SVIA STABLE TIMES
The publication of the Stable Value Investment Association Volume 16, Issue 1 • First Half 2012

In this Issue

How Stable Value Stacks Up (Answer: Well)

By Randy Myers

As professor emeritus of insurance and risk management at the University of Pennsylvania's Wharton School with a Ph.D. in finance from the University of Florida, consultant David Babbel brings the cold calculus of a quantitative analyst to his assessment of investment options. After adding up the attributes of stable value funds, he's concluded that they make sense for a wide range of investors, not just near-retirees.

Babbel began studying stable value funds in 2006 on behalf of the Stable Value Investment Association. Back then, he was surprised to discover that they exhibit what mathematicians classify as first-degree stochastic dominance over any other major asset class—stocks, bonds, or cash. That means that any investor who likes money, whether they are risk averse or have an appetite for risk, would logically prefer the return probabilities for stable value funds to those of the other asset classes. Babbel also discovered that stable value funds enjoy second-degree stochastic dominance over intermediate-term bonds, meaning that all risk-averse investors would logically prefer stable value funds over an intermediate-term bond portfolio.

continued on page 2

Dodd-Frank Update: Swap Definition Finally on Horizon

By Randy Myers

The long-awaited decision by federal regulators on whether stable value contracts count as swaps under the Dodd-Frank Act of 2010 may finally be at hand.

In a bid to tighten control over what was then a largely unregulated segment of the financial markets, Congress specified in the Dodd-Frank Act that swaps would be subject to increased scrutiny and regulation. Swaps were generally defined at the time to mean over-the-counter derivatives, but loose wording opened the door to the possibility that stable value wrap contracts could qualify, too. Wraps are a specialized type of insurance that assure investors they can withdraw assets from a stable value fund

continued on page 4

Stable Value: Past, Present, and Future

By Randy Myers

The 2008 credit crisis was a blow to financial markets around the globe, and the stable value industry did not escape unscathed. But Karl Tourville, founding partner and chairman of the executive committee at stable value manager Galliard Capital Management, is feeling optimistic about the industry's prospects. "From where I sit," he told participants at the SVIA's Seventh Annual Spring Seminar in April, "things seem to be getting stronger every day."

The effects of the credit crisis on the stable value industry were easy to spot. As the Federal Reserve drove down short-term interest rates to prop up the economy, market-value to contract-value ratios for stable value funds temporarily swooned, prompting issuers of stable value contracts to reassess the risks inherent in their business.

continued on page 3

How Stable Value Stacks Up (Answer: Well)

continued from page 1

In fact, Babbel found, stable value was the only asset class exhibiting any degree of stochastic dominance (there are four degrees in total) over any other asset class—a startling performance.

Babbel has continued to study stable value funds independently, and in April 2012, at the SVIA's Seventh Annual Spring Seminar in Scottsdale, Arizona, he reviewed a host of data suggesting that stable value funds have much to offer investors of any age. Among the highlights:

Young investors are conservative investors. Babbel cited a recent study indicating that 59 percent of Generation Y investors—those in their 20s and 30s—consider themselves conservative investors, as do 44 percent of Generation X investors, the next oldest cohort. By comparison, only 39 percent of Baby Boomers attach that label to themselves. He also cited another study which found that 40 percent of Generation Y investors agree with the statement that they will never feel comfortable investing in the stock market. "Maybe focusing on the older investor (when marketing stable value funds) is pushing against the grain," Babbel said. "You're assuming you know better than people's own feelings. Maybe it's the younger group that is a good candidate for stable value. They've seen what happened to their parents' funds. They want an asset that can grow over time."

Stable value scores high on several risk measures, including the Sharpe and Sortino ratios. The Sharpe ratio measures the returns delivered by an asset relative to the volatility risk it presents. A higher Sharpe ratio represents more attractive risk-adjusted performance. Babbel compared Sharpe ratios for a variety of asset classes—large and small stocks, long-term corporate bonds and long-term government bonds, intermediate-term bonds, and stable value funds, based on quarterly data from the first quarter of 1989 through the fourth quarter of 2011. He found that stable value funds generated the highest Sharpe ratios by far—in the range of 1.6 percent to 1.7 percent, versus less than 0.3 percent for all the other asset classes. The Sortino ratio is similar to the Sharpe ratio but assesses performance only against downside risk. Again, a higher number is better, and over that time period, stable value funds excelled again, with Sortino ratios of about 26 percent to 27 percent, versus 0.2 percent to 0.5 percent for other asset classes. Babbel noted that stable value funds also score well in mean-variance analysis, which is used to calculate an "efficient frontier," along which investments will generate the highest level of return for any given level of risk.

Stable value returns are less volatile than returns of most other investments. The crediting-rate formulas used by stable value funds help to smooth their returns over time, making those returns less volatile than the returns generated by most other asset classes. This is appealing to investors, Babbel said, noting that stable value funds have performed particularly well relative to other asset classes over the past dozen years, a period in which the financial markets have been quite volatile. An investor who contributed $100 a month to a low-cost S&P 500 stock index fund from 1999 through 2011, he observed, would have finished the period with $16,608. That's only about $2,000 more than the $14,700 the investor would have put into the fund. By contrast, the same $100 invested in a stable value fund, after fees, would have built up to a total value of $20,011, with far less volatility along the way.

SVIA STABLE TIMES

Volume 16, Issue 1 First Half 2012

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

About Randy Myers

Randy Myers is an award-winning business and financial writer published in national newspapers, magazines, and online publications. He also writes for SVIA in *Stable Times.* He is a veteran journalist with more than 30 years of experience.

Stable Value: Past, Present, and Future

continued from page 1

Some left, compromising wrap capacity for the entire industry. Others tightened investment guidelines for stable value funds and began raising their fees, rankling, in some cases, fund managers and retirement plan sponsors.

Still, Tourville contends, the industry hit its low point in 2008 and 2009, and developments since then have been positive. Higher wrap fees, for example, have helped attract new participants, most of them insurance companies, into the wrap business. And tighter investment guidelines have forced the industry to refocus on its fundamental purpose, which is to protect investors' principal while generating a stable return on their investment. "To the extent plan sponsors are not happy about having to deal with some of these developments, that is something the industry needs to address," he said. "But overall, things are looking up."

It helps, of course, that stable value funds continued to perform superbly through the crisis, generating returns that outpaced virtually every asset class except U.S. Treasury bonds. "The 2008 credit crisis was a watershed event for us," Tourville said. "It was the time this product was needed the most, and we delivered."

Warren Howe, national sales director for retirement and benefits funding at insurance company Met Life, said the renewed interest in the stable value market by insurance companies has been striking. Data compiled by the industry trade group LIMRA found that there were two insurance companies that did $1 billion or more of wrapped product sales in 2008, he noted. In 2009, that number grew to three insurers, in 2010 it hit four, and in 2011 it was eight. "If you went back to 2005–2006 and said there would be a panel on wrap capacity at this seminar and all the participants would be insurance companies, it would have been hard to believe," Howe remarked.

Despite the improving climate for stable value funds, Tourville and the other panelists conceded that the industry still faces challenges. Convincing plan sponsors that tighter investment guidelines and higher fees are in the best interests of their plan participants is one. So is convincing them that still other changes might be needed to buttress the long-term viability of the stable value industry. Among the ideas attracting the most attention are the push from some wrap issuers to lengthen the 12-month put that is common most pooled funds and the possibility of introducing hybrid stable value funds in which some of the funds' assets aren't protected by a wrap contract.

Revisiting the 12-Month Put

The 12-month put gives a retirement plan the right to exit a pooled fund at contract value within one year of giving notice. Because the duration of the typical pooled fund exceeds 12 months, some wrap issuers have been arguing that one year could prove to be an insufficient period of time to return a plan's money if market conditions are unfavorable. Some have already persuaded plan sponsors to accept a 24-month put. Others are talking to plan sponsors and fund managers about introducing puts of other lengths, or trying alternative solutions such as shortening a fund's duration. Earlier this year, J.P. Morgan Asset Management announced that it was eliminating the 12-month put on a pooled fund it manages. Instead, plan sponsors will be able to leave the fund with 30 days notice and will receive a payout equal to either the fund's contract value or market value, whichever is lower.

Jon DeBow, executive director and senior client manager in the Institutional Fixed Income Group at J.P. Morgan Asset Management, said the reaction from plan sponsors thus far has been favorable. "As a result of the changes we made to our pooled fund, only 1 percent of the clients in that pool made a change," he said. "We think sponsors want solutions that will allow funds to be a long-term viable option, optimally invested, without having to hold large amounts of cash or sub-optimal portfolios designed to accommodate exit provisions."

Brett Gorman, senior vice president in the Defined Contribution Practice at Pacific Investment Management Co. (PIMCO), was open to the idea. "If moving to a different solution can bring good capacity to the pooled-fund space, we think it makes sense to explore those options," he said. "Our view is that there are certainly terms in a book-value (wrap) contract that are non-negotiable, but the 12-month put is not one of them."

PIMCO recently launched a new pooled fund with a 24-month put, but Gorman noted that his firm doesn't believe the 12-month put is going to go away completely. "It still makes a lot of sense," he said, "especially for some of the long-established funds that have been able to access all the wrap capacity they need."

Galliard's Tourville said his firm's pooled fund has always had a 12-month put, and he said the firm is not expecting to move away from that. "However," he added, "we view some of the changes that are occurring as interesting and worth studying. We think PIMCO's decision to enter the collective (pooled) fund market is a huge positive for the industry."

Would Hybrids Work?

As part of their effort to address the shortage of wrap

continued on page 4

The Evolution of Defined Contribution Plans: Where Does Stable Value Fit?

By Randy Myers

For much of their 40-plus years, stable value funds have maintained a relatively low profile. That changed after the 2007–2009 credit crisis, when retirement plan sponsors began looking more closely at all of the investments they offer in their defined contribution plans, including stable value funds.

Today, many plan sponsors still like what they see. Stable value funds performed admirably through the crisis, continuing to generate positive returns even as most other asset classes were losing money. Just a few years removed from the worst financial crisis of the past seven decades, the funds on average have a crediting rate of 2.8 percent and a market value comfortably in excess of contract value. And while the steep decline in interest rates has pared the crediting rates stable value funds offer to investors, they continue to yield far more than money market funds.

Where plan sponsors do have concerns, they center largely on the new demands being made by the banks and insurance companies that provide wrap contracts for stable value funds. Those contracts ensure

continued on page 5

Stable Value: Past, Present, and Future

continued from page 3

capacity in recent years, some stable value managers have been assessing the possibility of introducing hybrid funds. With a hybrid, some assets would be wrapped but others would not. "The concept is to blend two funds together," DeBow said. "One would be a stable value fund with a $1 per share net asset value on a daily basis to provide a shock absorber to volatility in the marketplace, and it would be combined with a low-volatility, short-duration fixed income portfolio."

Such a fund, DeBow said, could go a long way toward reshaping the expectations of retirement plan participants. Over the past 20 to 30 years, he said, participants seemingly have come to take for granted the idea that stable value funds must have a $1 per share NAV every day. "I think we could argue whether participants really need daily principal preservation," he said, "or if their time frame for a conservative option is more like a monthly time frame or a quarterly time frame."

Plan sponsors might like the approach, DeBow added, if it removes some of the "handcuffs" they perceive to be associated with wrap contracts today, such as more restrictive investment guidelines. "I don't think the hybrid approach should be a threatening concept," he concluded. "In the long run, I think it's better for all of us if we have more plan sponsors engaged in contract-value accounting products, even if they can't have full stable value implementation. Providing flexible alternatives and solutions in the capital preservation space will be key as we move forward." SVIA

Dodd-Frank Update: Swap Definition Finally on Horizon

continued from page 1

at contract value under most circumstances, even if the market value of their fund's portfolio falls below its contract value.

Recognizing that it might not be appropriate for wrap contracts to count as swaps, Congress gave regulators—the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC)—authority to study and rule on the issue. Speaking at the SVIA's Seventh Annual Spring Seminar in late April, Steve Kolocotronis, vice president and general counsel for Fidelity Investments and chair of the SVIA Government Relations Committee, said regulators were expected to issue final rules in June of this year that would further define the term "swaps." Once that was done, it would pave the way for the SEC and CFTC to conclude their study of wrap contracts. If they determine the contracts are swaps, regulators have the authority to exempt them from Dodd-Frank oversight if they conclude it would be in the public interest. Kolocotronis said he expects a quick decision.

The stable value industry has argued forcefully that wrap contracts should not be considered swaps, and it has spent considerable time explaining its position to SEC and CFTC commissioners and staff members. Regulators have responded, in part, by clarifying that the public will have a chance to comment on their findings when they are released in the Federal Register. While reluctant to forecast an outcome, Kolocotronis said at the SVIA seminar that "we are optimistic about the opportunity to provide comments and the decision-making process."

Because the final ruling by regulators will be forward-looking and not retroactive, Kolocotronis said any stable value contracts executed before that happens will not be considered swaps for purposes of Dodd-Frank enforcement. SVIA

The Evolution of Defined Contribution Plans: Where Does Stable Value Fit?

continued from page 4

that investors can make withdrawals from their stable value funds at contract value under most circumstances, even when the market value of their fund's portfolio falls below contract value. To minimize the risks associated with those contracts, wrap issuers have been imposing tighter investment guidelines on stable value managers and tightening the conditions under which investors can exit a stable value fund at contract value. Some are also becoming sensitive to plan sponsor communications that could induce withdrawals from the stable value fund if it became distressed since, in the event of a mass withdrawal, wrap contracts protect the fund and the remaining participants. Finally, most wrap providers have increased their fees, which also has caused concern among some plan sponsors.

"I get a lot of questions from our plan sponsor clients about stable value, and it ranges from how can I make it better to how can I get rid of it because I've been struggling with some of these changes since 2008," Rod Bare, a defined contribution consultant for Russell Investments, told participants at the Seventh Annual SVIA Spring Seminar. "Particularly in terms of their legal responsibility to be loyal to the interests of plan participants, some sponsors are wondering how they can do that and also fulfill the contract terms with the wrap provider in terms of what kinds of communications are allowed with participants."

Bare said that in his view, stable value continues to serve a useful purpose, especially for participants who are approaching and moving into retirement. As a result, "I tell my clients 'don't get rid of it,'" he said. Instead, he encourages plan sponsors with concerns about their stable value funds to consider moving to a new fund provider. "There are some providers that I think have better relationships with their wrap issuers and seem to be better positioned to manage a large separate-account fund," he explained.

While he continues to champion stable value funds, Bare challenged the industry to do a better job of educating plan sponsors about the reasons for the changes that have been made. "They say confusion breeds contempt, and that's what I'm seeing out there among some plan sponsors," he said. "I try to nip that in the bud as soon as I can."

Bare added that plan sponsors become particularly puzzled—and often upset—when a stable value manager that had been managing assets internally hands them off to a sub-advisor but doesn't reduce its own management fee. "I know it doesn't create a large percentage increase in the fund's overall cost and that the aggregate fee doesn't go up much, but it (the sub-advisor's fee) is an incremental fee, and it doesn't feel right to my customers," Bare said. "I would try to explain that better."

Finally, Bare suggested that the stable value industry start thinking about how its products can help plan participants convert their retirement savings into retirement income, and take that message to plan sponsors and plan participants. It is becoming a matter of growing importance, he noted, as the Baby Boomer generation begins to leave the workplace. SVIA

Money Market Funds Adapt to New Regulations

By Randy Myers

For years, stable value funds and money market funds have competed for investors who put principal protection at or near the top of their investment wish list. At the SVIA's Seventh Annual Spring Seminar, the stable value industry took a closer look at how money market funds fared through the recent financial crisis and how they are changing as a result. Long among the most conservative investments in the financial markets, money market funds are now even more conservative.

The blame—or credit—goes largely to the U.S. Securities & Exchange Commission (SEC), which in January 2010 amended the rules governing how money market funds can invest their portfolios. The SEC acted after the oldest such fund in the country, the Reserve Primary Fund, "broke the buck" in 2008. When its net asset value fell below $1 a share, investors in the fund were no longer assured they could redeem their shares for what they had paid. In fact, the fund ultimately was liquidated, and they received 99 cents on the dollar.

In a bid to avoid a repeat of that incident, the SEC mandated that money market funds must keep more of their assets in cash and less in illiquid securities, reduce the maximum weighted average maturity of their holdings by one-third, and perform monthly stress tests on their portfolios. The SEC also mandated that the funds begin to publicly disclose their actual portfolio holdings monthly and also disclose their "shadow NAV," or the mark-to-market value of their portfolio. Implementation of the new rules was completed in November 2011.

continued on page 6

Money Market Funds Adapt to New Regulations

continued from page 5

Speaking recently at the SVIA seminar, Kevin Lyman, general counsel for the Institutional Division of Invesco National Trust Co. and assistant general counsel for Invesco Advisors Inc., said the new rules seem to have helped stabilize the money market fund marketplace. Despite some major developments in the global financial system since the 2008 credit crisis, including the first-ever downgrading of the U.S. government's credit rating and a seemingly intractable debt crisis in southern Europe, cash flows into and out of money market funds have remained fairly stable over the past two years. Assets in money funds peaked at nearly $4 trillion in the first quarter of 2009. They fell steadily through mid-2010 as interest rates sank and financial markets stabilized, but have since held at about the $2.6 trillion level.

"I think that prior to the credit crisis, investors had lost sight of the fact that you have to understand what it is you are buying," observed Laurie Brignac, senior portfolio manager and co-head of North American Cash Portfolio Management for Invesco Fixed Income, who also spoke at the SVIA seminar. "I think that is why the new transparency rules have been a big help in stabilizing the market. Portfolio holdings are now disclosed monthly at the same time by all funds, which means that investors can now compare apples and apples on the same business day."

Money market funds may yet face additional regulation. Following up on work done by a President's Working Group, the SEC has been mulling additional changes. The most controversial is a proposal to allow the net asset value of the funds to float, just as it does for any other mutual fund, rather than be fixed at $1 per share. Proponents argue that getting rid of the $1 NAV presumption would excuse the funds from having to make good on that presumption in the event market conditions ever turn highly negative again.

The fund industry has fought the floating NAV idea, arguing that it won't necessarily reduce risk and could actually increase it. The industry notes that during the 2008 credit crisis, floating-rate, ultra-short bond funds experienced a substantial outflow of investor dollars, with assets falling more than 60 percent from their peak in mid-2007. If money market NAVs were allowed to float, the industry argues, money market funds could experience similar outflows in a difficult market environment. Investors could turn instead to investment pools in the United States and offshore that aren't registered with the SEC and therefore aren't subject to the same investment guidelines established to protect investors.

Lyman said the SEC appears to have backed away from the floating NAV idea for the moment, and it no longer seems to be a given that it will happen.

Lyman also noted that money market funds haven't been alone in coming under increased regulatory scrutiny. On April 9, the Office of the Comptroller of the Currency proposed new rules for short-term investment funds (STIFs) held in retirement plans subject to the Employee Retirement Income Security Act. STIFs are similar to money market funds, and many of the OCC's newly proposed rules are similar to those introduced in 2010 for money funds. They are designed to improve the liquidity and credit quality of STIFs and increase their transparency. They also call for stress testing of the funds; the adoption of shadow, or mark-to-market, pricing reports; and the establishment of orderly liquidation procedures.

Lyman said the proposed new rules shouldn't be a "seismic shock" for the STIF industry, in part because institutional investors have already been pushing STIF managers to adopt some of the 2010 changes imposed on the money fund industry.

Meanwhile, the money market industry has other issues to keep its eye on. The European debt crisis remains a concern, even though money market funds have dramatically pared their exposure to European bank debt. Also, credit-rating firm Moody's announced in February that it is reviewing 17 large banks, securities firms, and "global capital market intermediaries" for possible credit-rating downgrades. Money market funds could be precluded from buying debt issued by those banks if their credit ratings were lowered. However, Lyman observed that the impact could be muted if the banks maintained first-tier ratings with two other major rating firms, such as Standard & Poor's and Fitch.

Stable Value Industry Outlook: Healthy and Improving

By Randy Myers

It's an impressive record. Stable value funds outperformed equities in two of the past four years. They outperformed money market funds in all four years. In 2008, when virtually every asset class save Treasuries was getting pummeled, stable value funds stayed the course, generating total returns in the neighborhood of 4 percent. Today, just a few years removed from the worst financial crisis of the past seven decades, crediting rates for stable value funds average 2.73 percent, and their market-value to contract-value ratios have returned to historically strong levels.

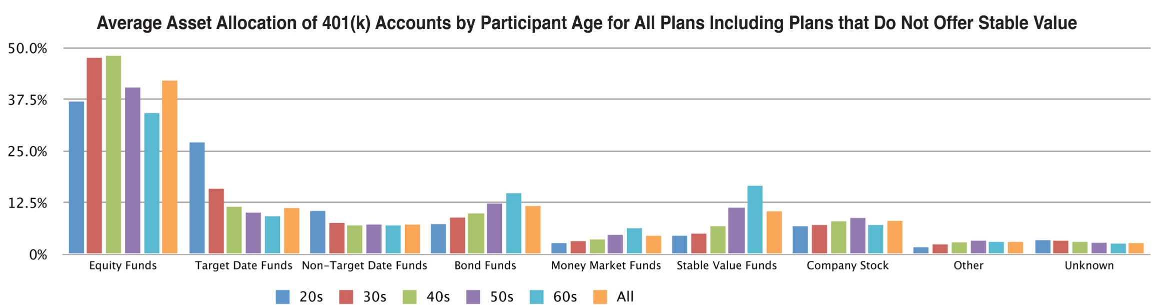
"Stable value funds offer investors important benefits in terms of performance, protection, and risk-return reward," James King, chairman of the Stable Value Investment Association, told participants at the SVIA's Seventh Annual Spring Seminar in Scottsdale, Arizona. "We have a great story to tell, and we have to make sure that story becomes well known."

Stable value funds accounted for about $440 billion of the $4.5 trillion in defined contribution plan assets in the fourth quarter of 2011, but even with that healthy market share, King said, there is still room for growth. A key reason: only about half of all defined contribution plans currently offer a stable value investment option.

Among plans that do offer stable value, King said, plan participants take advantage of it in an age-appropriate way. Participants in their 30s allocate a modest 4.9 percent of their plan contributions to stable value on average, for example, while those in their 60s allocate 16.5 percent, according to a a December 2011 Issue Brief from the Employee Benefit Research Institute (No. 366).

King conceded that the stable value industry is not without challenges. Notably, it has been wrestling with a shortage of wrap capacity since the financial crisis. Wraps are a specialized type of insurance that ensure a stable value fund's benefit responsiveness, meaning that investors can withdraw their assets at contract value under most circumstances, even if the market value of their fund's portfolio falls below its contract value. King, who is also senior

continued on page 17

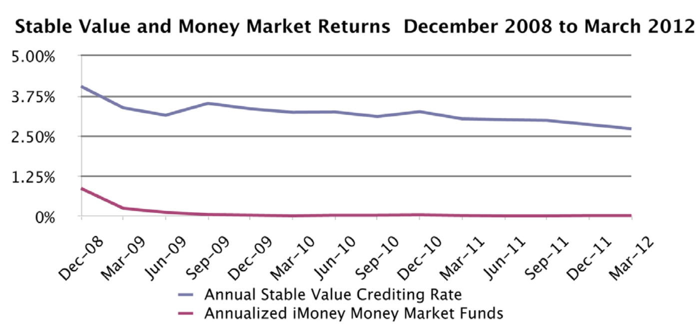


SVIA Quarterly Survey Shows Stable Value's Strength

By Gina Mitchell, SVIA

SVIA's Quarterly Characteristics Survey continues to demonstrate stable value funds' strength. For the first quarter of 2012, stable value fund assets included in the survey were $441 billion, with an average crediting rate (return) of 2.73 percent, which compares favorably with 0.03 percent return for iMoney Net Money Market Funds.

The survey covers 14 quarters through the first quarter of 2012 and includes data provided by 24 stable value managers who collectively manage $441 billion in assets. Assets have risen by 27 percent since the start of the survey in the last quarter of 2008, when assets totaled $347 billion. Crediting rates have declined over the survey period, which reflects the low-interest-rate environment. Even so, stable value crediting rates continue to offer a considerable premium over money market funds for defined contribution retirement plan participants.



Stable Value Market Gaining Additional Wrap Capacity

By Randy Myers

The wrap capacity shortage may not be over, but it is easing.

In the wake of the 2008 credit crisis, a number of wrap contract issuers exited the stable value marketplace, making it hard for stable value managers to grow or even maintain their business. Some could not buy all the capacity they needed, and others were forced to hold more cash in their portfolios than they would have preferred.

Wrap contracts are crucial to the stable value marketplace. Specialized insurance contracts, they ensure the benefit responsiveness of stable value funds, meaning that investors can withdraw their money from their funds at contract value under most circumstances, even if the market value of the fund's portfolio has fallen below its contract value.

A few new wrap issuers entered the market on a small scale in 2009, but now there are signs that wrap capacity is growing more substantially. Speaking at the SVIA's Seventh Annual Spring Seminar in April, Marijn Smit, president of Transamerica Stable Value Solutions, said an SVIA survey of issuers found that one group of 18 respondents was planning to offer at least $67.5 billion to $100 billion or more of new capacity, in total, to the market this year. This suggests a net increase in capacity for the industry, even taking into account planned reductions in capacity by four other issuers. They said their reductions could range from as little as $20 billion to over $27.5 billion. The new capacity would come from 11 current issuers plus seven new entrants to the marketplace.

Marijn cautioned that it's possible not all of that capacity will find a home. "Maybe it's all chasing the same two stable value managers, and only $20 billion will be put to work," he said. "It's an open question as to whether the terms of this new capacity will be acceptable to fund managers and plan sponsors, so there are a lot of ways to downplay the survey results." Still, he said that at a time when many people remain focused on the number of wrap issuers who have exited the business, the survey results suggest there's a better story to be told.

Judy Wilson, senior vice president of stable value products for Protective Life Insurance Co., said her firm, which specializes in offering traditional guaranteed investment contracts, or GICs, welcomes the debut of new issuers into the marketplace. "If nothing else, it will help break the cycle of issuers leaving the business and leaving stable value managers wondering why they are bothering putting time and resources into managing traditional GICs."

United Mutual of Omaha was one of the new entrants in the wrap marketplace in 2009, and John Fischer, the company's director of institutional investment products, said the survey results confirmed the anecdotal evidence he'd seen that other issuers were entering the market, too. "I think it's very encouraging for the industry," he said.

United Mutual of Omaha has grown its wrap business since 2009. "Our board approved us to enter the market in the middle of that year," Fischer reported. "We issued our first contract later that year with limited capacity. In 2010, we got authorization to increase capacity somewhat, and in 2011 we got authorization to increase it again." Fischer said his firm has issued contracts for both separate-account and pooled stable value funds, subject to "rigorous underwriting and review."

Prudential Retirement was another new entrant to the wrap business in 2009. William McCloskey, vice president of the company's Stable Value Markets Group, said it has grown its book of business in the synthetic wrap space rapidly since then but also has been selling in the traditional GIC market. "Our model is to have a complete suite (of products) so we can respond to demand wherever it comes in," he said.

McCloskey predicted that pooled funds featuring 12-month puts will continue to face some difficulty in finding sufficient wrap capacity. A 12-month put gives a retirement plan the right to exit a pool at contract value within one year of giving notice. Since the 2008 credit crisis, some wrap issuers have been pushing for alternatives to the 12-month put—including extending the put term—to alleviate the risks associated with wrapping pooled funds. (See "Stable Value: Past, Present, and Future" elsewhere in this issue of *Stable Times*.)

Fischer said his firm has been pleased with the performance of the pooled funds it has underwritten to date and added that he is uncertain how plan sponsors will react to the idea of giving up the 12-month put. "If they view the change as unfavorable, demand will decrease, and ultimately cash flow will decrease to those pools, which obviously would be a concern to wrap issuers," he said.

Spring Seminar
April 14–16, 2013
Four Seasons Resort Palm Beach
2800 South Ocean Boulevard, Palm Beach, FL

New ERISA Disclosure Rules: Implications for Stable Value Funds and Their Providers

By Donald J. Myers and Michael B. Richman
Morgan, Lewis & Bockius LLP

Later this year, two new ERISA disclosure rules are going into effect. The first, a regulation under section 408(b)(2) of ERISA, requires "covered" service providers to ERISA-governed retirement plans to make specified disclosures to the plan fiduciaries regarding their services and their direct and "indirect" compensation. The second, a regulation under section 404(a) of ERISA, requires the plan administrators of participant-directed individual account plans—the types of plans that commonly use stable value funds as investment options—to make specified disclosures to the plan participants and beneficiaries regarding the fees and expenses that may be charged to plan accounts and the plan's investment options. The new disclosure regime will impose disclosure and compliance obligations on the managers of, and (subject to certain limitations and exceptions) the other service providers to, single-plan and commingled stable value funds that serve as investment options for participant-directed retirement plans that are subject to ERISA, as well as stable value investments for other plans that, while not subject to ERISA, require compliance with the ERISA fiduciary rules. Therefore, they need to be prepared to come into compliance.

Service Provider Disclosure Rules

A service provider to an ERISA plan must comply with an exemption from the ERISA-prohibited transaction rules to be able to provide services to the plan without violating ERISA. The exemption under section 408(b)(2) of ERISA offers broad exemptive relief for the provision of services to a plan subject to three conditions—the services must be (1) "necessary" and (2) provided under a "reasonable arrangement" (3) for "reasonable compensation." These conditions were described in a Department of Labor (DOL) regulation from 1977. The 1977 regulation did not describe any disclosure requirements.

Around 2005, DOL announced a three-part initiative to improve disclosures to plan

continued on page 10

"New ERISA Disclosure Rules: Implications for Stable Value Funds and Their Providers" highlights the Department of Labor's rules and their application to stable value funds and their providers. "Reducing Fiduciary and Participant Risks with Increased Transparency" looks at how some plan sponsors and stable value managers are implementing the disclosure rules.

Reducing Fiduciary and Participant Risks with Increased Transparency

By Randy Myers

Beginning this summer, the retirement plan industry will be required to disclose more information about the fees being charged to retirement plans and retirement plan participants.

Under Section 408(b)(2) of the Employee Retirement Income Security Act, service providers acting as an ERISA fiduciary or registered investment advisor must begin disclosing compensation information to their plan-sponsor clients. Details must include the total cost to the plan, with a breakdown of the costs of individual services such as recordkeeping, administration, and investment management.

Meanwhile, section 404(a)(5) of ERISA requires that plan sponsors begin disclosing to plan participants any fees and expenses that are, or could be, deducted from their accounts. They also must provide performance and expense data for each of those investment options. As part of that discussion, sponsors also must disclose any features of the plan that could impact the performance of those investments, including the turnover ratios for each investment option.

Not surprising, the new disclosure rules are presenting challenges to plan sponsors and their service providers, including stable value managers. In a panel discussion at the SVIA's Seventh Annual Spring Seminar, several SVIA members outlined how their firms were planning to comply.

One of the challenges, they all agreed, was figuring out how to classify, and where to report, some of the expenses associated with stable value funds, particularly the cost of wrap contracts. Wraps are specialized insurance contracts that assure a stable value fund's benefit responsiveness, meaning that investors can withdraw their assets at contract value under most circumstances, even if the market value of their fund's portfolio falls below its contract value.

Nick Gage, a director with Galliard Capital Management, said his firm was including wrap fees in the overall expense ratio for its stable value funds. That, he said, seemed to be the approach most commonly being used by other stable value managers. Susan Graef, a principal with Vanguard Group, said her

continued on page 12

New ERISA Disclosure Rules: Implications for Stable Value Funds and Their Providers

continued from page 9

fiduciaries and plan participants regarding the fees and expenses charged against plan assets that could reduce plan benefits. The first part of the initiative involved revising Schedule C to the Form 5500 annual report filed by "large" employee benefit plans (generally those with 100 or more participants and beneficiaries), which lists certain of the service providers to a plan and their compensation. Those changes have been effective since the 2009-plan-year reporting period. The second part was to make changes to the section 408(b)(2) regulation to add disclosure requirements. The third part is the participant-level disclosure rule discussed below.

DOL chose to impose the service provider disclosure requirements under section 408(b)(2) (as part of the "reasonable arrangement" condition) to make them a condition to avoiding a non-exempt prohibited transaction in connection with the provision of services. This way, non-compliance by the service provider is a prohibited transaction that could result not only in ERISA liability for the plan fiduciaries but also prohibited transaction excise taxes that would be imposed on the non-complying service provider. Because the new regulation permits the plan fiduciaries to avoid liability if they meet certain due diligence conditions and report continued non-compliance to DOL, it is designed to focus the penalties for non-compliance on the non-disclosing service provider.

Covered Service Providers

The rules require disclosures from "covered" service providers. These fall into three categories:

(1) Providers of services as an ERISA fiduciary or a registered investment adviser. This category would include all of a plan's investment managers, such as the manager of a plan's stable value investment option.

In addition, this category covers the fiduciaries of a fund treated as holding "plan assets" under ERISA, such as a bank collective fund or insurance company separate account, in which an ERISA plan holds a direct equity investment. Thus, the trustee or manager of a stable value commingled fund would be covered. However, non-fiduciary service providers to such a fund are not covered.

(2) Providers of recordkeeping or brokerage services to a participant-directed individual account plan that make available, in connection with their services, the plan's "designated investment alternatives"—i.e., the designated investment options under the plan. This generally covers the providers of recordkeeping and investment platforms to participant-directed plans.

(3) Providers of certain other specified services—including brokerage, consulting, third-party administration, and investment advice—for which the service provider, an affiliate, or subcontractor reasonably expects to receive "indirect" compensation. As "indirect" compensation is defined broadly, many of these providers, such as consultants on stable value portfolios, may be subject to the new rules.

To be "covered," a provider must reasonably expect to receive at least $1,000 in direct and indirect compensation. Because this threshold is measured over the life of the service arrangement, rather than over a particular year, it may not prove to be much of a limitation on "covered" status.

Required Disclosures

The first element of the required disclosures is a description of all the services to be provided under the arrangement. It must include a statement as to whether the covered service provider is providing services as either (a) an ERISA fiduciary directly to the plan, such as would be the case for an investment manager for a plan's separately managed account; (b) an ERISA fiduciary to a plan asset entity, such as would be the case for the manager of a collective investment fund; or (c) a registered investment adviser.

The second element is a description of the covered service provider's direct and indirect compensation. Because these rules deal with fee disclosure on a prospective basis, as opposed to the retrospective disclosures required for Form 5500 Schedule C reporting purposes, they cover what the service provider reasonably expects to receive over the life of the arrangement. This may require the use of estimates or ranges, as appropriate. The goal of the disclosure, according to DOL, is to provide sufficient information to permit the party receiving the disclosure —the plan fiduciary responsible for the plan entering into the service arrangement—to evaluate the reasonableness of the service provider's compensation.

In addition to these general disclosure requirements, there are special rules on disclosures for particular types of service arrangements, such as for participant-directed plan recordkeeping and brokerage arrangements that make available designated investment options. Other special rules require additional disclosures for "bundled" service arrangements, in which a plan has entered into a single arrangement that includes services from multiple providers, and for participant-directed plan recordkeeping services for which there is no explicit charge, requiring an estimate of the stand-alone cost for those services. An additional obligation of the service provider is that it must, on request, furnish any compensation-related information required for the plan to comply with ERISA reporting and

continued on page 11

New ERISA Disclosure Rules: Implications for Stable Value Funds and Their Providers

continued from page 10

disclosure requirements, including the Form 5500 service provider schedule, reasonably in advance of the applicable reporting or disclosure deadline.

Disclosure Format

There is currently no required format for the disclosures to be provided under these rules. DOL did provide a "sample guide" that it "strongly encourages" service providers to use, and it is working on a separate rule that may establish a required format going forward. The sample guide is a one-page outline of the required disclosure categories that cross-references relevant provisions in documents such as a client agreement rather than list the actual disclosures, so that this appears to be an acceptable approach. In addition, DOL has confirmed that there is nothing in the rule that would prevent the disclosures from being provided electronically.

Timing and Effective Date

The effective date of these rules is July 1, 2012. Because the rules apply not just to new service arrangements but also to existing service arrangements, the disclosures must be provided to a covered service provider's current plan clients by that date. Therefore, firms that provide "covered" services should, in addition to preparing for compliance in connection with new arrangements entered into after July 1st, be preparing disclosures to go out to their existing plan client base.

DOL is expected to provide additional guidance to clarify issues under the rules prior to the effective date. In a Field Assistance Bulletin that it issued in early May, which focused more on the participant-level disclosure rules discussed below, DOL did announce that it would take into account good faith efforts based on reasonable interpretations of the new rules when considering enforcement action, but that was specifically in connection with failures to comply with additional guidance given shortly before the applicable effective dates. DOL also announced that it will not further extend the effective dates.

Considerations for Stable Value Service Providers

Managers of stable value funds for ERISA plans, both single-plan arrangements and commingled funds, will be subject to these new disclosure rules. In addition, consultants on stable value investments may be covered if they acknowledge ERISA fiduciary status or if they receive any form of indirect compensation (including gifts and gratuities) in connection with the services they provide to plans.

Non-fiduciary service providers to commingled stable value funds would not be covered. Non-fiduciary service providers to single-plan arrangements may be covered, depending on the types of services provided and whether they receive indirect compensation.

A provider of "wrap" coverage to a stable value arrangement should not, solely by reason of that relationship, be a covered service provider to the plan. This is because wrap coverage would not be considered a service, which also means that it would not be subject to section 408(b)(2) coverage. Consistent with this position, the terms of wrap contracts typically rely on an exemption other than section 408(b)(2) to avoid violating the ERISA-prohibited transaction rules.

Those stable value service providers that determine themselves to be "covered" should make sure they take the necessary steps to comply with the new disclosure rules by the July 1, 2012, effective date.

Participant-Level Disclosure Rules

The third part of the three-part DOL disclosure initiative discussed above is a set of rules contained in ERISA Regulation 404a-5 that are imposed on the plan administrators of plans that permit participant direction of plan investments, requiring disclosures to the participants and beneficiaries of information about the plan, plan expenses, and plan investments. The first disclosures required under these rules must be made by August 30, 2012. Because the service provider disclosure rules cross-reference the participant-level disclosure rules, and because service providers will be expected to assist plan administrators in developing participant disclosure documents, these rules also are relevant to stable value service providers.

There are two sections to the disclosure rules. The first requires disclosure of "plan-related information," which is information relating to the general operation of the plan and the plan's administrative expenses that may be charged to participant accounts. The second requires disclosures of "investment-related information," providing details regarding the investment performance, fees, and expenses of the plan's designated investment options.

One of the issues for stable value funds is where they fit into the investment-related disclosure regime. The rules differentiate between funds with a fixed return, for which the performance disclosure is the annual rate of return and the term of the investment, and funds for which the return is not fixed, for which the disclosure consists of the fund's average annual total return over 1-, 5- and 10-year periods, compared to an appropriate benchmark. While a guaranteed investment contract, standing alone, would be in the fixed-return category, DOL specified that stable value funds fall in the variable-return

continued on page 12

New ERISA Disclosure Rules: Implications for Stable Value Funds and Their Providers

continued from page 11

category because they are not free of investment risk.

Another issue is the determination of an appropriate benchmark. The relevant provision requires that the benchmark used be "an appropriate broad-based securities market index." Many stable value funds compare their performance to a peer group of other stable value funds, such as a Hueler index. This, standing alone, would not meet the requirement. Some of the sample disclosure forms being circulated by large recordkeeping firms have used a 3-month Treasury Bill index as the benchmark for stable value investment options.

There also has been a question about the calculation of a stable value investment option's "total annual operating expenses." Different firms have taken different positions on whether these expenses should take into account the "wrap fees" charged to the stable value fund for book-value coverage, based on whether wrap fees can be analogized to brokerage costs that are not included in a registered mutual fund's reported expense ratio under federal securities law. In the Field Assistance Bulletin issued in early May, DOL took the position that wrap fees must be included in a stable value fund's total annual operating expenses, because they reduce the fund's rate of return.

Timing

For a calendar-year plan, the first participant disclosures are required by August 30, 2012. The first quarterly disclosures are to be furnished no later than 45 days after the end of the quarter in which the initial disclosures are provided, which, for a calendar-year plan, will be November 14, 2012 (45 days after the September 30, 2012, end of the third quarter).

Conclusion

The new ERISA disclosure rules, which go into effect over the next several months, will require many disclosures relating to stable value funds and their service providers. Affected providers should be considering what steps they will need to take to come into compliance by the effective dates.

Reducing Fiduciary and Participant Risks with Increased Transparency

continued from page 9

company also was including wrap fees in the expense ratio, but making them transparent by breaking them out separately under the heading of administrative fees. (Administrative fees are included in a fund's expense ratio.)

On May 7, two weeks after the SVIA conference, the Department of Labor finally issued guidance on how to report wrap fees, confirming in a list of "frequently asked questions" that they should, indeed, be included in a fund's expense ratio.

Both Gage and Graef said their firms were already providing much of the information required under the new ERISA rules. Galliard produces quarterly fund fact sheets and annual disclosure documents for the stable value funds it manages. Those documents describe the principal strategies and attendant risks of the funds, the assets in their investment portfolios, portfolio turnover rates, investment performance, and related fees and expenses. Vanguard provides plan administrators with a quarterly fact sheet for pooled funds and an annual disclosure document with additional information about the funds.

One area where the stable value industry has yet to settle on a uniform approach to compliance is in the reporting of turnover ratios for stable value funds. The metric measures how many of an investment portfolio's holdings have been replaced over the course of a year. Some noted that the rules exempt money market funds and "similar investment products," which they argue include stable value funds. The remaining 13 plan to use a variety of methodologies to calculate turnover. For collective investment trusts, separate-account contracts, and synthetic contracts, the most common approach cited was the "look through" method, in which the ratio would be based on the trading of individual securities in the underlying investment portfolio. For cash holdings and short-term investment funds, or STIFs, most plan to show zero turnover. There was no consensus on how to handle general-account contracts, although options mentioned included showing zero turnover or counting the purchase or sale of a guaranteed investment contract as a turnover event. Regardless of methodology, about two-thirds of the survey respondents said that they expect turnover ratios for their funds to be below 75 percent.

Joe Fazzino, senior manager of pension investments for United Technologies Corp., addressed the new disclosure requirements from a plan sponsor's point of view. He said investment performance and plan fees and expenses aren't the only areas that his company focuses on when disclosing information to the 70,000 participants in its defined contribution plan.

In the case of the stable value fund it manages in house, he said, the company also tries to provide insight into the quality of the wrap contracts backing the fund's benefit-responsive guarantee. The fund has six wrap contracts provided by three insurance companies, and in its disclosures to participants, it names those companies and

continued on page 13

Reducing Fiduciary and Participant Risks with Increased Transparency

continued from page 12

shows their financial strength ratings. "When we communicate to our participants, we emphasize exposure to the contracts … (not) the sector exposures or average credit quality (of our underlying investment portfolio)," Fazzino said.

Fazzino said United Technologies breaks out fees for stable value funds at three levels: insurance wrap fees, investment management fees, and administrative fees. It compares the performance of its fund, as measured by its crediting rate, against six-month CD rates.

Fazzino said United Technologies isn't yet sure how it's going to handle disclosure of turnover ratios for its stable value fund. "Since our fund is 100 percent insurance wrapped, we might be able to argue that turnover isn't applicable," he said.

The panel' speakers were not sure whether the enhanced disclosure regulations will lead to better investment results for retirement plan participants. Fazzino, for one, worries about a "race to the bottom" in which valuable plan benefits and features could be eliminated to reduce costs.

"It's an awful lot of information for participants," Graef added. "If communications are to be meaningful, they have to be focused. Hopefully, what will happen is that to the extent the new disclosures cause confusion, at some point they can be reexamined and refashioned more toward plain talk." SVIA

Editor's Corner: Perspective

By Marijn Smit, Transamerica Stable Value Solutions

As you read through this issue of *Stable Times,* there are two major themes that emerge. First, stable value funds have performed as expected, delivering capital preservation and steady, conservative returns that consistently outperform money market funds over time. They have performed through a variety of market cycles in their almost 40-year history since the enactment of ERISA, including the recent "Great Recession," which has presented a number of unique challenges. While past is not always prologue, having a successful track record is certainly a key factor when evaluating future success. Second, making sure stable value funds continue to offer an attractive value proposition takes hard work and dedication. It is a continuous process that involves diligence by the key stable value players: contract issuers, stable value managers, plan sponsors, and consultants.

What is striking given stable value's performance through the worst financial crisis in our nation's history is how differently some view this process. Be it concerns with how stable value will perform in a rapidly rising rate environment, how sponsors and consultants view stable value contracts, the challenges in procuring contract coverage, or implementation of the new fee disclosure regime for 401(k) providers and plan participants, these concerns seem to distill themselves to the sometimes differing viewpoints of these same key stable value players.

All perspectives were shaped by the proximity to the "storm" presented by the financial crisis. While stable value did not contribute to this crisis, and actually played a crucial role in helping shelter plan participants from the storm, it definitely was in the path of this hurricane. For stable value, the aftermath of the storm expressed itself in the form of new risk management policies that recognize the tail risk inherent in stable value funds, higher contract fees, more conservative guidelines and contract terms, and limited availability of wrap capacity. While individual members of the stable value community may have different viewpoints on some of these issues, they all share the same goal: ensuring stable value funds deliver for plan participants who rely upon this important asset class. With this goal in mind, the industry's track record has demonstrated its ability to adapt to the changing environment, and many of the items currently being addressed are part of this process.

I think you will find this issue of *Stable Times* particularly interesting in its presentation of these perspectives and the various ways your stable value colleagues have tackled the issues facing stable value. As you know, success does not come easy. It takes work. This issue demonstrates how the stable value community has and continues to work to uphold stable value's promise.

Benchmarking Stable Value Funds

By Randy Myers

If you manage a large-cap domestic stock fund, choosing an index to benchmark your performance is fairly easy: the Standard & Poor's 500 is the widely recognized standard. If you manage a broadly diversified U.S. bond market fund, the decision is pretty easy again: the Barclays U.S. Aggregate is the obvious benchmark.

And if you manage a stable value fund? Not so easy.

Stable value managers compare the performance of their funds to a benchmark for a variety of reasons, notes Jennifer Gilmore, senior portfolio manager and head of stable value portfolio management for Invesco Advisors Inc. Speaking recently at the SVIA's Seventh Annual Spring Seminar in Scottsdale, Arizona, Gilmore said benchmarking provides transparency to retirement plan sponsors, plan participants, and plan consultants. It also helps fund managers and other stakeholders, such as plan sponsors and consultants, evaluate portfolio performance for internally managed and sub-advised fixed income portfolios. And it facilitates their conversations with wrap providers regarding portfolio strategy and investment guidelines.

Unfortunately, choosing the right benchmark for a stable value fund can be a challenge. Some plan sponsors or consultants have particular benchmarks they like to see, but those benchmarks are sometimes less representative of the stable value marketplace than others. Some plan sponsors like to see contract-value benchmarks to make sure a fund's crediting rate is tracking market interest rates and is providing a competitive return to plan participants. Others want to see market-value benchmarks to better understand how well the fund's underlying investments are performing. If a fund uses multiple investment managers with different investment mandates, and plan sponsors or consultants want to see how each is performing individually, then different benchmarks may be needed for each manager. In all cases, fund managers must be mindful of the ruling by the Department of Labor's Employee Benefits Security Administration (EBSA) to use broad-based securities market indexes as benchmarks.

Gilmore said Invesco uses multiple managers for its stable value portfolios where allowed by guidelines, and aligns each with a publicly available market-value benchmark. Examples include the Barclays 3-Month Bellwether Index for cash portfolios, the Barclays Custom Short-Duration Index for short-duration portfolios, the Barclays Intermediate Government/Credit Index for intermediate-duration portfolios, and the Barclays Aggregate Index for core portfolios. Invesco also uses several contract-value benchmarks where business partners or clients want to see them, she said, including the Barclays U.S. Treasury 3-Month Bellwether Index, the iMoneyNet MFR, the 5-Year Constant Maturity Treasury Index, and the Ryan Labs GIC Index.

Andrew Apostol, senior director with stable value manager Galliard Capital Management, said choosing which benchmarks to use for his firm's clients depends largely on what type of client they are: big-picture oriented or detail oriented. "Big-picture clients are easiest to satisfy," he said. "They focus primarily on contract-value performance benchmarks, and their concerns are twofold: is my fund tracking market interest rates as it should, and is it producing a competitive return?" For them, he said, a typical benchmark would be a three-year or five-year constant-maturity Treasury (CMT) index with a spread of, say, 50 to 75 basis points. Often, he said, those clients also want to see returns relative to Treasury bills, inflation, or a GIC index.

Detail-oriented clients, Apostol said, typically want to see funds compared to both a book-value and a market-value series of returns. "They certainly require a higher level of transparency," he said. "They want to see market-value performance reporting after stripping away the benefit-responsive wrap contracts, and they want to see performance for any sub-funds within the portfolio too. They also want to understand the fund manager's market outlook, the fund's sector allocations, and the duration of the fund's portfolio—the main factors that will impact market-value returns." Some of these clients, Apostol noted, can receive benchmarking reports that are one-inch thick.

For participant-level reporting, Apostol said, Galliard follows the EBSA mandate to use broad-based securities market indexes. "We like to get feedback from plan sponsors (on which benchmarks to use) because they know their participants, their plan demographics, and the sophistication of their plan participants," he said. Commonly used benchmarks include a 91-day Treasury bill or money market fund index. Supplemental benchmarks might include inflation, a constant-maturity Treasury index, or even a blended index split between a Treasury bill index and a short-term fixed income index.

Tom Schuster, vice

continued on page 15

Benchmarking Stable Value Funds

continued from page 14

president of corporate benefit funding for the Stable Value Investment Products group at insurance company Met Life, said selecting an appropriate benchmark is important for companies like his when underwriting a wrap contract. He noted that the performance of a stable value fund's sub-advisors relative to a benchmark provides a starting point for a wrap issuer's due diligence activities. A neutral or shorter duration than the benchmark, a higher overall credit quality, a higher Sharpe Ratio, or a lower standard deviation would all be considered favorable attributes. "We feel comfortable providing wrap coverage for that kind of manager," he said, "because ultimately they will protect us."

Matthew Gleason, head of the Stable Value Group at Dwight Asset Management, said his firm also uses a wide variety of benchmarks for participant and plan-sponsor reporting. Choosing the right benchmark has always been a challenge, he said, because no two stable value portfolios are alike.

Last summer, Dwight debuted its own stable value benchmark. Gleason described it as a cash-flow-adjusted, book-valued-based custom benchmark that takes into account a fund's starting date, investment guidelines, cash-flow patterns, and other unique characteristics.

For any wrapped fixed income strategy, Gleason said, the new benchmark takes the actual contract value and market value of the fund at its starting point and then uses the yield and duration from the benchmark to run through a crediting rate calculation and arrive at an ending contract value. It also makes monthly net cash-flow adjustments for each sector of the portfolio. "At the end of the day," he said, "we add up those total contract values (for each sector of the portfolio) and do a book-value return calculation."

Taking the starting date of a fund into account is one of the keys to the custom benchmark's methodology, Gleason said. "What we're effectively doing at every point in time, every single month, is going back and recalibrating a return," he said. "We're not geometrically linking monthly returns and storing those; we are running through the calculation every single month."

While it is still quite new, Gleason said retirement plan consultants generally have been receptive to the new benchmark. SVIA

Stable Value and Rising Interest Rates

By Karl Tourville, Galliard Capital Management

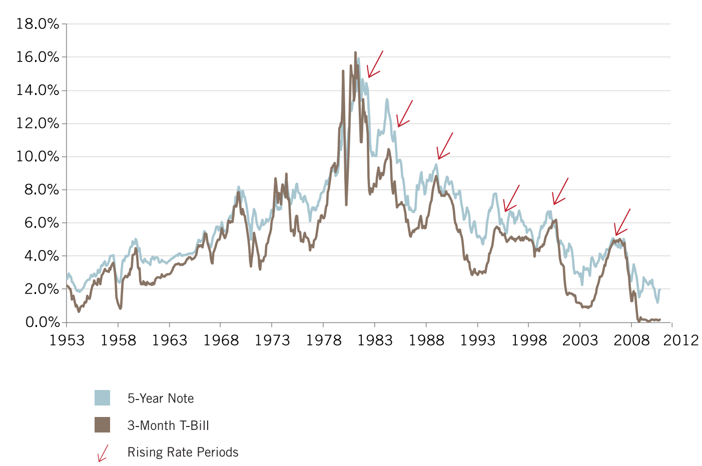
Stable value managers are frequently asked how stable value funds will respond in a rapidly rising interest rate environment. Some consultants and plan sponsors seem to fear that today's historically low interest rate environment will disadvantage stable value funds should rates rise. To address this fear, it is helpful to look at what makes this period of time unique and evaluate how stable value has performed under past interest rate challenges.

The Great Recession is a very historic time. Interest rates have never been so low, but the Federal Reserve has not formally announced any plans to sustain these low rates for the next two years. With the Federal Reserve providing an early warning for rising rates and stable value funds' strong fundamentals, stable value is well positioned to respond to this challenge. Market-value to contract-value ratios continue to be strong at 104.49 percent, crediting rates average 2.73 percent, overall credit quality for stable value portfolios continues to be AA to AA+, and portfolio durations average 2.83 years.[1]

> During each period of rising rates, stable value has performed as expected and has delivered upon its primary investment objective.

continued on page 16

Figure 1: An Historical Review of Interest Rates Short and Intermediate Rates Since 1953



Stable Value and Rising Interest Rates

continued from page 15

Historical Backdrop

In the late 1970s and early 1980s, the U.S. economy was plagued by chronically high inflation and poor economic growth. The Fed, under then-chairman Paul Volcker, successfully brought down the inflation rate from a peak of 13.6 percent through a painfully restrictive monetary policy—laying the groundwork for almost three decades of declining interest rates and the secular bull market in bond prices (See Figure 1).

More recently, Ben Bernanke's Fed implemented unprecedented accommodative monetary policy. That, coupled with increasing amounts of debt on the nation's balance sheet and bouts of inflationary pressure, has raised concern among investors that we may begin entering a sustained period of rising interest rates and a secular bear market in bonds. Indeed, with the current level of short-term interest rates at or near historic lows, it would appear rates have nowhere to go but higher. As a result, investors are assessing the impact rising inflation and interest rates would have on asset returns, including stable value.

Throughout stable value's history, there have been six full interest rate cycles, which have been characterized by increasing inflationary pressures, restrictive monetary policy, and a rise in the level of interest rates.

Rising Rates Not New to Stable Value

A rising rate environment could present an issue to a stable value portfolio if the rate increases are significantly above the portfolio's crediting rate.

In that context, it is worth pointing out that the Fed generally implements shifts in the federal funds rate, which historically has been used to control short-term interest rates, in 25-basis-point increments following scheduled Federal Open Market Committee meetings. With the fed funds rate at nearly zero, it would likely take over 10 increases of 25 basis points each just to bring money market fund yields into equilibrium with current stable value portfolio crediting rates.

Throughout stable value's history, there have been six full interest rate cycles, which have been characterized by increasing inflationary pressures, restrictive monetary policy, and a rise in the level of interest

Throughout stable value's history, there have been six full interest rate cycles, which have been characterized by increasing inflationary pressures, restrictive monetary policy, and a rise in the level of interest rates.

During each of these periods of rising rates, the product performed as expected and delivered on its primary investment objectives.

Stable Value and Inverted Curves

The yield curve has been positively sloped the majority of the time due to investors requiring a maturity risk premium. However, there are periods when the yield curve becomes "inverted"—meaning short-term rates exceed intermediate and long-term rates. In this environment, money markets may become a more attractive investment alternative, at least in the short run, relative to other conservative options such as stable value.

continued on page 17

Table 1: Periods of Inverted Yield Curves[2]

Inversion Period	# of Months	Magnitude of Inversion
October 1966	1	8 bps
January 1967	1	2 bps
June 1973 to May 1974	12	59 bps
August 1974	1	33 bps
January 1979 to April 1980	16	70 bps
November 1980 to February 1981	4	169 bps
May 1981 to July 1981	3	87 bps
July 1989	1	5 bps
August 2000 to January 2001	6	30 bps
August 2006 to May 2007	10	25 bps
Average # of Months	5.5	
# of Inversion Periods	10	
Average Inversion	60 bps	
Average Inversion 1982 Onward	26 bps	

A review of yield curves over the last half century suggests a very small probability of money markets outperfoming stable value on a consistent, long-term basis.

Stable Value and Rising Interest Rates

continued from page 16

Since 1953, there have been 10 instances of yield curve inversion as measured by the slope of the UST 3-month Bills versus UST 5-year Notes. The typical inversion lasted 5.5 months, with an average inversion of 60 basis points. Over nearly six decades, there have only been 55 months (or 8 percent of the time) when the yield curve has been inverted. The number of curve inversions correlates closely with Fed policy and the number of economic cycles the U.S. economy has been through. Inversions tend to be short because they are driven by Fed actions to cool inflationary pressures by making short-term borrowing more expensive. Once the economy slows, the Fed reverses the process, and the yield curve returns to its normal configuration.

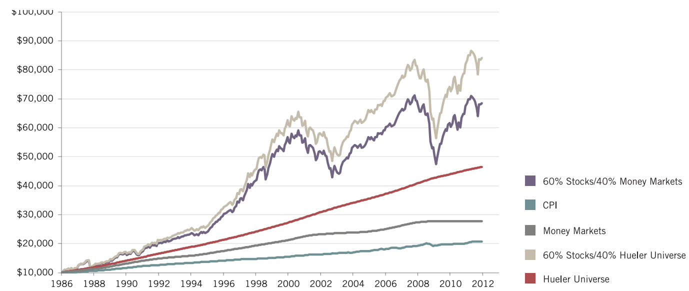
Table 2: Total Returns of Money Markets and Stable Value Pooled Funds During Periods of Inverted Yield Curves

Dates	Inversion Period Months	Money Markets	Hueler Universe	Excess Returns
July 1989	1	0.73%	0.72%	0.01%
Aug. 2000-Jan. 2001	6	3.33%	3.19%	0.14%
Aug. 2006-May 2007	10	4.26%	3.99%	0.27%
				0.42%

While there have been instances over the past 30-plus years when money markets have outperformed stable value, these periods have been relatively short lived. A review of yield curves over the last half century suggests a very small probability of money markets outperforming stable value on a consistent, long-term basis.

Over the last 25 years, the yield curve has been inverted three times for a total of 17 months (See Table 1). Comparing money market returns with the Hueler Pooled Fund Universe returns shows

Figure 2: Growth of $10,000: Performance of Stable Value vs. Money Market



that the total, cumulative excess returns generated by money markets during these inversion months was just 0.42 percent (See Table 2). In contrast, the cumulative outperformance of the Hueler Universe relative to money markets since 1986 has been 77 percent higher for the same dollar amount invested over that period.

Rising interest rates, yield curve inversions, and other market dislocations will continue to come and go in the future, but the fundamental proposition of stable value—namely to provide principal preservation while delivering returns comparable to those of short/intermediate bonds with limited volatility—will not change. For almost 40 years (and since the dawn of the Hueler Universe), stable value funds have delivered principal preservation and steady, consistent, conservative returns. Focusing solely on return for a specific period minimizes what stable value delivers to plan participants: diversification benefits since it has the least correlation to equities, the ability to provide an intermediate bond-like return without the volatility, and principal preservation (See Figure 2).

[1] SVIA Stable Value Quarterly Stable Value Funds Characteristics Survey covering 24 managers with stable value assets of $441 billion for the first quarter, 2012.
[2] Calculations are derived from H.15 data available from the Federal Reserve, (http://www.federalreserve.gov/releases/h15/data.htm). Inversion periods are defined as periods when yields on the 5-year Treasuries were less than the 3-Month T-Bill.

Stable Value Industry Outlook: Healthy and Improving

continued from page 7

vice president and head of the Stable Value Markets Group at Prudential Retirement, said there are signs that the wrap capacity shortage is being addressed. A recent SVIA survey found that somewhere between $67.5 billion and $100 billion of additional capacity is scheduled to become available this year from new market entrants and existing issuers. “That,” he said, “should have a very positive influence on the marketplace.”

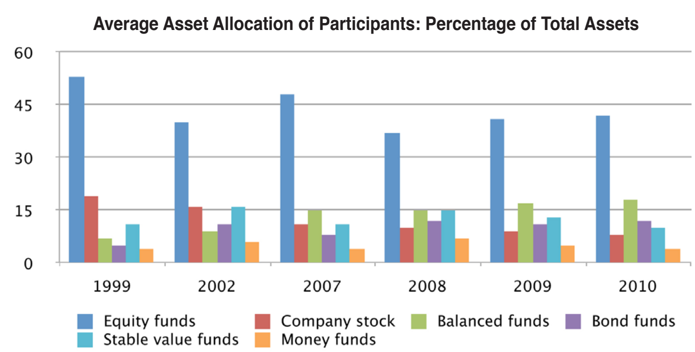
It should be good news, too, for retirement plan sponsors and their employees who count on stable value funds for dependable investment returns, even in times of unusual market volatility. It will help ensure that stable value funds remain readily available for those investors who want and rely upon them.

EBRI-ICI Database Shows Stable Value Is a Key Component in 401(k) Asset Allocation

By Marijn Smit, Transamerica Stable Value Solutions

According to research data from EBRI/ICI, stable value remains by far the largest conservative investment option within 401(k) plans. This is based on information in the ICI Research Perspective, which was published in December of 2011, covering over $1.4 trillion in 401(k) assets and over 23 million participants. According to EBRI/ICI Database, the size of the allocation to stable value is similar to that of all bond funds and over two times higher than the allocation to money funds (see Figure 1).

Figure 1: Average Asset Allocation of 401(k) Participants (% of total assets)



Notes: "Funds" include mutual funds, bank collective trusts, life insurance separate accounts, and any pooled investment product primarily invested in the security indicated. Minor investment options are not shown; therefore, percentages do not add to 100 percent. Percentages are dollar-weighted averages.
Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project.

At the height of the financial crisis at the end of 2008, stable value assets represented as much as 15 percent of the overall asset allocation within 401(k) plans, compared to 11 percent in 2007. By 2010, the allocation had moved back to a more normalized pre-crisis level of around 10 percent. A similar effect was visible during the stock market drop in 2002, when stable value assets hit a peak of 16 percent of the total 401(k) asset allocation. Since not all plans within the EBRI/ICI universe offer stable value, the picture is even more pronounced when looking at the shifts in asset allocation for plans that offer a stable value option. For plans that offer stable value, the average allocation to the stable value investment option rose to around 25 percent in 2008, compared to a pre-crisis level of around 17 percent in 2006. In 2010, the picture had normalized again, with an average allocation of around 18 percent. This compares favorably to average allocations of around 8 percent and 2 percent to bond funds and money funds, respectively, illustrating that when participants have the option, they clearly prefer stable value over other investments on the conservative side of the spectrum. Much of the dramatic swing in stable value allocation percentages from year to year reflects 401(k) balances fluctuating with market returns, rather than an aggressive move in and out of stable value. According to the ICI data, the average 401(k) retirement account fell by around 24 percent in 2008. This effect alone would have increased the average stable value allocation to over 14 percent from 11 percent, even if participants made no active shifts in their portfolios. This reinforces the stabilizing effect that stable value has on diversified portfolios—when other asset classes decline in value, stable value is the rudder in the water that acts as a stabilizing force in turbulent times.

This is why stable value is an important retirement savings tool for participants in all age brackets. While participants at or near retirement remain the most significant users of stable value, stable value is used by participants across demographic profiles. Looking at plans that offer the broadest range of investment options (including company stock and stable value), the overall allocation to stable value in 2010 was just over 18 percent. The range among age groups varied from just over 8 percent to over 29 percent, with allocations increasing as age increases. In this sample, for participants in their 60s, the allocation to stable value is the second largest allocation, with equity funds being marginally higher. Even for participants in their 20s and 30s, stable value is a meaningful component of their overall assets, larger than bond funds and money funds combined.

As shown in Figure 2, the use of target-date funds and other life cycle funds is relatively high in the younger age segments, most likely driven by increased auto enrollment and the pervasive use of these types of funds as default investment options. It will be interesting to see if, as participants age, this leads to a longer-term trend where stable value allocations do not increase to the levels we have seen historically. This will depend on whether these participants will take

continued on page 19

EBRI-ICI Database Shows Stable Value Is a Key Component in 401(k) Asset Allocation

continued from page 18

a more active approach in managing their allocations over time, or if they will leave most of their assets in these types of funds until they hit their retirement age. With participants in the older age brackets representing the highest average 401(k) balances and the highest level of allocation to stable value, this will be an important trend to watch over time.

Access to Stable Value

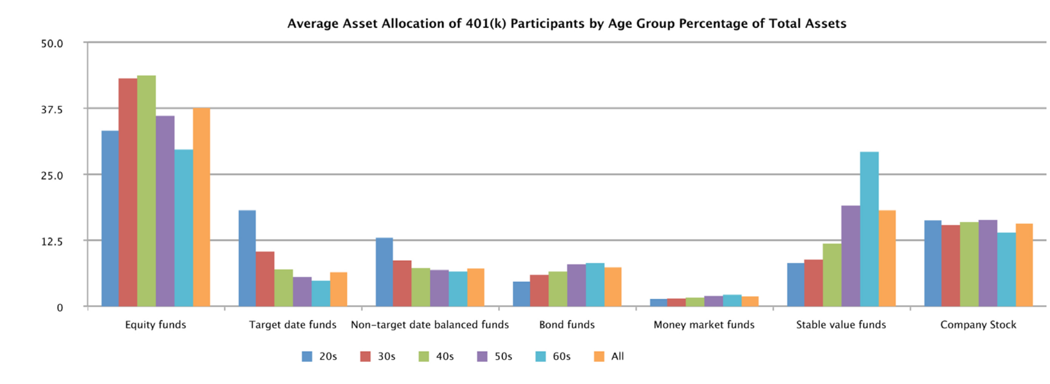
As mentioned above, not all 401(k) plans offer a stable value fund in their lineup, and therefore not all participants in 401(k) plans have access to stable value's unique combination of characteristics. Based on the ICI 2010 data sample of over 23 million 401(k) plan participants, nearly 51 percent of those participants had access to a stable value fund through their plan. This is lower than the 54 percent of plan participants that had access to stable value according to the 2008 ICI data. This trend is also visible in the percentage of plans that offer stable value. Whereas in 2008 over 45 percent of 401(k) plans offered a stable value option, this had declined to 36 percent in 2010.

Since the decline in the number of participants who are in plans that offer stable value is smaller than the decline in the number of plans offering stable value, it seems to be the case that more small plans have discontinued offering stable value to their participants than large plans. It is speculative to try and assess the drivers behind this, but here are some thoughts. Part of it could be driven by a difference in scope between the two survey dates, as the 2010 EBRI/ICI database covered 46 percent of the universe of 401(k) participants and 10 percent of 401(k) plans, compared to 48 percent and 12 percent, respectively, in 2008.

Another factor that could help explain the change includes the proportionally higher usage of pooled funds among smaller plans. Small plans tend to not run their own stable value fund, whereas very large plans with broad participant bases and hundreds of millions in plan assets tend to want to structure a stable value fund that meets their specific needs. In addition, average allocations to stable value tend to be lower for very small plans compared to large plans, possibly reflecting different employee base demographics. These factors could mean that some small plans felt less ownership of the success of their stable value fund and chose to exit the fund option during the turbulent times during the financial crisis. Since it's operationally easier to exit from a pooled fund than from a large individually managed stable value fund, this could help explain the decline in the number of plans offering stable value, whereas the decline in the number of participants who have access to stable value was much less pronounced. In addition, a number of pooled funds closed or limited new deposits, which could have prompted some smaller plans to terminate the option altogether, although this trend probably wasn't fully visible yet in 2010.

On balance, the EBRI/ICI report confirms that stable value remains a very important plan option for over half of all 401(k) plan participants, with participants across demographic groups allocating significant parts of their overall retirement assets to the most important conservative option in their plan. With the capacity picture in the stable value industry starting to show signs of healing, the industry should be in a position to ensure that the benefits of stable value continue to be available to the plans and participants who want and need it.

Figure 2: Asset Allocation by Participant Age, Plans with Stable Value and Company Stock (% of total assets)



Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project.

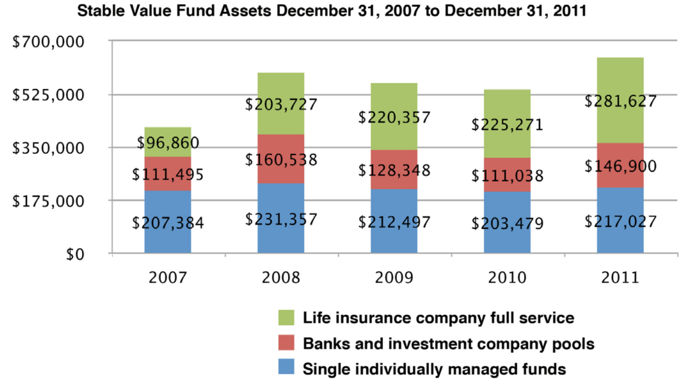
Stable Value Investment and Policy Survey Covers $645.6 Billion in Assets

By Gina Mitchell, SVIA

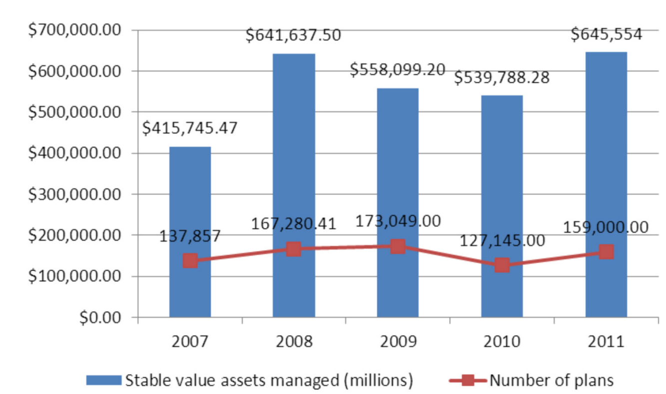
SVIA's most recent *Stable Value Investment and Policy Survey* covers the largest asset figure yet for stable value funds: $645.6 billion in assets as of December 31, 2011. The 16.4 percent increase reflects an increase in all three management segments: individually managed accounts by 6.2 percent, pooled funds by 24.4 percent, and life insurance full service company accounts by 20.0 percent. The increase occurred in part due to greater participation: two companies with life insurance full service company accounts participated in 2011 and were not included in prior years.

As the chart below illustrates, the life insurance company full service account segment has grown into the largest management segment, followed by single individually managed accounts, and then pooled funds.

Stable Value Fund Assets December 31, 2007 to December 31, 2011



For 2011, survey participants reported that 159,000 plans were covered, which is a 25 percent increase over plans covered in 2010.



While survey participation may vary from year to year, 2011's increase in both assets and plan covers shows that stable value remains a core investment option in defined contribution plans and participants' asset allocation, despite press articles that report on individual plan terminations of stable value funds.

From 2007 through 2011, use of stable value was predominantly by defined contribution plans with over 92 percent in all years. The remaining seven to eight percent was concentrated in 529 plans, Taft-Hartley plans, and grandfathered defined benefit plans.

The survey also found that net crediting rates continue to be strong for stable value, with 2011's average net crediting rate at 2.88 percent. As the table below demonstrates, stable value crediting rates have been declining, which reflects the current interest rate environment. However, stable value crediting rates across all management segments have retained a sizeable premium over money market funds.

Net Crediting Rates

December 31, 2007 to December 31, 2011

	Overall	Single individually managed funds	Banks and investment company pools	Life insurance company full service
2007	4.81%	5.00%	4.58%	4.83%
2008	4.17%	3.97%	3.73%	4.67%
2009	3.24%	3.26%	1.71%	3.83%
2010	3.43%	3.27%	2.70%	3.93%
2011	2.88%	2.91%	2.30%	3.15%

SVIA's *16th Annual Stable Value Funds' Investment and Policy Survey*, which covers stable value funds as of December 31, 2011, is available in its entirety to SVIA members in the Members' Only Survey Section of www.stablevalue.org.

SVIA thanks the 38 firms and/or managers who participated in this year's survey for this important data.