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Wharton Professor Makes a Case for Stable Value

By Gina Mitchell, SVIA

Wharton Finance Professor David Babbel pointed out three common misconceptions that make it harder for 401(k) investors to understand stable value and achieve retirement goals. He spoke at SVIA's Spring Seminar in Charleston, South Carolina. Correcting these misconceptions sets the stage to compare stable value funds to other asset classes used by 401(k) investors.

Financial Markets Have Changed and So Have Anticipated Returns

While most financial gurus urge investors to rely upon stocks, Babbel cautions that today's financial markets are very different from those of the past. He points out that the assumption that equities will continue to provide a sizeable return premium over the long term has been challenged on several fronts. In fact, the warnings in most prospectuses that the past history of returns is not a reliable indicator for future returns is equally applicable to the future returns of equities.

Most research on equities looks at 30-year periods to provide historical returns, explains Babbel. Since 1926, however, when reliable data first became available, there have been only two non-overlapping periods of 30 years, which is not considered a meaningful statistical standard, says Babbel.

In addition, Babbel notes that in shorter holding periods, equities often exhibit lower returns and higher risks. These shorter periods are particularly important, because the 30-year periods are relevant only for workers who have at least 30 more years for their investment period. The number of workers who have a 30-years-or-more investment horizon is an increasingly small fraction of the workforce due to the aging of the population and increased employment mobility.

Babbel further explains that past equity returns reflected an economy that was markedly different from today's. That is also why most financial economists today expect an equity return premium that ranges from 2 percent to 3.5 percent over Treasuries rather than the historical 6.5 percent to 8 percent.

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Work Longer, Save More

Retirement Expert Sees Hard Choices for American Workers

By Randy Myers

Alicia Munnell has peered into the future of the average American worker and does not much like what she sees. Thanks to the gradual disappearance of traditional pension plans and the inability of individual workers to compensate with personal savings, she says, nearly half the nation's households are at risk of being financially unprepared for retirement. While some may improve their lot by ramping up their savings, she predicts that many will simply have to work past the traditional retirement age.

As Director of the Center for Retirement Research (CRR) at Boston College, Munnell has attempted to quantify what many Americans know in their gut: They are not saving enough for old age. While the 401(k) plans that are now the main retirement savings vehicle for most workers are theoretically capa-

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EBRI Sees 401(k) Plans as Viable Retirement Savings Vehicles—If Used Faithfully

By Randy Myers

It is common to hear retirement industry professionals decry the failure of the 401(k) plan, in its current form, as a viable substitute for the once ubiquitous but rapidly disappearing traditional pension plan. The 401(k), after all, was designed to supplement, not supplant, a pension, and its successful performance depends on the voluntary participation of workers who, in most cases, know little or nothing about investment strategy or practice. It is also true that countless studies have shown that a sizeable percentage of 401(k) plan participants are not investing fast enough or smart enough to assure themselves a financially secure retirement—if they participate in their plan at all.

Still, the 401(k) might be taking a bit of a bad rap. Jack VanDerhei, a Fellow with the non-profit Employee Benefit Research Institute (EBRI), says

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Editor's Corner

By Richard Taube, Pacific Life Insurance Company

This issue of *Stable Times* highlights the SVIA's Second Spring Forum held on April 15-17 in Charleston, South Carolina, where the theme was "Evaluating 401(k)s: How Demographics, Savings, Plan Design, and Investment Choice Are Shaping Retirement Security." Forum speakers addressed the nation's current state of retirement readiness and what is being done by individuals, employers, policymakers, and others to improve workers' likelihood of achieving a secure retirement.

Attending the Spring Forum and authoring this Editor's Corner is particularly pertinent and timely for me, as I have recently hit a landmark event in life: sending off the first official college payment for my oldest of three sons, Matthew. Although he doesn't actually hit the UCLA campus until September, the initial installment for room and board was due in May. For the first time, after years of saving, I dipped into a 529 College Savings Plan account.

That stark reality triggered me to re-evaluate my personal financial plan and think about those things that people generally don't like to think about. Whether it concerns saving for college or saving for retirement, many of the same questions apply. Did I start saving early enough? Am I contributing enough? Have I made reasonable assumptions about expenses, inflation, how much money I will ultimately need, and when I will need it? Did I make the right choices regarding asset allocation and investment options? What could go wrong along the way, what are the consequences of not saving enough, and is that a risk I am willing to take?

With much at stake as the nation's 77 million baby boomers reach or near retirement age, the Spring Forum addressed these very questions and more. Speakers probed into faulty retirement planning assumptions, common misperceptions and investment mistakes, and participant behavior inertia, all leading to the potential of low income-replacement rates and the risk of being financially unprepared for retirement. The takeaway was not a real surprise to industry insiders: Americans are just not saving enough for old age. Individuals need to start saving earlier, saving more, and working longer.

Fortunately, much is being done to improve the retirement security landscape. The Spring Forum addressed the Pension Protection Act, which makes it easier for employers to automatically enroll employees in their 401(k) plans, automatically increase deferral rates, and default assets into diversified-investment portfolios. Speakers discussed how product innovation has kicked into high gear, with service and investment providers focusing on asset allocation and managed portfolios, guaranteed-income annuity products, and combination products that might also contain elements providing disability insurance, longevity insurance, and/or long-term care coverage.

While it is common to hear criticism of the 401(k) plan as a viable substitute for the vanishing traditional defined benefit plan, presentations at the Spring Forum concluded that the 401(k), when combined with Social Security benefits (even as limited as they might become), can in fact provide sufficient retirement income if workers defer enough and continue to participate in a 401(k) for their full working lives.

Fortunately for this readership, it was also duly noted that stable value can play an important role. Rigorous research, as conducted by CRA International and the Wharton School under a variety of measures, proved the superior risk-adjusted returns of stable value funds relative to money market funds, bond funds, and even equity funds. Under the basic assumptions that individuals prefer more wealth to less wealth and less risk to more risk, stable value has proved to be a dominant asset class for retirement savings purposes.

So, the challenge is set. American workers and retirees need help. Stable value can be a viable part of the solution. As an industry, we need to do our part in shaping retirement security by continuing to spread the stable value message and by finding innovative ways to package stable value into solutions that meet those needs.

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Using the Simplest Asset Allocation Model May Leave Savers Short

While mean-variance modeling may be easy to perform and simple for 401(k) investors to understand, Babbel cautions that reliance on this popular means of asset allocation does not take into account investors' aversion to loss. Mean-variance is also of limited use, as it may be accurate for only short periods of time and is useful only for normal return distributions. In Babbel's analysis of common 401(k) assets—stable value funds, bond funds, money market funds, and stocks—there was less than one chance in a million that the assumption of the normal bell curve of returns was warranted. To the contrary, the returns on bonds, money markets, and stocks showed skewed returns and extreme returns that are not captured adequately by normal distributions, which underlie all mean-variance portfolio approaches.

Babbel elaborated that the shortcomings of mean-variance modeling are well known. Since Fred Arditti demonstrated in 1967 that investors care about risk and that return measures are not adequately described by simple mean-variance measures, economists have recognized that a more robust characterization of asset returns is necessary to make asset-allocation determinations. Mean-variance rankings of portfolio opportunities fail to distinguish some investments that would be selected by any and all rational investors because of the limited use of return-distribution information that is made with the mean-variance approach.

Stable Value Is Not Like Money Market or Bond Funds

Stable value funds are often grouped together with money market funds in surveys and studies, but there are significant differences. Babbel declares this assumption to be fundamentally wrong and explains that while both are intended to provide stability of principal, money market funds invest in shorter-term instruments. This results in lower and more variable investment returns.

By investing in a diversified portfolio of GICs and/or intermediate-term, investment-grade bonds, stable value funds achieve significantly higher average interest rates and provide consistent, predictable growth over the long term. "These are important characteristics to investors, especially those investing for retirement," emphasizes Babbel.

Stable Value Stacks Up

Babbel's analysis of how stable value funds compare with money market funds, bond funds, and stock funds in producing retirement wealth used three widely accepted methods in finance and economics: mean-variance analysis, stochastic dominance analysis, and multi-period utility analysis. Each method has its advantages and shortcomings, stressed Babbel. When used together, however, they form a powerful set of tests that can help determine which asset classes are most suitable for people accumulating retirement assets, explains Babbel.

Using the limited mean-variance analysis, Babbel found that stable value funds had superior risk-return characteristics to equities, money market funds, and bond funds. Babbel reports that no combination of money market

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Stochastic Dominance Summary: Do SV Funds Dominate MM, Bonds, and Stocks?
January 1989 to December 2006

Period: Jan-89 to Jan-06 (216 obs.)		First Degree (FSD)	Second Degree (SSD)	Third Degree (TSD)	Fourth Degree (4SD)
SV Dominates	MM	YES	YES	YES	YES
	Bonds	NO	YES	YES	YES
	Stocks	NO	NO[a]	NO[a]	NO[a]
MM Dominates	SV	NO	NO	NO	NO
	Bonds	NO	NO	NO	NO
	Stocks	NO	NO	NO	NO
Bonds Dominate	SV	NO	NO	NO	NO
	MM	NO	NO	NO	NO
	Stocks	NO	NO	NO	NO
Stocks Dominate	SV	NO	NO	NO	NO
	MM	NO	NO	NO	NO
	Bonds	NO	NO	NO	NO

[a]SSD fails for the 37 largest stock returns, or 17.1 percent of all months. This is the reason TSD and 4SD also fail.

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fund investments, bond fund investments, or stock fund investments were able to achieve the same level of returns with such low risk that was achievable through stable value funds.

Babbel next examined the asset allocation strategies using a more robust technique known as stochastic dominance analysis. This technique was developed in the 1970s to address the severe shortcomings of the mean-variance approach, and it is relied upon to this day, says Babbel. It has the distinct advantage that the investment analyst need not know the particulars of the preferences of the investors. Rather, the analyst needs to know only the investor's preferences for wealth and risk.

Using the more rigorous stochastic analysis, there was no case in which investments in stocks, bonds, and money markets dominated each other, or dominated investments in stable value funds. However, the analysis did demonstrate that stable value funds dominated (i.e., was preferred to) money market funds and bond funds. This result held true for all possible forms of preference functions that an investor might have, as long as the investor preferred greater wealth to lesser wealth and lesser risk to greater risk. The study also considered investors who preferred positively skewed returns to negatively skewed returns, as well as investors who were averse to "fat-tailed" return distributions, under which extreme results (either positive or negative) are more likely to occur.

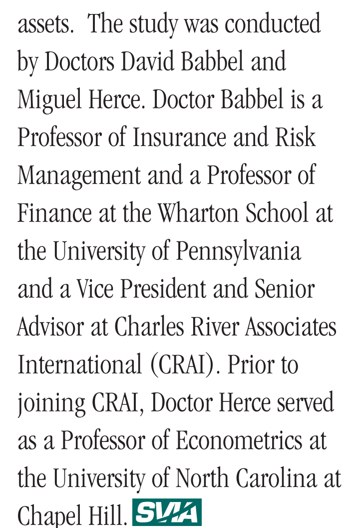
Lastly, Babbel used a multi-period, utility investment framework to evaluate portfolio performance. This framework was developed at Berkeley, Yale, Wharton, and the Massachusetts Institute of Technology. Under this approach, Babbel explains, a family of preferences is used that has an attractive characteristic. It is termed "investor myopia." Investors that follow myopic behavior feel that it is consistent with asset-allocation optimality over long horizons as well. Babbel explains that this family of preferences is the most widely used in the financial economics literature today.

The risk and return distributions of equity, bond, money market, and stable value investment funds were entered into the optimal asset-allocation program for analysis. For almost all levels of investor risk aversion, the model found that the optimal asset allocation would consist either of stable value funds, equity funds, or some combination of both. There was no balanced fund, combination of equities and money markets, or combination of equities and bonds that beat stable value, notes Babbel. Furthermore, multi-period utility analysis found no empirical support for the life-stage funds that have become popular over the past three years.

Importantly, says Babbel, the third approach found that stable value funds enable investors to better plan for the future by providing consistent, competitive returns and principal stability. These stable value fund characteristics are also less likely to cause an investor to "turn off" saving in a 401(k) plan as negative and volatile earnings are minimized. Minimizing the "turn off" factor is an important consideration in selecting a default option for a plan sponsor who is trying to encourage a non-participating employee population to save in the 401(k) plan, noted Babbel.

About the Study

The study, which is sponsored by SVIA, is expected to be released this summer. It examines the risks and net returns of various assets. Stable value net returns were developed from data supplied by nine stable value managers who manage commingled funds, separate accounts, and full-service funds representing $189 billion in assets. The study was conducted by Doctors David Babbel and Miguel Herce. Doctor Babbel is a Professor of Insurance and Risk Management and a Professor of Finance at the Wharton School at the University of Pennsylvania and a Vice President and Senior Advisor at Charles River Associates International (CRAI). Prior to joining CRAI, Doctor Herce served as a Professor of Econometrics at the University of North Carolina at Chapel Hill.



Work Longer, Save More

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ble of producing just as much retirement income as the defined benefit pension plans they replaced, Munnell says that workers simply make mistakes at every step of the retirement planning process. More than one-fifth of workers don't participate in their plans, nearly nine out of 10 don't contribute the maximum amounts allowable, about half don't diversify their investments, and nearly half don't roll their balances into a new plan when they leave a job, cashing out instead. And, of course, not all workers have access to a 401(k) or comparable defined contribution plan.

Munnell recently served as the kickoff speaker for the Stable Value Investment Association's 2007 Spring Forum in South Carolina, where she emphasized that the unfortunate consequence of these changes is that retirement readiness is shrinking for many Americans. This is in no small part due to skyrocketing health care costs. The National Retirement Risk Index created by Munnell and her colleagues at Boston University indicates that 43 percent of U.S. households won't have enough money at age 65 to maintain their pre-retirement living standards. For at-risk households with high incomes, that might mean foregoing travel and entertainment. For lower-income households, it could mean not being able to afford necessities such as shelter, food, or health care.

The federal government has taken some steps to improve the situation. Last year, Congress enacted the Pension Protection Act of 2006. The Act makes it easier for employers to automatically enroll employees in their 401(k) plans, automatically increase their savings rates over time, and default their assets into broadly diversified portfolios. If widely adopted, such measures could increase 401(k) participation and savings rates, particularly for lower-income workers.

Ultimately, though, it is workers themselves who must take responsibility for their retirement readiness, Munnell said, and thus far they have shown little inclination to do so. Each year, she noted, researchers

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research by that organization suggests that 401(k)s, when combined with participants' Social Security benefits, have the capability to provide adequate retirement income for post-baby boomers. To do so, however, they must participate in those plans from the beginning to the end of their careers.

Speaking at the SVIA's 2007 Spring Forum in Charleston, South Carolina, VanDerhei said that his conclusion was based on EBRI's analysis of plan participants born between 1965 and 1974. He assumes that participants' savings and investment habits as they age should parallel the way the preceding generation of participants saved as they aged. Depending on income level, he said, the post-baby boomers should be able to replace anywhere from 83.9 percent to 106.4 percent of their pre-retirement income when they quit working at age 65 and start drawing on both Social Security and their 401(k) nest egg. Those in the lowest income quartile will have the highest replacement income, because their Social Security benefits will equate to a greater percentage of their pre-retirement incomes.

VanDerhei also discounted the gloomy statistic showing that the average 401(k) participant only has about $60,000 in his or her retirement account. That number is skewed by the accounts of young participants who have not had time to accumulate a significant balance and by accounts of older workers who did not have a chance to participate in a 401(k) prior to the launch of the first plan in 1981. Still, VanDerhei noted, workers in their sixties who are nearing retirement have, on average, about $180,000 in their accounts. That's not enough to sustain most people in retirement, but it's better than the broad averages would indicate.

The problem, of course, is that not all U.S. workers have access to a 401(k) plan, and those that do often do not take full advantage of them. Statistics compiled by EBRI from its database of 47,000 plans covering 17.5 million participants indicate that 15 percent of those participants allocate nothing at all to equities, including 18.5 percent of participants in their twenties and 13.3 percent of participants in their thirties. Most investment professionals agree that young investors should have a substantial allocation to stocks.

One reason for the disconnect may be that people do not have a realistic handle on how much they will need to sustain themselves in retirement—or they are simply unwilling to face up to that figure. In its Retirement Confidence Survey earlier this year, in which it polled more than 1,200 workers aged 25 and older, EBRI found that a significant number—18 percent—think they can get by on less than $100,000. On average, they project they'll need a nest egg equal only to about 6.5 times their current income. But VanDerhei said every EBRI simulation shows that people will truly need much more. Finally, while 17 percent of survey respondents said they worked for an employer that in the past two years had decreased their retirement benefits, almost 40 percent of that group said they would be doing nothing at all to offset that decrease.

Many retirement industry experts are hoping that by automating participation in 401(k) plans, as encouraged under the Pension Protection Act of 2006, more American workers will begin saving for their retirement. VanDerhei said EBRI's analysis shows that adding an automatic enrollment feature to 401(k) plans, in which all eligible workers are enrolled unless they take action to opt out, would dramatically improve the retirement security prospects for lower-income workers, even if plan participants are defaulted into saving just 3 percent of their paychecks. Automatic enrollment, however, has little, if any, positive impact on higher-income workers, he said, primarily since those workers would have been more likely to join their plans already, often at higher deferral rates.

EBRI's findings suggest 401(k) plans can play an important role in providing financial security for retired Americans, but only if plan participants spend their entire working lives participating in them. SVIA

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at the Employee Benefit Research Institute poll U.S. workers to find out how long they plan to stay in the work force, and the universal answer always come back as age 65. And yet each year, she said, many workers continue to retire at age 62, when they become eligible for Social Security benefits, often for frivolous reasons they have not given a lot of thought to, such as disliking their young new boss.

Saving more and working longer could dramatically improve their retirement readiness, she said. Under the CRR's model, increasing savings rates by 3 percent across the board would reduce the number of households at risk by 11 percent. If everyone retired at age 67 instead of age 65, Munnell said, only 32 percent of households would be at risk instead of 43 percent.

Munnell also argued that employers and the government could both do more to improve the retirement outlook in the United States. Employers, she said, need to revise personnel policies to encourage older workers to stay on the job a little longer and adopt automatic enrollment and deferral rate increases for their 401(k) plans so that more workers save at higher rates. Only about a third of large companies have automated their 401(k) plans to date, she said. The government could help by redefining the policies that allow workers to begin collecting Social Security benefits as early as age 62 and by introducing a new national, privately managed retirement savings program to supplement Social Security and private savings.

The government also could help retirees, Munnell said, by looking for ways to help them manage the drawdown of their savings during retirement. One option might be to create a low-cost "default annuity" that would let retirees convert their nest eggs, or some portion of them, into a steady stream of guaranteed income for the rest of their lives. Coming up with an annuity solution that satisfies everybody could be difficult, she conceded, because retirement professionals are not united on the question of whether annuities are appropriate for most people.

Finally, Munnell said, the federal government must come up with a solution to the funding crisis that is confronting the Social Security system. "We should be really careful before we cut Social Security benefits to solve the financing gap (in that program)," she warned. "There's no silver bullet. It's hard to raise taxes or cut benefits. But if you look at the issue in the context of retirement income needs, it makes me come down on the side of putting more money into the program." SVIA

Building Better Retirement Funds

By Randy Myers

Widely held assumptions about how people save for retirement are flawed, a Wall Street money manager told attendees at the SVIA's 2007 Spring Forum. These false assumptions may be undermining the effectiveness of target-date retirement funds, one of the fastest-growing investment vehicles in 401(k) plans.

Anne Lester, a Managing Director and Senior Portfolio Manager with JPMorgan Asset Management, said that because of asset managers' flawed assumptions, some target-date retirement funds may not provide the secure retirement investors want from them, especially under worst-case market scenarios. Target-date funds are asset-mixed funds that rebalance as the investor ages and approaches retirement. They automatically become more conservative as investors approach retirement.

In calculating how much investors will need in retirement and how their target-date funds should be constructed, Lester said asset managers make several assumptions. They often assume that 401(k) participants will gradually increase their savings deferral rates to 10 percent of salary by age 35, enjoy annual salary increases, not borrow from their accounts prior to retirement, and smoothly withdraw about 4 percent to 5 percent of their assets from their accounts once they do retire.

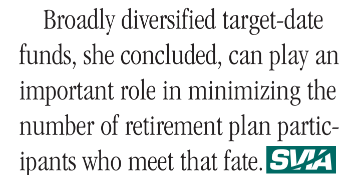
In fact, Lester said, an analysis of the behavior of the more than 1.3 million participants in a proprietary JPMorgan database shows that they increase their deferral rates slowly, typically not reaching 10 percent of salary until age 55. They get raises only every two to three years, not annually. Twenty percent borrow, on average, 15 percent of their account balance prior to retirement. And the average participant withdraws more than 20 percent of this account balance shortly after retiring rather than parceling it out at a conservative rate of 4 percent to 5 percent annually.

Among other things, Lester said, these misperceptions can lead asset managers to calculate that investors will need higher levels of income in retirement than they actually do need. The result is higher-than-warranted allocations to equities in their target-date retirement funds once they've stopped working. "We think people are making very dangerous assumptions about the length of time people are staying in their plans," Lester said. "We think the actual time horizon is much shorter, which influences how much equity their portfolios should have at the end."

The best way to measure the success of a target-date fund, Lester suggested, is by the degree to which it maximizes the number of investors who hit a targeted, minimum level of income replacement by retirement age. The best way to maximize that number, she suggested, is to build highly diversified funds that include allocations not only to domestic and international stocks and domestic bonds but also to domestic real estate investment trusts, high yield, fixed income securities, emerging-markets debt, and direct real estate investments. She said an efficient frontier analysis of two target-date funds, one invested only in the first group of asset classes and the other in the broader group, showed the more diversified portfolio yielding slightly higher returns with less volatility. In Monte Carlo simulations, she added, the more highly diversified portfolio also yielded higher-than-expected account balances under worst-case market scenarios than did the more concentrated portfolio.

Worrying more about how well a retirement fund will do in a negative environment than a positive one is important, Lester said. The pain of retiring with less money than needed is worse than the pleasure of retiring with more than is needed. "Let's say you have $200,000 extra; that's nice," she said. "But if you have $200,000 less, you're moving out of your home, you're not paying for your medicines. You've seriously hampered your lifestyle."

Broadly diversified target-date funds, she concluded, can play an important role in minimizing the number of retirement plan participants who meet that fate. SVIA



Defining Stable Value

By Randy Myers

Maybe the stable value industry is due for an image makeover. Long accustomed to operating outside the financial limelight, some industry insiders suggest it might have a brighter future if retirement plan sponsors and consultants understood it just a little bit better.

"Stable value is like the quiet, good child," laments Victoria Paradis, Managing Director of Fixed Income for JPMorgan Asset Management. "Its returns are typically positive and stable, and it rarely gets a lot of attention. Everybody focuses on the wild child in the family."

Part of the problem, says Dylan Tyson, Vice President of Stable Value Markets for Prudential Financial, is that different people have different ideas of what stable value is, and they often do not have a deep understanding of its underlying mechanics. To some, it's an asset class that provides long-term returns comparable to an intermediate-term, fixed income portfolio, while offering the stability and liquidity of a money market fund. To others, it's simply an investment appropriate for retirement plan participants who seek interest income and safety of principal. For still others, it's just the most widely used yet least well-understood investment option within qualified retirement plans.

One consequence of this confusion, Tyson says, is that retirement plan sponsors and consultants, when evaluating a stable value fund, too often focus almost exclusively on its crediting rate, which ultimately tells them very little about how the fund is managed or how appropriate it is for the investors in a particular retirement plan. Nor does that single-minded approach always satisfy the high level of fiduciary oversight

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JPMorgan Introduces New Performance Metric for Stable Value

By Randy Myers

For years, the stable value industry has struggled to come up with a benchmark that would be useful for measuring the performance of stable value funds. It has been a difficult undertaking. Fund structures and investment policies vary widely from one product to the next, making apples-to-apples comparisons difficult. Book-value returns are a convenient metric for the individual investors who are the end customers of stable value funds. However, benefit-responsive contracts smooth returns and multiple factors outside the fund manager's control can influence book returns. As a result, book-value returns are of limited use to plan sponsors and consultants who want to gauge manager prowess. Market-value returns are far more helpful on that score, but without a standard market benchmark, apples-to-apples performance comparisons remain challenging.

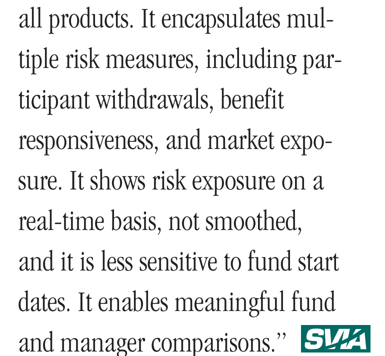
Now JPMorgan Asset Management, a stable value manager, is taking a fresh approach to the performance-measurement problem. Victoria Paradis, Managing Director of Fixed Income for the firm, says a new metric it devised could make it easier to gauge the performance of stable value investments and perhaps spur better across-the-board performance by the industry itself.

Paradis described the new metric at the SVIA's 2007 Spring Forum in Charleston, South Carolina. The metric begins by recognizing that a universal measure of stable value risk is the relationship between a fund's underlying asset market value and the fund's total book value. The closer the two values stay to each other, the less risk a fund has incurred. When market and book values are closer together, participant cash flows have a smaller impact on returns, a fund can better respond to changing interest rates, and the fund overall experienced lower market risk. The ratio of the fund's market value and book value is a useful point in time measure. A measure that tracks this risk historically is the volatility of the changing market-value/book-value ratio over time. In short, this volatility measure offers a convenient way to gauge a fund's exposure to total stable value risk.

While money market funds should have zero market-value/book-value volatility, the relationship between those values in a stable value fund will change over time and with the markets. The key to success lies with balancing return generated per unit of risk.

To evaluate a fund's performance within this useful risk framework, JPMorgan's Stable Value team has adopted a measure of return per unit of risk. This metric measures the underlying market-value performance in relation to the stable value risk taken on to earn that performance. Paradis said plan sponsors and consultants looking at the measure would immediately know important things about a stable value fund relative to its peers. It can be useful to evaluate how competing stable value products generate return per unit of risk incurred.

Paradis urged her SVIA colleagues to consider the potential benefits of embracing the new metric. "If we as an industry adopt this approach and use it to measure stable value performance at the total fund level, it will help to make our industry more transparent. It is simple to calculate for all products. It encapsulates multiple risk measures, including participant withdrawals, benefit responsiveness, and market exposure. It shows risk exposure on a real-time basis, not smoothed, and it is less sensitive to fund start dates. It enables meaningful fund and manager comparisons."



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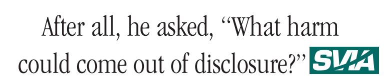
that sponsors and consultants should aspire to when choosing investment options for a retirement plan.

Addressing the SVIA's 2007 Spring Forum with Paradis, Tyson conceded that walking customers through the nuances of stable value investing, including the differing investment management styles and fee structures, is a tough assignment. But to the extent the industry is able to help retirement plan sponsors and consultants become better informed buyers, he said, they will feel more in control of their stable value investments and more comfortable with keeping them in their portfolios.

To help push the education process along, Tyson reported that the SVIA has undertaken three initiatives. One is the drafting of a white paper, currently out for member comment, on stable value investment practices. It is intended to describe, in an inclusive rather than prescriptive fashion, just what constitutes a stable value investment product. Another initiative is a stable value fee disclosure template, which is available at www.stablevalue.org. The template has been used by plan sponsors and stable value managers to identify and communicate fees associated with fund-management services and products. Lastly, the Association developed a white paper on performance measurement for stable value funds that managers have used to compare their respective performance.

"Right now, making an apples-to-apples comparison of one stable value fund with another can be difficult," Tyson says. "It must have taken me a year and a half to fully understand the economics of stable value across each type of stable value product. We need to make it easier, and the fee disclosure template does that. I'm not saying everyone has to use it, but to the extent they abide by its spirit, the industry is going to be a better one."

After all, he asked, "What harm could come out of disclosure?"



First Audit Cycle under New Accounting Guidance

By Randy Myers

On December 29, 2005, contract-value accounting was affirmed for stable value funds with the issuance of FASB Staff Position Nos. AAG INV-1 and SOP 94-4-1. Stable value funds and the 401(k) plans that use them are marking another landmark as they go through their first audit under the new standard.

"The audit landscape has changed," Kim McCarrel, a Senior Account Manager with INVESCO Institutional, told attendees at the SVIA's 2007 Spring Forum in Charleston, South Carolina. "The new guidance has changed the type and amount of information that has to be audited in the course of valuing stable value funds. For those of us who don't have an audit background, it's been a little puzzling why our auditors are now coming back asking for source data for every single piece of information in the stable value financial statements, even though they never asked for that in the past. Well, there's a good reason."

The new FSP requirements took effect at year-end 2006. Betsy Johnson, a Senior Manager with the accounting firm PriceWaterhouseCoopers LLP, warned stable value managers to allow for more time for their audits this year and to anticipate higher audit fees as a result.

The FSP, which generally applies both to stable value funds and the retirement savings plans that use stable value, has some new requirements. The FSP changed the financial statement presentation to require fair value of the underlying assets and an adjustment that when added together equals contract value. The FSP also requires footnote disclosure on the nature of investment contracts and the methodology used for calculating their crediting rate and credit rate sensitivity analysis. As Johnson elaborated, auditors will have to verify these new requirements.

One of the thornier requirements of the new reporting standards involves settling on a methodology for valuing GICs and synthetic GICs. Auditors, Johnson said, will have to test inputs and methodologies used for this work and will have to be able to recalculate reported values. That may require them to have access to information that they have previously not required. They also may need to confirm information with wrap providers and GIC issuers.

Johnson encouraged stable value managers and plan sponsors to discuss with the auditors what they will need early in the auditing process. "It's important to pull in all the appropriate parties and departments, including accounting, financial reporting, and portfolio management," she said. "You'll need to discuss valuation methodologies and approaches with your auditors for each type of investment and have someone document those methodologies and any significant assumptions that were made."

Stable value managers who track the securities in their funds on an accounting system, she noted, may find it easier to supply their auditors with the information they need than managers who track their investments in a portfolio or trading system, since the latter systems may not yield the complete cost records auditors need. The availability, nature, and extent of the records made available to auditors, she concluded, are critical to the audit process. The first year under a new requirement is a learning process for all, concluded Johnson. SVIA

Fidelity Executive Urges More Innovation for 401(k) Plans

By Randy Myers

Retirement industry professionals have been warning for years that U.S. workers are not saving enough for old age. That does not appear to be changing investor behavior, though. From 1999 through 2005, says mutual fund executive Steve Setterlund, the average amount of salary being socked into 401(k) plans rose almost imperceptibly, to 6.9 percent from 6.7 percent. But the percentage of eligible employees making any contribution at all to their plan actually declined, to 64 percent from 75 percent. The average account balance rose only modestly, from $55,700 in 2000 to $62,500 in 2005, and the median account balance swelled to only $22,300 from $15,700.

"Not only are individuals not changing their behavior," says Setterlund, Vice President of Marketing and Plan Sponsor Strategy for Fidelity Institutional Retirement Services Co., "but in some ways, it's getting worse." He said saving nearly 7 percent of salary wouldn't be bad if workers were receiving matching contributions from their employer and did that for their entire working lifetime. Unfortunately, many join their plans much later than they should. "Their account balances reflect that," he said. "The midpoint has to rise much higher."

Setterlund draws his conclusions from an analysis of the behavior of millions of participants in 401(k) plans for which Fidelity is the recordkeeper. He said that at the current pace, only about 14 percent of participants will be able to retire with the ability to generate 85 percent of their pre-retirement income. That's a fairly conservative estimate of what they might need, especially with health care costs soaring.

Speaking at the SVIA's 2007 Spring Forum in Charleston, South Carolina, Setterlund suggested that employers can help employees do a better job of saving for retirement by incorporating some of the best features of defined benefit plans into their 401(k) plans. They include features like professionally managed portfolios, options to convert balances to a lifetime of guaranteed income upon retirement, and even an insurance component. The insurance feature would cover individuals who become disabled and unable to work, and who are therefore unable to continue making contributions to their retirement plans. In addition, Setterlund said, employers and policymakers need to address the rising cost of health care if American workers are going to be assured of a financially secure retirement.

Those are tall orders, to be sure. But to allow retirement savings trends to continue on their current path, Setterlund suggested, could leave millions of American workers ill prepared for retirement. SVIA