SECURE 2.0 Act expands the use of 529 plans as they may be used for certain apprenticeship programs and up to $10,000 can be used to repay student loans. 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 2022 as college costs continued to soar, with the average, private nonprofit university costing ~$59,000 per academic year for tuition, room, board, and fees.[5] Assuming a 3% 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.

As of December 31, 2023, total assets reached $471 billion nationally[6]. 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.

Conclusion

On average, investors in 529 plans have much shorter investment horizons 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 may 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 and plan sponsors who view Stable Value as an attractive college savings tool will continue to grow. Plans that make Stable Value available to their investors may be doing plan participants a great service.

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[1]Prudential data, derived from Schwab 529 College Savings Plan | Kansas 529 College Savings Plan: Ratings, Tax Benefits, Fees and Performance (savingforcollege.com), April 2023.

[2]Stable Value at a Glance, stablevalue.org/stable0value-at-a-glance, July 1, 2024.

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Quarterly Survey Data Point Definitions:

Crediting Rate – The SVIA Stable Value Quarterly Characteristics Survey crediting rate is the weighted average contract yields as of the report date, gross of stable value management and distribution fees and net of contract (including wrap) fees. Data shown represents past performance and is not a guarantee of future results.

[3]Cerulli U.S. Defined Contribution Distribution 2023, Exhibit 2.12.

[4]SECURE 2.0 Act of 2022 Title I – Expanding Coverage and Increasing Retirement Savings, https://www.finance.senate.gov/imo/media/doc/Secure%202.0_Section%20by%20Section%20Summary%2012-19-22%20FINAL.pdf, Accessed August 14, 2024.

[5]Education Data Initiative, Average Cost of College & Tuition, May 2024.

[6]College Savings Plans Network, 529 Plan Data.

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