SVIA STABLE TIMES

The quarterly publication of the Stable Value Investment Association

Volume 10, Issue 3 • Third Quarter 2006

IN THIS ISSUE

Proposed Default Fund Rules Leave Room for Stable Value 1
By Randy Myers

Survey Demonstrates Consistent Performance of Stable Value 1
By Marc Magnoli, JPMorgan Chase and Gina Mitchell, SVIA

Editor's Corner 4
By Steve LeLaurin, INVESCO Institutional

Automatic Contribution Arrangements in Government DC Plans 5
By Jamie Kalamarides, Prudential Financial

DOL Set to Endorse Multi-Asset Funds as Default for 401(k) Investors 8
By Randy Myers

GASB Derivative Project Looks at Synthetic GICs 9
By Gina Mitchell, SVIA

SVIA Working Group Looks at Accounting Issue 10
By Gina Mitchell, SVIA

New Pension Law Highlighted 11
By Gina Mitchell, SVIA

Ten Are Running for SVIA Board 12
By Gina Mitchell, SVIA

Hobbs and Duffield: Last Year of Second Term 12
By Gina Mitchell, SVIA

SVIA's Annual National Forum and Membership Meeting

Mapping the Way

A Look at the Issues Affecting Retirement Security: The Rules, the Market, and Individual Choices

Ritz Carlton • Washington, DC
October 10-12, 2006

Proposed Default Fund Rules Leave Room for Stable Value

By Randy Myers

The Department of Labor's (DOL) impending endorsement of multiple-asset-class funds as the preferred default investment for 401(k) plan participants could seem to be bad news for the stable value industry. (See "DOL Set to Endorse Multi-Asset Funds as Default for 401(k) Investors" elsewhere in this issue of *Stable Times.*) Certainly, it will add another choice or consideration to stable value and money market funds for plan sponsors when they consider default investment options.

The DOL's endorsement of a multiple-asset-class default alternative adds a new competitor to stable value and money market funds' space. At this time, few of the multiple-asset-class alternatives such as lifecycle funds include a stable value fund as one of their underlying investments. That's because most lifecycle funds are a collection of mutual funds, and U.S. accounting standards preclude the existence of stable value mutual funds.

Still, there's little reason to expect a mass exodus out of stable value funds. For starters, most of the millions of people already participating in 401(k) plans actively selected their own investments. And stable value has consistently been one of three core options in corporate 401(k) plans: stable value, equities, and employer stock. According to data compiled by the human resources consulting firm Hewitt Associates, stable value funds account for more than 20 percent of all 401(k) assets. For these people, the proposed rules on default investments will have little or no impact.

Meanwhile, stable value funds are not being shut out from the lifecycle phenomenon. Already, some large retirement plans that offer institutional investment funds (rather than mutual funds) are using them to build their own lifecycle funds that include stable value investments. Stable value manager INVESCO Institutional, for example, says it has three such clients, including a state retirement plan, a large telecommunications company, and a health care company.

Elsewhere, a number of investment firms are creating institutional-grade lifecycle funds with stable value components and

continued on page 3

Survey Demonstrates Consistent Performance of Stable Value

By Marc Magnoli, JPMorgan Chase and Gina Mitchell, SVIA

SVIA's Tenth Annual Investment and Policy Survey on Stable Value Funds demonstrated the consistent performance that stable value funds provide. The survey, which covered 108,842 defined contribution plans with more than $397 billion in stable value assets, found that the average/median return of the 12 months ending December 31, 2005 was 4.75 percent, which compares favorably to the return on the Lehman Intermediate Aggregate Index of 2.02 percent and money market returns of 3.04 percent for the same period. Stable value returns were up from 4.53 percent in 2004.

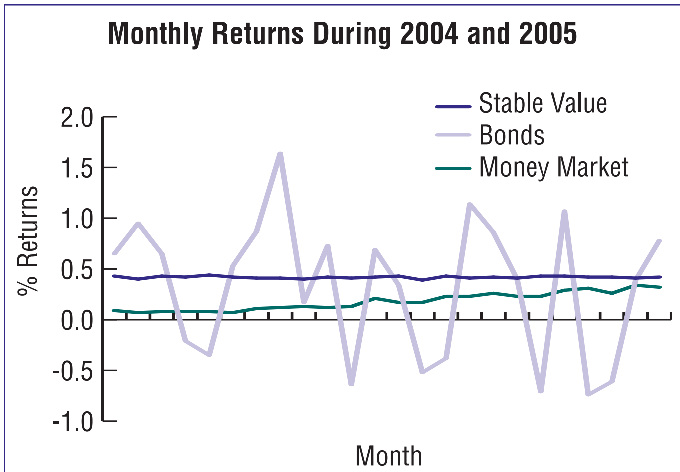
Focusing only on yearly returns hides how these returns are delivered. The following graph is a snapshot that shows how stable value consistently delivered positive monthly returns compared to the Lehman Intermediate Aggregate Index and the money market index over the past two years. As the graph shows, bonds

continued on page 2

Survey Results

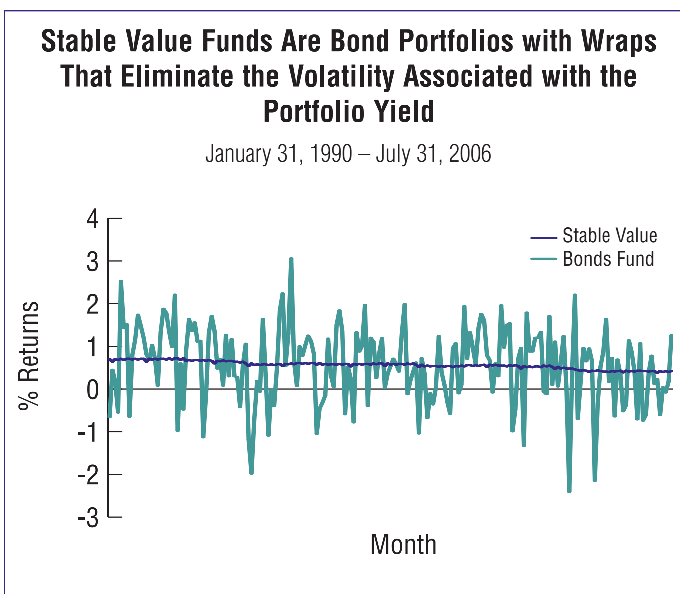
continued from page 1

experienced negative returns for five months in 2005 and three months in 2004.



Monthly Returns During 2004 and 2005

Taking a longer perspective, the following chart looks at monthly returns from January 31, 1990 through July 31, 2006 and shows how stable value removes the volatility associated with bonds while providing similar returns. Stable value produces bond-like returns with exceptionally low levels of volatility by investing in a wrapped portfolio of well-diversified bonds. The wrap protects the underlying portfolio from changes in value tied to interest rate fluctuations.

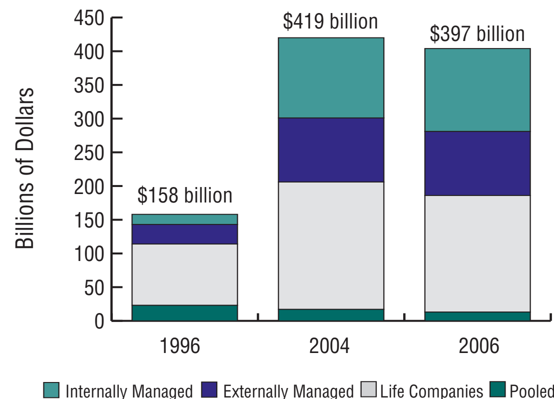


Stable Value Funds Are Bond Portfolios with Wraps That Eliminate the Volatility Associated with the Portfolio Yield

January 31, 1990 – July 31, 2006

The survey found that participant contribution levels declined in 2005 to 12 percent, compared to 15 percent in 2004. Withdrawals were almost unchanged at 12.6 percent.

Stable Value Assets by Management Segment



The distribution of assets among management segments changed slightly. External management represented 42 percent; pooled funds, 32 percent; life company full service, 23 percent; and in-house, 3 percent. The distribution for 2004 was as follows: external management, 45 per-

continued on page 3

SVIA STABLE TIMES

Third Quarter 2006

STABLE TIMES is a benefit of SVIA membership. Published by the Stable Value Investment Association located at 1025 Connecticut Avenue, NW; Suite 1000; Washington, DC 20036; phone 202-580-7620; fax 202-580-7621; www.stablevalue.org.

Editor:

Steve LeLaurin INVESCO Institutional (steve_lelaurin@invesco.com)

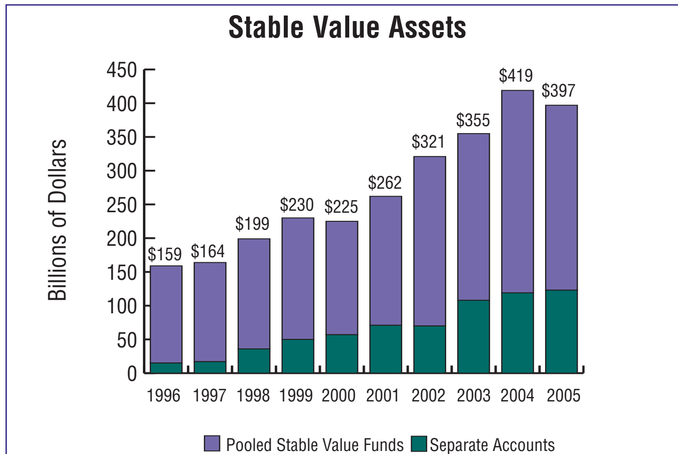
Editorial Board:

Bret Estep PIMCO (bret.estep@pimco.com)
Charlene Galt MassMutual Financial Group (cgalt@massmutual.com)
Tim Murphy New York Life Investment Management (tim_murphy@nylim.com)
Victoria Paradis JPMorgan Asset Management (victoria.m.paradis@jpmorgan.com)
Richard Taube Pacific Life Insurance Company (richard.taube@pacificlife.com)
Chris Tobe AEGON Institutional Markets (ctobe@aegonusa.com)
Robert Whiteford Bank of America (robert.whiteford@bankofamerica.com)
Greg Wilensky Alliance Capital Management Corporation (greg_wilensky@acml.com)

Survey Results

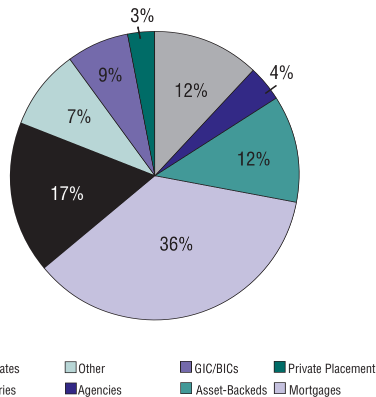
continued from page 1

cent; pool funds, 28 percent; life company full service, 19 percent; and in-house, 8 percent. (See Stable Value by Management Segment Chart)



Type of Bonds Held in Wrapped Stable Value Funds

as of December 31, 2005



Stable value portfolios underwent modest changes from 2004 to 2005. Wrapped portfolios represented the bulk of stable value assets for both years: 68 percent in 2005, compared to 70 percent in 2004. Guaranteed Investment Contracts (GICS) garnered 30 percent in 2005 and 27 percent in 2004. Cash comprised the remaining assets, representing 2 percent in 2005, compared to 3 percent in 2005. The following chart highlights how wrapped portfolios in 2005 were invested.

The duration of stable value portfolios also changed during 2005, to 3.28 years from 3 years in 2004. However, average credit quality for stable value portfolios remained high and virtually unchanged at AA+/Aa1 or better for both Moody's and Standard and Poor's, respectively.

To learn more about SVIA's Tenth Annual Policy and Investment Survey and the individual market segments, visit SVIA's website (www.stablevalue.org). The survey, which is a benefit of Association membership, is in Members' Only. SVIA

Proposed Default Fund Rules

continued from page 2

making them available to almost any 401(k) plan, regardless of size. In the last issue of this newsletter, for example, *Stable Times* reported that JPMorgan Asset Management had created a series of "SmartRetirement" date-based lifecycle funds as well as a series of "SmartMix" risk-based lifestyle funds structured as commingled pension trust funds. At the time, four clients had already invested $860 million in the SmartMix funds, and five had invested $299 million in the SmartRetirement funds.

Discount brokerage firm Charles Schwab Corp. is also competing in that space. Four years ago, it created a family of target-date lifecycle funds for the retirement plan market using institutional accounts rather than mutual funds as the underlying investment vehicles. All five funds in this Schwab Managed Retirement Trust Funds series include some allocation to stable value, ranging from as little as 2 percent in the 2040 fund to as much as 22 percent in the income fund that's designed for investors in or near retirement.

"We're a big fan of stable value," says John Sturiale, portfolio manager for the Schwab funds. "We use it in all of our bundled plans. We find that participants, plan sponsors, and plan consultants like that asset class. It has bond-like returns with lower volatility. When we did our research, we found that if we combined stable value in a core-plus fixed income portfolio, we could have returns that slightly exceed a bond benchmark but with lower volatility."

The Schwab funds had $1.2 billion in assets by the end of July and a solid base of long-term investors. Sturiale says the funds had net outflows on less than 10 trading days in 2005, making liquidity a non-issue for the funds' stable value manager, INVESCO.

Despite the changing retirement plan landscape, Sturiale doesn't see stable value funds disappearing, even as a default investment option. "I think you'll still get some plan sponsors who are very, very cautious and say, 'I don't want my participants to lose any money,'" he says. "Stable value may be the best thing for them, and I don't think that mindset is going away. While I do think you'll see more and more plans defaulting to these target-date funds—it's discussed at almost every finals presentation we go to—I don't think stable value is going away, either. And I certainly think it makes sense in a target-date fund." SVIA

Editor's Corner

By Steve LeLaurin

Sometimes when you are in the midst of busy times, you cannot tell how intense life really is. Stepping away from it often gives perspective on just how busy things really were.

Maybe I am over-reading things, but it does seem to me that 2006 may be a pivotal year (or at least noteworthy) in the stable value world. When we look back on this year, we might collectively say "WOW! Look at all the things that happened in 2006 that now shape stable value investments."

Consider these observations about 2006, many of which are highlighted in this *Stable Times* issue:

- Flat-yield curves have produced money market fund yields near or above stable value yields … certainly a point of nervousness in the stable value industry. But other than industry handwringing, we haven't seen much backlash from plan sponsors or participants. Once again, volatility in the stock market and the economy is stable value's friend.
- Steadily rising interest rates have also been our friend, at least compared to bonds. While that trend puts pressure on the "stable value vs. money market" comparison, it does produce very low or negative bond fund returns. This again highlights the advantage of low volatility in stable value.
- FASB has delivered accounting guidance that reinforces stable value accounting for single-employer plans and pooled funds. It will take effect this year.
- GASB may clarify book-value accounting treatment of stable value funds in state and local government and 529 savings plans. They are now in the process of review.
- Pension reform will enhance the stature of defined contribution plans overall. Defined contribution plan growth could certainly mean stable value asset growth.
- A number of 529 college savings plans are now using stable value investment options, and it may be a trend that continues.
- Pension reform also made permanent favorable tax treatment of 529 plan distributions, thus eliminating some uncertainty from 529 plan growth. Coupled with growing use of 529 plan stable value options, there is a chance for significant stable value growth in this area.
- There is a slow and steady "movement" among plans to use collective trust arrangements instead of mutual funds. The drive here is to save the costs unavoidably embedded in mutual funds. The DOL's pressure on plans to disclose expense ratios more clearly may be a big influence in this investment delivery shift. (More on what this means to stable value below.)
- Most lifecycle (or life-stage, lifestyle, or target-maturity) investment options have been invested in mutual funds, using money market funds as the conservative investment. But we have worked hard to convince the defined contribution community of the superiority of stable value over money market funds. Some plan sponsors have already gotten or will get their record keepers to create a custom lifestyle option for their own plan options, including stable value.
- The increasing interest in collective trust arrangements may induce collective trust companies to expand or create their own lifecycle "funds," using their own stable value collective trust fund as the conservative investment piece. When/if this happens, there will be a good alternative to the lifecycle mutual funds that use only money market funds as the conservative investment.
- Lifecycle options tend to evolve towards conservative investments, so those with stable value as the conservative investment will grow their stable value assets as their participant population ages.
- The growing use of lifecycle options with stable value could serve to stabilize cash flow volatility in stable value options. There just won't be as much incentive or interest among participants to make many investment changes. While stock market gains and declines could result in rebalancing ins-and-outs from a stable value fund among many clients, there should also be a steady influx of stable value dollars as the population ages.
- Automatic enrollment is likely to have a huge effect on the entire DC plan landscape, and in particular stable value. Certainly, auto-enrollment all by itself could have some positive effect, although most auto-enrolled participants will be younger employees who perhaps are less interested in stable value.
- The **biggest potential 2006 effect** on stable value is changing default options. Imagine two alternative scenarios:
  - Lifecycle options become the standard default, auto-enrollment gets into every plan, many employers force their employees to re-enroll, and mutual funds are the only game in town for lifestyle funds. RESULT: a potentially significant reduction in stable value balances, at least initially.
  - Same as above, except that plans adopt their own lifecycle programs from within their own plan options, or they add collective trust lifestyle vehicles with stable value as a component. RESULT: only modest decreases, or maybe even some increases, in stable value balances.

In both cases, I expect that once the early dust settles, stable value allocations in plans (regular stand-alone stable value, plus stable value imbedded in other plan options) will tend to stabilize. Reason: As noted above, participants will have very little incentive to reallocate since the lifecycle options take care of that for them.

The rest of the year should prove interesting, perhaps as a prelude to the future.

Automatic Contribution Arrangements in Government DC Plans

By Jamie Kalamarides, Prudential Financial

This article appears with the permission of the National Association of Government Defined Contribution Administrators (NAGDCA), which is a professional organization made up of the deferred compensation/defined contribution plan administrators from the 50 states and over 100 local governments and entities, as well as the private industry plan providers.
The article was published by NAGDCA in August 2006 as a brochure. For more information about NAGDCA or the brochure, please visit www.NAGDCA.org.

Faced with low participation rates, inadequate salary deferral percentages, and inappropriate asset allocation, and despite the efforts of traditional education, marketing, and one-on-one counseling methods, government plan sponsors are looking to "automatic contribution arrangements" as a potential solution to improve the likelihood that their employees will achieve a secure retirement. To adopt these arrangements, governments may need to revise legislation and state wage laws.

This brochure:

- Defines automatic contribution arrangements.
- Explores the reasons why employers are considering automatic enrollment.
- Reviews the impact of the Pension Protection Act of 2006.
- Offers a simple quiz to assess whether an automatic contribution arrangement may be right for your plan.
- Identifies the key decisions necessary to set up such arrangements in government plans.
- Discusses critical implementation considerations.

What is an "Automatic Contribution Arrangement"?

While there are many variations of automatic contribution arrangements, most experts agree that these arrangements have the following features:

- **Automatic Enrollment –** Employees are automatically enrolled in the defined contribution plan on their eligibility date. Employees are given the option to opt-out.
- **Automatic Contribution Rate –** Participants' contributions are automatically started at a meaningful level.
- **Automatic Escalation –** Participants' contributions are automatically increased annually to a specified maximum amount.
- **Default and Balanced Investments –** Participants' contributions are automatically invested in a prudent fund and rebalanced on a periodic basis.

Why Consider Automatic Contribution Arrangements?

Whether you are contemplating your fiduciary responsibilities, troubled by the future liabilities attributable to today's workers, or just altruistic, you have to be concerned about the retirement security of government employees.

The facts are startling:

- The U.S. personal savings rate as a percentage of disposable income is near 100-year lows.[i]
- Most workers (52 percent) have less than $25,000 saved, not including their primary residence.[ii]
- 59 percent of all workers feel as though they are behind schedule in savings toward retirement.[iii]
- 52 percent of Americans in their thirties are saying "just tell me what to do."[iv]
- 80 percent of participants are not engaged or involved in retirement planning.[v]
- 46 percent of participants never change their asset allocation.[vi]

You may have tried a variety of traditional approaches to change participants' behavior—like one-on-one counseling, direct marketing, and signature-only enrollment cards—only to be frustrated by their unwillingness to change due to inertia.

Academics and industry experts are very excited about the potential benefits of automatic contribution arrangements.[vii] They have found that for many employees, it is primarily inertia that has caused a failure to save.[viii] Under automatic enrollment arrangements, inertia works in favor of savings for those employees who want to save. The data indicates that automatic contribution arrangements materially increase the savings levels among low- and middle-income employees.[ix]

continued on page 6

NAGDCA's Position

There are many ways to ensure increased savings to retirement including education, advice as well as automatic enrollment. Data shows that automatic enrollment increases savings. Therefore NAGDCA supports the addition of automatic enrollment features for public employees when supported by state and local governments.

From "Letter to Chairman Grassley," March 6, 2006

Automatic Contribution Arrangements

continued from page 5

What is the Impact of the Pension Protection Act of 2006?

The Pension Protection Act of 2006 defines "automatic contribution arrangements" for ERISA plans in section §902.

The Act gives ERISA plan sponsors the choice to adopt qualified automatic contribution arrangements to avoid nondiscrimination testing and enable employees to reap the benefits of behavioral economics. The Act provides for the pre-emption of state wage laws that currently prohibit employers from automatically enrolling eligible employees in ERISA-covered defined contribution plans. Automatically enrolled participants will start at a 3 percent contribution rate and escalate 1 percent per year until they are contributing 10 percent in their eighth year of employment. To qualify, employers must provide a 100 percent match up to 1 percent of compensation and 50 percent match on elective contributions from 1 to 6 percent of employee contributions. Plan sponsors are not required to retroactively enroll non-participants. Also, under §624, ERISA sponsors have fiduciary protection for default investments whose objectives may include capital preservation and long-term capital appreciation.

However, the Act does not address automatic contribution arrangements for section 457 government deferred compensation plans and other non-ERISA plans. Why? Some say Congress was reluctant to consider legislation that states can create themselves. Others did not want Congress to pre-empt states' wage laws for their own employees. Still others wanted to avoid defining fiduciary protection for default investments in non-ERISA plans based on ERISA.

What does this all mean to government plan sponsors? To enable automatic contribution arrangements for government plans, each plan must adopt its own "automatic contribution arrangement" and modify, if necessary, any wage laws that restrict employers from withholding wages without the employee's written consent. Moreover, local instrumentalities are also dependent on their states' legislation.

State of Kansas

On March 31, 2006, Kansas Governor Kathleen Sebelius signed Kansas HB 2669, which enables all employers (including government plans) to withhold wages for contributions to automatic enrollment retirement plans. Employees covered by such arrangements will retain the right to opt-out, and employers are still able to offer opt-in retirement plans.
www.kslegislature.org/supplemental/2006/SN2669.pdf

Is an Automatic Contribution Arrangement Appropriate for Your Government DC Plan?

While there are a number of considerations often unique to each situation, ask yourself the following questions and count the number of "yes" answers.

1. Is your organization's primary retirement plan a defined contribution plan?
2. Does your defined contribution plan have lower participation than desired?
3. Is the eligible workforce not contributing enough to get a match (if applicable)?
4. Do fewer than 10 percent of participants increase their contributions over time?
5. Are assets concentrated in just a few investments for many age cohorts?
6. Do fewer than 10 percent of participants rebalance their assets periodically?
7. Is the eligible workforce younger and likely to vest?
8. Can your organization afford to pay a match (if applicable) to more participants?
9. Is it impractical or too expensive to increase participation, contributions, or diversification through traditional techniques such as one-on-one counseling or targeted marketing?
10. Is your enrollment process currently paperless?
11. Do you have benefits and an investment philosophy that is altruistic or paternalistic?

If you answered "yes" to seven or more questions, you may want to seriously consider adopting an automatic contribution arrangement. If you answered "yes" to four to six questions, some of your employees may realize real benefits from automatic contribution.

If you answered "yes" to fewer than three questions, you may want to consider more focused solutions – rather than automatic contribution arrangements – to achieve your goals. For example:

- lifecycle funds,
- simplified enrollment methods like postcards and using electronic signatures, or
- starting a match.

What Are the Key Decisions Required to Implement Automatic Contribution Arrangements in Government DC Plans?

To implement an automatic contribution arrangement, a plan needs to determine its approach to the following implementation choices. You should seek early assistance on these topics from your administra-

continued on page 7

Automatic Contribution Arrangements

continued from page 6

tor and record-keeper to understand any implementation constraints and additional costs.

Implementation Decision	Considerations
• What are your goals from automatic contribution arrangements?	• Write them down before you answer the rest of these questions as they will guide your decisionmaking.
• What percentage of income or dollar amount should eligible participants automatically contribute?	• Three percent of wages may become the market standard based on the Pension Protection Act of 2006..
• What time of year should the arrangement automatically increase salary deferral?	• Your employees won't miss the increase if you match the timing with annual salary increases.
• By what amount should salary deferrals be increased?	• One percent of wages or 50 percent of negotiated dollar wage increases are common.
• What is the maximum amount that should be deferred?	• Many employers are deciding between 10 percent and 15 percent of wages.
• Should non-participating employees be enrolled retroactively?	• Retroactive enrollment will increase participation faster for older and longer-tenured workers.
• Will you provide a match or base contribution?	• Matches give tangible incentives to stay enrolled.
• In what investments will you invest automatic contributions?	• Use your written goals and investment policy to deter mine the appropriate solution for your plan. Typical alternatives include stable value funds, target maturity funds, lifecycle funds, and balanced funds.
• How will funds be rebalanced?	• Rebalancing is often done quarterly or annually.
• What will be the form and frequency of opt-out notification?	• Opt-out notification should occur before automatic contributions start and at least annually thereafter.
• Will you market to those who have opted-out to reconsider?	• Non-participants' situations may change in future years.
• Will you re-examine the default payout vehicle for retirees and terminations?	• To create a retirement paycheck for life from participants' DC balances, some sponsors are considering moving the default payout away from lump-sum toward annuitization or guaranteed withdrawal provisions.
• If you currently have multiple retirement plan providers/administrators, which will keep records and invest the automatic contributions?	• Your plan may want to consider consolidating providers first and/or issuing an RFP to determine the most competitive offer for automatic contributions.

continued on page 8

DOL Set to Endorse Multi-Asset Funds as Default for 401(k) Investors

By Randy Myers

Safety first has long been the mantra of employers choosing a default investment option for their 401(k) plans—safety of principal, that is. However, times are changing and safety of principal is but one of many goals that employers must balance.

Sometime this fall, the U.S. Department of Labor (DOL) is slated to publish proposed regulations that would effectively endorse multiple-asset-class funds, such as lifecycle funds and balanced funds, as the best investment vehicles for retirement plan participants who don't choose their own. Specifically, the new regulations would create a fiduciary safe harbor for plan sponsors—employers—who designate such a fund as their plan's default option. That means employers could not be held liable for the performance of the fund by plan participants who were defaulted into it, as long as the employer had prudently selected and monitored the fund—a responsibility sponsors always have for all investment options they offer.

Until now, most employers have designated either a money market or stable value fund as the default investment option for their 401(k) plans, theorizing that they could minimize their fiduciary risk by not putting their participants' principal at risk. According to some experts, the proposed DOL regulations scratch that idea.

"In a sense, fiduciaries who had previously used a money market default account are being told that, if they do not put the participants' money at risk (that is, with some allocation to stocks) then the fiduciaries will be at risk," well-known ERISA attorney Fred Reish of Reish Luftman Reicher & Cohen wrote in a recent client newsletter.

Correspondingly, if fiduciaries put the participants at risk in a proper way (for example, through a multi-asset-class vehicle) then the fiduciaries will not be a risk."

The choice of a default fund has become more important as increasing numbers of employers have chosen to automatically enroll eligible employees in their 401(k) plans rather than wait for employees to join voluntarily. This makes it more likely that the default process will actually come into play. According to the Annual 401(k) Benchmarking Survey conducted by the Human Capital practice of Deloitte Consulting LLP, 23 percent of plan sponsors had embraced automatic enrollment by year-end 2005, up from 14 percent in 2004.

The DOL has not been shy about letting the retirement plan industry know that it was planning to address this issue. "With

continued on page 9

SVIA is pleased to announce the Second Spring Seminar will be held April 15-17, 2007 at the Charleston Place Hotel in Charleston, South Carolina. Hold these dates to learn the latest developments affecting stable value fund management during the home and garden tour season in beautiful, historic Charleston.

Automatic Contribution Arrangements

continued from page 7

About NAGDCA

The National Association of Government Defined Contribution Plan Administrators is composed of deferred compensation and defined contribution plan administrators from the 50 states and over 100 local governments and entities, as well as the private industry plan providers. NAGDCA is an organization in which the members work together to improve government 457 plans through a sharing of information on investments, marketing, administration, and laws relating to public-sector deferred compensation/defined contribution plans.

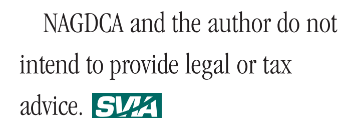
For more information, visit www.nagdca.org .

About the Author

John J. (Jamie) Kalamarides is senior vice president of the Tax-Exempt Segment for Prudential Retirement, a unit of Prudential Financial, Hartford, CT. He chaired the 2006 NAGDCA Taskforce on Automatic Enrollment.

The author would like to acknowledge the NAGDCA 2006 Automatic Enrollment Taskforce for their contributions to this brochure. The taskforce included: Robert Hansel, NAGDCA; Kris Heurich, ICMA/RC; Elaine Lewter, State of Michigan; Jay Mitchell, Mass Mutual; Alex Turner, State of Arizona; Susan White, Susan White Associates; and, Cathy Woodard, City of Anaheim. The author would also like to acknowledge the input of his Prudential colleagues: Sanford Koeppel, Lynn Whitmore-Christiano, and Tom Porcello.

NAGDCA and the author do not intend to provide legal or tax advice.



[i] U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts of the US.
[ii] Retirement Confidence Survey conducted by Employee Benefit Research Institute (EBRI), American Savings Council (ASEC), and Matthew Greenwald & Associates (Greenwald), 2005.
[iii] Prudential's Four Pillars of Retirement Series, 2005.
[iv] ibid.
[v] Retirement Services Roundtable, 2006.
[vi] ibid.
[vii] "Save More Tomorrow: Using Behavioral Economics to Increase Employee Savings," by Thaler and Bernatzi, August 2001. "Saving for Retirement on the Path of Least Resistance," by Choi, Laibson, Madrian and Metrick, Updated: July 2004. "Coming Up Short: The Challenge of 401(k) Plans," by Munnel and Sunden, 2004.
[viii] Retirement Confidence Survey.
[ix] "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States," by Boshears, Choi, Laibson, and Madrian, 2006.

DOL Set to Endorse Mulit-Asset Funds as Default for 401(k) Investors

continued from page 8

the move toward automatic enrollment, the choice of a default fund becomes critically important because many employees will be placed in the fund and are likely to leave their assets in the default," said Ann Combs, Assistant Secretary of the DOL's Employee Benefits Security Administration in January during a speech before the Northern Indiana ASPPA Benefits Council. "A money market fund is not a good long-term investment for a retirement plan. We are considering allowing employers to use more appropriate investment alternatives, such as lifecycle or target-age funds, balanced funds, or professionally managed accounts as defaults."

Lifecycle funds, which feature a gradually changing asset allocation mix targeted to the investor's planned retirement date, are expected to be especially popular once the new regulations take effect. Even without the DOL's backing, they've been springing up in retirement savings and 529 plans. Last year, the Deloitte survey found, 44 percent of 401(k) plan sponsors offered the funds, up from 28 percent the prior year.

Reish expects that once employers understand the value of a fiduciary safe harbor, they will make multiple-asset-class funds the default investment option for almost all 401(k) plans. In fact, he told clients in his firm's July newsletter that employers may even manage their plans, over time, to encourage participants to let themselves be defaulted into those funds. For example, when changing plan administration providers, they might say that unless participants choose new investments prior to the conversion, they will be defaulted into the default choice. Or they might redesign enrollment forms to show that if participants do not choose their own investments, they will be placed into the default vehicle. For all participants who allow this to happen, employers would enjoy a fiduciary safe harbor that does not currently exist even for participant-directed investments unless the plan meets the roughly two dozen requirements spelled out in Section 404(c) of the Employee Retirement Income Security Act.

Once the proposed regulations are published, the DOL will solicit and review comments from the public, a process that can take at least six months. Reish estimates that final regulations could be published in mid-2007 and take effect then or on January 1, 2008.

Most retirement plan experts expect the new rules to have some impact on the stable value industry, and indeed, it's hard to construe government endorsement of a competing investment option as a plus. But with more than 20 percent of 401(k) assets currently allocated to stable value investments, and with the product's unique investment proposition—bond-like returns with the stability of a money market fund—many experts also believe that stable value will continue to play an important role in the 401(k) marketplace. For more discussion of the impact the new rules might have on the stable value industry, see "Proposed Default Fund Rules Leave Room for Stable Value" elsewhere in this issue of *Stable Times.* SVIA

GASB Derivatives Project Looks at Synthetic GICs

By Gina Mitchell, SVIA

The Governmental Accounting Standards Board's (GASB) Preliminary Views Document on Accounting and Financial Reporting for Derivatives may have implications for the $100 billion[1] invested in stable value funds by state and local defined contribution[2] and 529 plans.

GASB, which is the accounting standard-setter for all state and local governmental entities, has been working on a comprehensive standard for reporting on derivatives since 2003. The Preliminary Views, or PV, proposes placing the fair market value of derivatives in the financial statements of state and local governmental entities and increasing derivatives disclosure requirements. GASB currently requires that state and local governments disclose the value of their derivatives in the notes to their financial statements and describe their potential risk exposure to derivatives.

The PV as currently written would require stable value funds that use synthetic GICs—wrapped bond portfolios—to report fair market value rather than contract value in plan financial statements. Stable value funds use contract value, which is principal plus accumulated interest for reporting purposes. Importantly, contract value also is the amount that all participant transactions occur within a stable value fund. The SVIA filed comments and met with the GASB Board to explain why contract value is the appropriate valuation method for stable value funds.

In recognition of contract value's importance to state and local plans and participants, the GASB Board will consider accounting for synthetic GICs at its August meeting. The SVIA Accounting Committee will continue to follow this issue and provide an update shortly. SVIA

[1] $100 billion invested by state and local governmental plans in stable value funds according to Nelson's Directory of Pension Plan Sponsors.

[2] Defined contribution plans include 457, 403(b), 401(a), and 401(k) plans used by state and local governments. Additionally, state and local governments also use stable value in college savings 529 plans.

SVIA Working Group Looks at Accounting Issue

By Gina Mitchell, SVIA

On December 29, 2005, the Financial Accounting Standards Board (FASB) released FASB Staff Position (FSP) Nos. AAG INV-1 and SOP 94-4-1[1]. Even now, the FASB pronouncement should be viewed positively because it recognized stable value accounting or contract value during a time when there are few if any exceptions to market value. FASB's pronouncement validated the appropriateness of contract value for stable value funds.

The FSP clarified the applicability of the AICPA's SOP 94-4, which had been the accounting reference for stable value funds used by corporate defined contribution plans. FASB strengthened the benefit-responsive criteria that was the heart of the AICPA standard and established some new disclosure and requirements.

To account for a stable value fund at contract value, FASB requires that the stable value fund meet all of the following criteria:

- The investment contract is effected directly between the fund and issuer and prohibits the sale or assignment of the contract or its proceeds to another party without the consent of the issuer;
- The repayment of principal and interest credited to participants in the fund is a financial obligation of the issuer of the investment contract. Prospective interest-crediting rate adjustments are permitted as long as they are not less than zero;
- The terms of the investment contract require all permitted participant-initiated transactions with the fund to occur at contract value;
- An event that limits the ability of the fund to transact at contract value with the issuer and limits the ability of the fund to transact at contract value with participants in the fund must not be probable of occurring;
- The fund itself must allow participants reasonable access to their funds.

FASB's benefit-responsive criteria and financial statement presentation is required for all private-sector stable value funds that issue financial statements. The FSP does not apply to state and local governmental plans that use stable value since the Governmental Accounting Standards Board has oversight over these entities.

For financial statement presentation, the FASB requires reporting:

- All investments (including traditional guarantee investment contracts (GICs) and wrappers) at fair value;
- Total assets, total liabilities, and net assets reflecting all investments at fair value and net assets at which participants can transact with the fund;
- The difference between the last two items is the adjustment of the fully benefit-responsive contracts from fair value to contract value.

To make this presentation, GICs and wrapper contracts, which are also called wraps, must be part of the schedule of investments and reconciled to the corresponding line items in the financial statements. For the schedule of investments, the fair value of each investment contract must be shown along with the underlying investment held by the fund, the wrapped portfolio of assets. An adjustment from fair to contract value is also required for each fully benefit-responsive contract. Lastly, the credit rating for the issuer or wrap provider must be shown.

Since wrap contracts are non-transferrable, determining fair market value is not as straightforward as with a bond or stock. Before the FSP, wrap contracts were valued simply as the difference between the overall fund's contract value and the market value of the underlying fund's assets.

The Stable Value Investment (SVIA)'s Working Group on Wrap Valuation[2] has been studying two possible approaches to determine the wrap's value. They are based on income or replacement cost.

The income approach uses valuation techniques to measure future cash flows. The Working Group used Black-Scholes options pricing and Monte Carlo simulations. Based on initial testing by the group, the Monte Carlo simulation appeared somewhat better than option pricing. The group's chair, Laura Powers, a Director at Merrill Lynch Investment Management, explains, "Option pricing is not a perfect fit. Wrap contracts behave more like insurance than a derivative or put option. You would not use an option pricing model to value insurance. Plus, the option only has value when the fund or plan is in distress, which negates an option's concept of being a 'going concern.'"

The group also ran a sample of Monte Carlo simulations. The sample produced a wide range of results based on the factors used by a wrapper and/or manager. The sample also showed that slight variances in input produced wildly different values.

The group also reviewed replacement cost and matrix pricing as a way to determine the fair value of the wrap. Replacement cost is simply the cost of replacing the contract today, present valued over the duration of the contract or the termination notice period of the contract if longer.

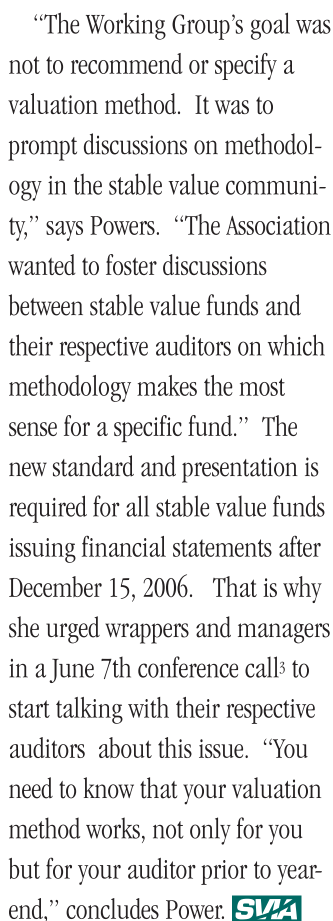
continued on page 11

SVIA Working Group Looks at Accounting Issue

continued from page 10

Replacement cost is easy to calculate and represents the cost quoted by the issuers incorporating their assumptions about the risk of withdrawals over various paths of interest rates. However, this approach may be burdensome because wrappers will have to reprice all contracts, and valuations should remain pretty stable as market conditions change.

A matrix price approach would attempt to type wrap contracts and put them into buckets based on common factors such as: average credit quality of the portfolio, buffer size, cash flow, contract size, duration of the portfolio, market-to-book value ratio, withdrawal protocols, and whether the fund was a pool or separate account. Wrappers would price these buckets and their responses would be consolidated for use in valuing wraps with similar characteristics. While this approach might seem like less work for wrappers, it would not recognize all the determinants that wrappers use in pricing contracts. Matrix pricing would not recognize the differences in the way wrappers weigh various factors in determining a wrap's price.



Matrix pricing would provide a process and a level of independence from a specific wrapper in determining the value of the wrap. The process and independence may produce a more consistent method of valuation across the spectrum for all wraps.

"The Working Group's goal was not to recommend or specify a valuation method. It was to prompt discussions on methodology in the stable value community," says Powers. "The Association wanted to foster discussions between stable value funds and their respective auditors on which methodology makes the most sense for a specific fund." The new standard and presentation is required for all stable value funds issuing financial statements after December 15, 2006. That is why she urged wrappers and managers in a June 7th conference call[3] to start talking with their respective auditors about this issue. "You need to know that your valuation method works, not only for you but for your auditor prior to year-end," concludes Power. SVIA

---

[1]FASB Staff Position Nos. AAG INV-1 and SOP 94-4-1 is titled, "Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans." FASB Nos. AAG INV-1 and SOP 94-4-1 will be referred to simply as the FSP.

[2]Members of SVIA's Working Group on Wrap Valuation are: Robin Foley, Fidelity; Steve Kolocotronis, Fidelity; Aruna Hobbs, AEGON; Marc Magnoli, JPMorganChase; Kim McCarrel, INVESCO; Brian Murphy, AEGON; Laura Powers, Merrill Lynch; and Jeanie Spano, Merrill Lynch.

[3]This June 7 conference call is summarized in this article. The conference call was recorded for the benefit of SVIA members. Members can listen to this discussion by visiting the Members' Only section at www.stablevalue.org. This issue was also discussed as part of the April 2-4 Spring Seminar presentation on "Accounting Issues and Implementation."

New Pension Law Highlighted

By Gina Mitchell, SVIA

With President Bush's signature on August 17, the Pension Protection Act of 2006 was signed into law. The new pension law makes substantial changes to traditional defined benefit plans and defined contribution plans.

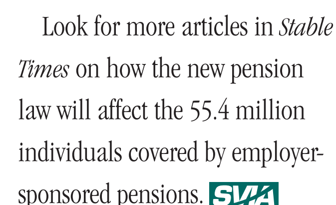
The law imposes new funding requirements on defined benefit plans and recognizes the growing importance to most workers of retirement savings through defined contribution or 401(k) plans. A few of the Act's provisions are highlighted below.

Provisions affecting 401(k) plans are expected to increase retirement savings by encouraging employers to automatically enroll workers in their 401(k) plans. Additionally, the pension law will permit employers to increase gradually the amount that workers save. The Retirement Security Project, a non-profit research organization, estimates that auto-enrollment and auto-increase will increase savings an additional $10 to $15 billion each year when fully in effect.

The law made permanent the tax-advantaged contribution limits for Individual Retirement Accounts (IRAs) of up to $5,000 in 2008 and for 401(k) plans of up to $15,000 in 2006, including catch-up contributions of up to $1,000 each year to an IRA and $5,000 each year to a 401(k) plan. These limits were set to expire in 2010.

Other provisions of interest to defined contribution plan sponsors and participants are:

- The ability of financial service firms to provide investment guidance to 401(k) plan participants.
- The use of mixed-asset funds such as target-date or lifecycle funds as a default investment option for employees who do not make an investment choice.



Look for more articles in *Stable Times* on how the new pension law will affect the 55.4 million individuals covered by employer-sponsored pensions. SVIA

WE'VE MOVED!

Effective May 30, 2006 our new address is:
Stable Value Investment Association
1025 Connecticut Avenue, NW, Suite 1000
Washington, DC 20036
Phone: 202-580-7620 • Fax: 202-580-7621

Ten Are Running For SVIA Board

By Gina Mitchell, SVIA

During the month of August, SVIA members were asked to nominate members to run for five open SVIA Board seats: two plan sponsor seats and three service firm seats. This year over 39 individuals were nominated by more than 70 percent of the voting members.

This year ten plan sponsors were nominated to be candidates. Only two chose to run for the two-plan sponsor seats. The plan sponsors are: Edward Adams from IBM and Karen Chong-Wulff from DuPont.

Service firm nominees had to receive at least five nominations in order to be a candidate. Only eight of the 29 nominees received five or more nominations. However, all of the eight service firm members chose to run for the three service firm positions. The service firm members who are running are listed below.

- John Axtell, Deutsche Asset Management
- Jeff Clark, Dwight Asset Management
- Daryl Dennis, ICMA
- Brian Murphy, AEGON
- Mike Norman, Galliard
- Laura Powers, Merrill Lynch
- Adam Silver, Royal Bank of Canada
- Richard Taube, Pacific Life

The elections will be held using the Internet after this year's October 10-12th National Forum and Annual Membership meeting. Each voting member will be asked to affirm the two plan sponsor candidates and select three out of the eight service firm candidates. Look for more information about the candidates in the Forum materials and in your emails during the week of October 16th.

Stable Value Investment Association's Annual National Forum and Membership Meeting

Mapping the Way

A Look at the Issues Affecting Retirement Security
The Rules, the Market, and Individual Choices

Ritz Carlton • Washington, DC • October 10-12, 2006

Lee Eisenberg

Randy Hardock

Mickey D. Levy, Ph.D.

Charlie Cook

Jeff Birnbaum

Hobbs and Duffield: Last Year of Second Term

By Gina Mitchell, SVIA

October 10 is not only the next meeting of SVIA's Board of Directors. It is also the last scheduled meeting for long-term retiring members of the Board. Aruna Hobbs, who heads AEGON Institutional Markets' pension group, and Nathaniel Duffield, Director of Trust Investments for Halliburton will be stepping down from the SVIA Board since the Association's bylaws limit Board service to two consecutive terms.

During Nat's six years, he has shared his experience running multi-billion international defined benefit and defined contribution plans. Stable value remains a core offering in the Halliburton's 401(k) plan, consistently garnering over 30 percent of assets.

Aruna has given her expertise on a wide range of issues affecting both GICs and wraps. However, she has distinguished herself by leading many of the Association's initiatives to secure stable value's accounting foundations. As Chair of the Association's Accounting Committee, she led the Association through the standard-setting process with the Financial Accounting Standards Board that clarified and affirmed AICPA SOP 94-4. She is now working with the Accounting Committee to obtain guidance on synthetic GICs from the Governmental Accounting Standards Board for state and local plans who invest in stable value. SVIA