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ASSESSING STABLE VALUE AFTER 2008

Performing as Designed

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EXECUTIVE SUMMARY

Stable value has evolved significantly since the 2008 financial crisis. Investment guidelines are tighter, restrictions on transfers to competing funds broader, fees slightly higher. These new standards are creating a stronger and more sustainable asset class, better positioning plan sponsors and intermediaries to meet the long-term needs of their retirement plan participants.

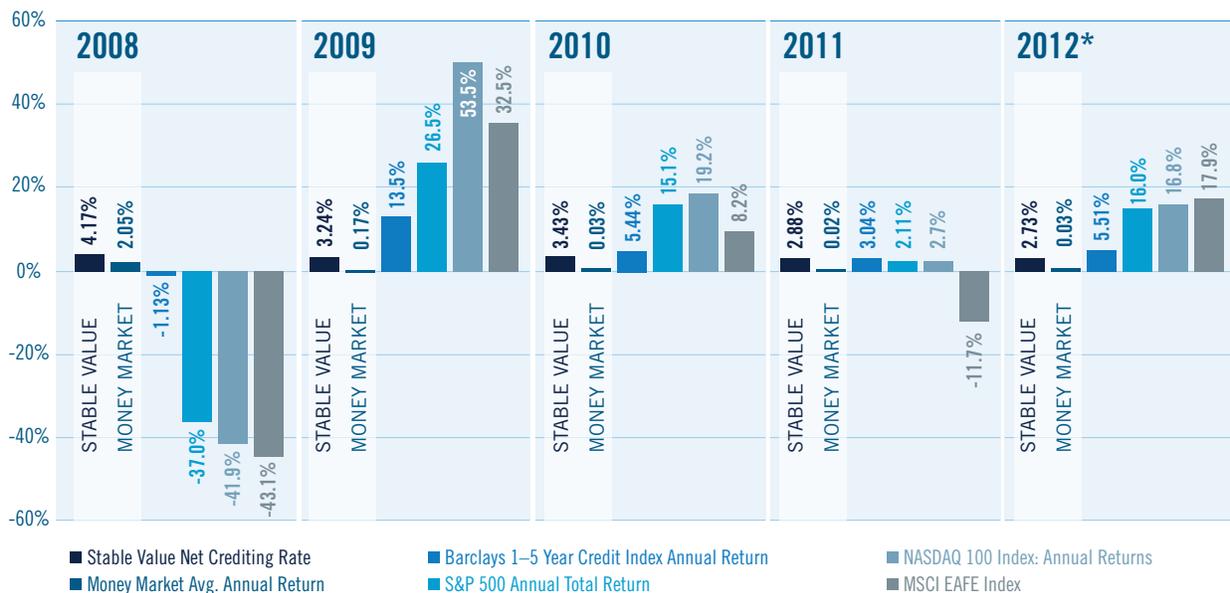
- 1 Higher fees for stable value “wrap contracts,” which guarantee stable value principal and earnings, reflect more thorough and accurate risk assessments for the asset class and are bringing much-needed capacity to the marketplace.
- 2 Tighter rules on transfers between stable value investments and competing funds are reducing the likelihood that short-term interest-rate arbitrage will harm long-term investors.
- 3 More conservative investment guidelines are adding further protections to the asset class, making it more resistant to future market dislocations and better prepared to deliver on its promise of book-value returns (principal plus accumulated earnings) to retirement plan participants.
- 4 Market-value-to-book-value ratios for stable value have generally improved, leaving this asset class well-positioned for future changes in interest rates.

Against this backdrop, defined contribution plan participants who have long made stable value investments a conservative anchor of their portfolios continue to invest in them. Aon Hewitt, a consulting and human resource services firm whose Aon Hewitt 401(k) Index tracks large-company 401(k) plans, says net inflows into stable value in the plans it tracks totaled \$7.1 billion from 2008 through the first 11 months of 2012.¹

¹ Aon Hewitt 401(k) Index, 2012.

Performance Under Pressure

During the financial crisis, stable value continued to generate positive returns without interruption.



*As of 1Q/2012. Source: SVIA - iMoneyNet.com • Barclays.com • Ycharts.com • Forecastchart.com • MSCI.com

Stable value remains extremely popular among large plans. For example, in 2011, 80% of large-company plans tracked by Aon Hewitt offered stable value investments, up from 66% as recently as 2005.² And stable value is represented in more than 60% of U.S. defined contribution plans overall.³

Stable value's continued strong appeal reflects in large

part its ability to deliver on its promise of positive returns to investors irrespective of market conditions.

At a time when investors remain concerned about financial market volatility, and when more and more retirement plan participants are retiring each day, the certainty and stability offered by stable value provides a uniquely compelling value proposition.

This paper explores the changes that have reshaped the stable value marketplace over the past four years, and can help plan sponsors and intermediaries determine whether stable value deserves a role in their retirement savings plans.

² Aon Hewitt 401(k) Index, 2012.

³ Cogent Research, 2012. Based on a representative cross section of 1,500 401(k) plan sponsors across micro, small, mid-size, large, and mega plans from February to April of 2012.

SECTION I

Recovering From Recession

The 2008 credit crisis shook the global financial system. In the U.S., equity markets fell precipitously, credit evaporated, and millions of American workers who thought they were on track to a financially secure retirement received a harsh lesson in market risk.

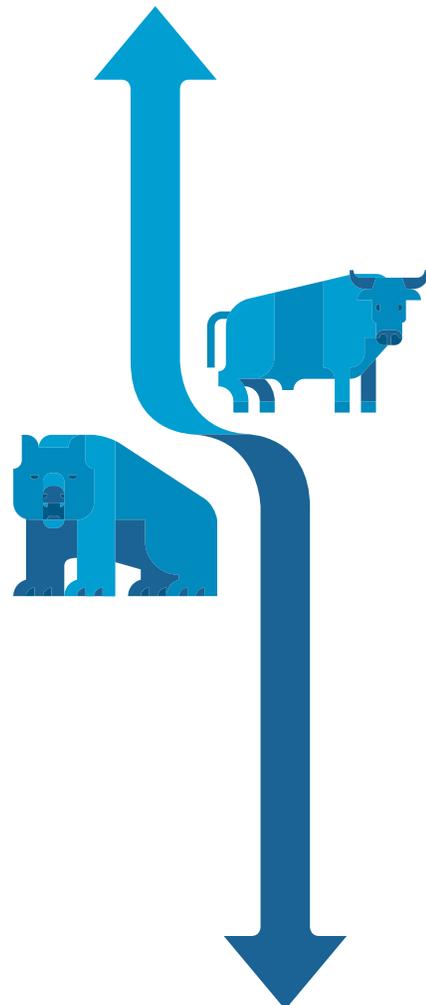
While equity and fixed-income markets have begun to recover, many retirement plan participants remain skeptical, especially in the case of stocks. Scarred by two major bear markets since 2000, they are increasingly intrigued by investment products that can help them manage the volatility that compromised their portfolios twice in the last dozen years.

For decades, plan sponsors and intermediaries who have looked to provide their plan participants with investments that could marry low volatility with consistently positive results have turned to stable value; an asset class that offers returns comparable to intermediate-term bonds but with the low volatility associated with money market funds, all supported by book-value (principal plus accumulated earnings) withdrawal guarantees.

Stable value still provides those benefits, even though the financial crisis has changed the stable value landscape: investment policies have become more conservative, fees are more robust and, as a consequence of an extraordinarily low interest-rate environment, returns are somewhat lower. While many plan sponsors and intermediaries have quickly adapted to these changes, some have become frustrated by new restrictions associated with stable value, and concerned about the outlook for investment returns. They are asking whether the changes have been worthwhile, and if stable value still deserves a place in their investment lineups.

Others who have considered offering stable value are similarly questioning whether now is the right time to do so.

For both groups, a reasoned decision begins with an exploration of exactly how the stable value marketplace has changed, and why.



SECTION II

The New Stable Value Landscape

The stable value marketplace in 2013 differs from the one that existed in 2008 in five key areas:

The provider landscape has changed.

During the 2008 credit crisis, many financial institutions were forced to increase their capital reserves to reflect deteriorating balance sheets. While stable value's contribution to that adjustment was minimal, some financial institutions that issued wrap contracts (principal and accumulated interest guarantees)—a large number of them banks—exited the business. This made it difficult for stable value managers to secure the wrap capacity they needed. In turn, a number of stable value managers exited the business too, forcing some plan sponsors to either remove stable value from their plans or find new providers.

Fees for stable value wrap contracts have increased.

Many wrap issuers who did remain in the stable value business began charging more for their contracts, reflecting their need to hold higher levels of capital to cover the risks exposed during the crisis. Wrap contract fees are levied as a percentage of assets wrapped, and on average they have increased to a range of 20 to 25 basis points from approximately 7 to 9 points prior to the crisis.⁴

Underwriting standards have tightened.

In addition to raising wrap fees, some wrap issuers began tightening their underwriting standards in the wake of the credit crisis. Some required that managers adhere to more conservative investment guidelines, limiting or precluding investments in

securities deemed to have excessive credit or duration risk. Others required managers to boost the cash buffer in their funds, providing an extra cushion to meet participant withdrawals in the event the market value of their underlying bond portfolios fell below book value. Finally, some issuers expanded their equity-wash rules, adding additional types of investments to the list of “competing funds” that cannot accept direct transfers from stable value investments.



Rebalancing Risk/Reward

Many wrap issuers are charging more, reflecting their need to hold higher levels of capital to cover the risks exposed during the crisis.

⁴ “Stable Funds Are Looking Shakier,” The Wall Street Journal, 2010.

Declining interest rates have pressured stable value investments.

Since the credit crisis and subsequent recession, the Federal Reserve has launched an expansive monetary policy aimed at boosting the U.S. economy. A key component of that strategy has been to lower the target for the Federal Funds rate—the rate on overnight, interbank lending—to between 0% and 0.25%. The impact on short-term securities has been predictably severe. From 2009 through March 2012, the annualized yield on the average taxable money market fund tracked by iMoneyNet fell to nearly 0% from about 1%. Average annualized crediting rates for stable value investments also contracted, but far less dramatically to just below 3%.⁵

The Dodd-Frank Act has created regulatory uncertainty.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 set new regulatory standards for over-the-counter derivatives contracts, or what the statute calls “swaps.” The statutory language

defining a swap was broad, however, and some financial experts worried that it might be interpreted by regulators to include products Congress did not intend to be subject to the law, such as stable value wrap contracts. Conceding this issue, Congress added language to Dodd-Frank requiring the U.S. Securities & Exchange Commission and the Commodity Futures Trading Commission (CFTC), in consultation with the U.S. Department of Labor, to study whether stable value wrap contracts should be treated as swaps. If regulators concluded that they should, the statute further authorized the SEC and CFTC to exempt the contracts if they deemed it appropriate and in the best interest of the public.

As this publication went to print, regulators had yet to complete their study. If they ultimately decide that wrap contracts do qualify as swaps, and do not then exempt them from Dodd-Frank, issuers may have to comply with a host of new requirements, including mandatory clearing, new reporting and record keeping obligations, and minimum capital and margin requirements—all of which could add to the cost of stable value investments.

Average annualized crediting rates for stable value investments contracted between 2009 and 2012 to just below 3%, but still much higher than money market funds, which fell to nearly 0%.⁵

⁵ “A Quarterly Survey Shows Strength of Stable Value,” SVIA Quarterly Characteristics Survey, 2012.

SECTION III

Is Stable Value Still “Worth It?”

While the changes to the stable value marketplace may have been disruptive in the short term, many in the industry consider them to be additive, heralding a return to the conservative investment strategies, risk parameters and performance goals that characterized the asset class when it debuted four decades ago.

New restrictions on transfers to competing funds better protect long-term investors.

By adding target-date funds and self-directed brokerage windows to the list of “competing funds” that cannot accept direct transfers from stable value investments, wrap issuers have minimized opportunities for arbitrage between those investment options and stable value investments during periods of rising interest rates. This minimizes the chance that fund managers, to meet redemption requests, might have to liquidate some of their bond holdings at the very time their market value has been depressed. It also protects long-term investors in stable value, whose subsequent returns could be harmed by forced liquidation sales.

Longer put options provide for more orderly book-value distributions.

Pooled, or commingled, stable value investments have long specified that if participant withdrawals from an investment are attributable to employer-initiated events, such as mass layoffs, early retirement programs, bankruptcy, or termination of an employer’s participation in the investment, participants will be guaranteed access to their money at book value over a period of time rather than immediately (although distributions at market value can usually still occur at anytime). This minimizes the impact of those withdrawals on the remaining participants in the investment.

Typically, the payout period has been 12 months. Efforts by some wrap issuers to extend this 12-month “put” to 18 months or longer will enhance the protections for an investment’s long-term investors in extreme market environments—environments that might preclude an orderly liquidation of assets within one year.

Tighter investment guidelines are reducing credit and duration risk.

The credit crisis of 2008 exposed risks in some stable value investment portfolios that some wrap issuers had not always appreciated in earlier, less volatile markets. In response, several wrap issuers began tightening investment guidelines to minimize credit and duration risk in the portfolios of the funds they insure. While these restrictions may slightly dampen yields and ultimately crediting rates for stable value, they also are helping to better align fund objectives with investor interests. That’s important as plan participants, post-crisis, are placing a higher degree of importance on safety of principal than they did in the past.

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Wrap capacity is expanding.

Although wrap capacity has not recovered to pre-crisis levels, the Stable Value Investment Association (SVIA) industry trade group reports that higher wrap fees have attracted several new entrants in the past two years, bringing an estimated \$67.5 billion to \$100 billion in additional wrap capacity to the marketplace.⁶ As a consequence, most stable value managers are once again able to find the wrap capacity they need to meet demand for their products.

Higher wrap fees help preserve the integrity of the asset class and its ability to deliver book-value redemption guarantees.

As noted, higher wrap fees are helping to attract new providers to the stable value marketplace. This not only creates a stronger, more competitive industry, but also helps insure that stable value's unique book-value redemption guarantees remain available for current and future generations of retirement plan participants. Without adequate fees to compensate them for the associated risks and capital requirements, financial institutions would find it economically infeasible to continue offering stable value.

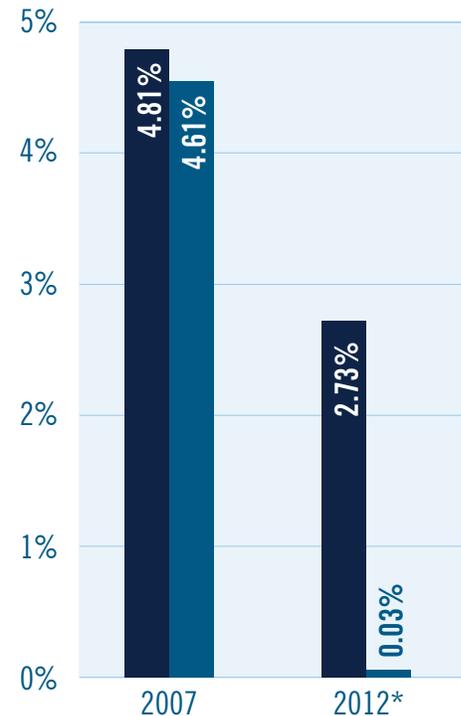
Relative performance is very strong despite higher wrap fees.

Higher wrap fees have resulted in only a modest increase in the total cost of stable value investments. As noted earlier, wrap fees now hover in the range of 20 to 25 basis points. In comparison with fund performance, though, that's a relatively small amount. From December 2007 through March 2012, for example, the average annualized crediting rate for stable value fell just over 100 basis points, according to the SVIA.⁷ Clearly, the vast majority of that drop was attributable to declining interest rates rather than higher wrap fees.

Despite a declining interest rate environment, stable value crediting rates are approximately **90 times** higher than money market returns.

Outperforming the Competition

Despite a declining interest rate environment, stable value crediting rates are approximately **90 times** higher than money market returns.



■ Stable Value Funds Crediting Rate
■ Money Market Average Annual Return

* As of 1Q/2012.

Source: SVIA Annual Investment Policy Survey, 2012; iMoneyNet.com, 2012.

⁶ SVIA survey of 27 wrap issuers, 2012.

⁷ "A Quarterly Survey Shows Strength of Stable Value," SVIA Quarterly Characteristics Survey, 2012.

The regulatory outlook for stable value is under review.

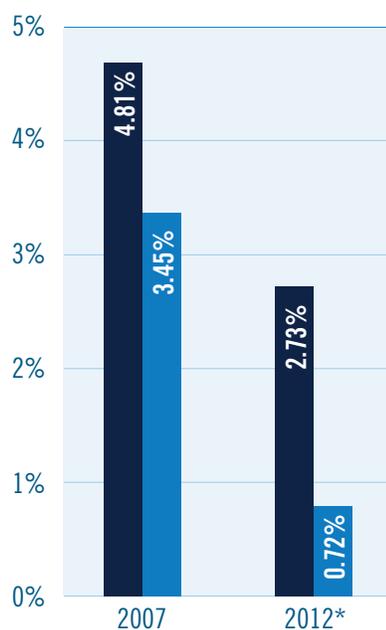
As noted earlier, a broad reading of the Dodd-Frank Act initially raised concerns that stable value wrap contracts might be treated as swaps under the new law, subjecting their issuers to extensive new regulatory oversight. While federal regulators had not yet completed their study as this paper went to print, the SVIA and its counsel are hopeful that wrap contracts ultimately will not be subject to Dodd-Frank.⁸ Their case is built on several factors, such as the many differences between a typical swap and a wrap contract. Wraps are neither tradable nor assignable, for example. Wraps also are inherently collateralized, since the entire portfolio of securities held by a stable value investment, plus its cash buffer, must be exhausted before a wrap issuer has any payment obligation. The stable value industry is awaiting final guidance on these issues.⁹

Stable value appears positioned to manage both a continued low interest-rate environment and any eventual uptick in interest rates.

With the Federal Funds rate near zero, fund managers and wrap issuers have been modeling the impact of an extended low-rate environment on their products and, more specifically, on the crediting rates they will be able to offer. Their findings, grounded in past experience, have been promising. Example: From 2007 to the 1Q of 2012, the yield on the five-year Treasury note fell nearly 300 basis points to 0.72% from 3.45%. But the crediting rate for the average stable value investment fell only 208 basis points, to 2.73% from 4.81%, according to the SVIA's Annual Investment Policy Survey. That softer landing was

Leading the Pack

Amid a declining interest rate environment, stable value has had a much “softer landing” than Treasury Notes.



■ Stable Value Funds Crediting Rate
■ 5-year Treasury Note Yields

* As of 1Q/2012.

Source: SVIA Annual Investment Policy Survey, 2012; U.S. Department of the Treasury, www.treasury.gov, 2012.

⁸ “A Dodd-Frank Update: Stable Value Still in Limbo,” SVIA Stable Times newsletter, Second Half 2012.

⁹ The Stable Value Investment Association, The American Bankers Association, and the Financial Services Roundtable Response to the U.S. Commodity Futures Trading Commission and the Securities and Exchange Commission Acceptance of Public Submissions Regarding Study of Stable Value Contracts Release No. 34-65153; File No. S7-32-11. See also: Letter from the American Council of Life Insurers to the Secretaries of the CFTC and SEC, Sept. 26, 2011, re: File No. S7-32-11C, “Stable Value Contract Study.”

attributable in part to the way crediting rate formulas are calculated; they amortize prior market-value gains in the underlying investment portfolio to cushion the impact of declining yields. Stable value providers anticipate that the amortization of prior market-value gains in their underlying bond portfolios will continue to cushion declines in crediting rates for some time to come.

When interest rates eventually do begin to rise, stable value will face different threats. The market value of its bond holdings, currently well above book value on average, will be reduced, and investors may be tempted to switch to other investments offering higher returns. Yields on money market funds tend to rise more quickly in a rising rate environment than crediting rates for stable value, narrowing yield spreads between the asset classes.

However, even in rising rate environments, stable value still tends to outperform money market funds over a market cycle. While there have historically been some brief periods when this relationship has not held, relative yields tend to return to equilibrium over time, restoring the stable value yield advantage.¹⁰

Additionally, several factors should mitigate the impact of rising interest rates on stable value investments.

Equity-wash rules prohibit direct transfers into competing funds, for example, and restrictions limiting the percentage of a stable value investment that may be immediately paid out at book value as a result of some employer-initiated events are more prevalent. Also, longer-termed puts further prevent immediate liquidations in pooled funds.

Finally, stable value managers have other tools to mitigate interest-rate risk. These include adjusting the duration of their portfolios, reallocating assets among different sectors of the fixed-income market, allocating some assets to Treasury Inflation-Protected Securities, and even hedging their portfolios using futures and options.

With the Federal Funds rate near zero, fund managers and wrap issuers have been modeling the impact of an extended low-rate environment on their products and, more specifically, on the crediting rates they will be able to offer.

¹⁰ “Stable Value Funds: Performance from 1973 through 2008,” Dr. David Babbel and Dr. Miguel A. Herce, 2009.

There are no direct substitutes for stable value.

Stable value offers retirement plan participants a blend of low volatility, bond-like investment returns and book-value redemption guarantees that simply are not available in other retirement plan investment options. Money market funds have long been viewed as the closest alternative to stable value, and they do allow investors to redeem at net asset value—usually \$1 per share—in any amount, at any time, for any reason. But returns on money market funds historically have lagged those offered by stable value by a substantial margin. More strikingly, money market funds offer no guarantees relating to principal or yield.

During the 2008 credit crisis, for example, one prominent \$63 billion money market fund saw its N.A.V. fall below the \$1 mark, thereby “breaking the buck.” Ultimately, the fund was forced to liquidate. Between 2007 and 2011, more than six dozen other money market funds sought capital from their managers to prevent their N.A.V.s from falling below \$1.¹¹ The U.S. Treasury, to prevent a run on other money market funds, stepped in to temporarily backstop the industry. Treasury documents published since then show that when the government’s insurance program began, more than a dozen money market funds had portfolios with an N.A.V. below \$1 per share.¹²

As a result, federal regulators are considering whether to require money market funds to maintain a capital reserve,¹³ and also are contemplating whether the funds should allow their reported share values to fluctuate to reflect their true market value.

Meanwhile, the Treasury department has also encouraged regulators to consider imposing higher capital requirements on banks that sponsor money market funds.¹⁴

Investment-grade, intermediate-term bond funds are the other natural alternative to stable value. Unlike money market funds, these funds historically have generated returns comparable to those available from stable value. They also are liquid and scalable. On the downside, their returns are much more volatile than stable value crediting rates. In 2008, for example, during the height of the credit crisis, many intermediate-term bond funds actually generated negative returns.

Also, like money market funds, intermediate-term bond funds offer no principal or return guarantees. Instead, they shift credit-default risk and market-volatility risk to plan participants.

From a performance perspective, stable value investments have served investors well. Research by

Stable value offers retirement plan participants a blend of low volatility, bond-like investment returns and book-value redemption guarantees that simply are not available in other retirement plan investment options.

¹¹ “The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2000 to 2011,” Federal Reserve Bank of Boston, 2012.

¹² “Breaking a Buck, Maybe, but Not Taxpayers’ Backs,” The New York Times, 2012.

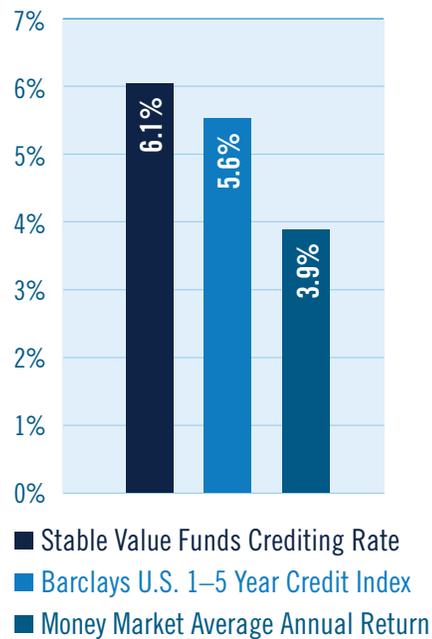
¹³ “Money Market Mutual Fund Reform: Why?” Center for Capital Markets Competitiveness, 2012.

¹⁴ “Geithner Wants Regulatory Council to Push SEC on Money-Market Funds,” The Wall Street Journal, 2012.

Consistently Outperforming the Competition

From 1989 through 2009, stable value products generated an **average annual return of 6.1%**, outpacing both intermediate-term bond funds, which averaged 5.6%, and money market funds, which averaged 3.9%.

Source: "Stable Value Funds: Performance to Date," Dr. David Babbel and Dr. Miguel A. Herce, The Wharton School, 2011.



Dr. David Babbel of the Wharton School and Dr. Miguel Herce of Charles River Associates shows that from 1989 through 2009, stable value products generated an average annual return of 6.1%, outpacing both intermediate-term bond funds, which averaged 5.6%, and money market funds, which averaged 3.9%.¹⁵

In 2008, at the height of the credit crisis, stable value continued to generate consistently positive returns, averaging a total return of 4.17%,¹⁶ while money market funds earned 2.05% and the Barclays U.S. 1-5 Year Credit Index lost 1.13%.¹⁷

Stable value has continued to outperform money market funds by a wide margin since then. As of the first quarter of 2012, SVIA data show, the crediting rate for the average stable value investment was 2.73%, while the average money market fund was still yielding virtually 0%.¹⁸

In short, without stable value, retirement plan participants looking for stable returns would have had to accept greatly reduced returns over the past two decades in exchange for that stability.

¹⁵ "Stable Value Funds: Performance to Date," Dr. David Babbel and Dr. Miguel A. Herce, The Wharton School, 2011.

¹⁶ SVIA 14th Annual Stable Value Investment & Policy Survey, years 2008 and 2009, SVIA's 2010 Spring Forum.

¹⁷ Barclays U.S. 1-5 Year Credit Index, 2012.

¹⁸ SVIA Quarterly Characteristics Survey, iMoneyNet.com, 2012.

SECTION IV

Retirement Plan Participants Want Stable Value

Plan sponsors and intermediaries trying to decide whether stable value belongs in their retirement plans should consider not only how the marketplace has changed, but also what plan participants want. Various studies have shown that investors in general have become more risk averse since the financial crisis.

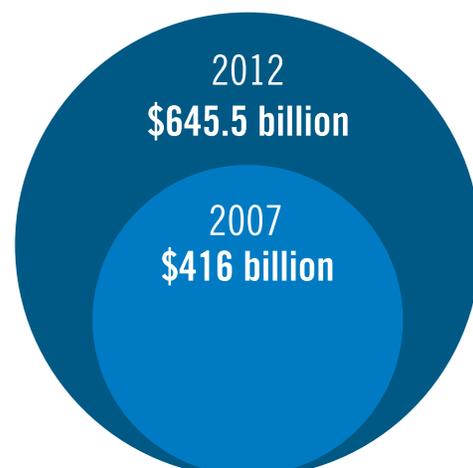
- A 2010 survey by consulting firm Aon Hewitt found that of those surveyed, nearly 20% of retirement plan participants who are part of Generation X—those born between 1965 and 1977—have allocated none of their savings to equities.¹⁹
- A 2011 survey by a major mutual fund company found that 40% of those surveyed in Generation Y—those born between 1978 and 1995—agree with the statement that they will “never feel comfortable investing in the stock market.”²⁰
- As for baby boomers—Americans born between 1946 and 1964—some 30% of near-retirees surveyed reallocated their 401(k) assets in 2008, with nine out of 10 moving to more conservative investments.²¹

Apart from this data, the simple growth in total stable value assets demonstrates that plan participants continue to value this asset class. As of June 30, 2012, they had entrusted \$645.5 billion of their savings to stable value, representing about 14% of all assets in those plans. That was up from approximately \$416 billion in 2007, before the financial crisis was in full swing.²²

Meanwhile, much academic research can be interpreted to support the use of stable value by investors saving for and living in retirement. Modern portfolio theory, for example, suggests that investors build portfolios holding a range of investment options with differing risk and return characteristics. Stable value can serve as an anchor for such portfolios, offering liquidity plus guarantees

of principal and interest along with yields that historically have surpassed those available from money market funds. Research conducted by Dr. Babbel also has shown that portfolios using stable value as their conservative core can track the efficient frontier more closely than those that use money market funds.²³

Savings Entrusted to Stable Value



¹⁹ “Retirement Readiness: Bridging the Gap Across Generations,” Aon Hewitt, 2010.

²⁰ “MFS Investing Sentiment Survey,” MFS, 2011.

²¹ Investment Company Institute, 2009.

²² Prudential Retirement, 2012.

²³ “Stable Value Funds: Performance from 1973 through 2008,” Dr. David Babbel and Dr. Miguel A. Herce, 2009.

Conclusion

During the worst financial crisis in more than 70 years, stable value has performed as advertised. It has delivered guaranteed yields comparable to those available from intermediate-term bond funds, but with low volatility comparable to that of money market funds. Investors with material allocations to stable value emerged from the crisis with far smaller losses than those whose portfolios were concentrated largely in equities or non-Treasury fixed-income securities. If they were invested only in stable value, they suffered no losses at all.

Still, the crisis prompted the stable value industry to reassess its structure and risk characteristics. That has brought changes to the stable value marketplace designed to make it an even safer and more secure investment option. Throughout, participants have continued to demonstrate an appetite for the product, with many continuing to make it a cornerstone of their retirement strategy—an anchor that allows them to invest more confidently in a broadly diversified portfolio.

Plan sponsors and intermediaries who offer stable value to their participants have given them a valuable tool for working toward their retirement savings goals. Millions of retirement plan participants have already indicated how they feel about stable value, demonstrating their support by investing in this uniquely compelling option. Plan sponsors who do not offer stable value owe it to their plan participants to consider whether it belongs among their investment options.



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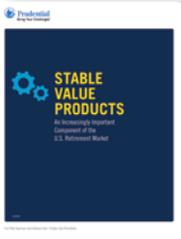
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Barclays Capital U.S. Government/Credit 1-5 Year Index: Includes all medium and larger issues of U.S. government, investment-grade corporate, and investment-grade international dollar-denominated bonds that have maturities of between 1 and 5 years and are publicly issued.

S&P 500® Index: Unmanaged index with over US \$5.58 trillion benchmarked (index assets comprising approximately US \$1.31 trillion of this total) that includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities.

MSCI EAFE Index: A market capitalization-weighted index comprised of companies representative of the market structure of 21 developed market countries in Europe, Australia and the Far East. The MSCI EAFE Index is available both in local currency and U.S. dollar terms. The returns shown in the performance chart are calculated with dividends reinvested and are net of foreign withholding tax.

NASDAQ 100 Index: The NASDAQ-100 Index includes 100 of the largest domestic and international non-financial securities listed on the Nasdaq Stock Market based on market capitalization. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies including investment companies.

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