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Stable Value Funds: A Disclosure Dilemma

Spread profits earned by insurance companies on general account stable value funds still remain hidden to plan sponsors.

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I wrote about stable value funds in my October column. In brief, a stable value fund issued by an insurance company provides investors with a guaranteed return (backed by the financial soundness--the general account--of the insurance company itself or by assets set aside in a separate account unreachable by the general creditors of the insurance company) and smoothed income flow. These features are not free, however. They require investors to bear an increased (and little understood) assumption of risk and higher fees.

Another kind of stable value fund is issued by a bank or trust company in the form of a collective investment trust provided by an asset manager. The focus this month will be on stable value funds that are general account products issued by insurance companies.

This column will delve into a particular issue involving these funds--which really aren't funds but rather a fixed interest option offered in the form of a group annuity contract distributed by a life insurance company. The issue involved has taken on new importance for participants in retirement plans such as 401(k) plans and 457(b) plans with the Department of Labor's (DOL) implementation of the disclosure regulations under the Employee Retirement Income Security Act of 1974 (ERISA) earlier this year. To wit, the DOL's 408(b)(2) regulation requires service providers to retirement plans to make certain disclosures of costs--and provide descriptions of the services rendered in exchange for such costs--to plan sponsors. In turn, the 404(a)(5) regulation requires plan sponsors to make certain disclosures to participants of the charges made to their plan accounts over the previous calendar quarter.

Incomplete Fee Disclosures?

Stable value funds are not registered investment products under the Investment Company Act of 1940, nor do they need to be registered with the U.S. Securities and Exchange Commission. That's why these funds aren't subject to the rules for the reporting of underlying portfolio holdings and fee disclosures, both of which are required of mutual funds. This (legal)

lack of transparency, however, cuts against efforts made by the DOL to promote new cost disclosures concerning the investment options offered to participants in retirement plans.

The management fee of a stable value fund--that is, its annual expense ratio such as 90 basis points--is discernible because it's disclosed, for example, in the fine print of product advertisements. In some cases, though, a stable value fund doesn't charge an annual expense ratio. In those cases, the issuing insurance company has decided to work for free. OK, that's not true. (Note that stable value funds will always earn a spread (explained below) and some of them will also impose an annual expense ratio.)

What is true is that in cases where a stable value fund doesn't charge an annual expense ratio, the insurance company providing it nonetheless extracts a significant amount of revenue. That revenue--known as a "spread"--is derived from the difference between what an insurance company can earn on the fixed-income portfolio (i.e., the assets of the stable value fund itself) that it invests in and the percentage rate "guarantee" it pays out to those invested in the stable value fund, such as participants in retirement plans.

The spread profits earned by an insurance company on a stable value fund can be thought of as a kind of slush fund (i.e., with hidden and undisclosed revenue) from which other expenses that are incurred by it as the record-keeper of a retirement plan (such as administrative costs) are deducted. For example, suppose that an insurance company enters a bidding process to provide a retirement plan with a bundled solution as the plan record-keeper and investment provider. It may low-ball the record-keeping administrative costs it proposes to charge a plan sponsor, especially if a juicy stable value fund is already in the plan.