SVIA STABLE TIMES

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Economist Argues for Tax Restraint, Against Single-Payer Healthcare

By Randy Myers

It may be an understatement to say that Barry Asmus is skeptical of the federal government's historic ability to set sound economic policy. Senior economist for the National Center for Policy Analysis, a conservative think tank headquartered in Dallas, Texas, Asmus argues that when the government makes mistakes, they're often "shockwave kinds of mistakes" that cause tremendous harm to the public. And he fears we may be making some right now.

Asmus has no trouble pointing to past examples, such as raising tax rates, contracting the money supply, and passing the anti-trade Smoot-Hawley Tariff Act following the stock market crash of 1929. Today, all those moves are widely credited with exacerbating the Great Depression. More recently, he says, the Federal Reserve made a mistake when it allowed interest rates to remain extraordinarily low for years following the September 11, 2001, terrorist attacks in this country, rather than quickly pushing rates back up once the economy stablized. That decision, he says, helped fuel the housing bubble that ultimately burst in 2007 and 2008, leading to the current recession.

"Business expansions do not die, they are assassinated," Asmus told participants in the Spring Seminar. "And almost inevitably, the assassin is the government and government policy."

In a wide-ranging presentation, Asmus traced the rise of productivity in the Western world to the signing of the Magna Carta in 1215, Martin Luther's conceptualization of work as a duty, John Locke's advocacy of personal freedom, Adam Smith's inquiries into the nature of sovereign wealth,

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Stable Value Continues to Deliver During Tough Times

By Gina Mitchell

Despite a tough economic environment and negative press reports about stable value funds, stable value funds remain one of the few bright spots for 401(k) investors. Why? The answer is simple. The overwhelming majority of stable value funds have delivered what is expected: capital preservation and consistent, steady, positive returns.

At the close of 2008, the average 401(k) investor had lost 18 percent of his or her hard-earned 401(k) assets according to the Hewitt 401(k) Index™, while stable value funds returned, on average, 4.75 percent (as Graph I illustrates). Because of the bleak economic times in which we live, stable value funds' returns may tend to be lower in 2009, but so may other 401(k) investment options.

Several reports have said that 401(k) investors are dramatically changing their 401(k) asset allocation strategy and stuffing most of this money into stable value. This is simply not the case. Hewitt reports that *only six percent of net assets* moved in 2008. Their Index tracks $110 billion in total assets. They report that stable value received 79 percent of transfers, with the remainder split equally (7 percent) to bonds, company stock, and money markets. While "79 percent transfer to stable value" makes a good headline, it amounts to $5.21 billion. In fact, most investors are staying the course: continuing contributions, maintaining deferral rates, and maintaining their asset allocation.

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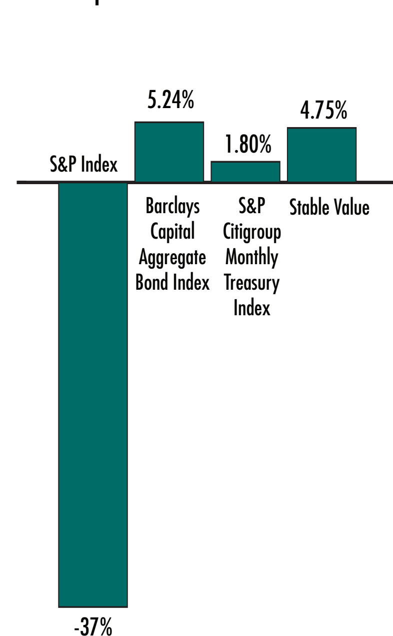
Graph I: 2008 Annual Returns



Critic Urges Target-Date Funds to Sharpen Their Aim

By Randy Myers

Target-date funds are one of the most popular investment options in retirement savings plans. They are endorsed by the U.S. Department of Labor as a qualified default investment alternative for plan participants who don't make their own investment choices, and millions of investors have entrusted them with their life savings.

Some of those investors, however, have been surprised by the volatility, and more may join them, warns investment consultant Joseph Nagengast. He argues that most target-date funds take far too much risk as they approach their investors' targeted retirement dates. Indeed, among those with a target date of 2010, the nation's three largest funds posted losses ranging from 21 percent to 27 percent last year. A fourth, also from a well-known fund family, lost an astonishing 41 percent. Declines like that can be financially devastating to someone about to retire, since those people have a limited time frame for recouping their losses.

Target-date funds are asset allocation funds that seek to automate the investing process by gradually reducing the amount of equities they hold as they near their target date—the date at which most of their investors, based on their age, would be expected to retire. But Nagengast, a principal with Target Date Analytics Inc., argues that this equity "glide path" is not nearly steep enough with most target-date funds, which continue to hold some equities right up to, and even beyond, their target date. Even now, following the devastating stock market losses over the past year and a half, some popular 2010 funds, which are aimed at investors planning to retire between 2008 and 2012, have more than half their assets in stocks.

Speaking at the Spring Seminar, Nagengast countered that it is inappropriate for target-date funds to hold any stocks once the funds reach their target date.

"The core function of these funds is to get me to my target retirement date safely, with my purchasing power intact, and to grow my assets to the extent that doing so doesn't violate the first goal," Nagengast said. "Instead, fund managers have co-opted the glide path to serve other functions—to cover longevity risk, to protect against inflation, even to make up for poor funding levels. A glide path cannot do any of those things well." Fund companies argue that investors need equities in their portfolios even after they retire, both to hedge against inflation and to generate returns sufficiently high to carry them through a retirement that could last 30 years or more.

Nagengast said investors should look to annuities, not stocks, to hedge against longevity risk, and to Treasury Inflation Protected Securities (TIPS) to protect against inflation. They should forget about owning big chunks of stock to make up for a lack of saving. "If you haven't saved enough, you haven't saved enough," he said. "You can't fix that by doubling down."

If fund managers start to build target-date funds with a more conservative asset allocation mix, Nagengast said, it could represent an opportunity for the stable value community, whose bond-based investment products come with guarantees of principal and accumulated interest protection. Stable value funds could be particularly useful additions to target-date portfolios once they begin to transition to an asset allocation mix that's focused more on principal protection than maximizing growth, he said, or about the time their investors are turning 55. SVIA

Magnoli Elected to Second Term as Chairman of SVIA's Board of Directors

Marc Magnoli, an executive director at JPMorganChase, was elected to a second term as chairman of the Stable Value Investment Association's board of directors. The 15-member board voted unanimously to extend Marc's term as chairman through 2011. His current term expires at the end of 2009.

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Some press reports have charged that stable value receives 'little scrutiny.' This also is simply not the case. Stable value funds have multiple layers of oversight, starting with federal law, the Employee Retirement Security Act (ERISA), and state laws for defined contribution plans; the Financial Accounting Standards Board (FASB) and the Government Accounting Standards Board (GASB), which establish accounting standards that define 'stable value'; and financial oversight by the Office of the Comptroller of the Currency for banks, the Securities and Exchange Commission for commingled funds, and state insurance departments for insurance company funds. Even Federal Reserve Chairman Ben Bernanke noted their importance in testimony on AIG before the House Committee on Financial Services. This hardly seems like little scrutiny.

Further, the press has misrepresented stable value funds' treatment of corporate-initiated events by refusing to explain them. Corporate-initiated events (layoffs, early retirement programs, bankruptcy) generally cause withdrawals en masse. These withdrawals can negatively impact investors and plans that choose to remain in the stable value fund. To treat stable value fund investors equitably and to maintain reasonable costs, employer-initiated events are not covered in most contracts. However, because these events are typically known in advance, the 401(k) plan sponsor and the stable value fund generally have time to negotiate coverage of these events so that all participants continue to transact at book value.

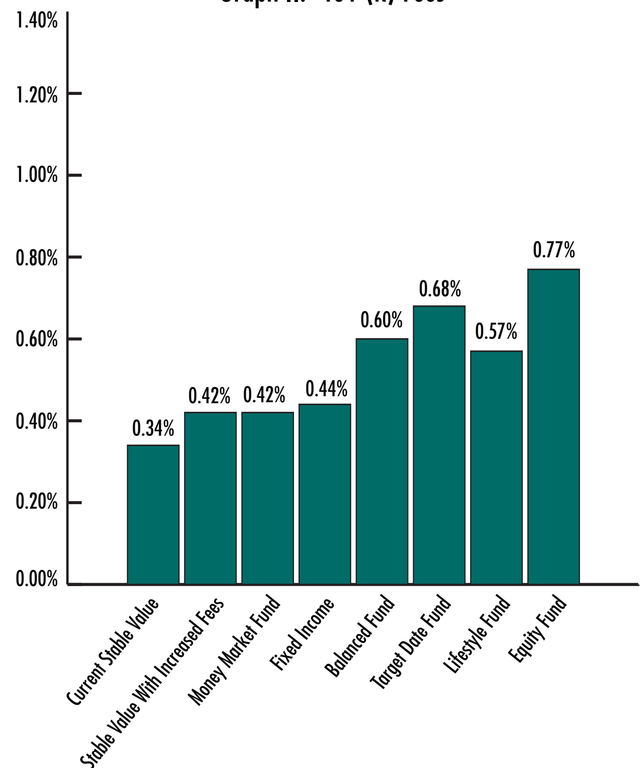
This did not occur in the Lehman Brothers bankruptcy. A combination of extenuating factors were involved: the historic adjustment of the financial markets, the scale of the Lehman Brothers' bankruptcy (it is the largest bankruptcy ever), the speed at which the bankruptcy proceeded, and the ferocity of the bankruptcy—half of Lehman Brothers' workforce lost their jobs immediately. The immediacy of the bankruptcy did not give the stable value fund time to work out protections to keep the stable value returns positive. Consequently, Lehman Brothers stable value fund investors had a negative return of 1.7 percent in December and a positive annual return of 2 percent for 2008, which exceeds returns from most other 401(k) options.

Furthermore, this did not occur with Chrysler's Stable Value Fund B. Stable value funds are permitted in tax-qualified, employer-sponsored defined contribution plans. Chrysler's Fund B was a non-qualified, deferred compensation rabbi trust and not a true stable value fund. Accordingly, unlike qualified plan assets, Chrysler's Fund B assets were not protected from claims by creditors in the event of bankruptcy. Rather than risking a lower payout under potential bankruptcy proceedings, Chrysler decided to immediately terminate Fund B and the applicable wrap agreements and pay investors in a lump sum at market value, which was reported at 89 percent of book value.

Some have also implied that stable value fund fees will increase dramatically. Even if stable value contract costs were to double, raising total stable value fees to 0.49 percent (up from 0.41 percent), stable value still compares favorably to other asset management fees, according to Morningstar, as Graph II demonstrates.

To combat misrepresentation and lack of information, SVIA has done many things. SVIA has talked to the press at length about stable value, establishing the Association as the source for stable value information. In many articles, SVIA has been the only voice pointing out stable value's positive performance despite current market stresses. SVIA created and posted a FAQ list on stable value funds that can be found on the Association's website: www.stablevalue.org. The FAQ list provides basic information about stable value funds and answers many questions related to current market conditions. SVIA has also written letters to the editor and held webcasts to educate key stable value constituents.

These efforts have helped the Association achieve an important goal: to educate the public about stable value funds. As some try to poke holes in stable value, one fact remains: Overall, stable value funds perform well despite an historic and prolonged market correction and continued market volitility. SVIA



Many of the articles featured in this issue of *Stable Times* highlight topics addressed at SVIA's Fourth Spring Seminar, "Living with Uncertainty: How 401(k) Plans and Stable Value Funds are Performing," held April 5-7, 2009.

The Economy in the Age of Obama

By Randy Myers

Economist Todd Buchholz sees early indications that the United States may be poised to climb out of its recession. Unfortunately, he also sees plenty of reason to worry where it will head once that happens.

"My basic view of the economy is that it stinks," Buchholz told participants in the SVIA's Spring Seminar, outlining his case for near-term optimism. "It seems to be decaying in lots of different sectors. Yet I actually think we're going to be hitting bottom this summer and have some positive growth this fall."

A former director of economic policy in President George H.W. Bush's White House and a past managing director at Julian Robertson's Tiger hedge fund, Buchholz said one reason for his benign near-term outlook is the collapse of the commodity-price bubble last year. The sharp decline in energy prices alone, he said, is injecting about $300 a month into U.S. households, giving consumers more money to spend.

Buchholz takes heart from data indicating that retail sales were marginally positive in January and February—though they nosedived again in March—and that sales of new and existing homes popped up in February, too, though they also fell again in March. "I think it's a little early to jump on this and say, 'We're there,' but this kind of data tells me we're not rolling into an avalanche," Buchholz said. He also noted that real weekly earnings have been generally rising lately, as has real disposable income, both good developments for the economy.

Buchholz discounted some of the widespread worry over weekly jobless claims, which have skyrocketed as businesses have furloughed workers in a bid to control costs. While jobless claims rose to a seasonally adjusted 669,000 in the week ended March 28—the highest absolute number since 1982—Buchholz said that's not a great comparison since the job market today is 50 percent larger than it was in the early 1980s. "To be worse than the early 1980s recession, claims would need to be over a million," he said. "We may get there, but we're not there today, and it's a disservice to consumer confidence and the overall economy to immediately claim that we're in the Great Depression." In fact, he added, a recent survey of employers showed that while existing layoffs were trending higher, the number of expected future layoffs was trending lower.

Meanwhile, he said, the tendency to focus on unemployment numbers can mask the fact that most people are still working and will continue to do so. "Even in a really bad recession, 90 percent of Americans are going to keep their jobs," Buchholz said. "Those 90 percent have more buying power today than they did a year ago thanks to the collapse of commodity prices and interest rates. They're simply afraid to deploy it. That additional buying power, combined with a 10 percent to 15 percent increase in the money supply as a result of the federal government's stimulus efforts, is basically going to provide the impetus for consumers to do a little more shopping by, I think, roughly this fall."

Consumer spending, of course, is one of the keys to the U.S. economy's health.

While Buchholz argued that the Federal Reserve has been right to inject liquidity into the financial system in a bid to stem the economic downturn, he's less enthused long term about President Obama's economic stimulus plan, which, he said, is steering money into some sectors of the economy, such as education and healthcare, where unemployment isn't a big problem. He also contends it's not sending enough money on infrastructure projects such as roads and bridges, that could help to raise productivity over the next five to ten years.

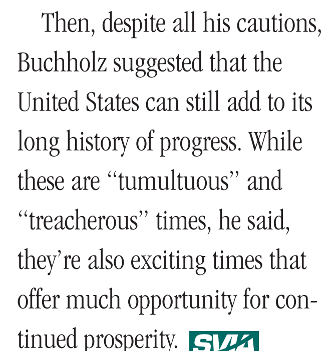
Even as he outlined the case for an economic recovery beginning later this year, Buchholz warned that the United States will continue to face big challenges once the recession ends. If oil falls to $40 or $30 a barrel, he said, "none of our alternative fuel scenarios will work out." And while big federal deficits may be okay for now, as the government tries to spend the country out of its recession, those deficits will become increasingly problematic in the years ahead, he warned, as non-defense spending continues to grow and consume an ever-bigger percentage of our gross domestic product.

Finally, he cautioned, the country needs to do a much better job of managing its human capital.

"We are the Jamaican bobsled team of education," Buchholz said, buttressing his argument by reciting statistics showing that the number of petroleum engineering graduates we're producing has fallen 90 percent since 1981, while the number of agriculture scientists we're turning out has been stagnant for two decades. Trends like those, he said, put the United States at a disadvantage as it seeks to compete in an increasingly global economy.

"Globalization changes our ability to trade and increases prosperity, which is why, in the end, education, along with free trade, are the most important structural things for us to focus on," Buchholz said.

Then, despite all his cautions, Buchholz suggested that the United States can still add to its long history of progress. While these are "tumultuous" and "treacherous" times, he said, they're also exciting times that offer much opportunity for continued prosperity.



Employers Focus on Enhancing Their 401(k) Plans

By Randy Myers

Nearly 30 years after the launch of the nation's first 401(k) retirement savings plan, employers are still trying to figure out how to make them as effective and affordable as possible.

Employers made some fairly significant changes to their plans in just the past few years, broadly adopting automatic enrollment of new hires, adding target-date funds as investment options, and often designating those funds the qualified default investment alternatives for plan participants who don't make their own investment choices.

Now, battered by a shocking stock market decline and a punishing recession, employers are rethinking their retirement plans yet again, reports Barbara Hogg, a principal and senior consultant with Hewitt Associates, a management consulting firm specializing in human resources issues.

The recession is prompting businesses to look for cost savings in every possible quarter, and a small but not insignificant minority of companies—including two dozen of the Fortune 500—have recently suspended their practice of making matching contributions to their employees' 401(k) accounts, Hogg told participants at the SVIA's Spring Seminar.

While those suspensions are likely to be temporary, Hogg said employers are looking for more permanent ways to make their plans work well for both them and their employees. Hot topics include risk management, improving plan design to control costs and provide better outcomes for participants, and helping participants take better advantage of what their plans offer.

The focus on risk is partly a response to pressure from regulators—namely the U.S. Department of Labor—to do a better job of understanding and reducing the costs associated with running retirement plans. A majority of sponsors surveyed by Hewitt have indicated that, at a minimum, they plan to step up the amount of advice they offer to plan participants about costs.

In terms of plan design, about a quarter of plan sponsors who haven't already adopted automatic enrollment for new hires say they are likely or somewhat likely to do so, and nearly 40 percent say they may escalate their own contributions to their employees' accounts in 2009. Nearly a third say they expect to increase the default contribution rate for their employees as well.

Meanwhile, some plan sponsors are taking a fresh look at target-date funds to see whether they're as suitable as they once thought for their plan participants. Many employees were shocked to see that target-date funds marketed to people at or near retirement age sustained double-digit losses in 2008. "A year ago, all the buzz was about whether the funds were aggressive enough, in terms of their allocation to stocks, when an investor turned 65," Hogg noted. "Now, the question is just the opposite; are they too aggressive?"

Plan participants have good reason to hope their employers make smart choices. Last year, Hogg said, the average participant account balance fell to $66,100 from $81,100, with 70 percent of participants experiencing a loss of more than 20 percent. That decline comes at time when industry estimates of how much money people will need to sustain themselves in retirement are going up, largely due to skyrocketing healthcare costs. Where the rule of thumb once held that retirees might need 70 to 80 percent of their pre-retirement income once they stop working, a

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Economist Argues for Tax Restraint

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and the U.S. founders' creation of a government of checks and balances. The overarching lesson, he says, is that freedom is America's best investment—a lesson reinforced by what's happening today in China. There, he said, the country's fledgling embrace of economic freedom in the form of private enterprise is building China into a new world economic power.

Economic freedom isn't on the march only in China, Asmus added, noting that 15 years ago the "Index of Economic Freedom" published by the *Wall Street Journal* and the Heritage Foundation rated 15 countries as free or mostly free. Today, he said, it accords that distinction to 87 countries.

"The surest route to abundance, the surest route to prosperity, is to encourage creativity and to let people keep the fruits of their labor," Asmus said. Accordingly, he argued against raising taxes, particularly the Obama Administration's proposal to create a cap-and-trade system for reducing carbon emissions, which he called "a trillion-dollar tax on the generation of electricity" that the economy can ill afford. He also characterized the government's subsidy of the corn-based ethanol industry as "madness," arguing that it consumes vast quantities of water and reduces the availability of corn as a food stock. "Starve the world," he said, "save the planet."

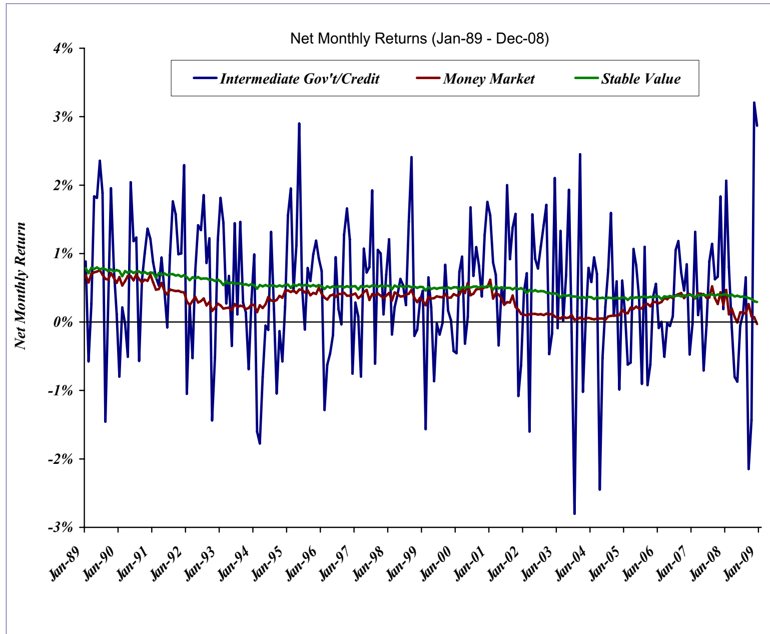
Finally, Asmus warned against pursuing a single-payer, nationalized healthcare system in the United States. He said such systems work fine in countries with younger populations, but become unsustainable as populations age—something, he said, that politicians in Germany are finding out at this very moment. "Germany," he said, "is privatizing its hospitals as we speak. Everyone is fleeing single-payer healthcare. We, maybe, are going to flee toward it."

Rather than assembling a single-payer system of the sort some liberals favor—though President Obama has said he won't pursue that as a first step toward reforming the U.S. healthcare system—Asmus argued for a competitive healthcare system that would pair high-deductible insurance plans for catastrophic health events with medical savings accounts that individuals could use to pay for their routine and low-end healthcare services. Some employers have experimented with that approach, but it has yet to be widely embraced. SVIA

Why Stable Value Makes Sense

By Gina Mitchell

In today's environment, stable value distinguishes itself with a positive, consistent return. However, investors shouldn't turn to stable value just during a down market. In fact, investors should be evaluating stable value in all market environments to determine how stable value can best be used to create a well-diversified 401(k) portfolio, according to Professors David Babbel, Ph.d., and Miguel Herce, Ph.d., both with Charles Rivers and Associates, Inc.



Babbel and Herce recently updated their study, *A Closer Look at Stable Value Funds Performance,* to include one of the most challenging years for investment options: 2008. The financial analysis now covers 20 years of stable value performance, including last year's systemic market correction. The study follows eight stable value fund families representing separate accounts, pooled funds, and life general accounts that had a combined asset base of $159 billion at the end of 2008.

Based on Babbel's and Herce's analysis, which is summarized in the table, stable value is a necessary component of a 401(k) plan since it has the least correlation or relationship to equities. This lack of correlation permits investors to adjust the risk in their 401(k) portfolio by using stable value, allowing them to make larger allocations to equities, with their higher risks and thus higher returns. They can also lower their risk exposure by increasing their allocation to stable value funds and receive lower but more consistent returns.

In fact, the updated study reinforces their observation that stable value should be the fixed income component of a well-diversified portfolio. They also found that stable value should be used during retirement to produce an annuity-like income stream.

Look for the updated study in its entirety at www.stablevalue.org.

Why Stable Value Makes Sense
Summary Statistics (January 1989 to December 2008)

	Large Stocks	Small Stocks	Long-Term Government Bonds	Long-Term Corporate Bonds	Intermediate Gov't/Credit	Stable Value	Money Market Funds
Net Monthly Returns							
No. of Months	240	240	240	240	240	240	240
Mean	0.65%	0.94%	0.73%	0.62%	0.46%	0.51%	0.33%
STDEV	4.18%	5.69%	2.70%	2.44%	0.97%	0.12%	0.17%
Minimum	-16.88%	-20.71%	-9.90%	-8.89%	-2.80%	0.29%	-0.03%
Maximum	11.28%	23.58%	14.36%	15.53%	3.20%	0.80%	0.76%
Sharpe Ratio	0.075	0.107	0.148	0.118	0.138	1.477	
Net Annual Returns							
No. of Years	20	20	20	20	20	20	20
Mean	8.80%	12.15%	9.16%	7.60%	5.73%	6.26%	4.08%
STDEV	19.63%	22.90%	10.56%	7.94%	4.31%	1.57%	2.07%
Minimum	-37.66%	-36.72%	-10.02%	-8.05%	-3.38%	4.29%	-0.71%
Maximum	35.52%	60.70%	29.80%	25.41%	13.66%	9.60%	8.36%
Sharpe Ratio	0.248	0.348	0.481	0.447	0.426	1.643	

Source: David Babbel, PhD. and Miguel Herce, PhD., March 2009 Analysis of Stable Value Funds from 1989 through 2008. Large stock returns are total returns on the S&P500 Index, Bloomberg. Small Stock, Long-Term Government and Corporate Bond returns are from Morningstar, SBBI 2008 Yearbook and 2009 update. Intermediate Government/Credit returns are from the Barclays Capital Intermediate U.S. Government/Credit Index, formerly the Lehman Intermediate U.S. Government/Credit Index. Stable value returns are asset-weighted average returns based on data provided by SVIA. Money Market returns are from the Merrill Lynch 3-Month T-Bill Index, Bloomberg.

Employer Focus on 401(k) Plans

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recent analysis by Hewitt indicated retirees might need as much as 126 percent of their final pay. "People think they can live on less, but in fact many are not living on anything less than 100 percent today," Hogg said, acknowledging the propensity of many Americans to live beyond their means.

Hogg said Hewitt's research suggests that as a result of the damage done to the typical 401(k) account over the past year and a half, a typical 35-year-old would have to save an extra 1 percent of his or her pay for the next 28 years—beyond what he or she already should have been saving—to have a fighting chance at a financially secure retirement. A 55-year-old would have to save an extra 12 percent a year for the next eight years.

Those are big hurdles and big reasons for plans sponsors to continue their quest to build the optimal 401(k) savings plans.

Rating Agency Sees Life Insurers Adapting to Financial Market Turmoil

By Randy Myers

Like other financial services firms, life insurance companies have been hurt by the turmoil in the financial markets over the past year and a half. But they're also making changes that should help them emerge from this period of turmoil in good health, says Douglas Meyer, head of the North American insurance rating group at Fitch Ratings.

The challenges, to be sure, are numerous. With stock and corporate bond prices depressed and interest rates on U.S. Treasury bonds at historic lows, life insurers are earning less asset-based fee income and less investment income than they did in the past, Meyer told participants in the Spring Seminar. They're also absorbing higher costs in their hedging programs after years of sweetening the guarantees they offer on their variable annuity products, and they are being forced to divert cash away from growing the business into their capital reserves.

In this environment, it's not surprising that Fitch downgraded its outlook on the life insurance industry to negative from stable last September. Indeed, Fitch cut its credit ratings on 20 life insurers last year, while raising its ratings on just two. As it approached the end of this year's first quarter, it had downgraded its ratings on another 22 companies and upgraded none.

Meyer said life insurers entered 2008 with strong risk-based capital levels and a favorable liability profile relative to certain other financial institutions. For example, the industry's risk-based capital ratio, an important measure of its financial health, stood at nearly 400 percent heading into 2008, "the highest levels we've seen," and by year-end, it had slipped only marginally, to 384 percent. He also noted that only 59 percent of the industry's capital was exposed to subprime and so-called Alternative-A mortgage securities—neither considered low risk—versus 200 percent-plus for major commercial banks and securities firms. That eased Fitch's concerns about insurers' ability to manage their exposure to bad mortgages. He also said life insurers had limited exposure to risky structured securities such as collateralized debt obligations and credit default swaps.

Heading into last year, Meyer said his firm had some concern about life insurers' exposure to the stable value market, particularly as it related to their ability to fund the payoff of maturing GICs, or guaranteed investment contracts. But he said Fitch concluded that it was, overall, "pretty comfortable" that insurers have sufficient liquidity to handle that activity.

Now, he said, his firm's primary concerns center on the possibility that any continued deterioration of the financial markets could further impact the earnings potential and capital reserves of life insurers and that the liabilities they face on their variable annuity business could become too taxing. However, he said, their reasonably strong liquidity should help them out on these fronts. He said their strong liquidity position also should allow them to hold many of their fixed income investments that have declined in value to maturity and avoid realizing what are, for now, still mostly unrealized investment losses on those bond portfolios.

Meyer also noted that life insurers have been repricing and restructuring their variable annuity products to offer less generous financial guarantees, another positive for the industry, from a risk perspective, over the long term.

Still, Meyer said, his firm is continuing to tweak the models it uses to assess the financial strength of life insurers, and it is, among other things, placing a greater emphasis on stress testing. It is also keeping a close eye on the industry's exposure to the commercial real estate market, which many economists view as the next major pothole in the road to economic recovery. However, Meyer said life insurers have done a better job of underwriting loans to that market than many other lenders, so that it expects any losses there to be manageable, at least under its best-case scenario.

All those positives, Meyer said, help to explain why most of the ratings downgrades that Fitch has made in the life insurance space have been relatively modest, typically moving companies down only one or two notches on the firm's rating scale. SVIA

Investors Continue to Flock to Stable Value

By Randy Myers

Retirement plan investors are moving money into stable value funds, one of the few asset classes to post positive returns amid last year's financial market turmoil. Returns for stable value funds tended to range between 3 and 5 percent in 2008, while the S&P 500 stock index, by contrast, lost 37 percent.

Investors noticed the difference. While they had a healthy 21 percent of their retirement savings in stable value products at the end of 2007, according to the Hewitt 401(k) Index, which tracks 1.5 million plan participants at large U.S. companies, that number shot up to 32 percent by the end of 2008, its highest level so far this decade. By February of this year, it had risen even higher, to 36.7 percent.

Some of that increase simply reflected the stock market's slump. As stock prices fell, stock funds held by plan participants decreased in value, notes Barbara Hogg, a principal and senior consultant with Hewitt Associates, the management consulting firm that maintains the index. But as she told participants in the SVIA's Spring Forum in April, the increase was also attributable to participants directing more of their 401(k) contributions into

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Stable Value Industry Foresees Wrap Capacity Improving

By Randy Myers

Laura Powers, a managing director with BlackRock Investment Management, recalls a time when there were more than 30 companies providing wrap contracts to the stable value industry. Now there are about a dozen, but she and other industry leaders are optimistic that the ranks of wrap providers will increase again as financial markets return to health.

"Several firms are actively pursuing entering the wrapper market," said Robert Whiteford, managing director in the Global Structured Products Group at Bank of America, addressing participants in the SVIA's annual Spring Seminar in April. "It's not going to be a quick process for anybody, but I think we will see some additional firms come into the market."

Wraps are contracts that backstop, among other things, a stable value fund's obligation to allow investors to transact at book value, which is principal plus accumulated interest, regardless of market value. The number of stable value wrap contract providers has been declining for some time, but the recent market dislocation has caused more wrappers to exit the business or at least pause as they reassess their risk and growth management strategies. As newly risk-averse investors simultaneously decide to shift more of their retirement savings into stable value funds, the industry's ability to meet demand for its products has been strained.

"We went through a difficult period in the fall where things seemed bad every day," Whiteford remarked. "Things have settled down somewhat, and if they continue as they are, I think we'll not only see new firms enter the wrap market, we'll also see existing wrappers come out with more capacity." In fact, he noted, his bank has been able to hedge a portion of its wrap exposure with third-party firms that don't operate their own wrap business. "It's not inexpensive, but it did show that it can be done, which was very important to our risk management people," he said.

Whiteford encouraged his colleagues in the stable value industry to seek out other institutions willing to stand behind current wrap providers, "either on their own on a straight-up credit basis, or by posting collateral to cover the risk. There are people who can do it."

Both Whiteford and Powers said stable value managers can help speed the entry of new players and new capacity into the marketplace by tightening investment guidelines. The goal, Whiteford said, would be to eliminate open-ended investment flexibility and ensure that funds are being managed conservatively. That would minimize the risks for wrap issuers and improve their appetite for the business.

Whiteford also encouraged managers to work with wrap issuers in developing more standardized contracts, which would make it easier for those issuers to identify the risks they are assuming.

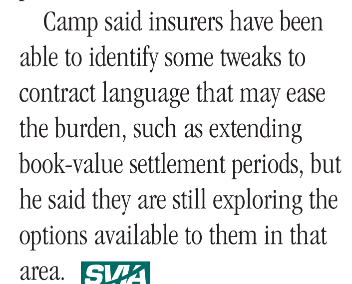
Powers also urged managers to consider the constraints insurers are facing when negotiating wrap contracts with them and to maintain open lines of communication. "It's important to understand that they need information for their risk models that we didn't have to provide to them in the past," she said.

Unfortunately, risk management isn't the only challenge wrap providers are facing. With the value of their own bond portfolios and the bond portfolios underlying stable value funds depressed, many are being forced to set aside greater loss reserves. That's eating up cash that could otherwise be used to write new wrap business.

Anthony Camp, U.S.-based vice president of the Stable Value Group at Dutch insurer ING, noted that financial requirements are being complicated by the debut last year of Financial Accounting Standard 157. The standard spells out new guidelines for calculating the fair value of assets for financial reporting purposes, and is applicable to, among other reporting entities, some issuers of stable value contracts. Depending upon how their accountants interpret the new standard, he said, FAS 157 is pushing up financial requirements for insurance companies that issue wrap contracts covering synthetic GICs, or guaranteed investment contracts.

One issue, Camp said, is that the accounting standard requires insurers to treat the wrap contract as an embedded derivative, the value of which will fluctuate with factors such as the market-to-book ratio of the GIC's underlying bond portfolio, the duration of that portfolio, and interest rates. Low market-to-book ratios and low interest rates can boost financial requirements. So can a short portfolio duration, since most synthetic GICs specify that if there is a book-value settlement when market value is below book value, the settlement period will be equal to the duration of the underlying portfolio.

Camp said insurers have been able to identify some tweaks to contract language that may ease the burden, such as extending book-value settlement periods, but he said they are still exploring the options available to them in that area. SVIA



Investors Flock to Stable Value

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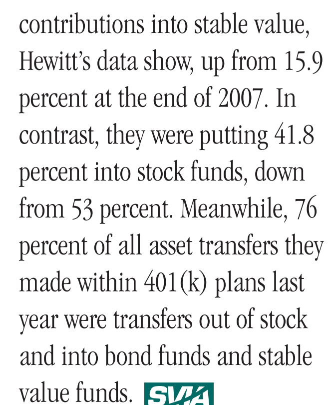
stable value products and switching some of their existing 401(k) assets out of stocks and bonds and into stable value.

By February of this year, investors were stuffing 23.8 percent of their new retirement plan contributions into stable value, Hewitt's data show, up from 15.9 percent at the end of 2007. In contrast, they were putting 41.8 percent into stock funds, down from 53 percent. Meanwhile, 76 percent of all asset transfers they made within 401(k) plans last year were transfers out of stock and into bond funds and stable value funds. SVIA



Plan Sponsors, Auditors Wrestle with FAS 157 Disclosure

By Randy Myers

In September 2006, accounting regulators issued a new standard—FAS 157—for calculating the fair value of securities in their financial statements. It took effect for fiscal years beginning after Nov. 15, 2007, meaning that many retirement plans have just begun to grapple with its intricacies, usually when trying to assign values to their stable value funds are part of this focus. For defined contribution plans, it is not a black-and-white exercise, and many plans are reaching out to their stable value fund managers for help.

Under FAS 157, retirement plans and other entities that file financial reports with federal regulators must classify their assets at one of three levels. Level one encompasses securities for which market prices are readily available, such as exchange-traded stocks or mutual funds. Level two covers securities, such as corporate bonds, for which there is no exchange-traded price because bonds are not traded on an exchange, but for which observable inputs, such as a credit rating, interest rate, or duration, can be compared.

Level three is a catch-all for anything that doesn't fall into level one or level two—assets for which there are neither market prices nor observable inputs. An example would be private equity, where valuations must rely on the reporting entities' own assumptions and calculations. Because such valuations are more subjective, FAS 157 calls for enhanced disclosures around how they are calculated.

Stable value investments tend to have characteristics of both level two and level three securities. They typically hold portfolios of short- and intermediate-term bonds, for instance, securities that fall fairly neatly into level two. Stable value bond portfolios are combined with a wrapper contract that preserves principal and accumulated earnings, which gives plan participants the ability to transact at book value. Most stable value funds use a replacement cost method for valuing wrap contracts, which is more complicated than valuing a bond portfolio's assets.

John Hubbe, a partner with Big Four accounting firm KPMG LLP, explained to participants in the Spring Seminar that there are other challenges to calculating the fair value of stable value funds. For example, he said, "evergreen" guaranteed investment contracts have no maturity, denying plans and auditors of at least one observable input. In his opinion, he added,"The basic GIC, which we always thought of as one of the easiest products to value, is turning out to be one of the hardest. We've have seen multiple companies provide multiple reasons for why the valuation they assigned was what it was, and there have been a lot of inconsistencies. A fair amount of work needs to take place to get to a level of consistency that we would like to see, and that would make audits and financial statement preparations more simple."

Hubbe also observed that in the case of pooled separate accounts, it can be difficult to figure out exactly what any individual retirement plan participating in the pool actually owns.

Despite—or perhaps in recognition of—such challenges, Hubbe said, there appears to be a growing consensus that most stable value contracts will wind up being classified as level three securities. Whatever the outcome, he said, retirement plans must be prepared to respond to questions from their auditors about how they have calculated fair value for their stable value assets. Because many small plans are unlikely to have staff with sufficient expertise to do this on their own, he warned, many of these plans will be looking to their stable value fund manager for guidance. Stable value managers need to be prepared to give guidance to small plans that do not have the resources or the expertise on stable value.

"Our clients (plan sponsors) have the responsibility to prepare their financial statements, and the fair values reflected in those statements are meant to reflect their views," Hubbe said. "But for better or worse, many of those statements are not being prepared by valuation specialists. In some cases, it may be the human resources department, in some cases it may be financial controllers, who may be phenomenally well-versed in how to make and account for widgets but who know nothing or very little about stable value contracts. They are looking to you, the stable value managers, for help, because in their mind, they are your investments. Who better to value them?" he concluded.

Hubbe noted that accounting rules prohibit a plan's auditor from valuing plan assets. Still, he said, the auditor must confirm that those valuations are properly described and calculated in accordance with generally accepted accounting principles.

Timothy Munchy, a partner with Big Four accounting firm Deloitte Touche LLP, joined Hubbe in addressing the Spring Seminar. He stressed that the financial statements are those of the 401(k) plan or the stable value fund. "These are your statements," he stressed. "You have to be comfortable with them and the methodology to support their valuations."

Munchy noted that since the end of 2008, he's seen a "tremendous uptick" in the number of plans seeking third-party valuation experts to help them value their stable value funds.

Ultimately, Hubbe said, some plans may classify their stable value assets as level-two securities and others as level-three securities, even where their stable value funds are virtually identical. That's because different plans will have different capabilities in terms of justifying their valuation practices. "The largest clients at KPMG or Deloitte may have the financial sophistication and clout with their investment managers to get all the information they need to bring that security to, say, level two," Hubbe said. "But our smallest client probably just won't care. They won't challenge the information that's given to them by their investment managers, and they will probably be comfortable classifying it as a level-three security." SVIA