

IN THIS ISSUE

As Market Stabilizes, Stable Value Industry Looks to Growth
By Randy Myers.....1

Millennials and Stable Value: Made for Each Other?
By Randy Myers.....1

Dodd-Frank Remains Work in Progress
By Randy Myers.....1

Collision Course: Social Security and a Slow-Growing Economy
By Randy Myers.....2

An Appraisal: ERISA at 40
By Randy Myers.....4

State and Local Pension Plans: Coping with Funding Challenges
By Randy Myers.....6

An Inside Look at How America Saves
By Randy Myers.....7

Roundtable: The Outlook for Retirement Income Security
By Randy Myers.....8

DC Plan Litigation: When Stable Value Becomes a Target
By Randy Myers.....9

Invesco Strategist Sees Continued Slow Growth, Low Rates in the U.S.
By Randy Myers.....10

Making Retirement Savings Last
By Randy Myers.....11

Living with Target-Date Funds
By Randy Myers.....12

As Market Stabilizes, Stable Value Industry Looks to Growth

By Randy Myers



With the turmoil of the 2008 financial crisis largely in the past, the stable value industry is turning its focus to growth.

The latest SVIA survey of 22 stable value managers shows that from the end of 2012 through the first half of 2014 stable value assets held fairly steady. In total, stable value funds now account for about \$721 billion in assets, or roughly 12 percent of the money held in defined contribution retirement savings plans as of 2013.

“That’s pretty amazing,” SVIA Chairman James King said in opening the 2014 SVIA Fall Forum in Washington, D.C., on October 13.

[Continues on page 2](#)

Millennials and Stable Value: Made for Each Other?

By Randy Myers



The millennial generation and the stable value industry may be made for each other.

The young are often painted as risk-takers, but in the case of millennials—those Americans born between 1982 and 2004—old measures may be misleading, says Neil Howe.

Neil Howe is the founding partner and president of LifeCourse Associates, a publishing, speaking and consulting company focused on generational research.

He contends that millennials are more risk averse than their predecessors in Generation X and the baby-boomers.

[Continues on page 5](#)

Dodd-Frank Remains Work in Progress

By Randy Myers

Four years after its passage, the Dodd-Frank Wall Street Reform and Consumer Protection Act remains a work in progress. While 73 percent of its rule changes and other requirements were completed by July of 2014, 27 percent were not finished, including 11 percent on which work had not yet begun.

“It won’t be until the 10th anniversary of Dodd-Frank that we will know the full range of its impact,” said Cady North, senior finance analyst for Bloomberg, in a presentation to the 2014 SVIA Fall Forum in October.

Over the past year, North said, regulators have made progress on a number of Dodd-Frank’s directives: writing rules to improve internal controls at credit rating agencies, re-proposing rules for margin and capital on uncleared swaps, addressing some of the confusion on the cross-border application of swaps rules, and approving rules to prevent runs on money market funds.

[Continues on page 3](#)

As Market Stabilizes, Stable Value Industry Looks to Growth Continued from page 1

"It is one of the single largest asset classes available to DC plan participants."

King congratulated SVIA members for holding the stable value asset class together throughout the financial crisis and its aftermath. Now, he said, it is time to devote the same energy to growing the industry via innovative new product development, exploring new markets and perhaps even "cracking the code, potentially, for the IRA market," where stable value funds are not available. King noted that the U.S. Government Accountability Office is taking a second look at Department of Labor guidelines on qualified default investment alternatives, or QDIAs, in defined contribution plans. Stable value was not designated as a QDIA. But King said that SVIA has been in discussions with the GAO, providing it with information about what stable value is, how it works, and ways in which it could function as a principal-preservation QDIA in defined contribution plans. He said he is optimistic that regulators will revisit stable value's potential role in the QDIA lineup.

Stable value has remained popular despite a general decline in interest rates since the financial crisis. That decline has helped push down the average crediting rate offered by stable value funds. Among the managers surveyed by the SVIA, the average crediting rate had fallen to 1.93 percent as of June 30, 2014, down from 4.15 percent at the end of 2008. Still, stable value crediting rates remain attractive relative to the roughly zero percent returns that many money market funds have delivered over the past few years.

King also shared statistics indicating that the much-discussed tightening of investment guidelines for stable value funds in the wake of the financial crisis may not have been as onerous as anecdotal evidence suggested. Since the crisis the average duration of the stable value funds represented in the SVIA Quarterly Characteristics Survey has held fairly steady: 2.87 years as of June 2014, versus 2.84 years as of December 2008. Also, the average credit quality of those portfolios, while still high, actually moved lower over that period of time, to AA- from AA+. **SVIA**

Collision Course: Social Security and a Slow-Growing Economy

By Randy Myers

Conventional wisdom holds that the Social Security program will soon become insolvent because the number of people collecting benefits has grown exponentially relative to the number of people paying into the system. That is largely true. But it is not the only challenge to the federal retirement program.

In an address at the 2014 SVIA Fall Forum, Jim Kessler, senior vice president for policy and co-founder of the Washington, D.C.-based think tank Third Way, argued that a slower-growth U.S. economy also is contributing to Social Security's poor finances.

From 1950 through 2000, Kessler noted, the U.S. economy grew at an average rate of 3.7 percent. Since then, it's grown at an average rate of 1.8 percent. "I think it's fair to say that the U.S. is now a perpetually slow-growth nation," he said. That's important for Social Security, he said, because wages follow growth. Wages, in turn, are important not only for how they impact the amount of money flowing into the Social Security system but also for how they impact the economy and the financial security of working Americans. From 2001 through 2013, the median household income in the U.S. fell by nearly \$5,000, Kessler said. That left household income about \$12,000 below where it would have been if the upward trend in income established between 1980 and 2000 had continued.

At the same time that household income is declining, the number of Americans over the normal retirement age of 65 is increasing. Between 2010 and 2030, Kessler said, the number of Americans ages 65 and older will increase by about 80 percent, while the number of people of prime

working age—ages 25 to 64—will increase by only 7 percent. Because Social Security is a pay-as-you-go system, the number of Americans paying into the program will be growing more slowly than the number taking money out of the program. That will continue to put pressure on the system's solvency. According to the latest report from the Social Security and Medicare Boards of Trustees, the Social Security trust fund is projected to become insolvent in 2033. The trust fund backing its disability insurance program is expected to be tapped out even sooner, in 2016. All this comes at a time when the federal government's finances are none too pretty, either. In the early 1960s, Kessler said, the federal government was spending about \$3 on public investments—space exploration, roads and bridges and so forth—for every \$1 on entitlement programs such as Social Security and Medicare. By 2013 it was spending \$3 on entitlements for every \$1 on public investments, and in another 10 years it will be \$6 on entitlements for every \$1 on public investments. Similar trends are playing out at the state level, he added.

Kessler said he doesn't believe politicians would ever get rid of Social Security because their constituents would not stand for it. Nor does he believe the government can simply raise Social Security taxes enough to put the program on a path to long-term solvency. He seemed to suggest that the program could be saved by a mix of tax increases and benefits adjustments, which he thinks the American people might support. After all, one recent survey showed that 75 percent of Americans agree that doing what's best for the country may mean doing things they don't like. "It's controversial, but not so controversial that politicians can't survive it," he concluded. **SVIA**

Dodd-Frank Remains Work in Progress

Continued from page 1

Among the significant work still to be done, North said, is:

- Completing corporate governance rules, including rules on disclosing the ratio of CEO-to-employee pay.
- Writing new rules for broker-dealers, including a fiduciary standard.
- Writing tailored standards for nonbank systemically important financial institutions (SIFIs), and determining whether any additional institutions, beyond the four already named, should be designated as SIFIs.
- Completing rules governing emergency assistance programs to financial institutions.
- Completing a study on stable value investments.

North said she expects the Securities and Exchange Commission to work on the disclosure rules for CEO pay ratios in the year ahead. She said she does not expect regulators to make a decision anytime soon on whether stable value contracts should be regulated as swaps. Until they do—the SEC and the Commodities Futures Trading Commission must both weigh in—the contracts are not being treated as swaps.

New rules on fiduciary standards are being delayed in part, North said, by the fact that both the SEC and the Department of Labor have yet to act on the issue. Beyond that, there is still “quite a bit of disagreement” on the subject among the SEC commissioners themselves, she said. So while investment advisors and broker-dealers can expect the SEC to devote some attention to the topic in the year ahead, “I don’t think this is something that will happen very quickly at all,” North said. “It falls very low on the priority list for the SEC compared to some of the other issues under Dodd-Frank.”

Additional issues the SEC may address, North said, are new disclosure requirements for investment advisors and the possibility of imposing a user fee on them. She also said it would not be surprising to see regulators push for greater disclosures to consumers about target-date investment funds. The SEC did recently publish new rules for money market funds that allow non-government money market funds to impose redemption fees or temporarily suspend redemptions if their liquid assets fall below 30 percent of their total assets.

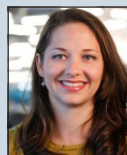
North predicted that government money market funds—those that invest at least 99.5 percent of their assets in cash, government securities and/or fully collateralized repurchase agreements—will see deposit inflows as a result, and non-government funds will see outflows. If that has a negative impact on the commercial paper market—commercial paper is a staple holding of non-government money

market funds—North speculated that the SEC might extend the implementation deadlines for the new money market rules to allow time for “other options to bubble up” to meet the needs of corporate treasurers.

Another big area of concern for regulators is identifying which nonbank financial institutions should be designated as systemically important financial institutions, or SIFIs—institutions so large and influential on the world financial stage that their failure could pose a risk to the broader economy. SIFIs are subject to increased supervision and regulation by the Federal Reserve, which is expected to impose more stringent capital restrictions on SIFI designees and require that they file so-called “living wills” outlining how they would wind down should they become insolvent. So far the Financial Stability Oversight Council, a regulatory authority created under Dodd-Frank, has identified three such institutions: Prudential Financial, AIG and GE Capital. It also has moved to include MetLife in that group, although MetLife is contesting the designation. Now, North said, the FSOC also is considering whether some of the country’s biggest asset managers should be considered SIFIs too.

North said the financial services industry should anticipate slow implementation of derivatives regulations, as funding challenges at the CFTC push more surveillance and enforcement duties to self-regulatory organizations such as the National Futures Association, the Financial Industry Regulatory Authority (FINRA), exchanges and clearing organizations. She noted that Timothy Massad, the new CFTC chairman, has indicated that his agency will probably want to tweak the existing regulations and provide new guidance on them. Areas where the financial industry will have an opportunity to provide input include final margin and capital requirements for uncleared swaps and the cross-border application of swaps rules. The SEC is soliciting comments on the latter subject, and CFTC guidance on the issue will not take full effect until its no-action letter expires at the end of this year. It’s possible, North said, that the CFTC could provide additional guidelines after investigating the effects on the market.

While there are a number of legislative initiatives underway to revamp Dodd-Frank, North said it is unlikely that any legislation will pass the Senate, at least in 2014 while Democrats still hold a majority of the Senate’s seats. **SVIA**



“New rules on fiduciary standards are being delayed in part, North said, by the fact that both the SEC and the Department of Labor has yet to act on that issue.” - Cady North

An Appraisal: ERISA at 40

By Randy Myers

Forty years ago President Gerald Ford signed into law the Employee Retirement Income Security Act of 1974, better known as ERISA. Congress' overarching goal in writing the law was to protect the interests of workplace retirement plan participants and their beneficiaries. The results have been mixed, although many of the shortcomings in the nation's private retirement system have less to do with ERISA than they do with how the retirement system itself has evolved over the past four decades. In a wide-ranging panel discussion at the 2014 SVIA Fall Forum, four retirement experts—Gary Ward of Prudential Retirement and attorneys Jan Jacobson, Donald Myers and Michael Richman—discussed how the retirement plan landscape has changed under ERISA, how it continues to evolve, and what the implications are for the stable value industry.

The great shift from DB to DC

The defining development in the private-sector retirement system since ERISA's passage has been the shift away from defined benefit pension plans funded by employers in favor of defined contribution plans typically funded at least in part by employees. From 1975 to 2011 the number of private-sector DB plans fell by more than half to just over 45,000, according to Department of Labor statistics, while the number of DC plans tripled to more than 638,000. Critics contend that this shift has left many American workers unprepared for retirement.

"I think employer-sponsored plans have done a good job, but we can do better and we can do more," said Jacobson, senior counsel, retirement policy, for the American Benefits Council, an employer association.

Jacobson explained that the performance of the private retirement system is typically gauged by two metrics: coverage and adequacy. The first relates to the percentage of workers covered by retirement plans, the latter to how much they have accumulated for their retirement years. The system often comes under criticism on both fronts, largely based on data indicating that the average 401(k) plan account balance is insufficient to support the typical worker in retirement and that only about half of U.S. workers have access to an employer-sponsored retirement plan. But those numbers can be misleading. Average account balances do not reflect the fact that many workers change jobs every few years and may have more than one account, or that older workers approaching retirement often have larger balances. Jacobson also pointed out that if one excludes part-time and seasonal workers and looks only at full-time employees, about 74 percent of workers have access to a workplace retirement plan.

Jacobson also noted that the employers who offer those plans are taking steps to make them more effective by adopting features such as automatic enrollment and automatic escalation of participant contributions. In a survey of ABC members last year, she said, 56 percent of plan sponsors said they have adopted automatic enrollment. Of that

group, 26 percent also have adopted automatic escalation of deferrals.

On the legislative front, Jacobson said, policymakers are looking to address coverage and adequacy by providing more ways for people to save. One example is the MyRA, a new type of Individual Retirement Account which President Obama announced in his January 2014 State of the Union Address. Meanwhile, Jacobson said, as many as 17 states are in various stages of trying to create state-sponsored plans that would be available to people who don't have access to a retirement plan at work.

While those efforts are encouraging, Jacobson said it's also important that policymakers remain committed to protecting the tax advantages of the retirement plans Americans currently enjoy. Over the fiscal years 2015 through 2019, she noted, the exclusion of employer-sponsored pension plan contributions and earnings from federal taxation, for both defined benefit and defined contribution plans, is expected to cost the U.S. about \$649 billion dollars—a tempting sum for legislators struggling to balance the federal budget. ABC recently filed a statement with the Senate Finance Committee emphasizing the successes of the current retirement system and explaining how even seemingly small changes in the tax code could have large consequences for its health.

Rethinking fiduciary duty

The basic rules of fiduciary duty first established by ERISA have not changed much. Among other things, they hold that a person who exercises any discretionary authority or control with respect to management of a retirement plan or disposition of its assets is a fiduciary—as is anyone who renders investment advice to the plan for a fee.

Soon, however, the rules may change. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, regulators are taking a fresh look at what constitutes investment advice and who should be held to fiduciary standards for offering it. Currently, investment advisors are considered fiduciaries but brokers, barring an agreement to the contrary, are not. Donald Myers, senior counsel in the Employee Benefits and Executive Compensation Practice Group at the law firm of Morgan, Lewis & Bockius, noted that the Securities and Exchange Commission is considering designating brokers as fiduciaries, too, but thus far has not acted.

One reason may be that the Department of Labor has announced that it is coming out with a proposal of its own in 2015, and neither entity seems to be sure who should move first.

One area where the DOL has already acted is in requiring that service providers offer additional disclosures about their services, fiduciary status and compensation to their retirement-plan clients.

An Appraisal: ERISA at 40 Continued from page 4

Now, Donald Myers said, the Labor Department must consider what it will do if it finds those disclosures to be inadequate, or if it sees an inappropriate reaction to those disclosures by plan sponsors or plan fiduciaries.

Litigation

The additional disclosures that service providers must now make are required under Section 408(b)(2) of ERISA. Michael Richman, of counsel to Morgan, Lewis & Bockius' Employee Benefits and Executive Compensation Practice Group, said no discussion of 408(b)(2) is complete without a discussion of litigation.

He noted that over the past decade the plaintiffs' bar has been more active in filing lawsuits against plan sponsors in two major areas: declines in company stock price where company stock was held in an employer-sponsored retirement plan, and excessive fees. Increased fee disclosure under Section 408(b)(2) could provide additional fodder for the plaintiffs' bar, he remarked.

Stable value: thriving amid the change

Gary Ward, senior vice president and head of stable value for Prudential Retirement, which is part of Prudential Financial, noted that throughout the 40-year history of ERISA stable value funds have continued to play an important role

in the retirement plan marketplace. But, he cautioned, the stable value industry must continue to exert its influence on retirement plan policy, particularly around the issues of making sure plans are available to as many American workers as possible and that those plans are up to the task of providing workers with a financially secure retirement.

Stable value can play an important role in those plans, Ward noted, not only for participants looking for stable and reliable investment returns but also for those looking to convert their savings to retirement income.

The stable value industry can also further its cause by staying involved in government efforts to expand the private retirement system, whether through the introduction of new individual retirement accounts such as the federal MyRA or through the expanded use of multiple small-employer plans, Ward said. One way the industry can do that, he said, is by working toward developing a simple and standardized approach to stable value, something retirement plan advisors and their clients increasingly value. **SVIA**

Millennials and Stable Value: Made for Each Other? Continued from page 1

That could be good for the stable value industry as millennials begin saving for retirement, since stable value funds are conservative investments offering principal preservation and interest rate stability that are not available from most other investment products.

One way we know millennials are risk averse is by their behavior, Howe said at the 2014 SVIA Fall Forum. The violent crime rate for offenders ages 12 to 20 peaked in the early mid-1990s, when Generation X last occupied those age brackets, and has since fallen by 75 percent.

Meanwhile, surveys show that substance abuse rates are at their lowest levels ever for students in grades 8, 10 and 12. Elsewhere, the percentage of teens applying for drivers' licenses fell over the 25 years from 1983 to 2008. And finally, data and surveys shows that older millennials are leery of investing in stocks.

"Risk-taking and independence no longer attract this generation," Howe said.

He expressed little surprise at the development. He contends that generations cycle through four archetypes: the

heroes (such as the "government issue," or G.I., generation that came of age in the 1920s and 1930s), the artists (the "silent generation" that followed the G.I. generation), the prophets (the Baby Boomers) and the nomads (Generation X).

The millennials, Howe said, remind him in many ways of the G.I. generation, which also eschewed risk-taking by turning inward, to family, amid the turmoil of the Great Depression. In fact, he said, millennials are much closer to their parents than previous generations were. In one recent survey, 82 percent of teenagers reported having no problems with any family member, up from 75 percent in 1983 and 48 percent in 1974.

Howe said millennials are accustomed to being protected by their parents and feeling special, and want to be good citizens and team players. He concluded that organizations that want to market to them should factor these attitudes into their messages. **SVIA**

State and Local Pension Plans: Coping with Funding Challenges

By Randy Myers

Strictly by the numbers, pension plans sponsored by state and local governments do not look to be in great shape. Many plan sponsors have not been making full annual contributions to the plans, and partly as a result the average funded ratio for those plans has fallen to 71 percent from 90 percent since 2004. Many plans are paring benefits, too. Since 2008, a total of 19 states have increased the amount that current employees must contribute to their plans, and six have boosted contribution rates for new employees. A number of others have increased eligibility requirements, lengthened vesting periods and reduced benefits, especially for new employees. Some also have decreased cost-of-living adjustments for retirees.

These changes impact a broad swath of the U.S. population. In an address at the 2014 SVIA Fall Forum, Joshua Franzel, vice president of research for the Center for State and Local Government Excellence, noted that in addition to 50 state governments, the U.S. is home to about 90,000 local governments. In 2012, those entities had approximately 14.4 million full-time employees. They sponsored approximately 4,000 retirement plans covering 19.6 million active and inactive members and 9 million retirees.

Defined benefit plans are much more popular in the public sector than they are in the private sector, Franzel noted. About 86 percent of state workers have access to a defined benefit plan while only 43 percent have access to a defined contribution plan. Among local government workers, the numbers are 82 percent and 30 percent, respectively. This is important because about 30 percent of state and local workers do not participate in Social Security. Assets in government-sponsored defined benefit plans totaled \$4.8 trillion in the second quarter of this year, or nearly nine times the \$538 billion in government-sponsored defined contribution plans.

Despite the decline in the funded status of their defined benefit plans, and in some cases reductions in what they deliver, government workers remain fairly upbeat about their benefits. In a 2014 survey, Franzel noted, more than 80 percent of government workers said they were somewhat or very confident about their retirement plan benefits.

The role of stable value

Among state and local governments that do offer defined contribution plans, 82 percent include a stable value fund as an investment option, according to a recent survey by the National Association of Governmental Defined Contribution Administrators. "Practically every other plan has a similar protected account, so it's almost a 100 percent penetration rate," said Roderick Crane, managing director, governmental and religious markets, for TIAA-CREF Financial Services, a retirement plan provider. Crane joined Franzel in addressing the SVIA Fall Forum, along with John Saeli, vice president for market development and government affairs at ICMA-RC, another retirement plan provider. Crane said the type of stable value product used in state and government retirement plans can vary depending upon the type of plan sponsor. In the higher education and K-12 school

space served by TIAA-CREF, he said, most plans offer an insurance-company product, either a general account offering or a 403(b)-qualified stable value product. But increasingly, he noted, plan consultants and advisors are pushing for greater use of "regular" types of stable value products such as "collective investment trust vehicles or GIC-type arrangements or custom stable value (funds)." He said that reflected a preference among plans for portability of assets and for not being tied to a single record keeper.

When choosing stable value funds, Crane said, plan sponsors are concerned "first, second and third" with the crediting rate, although, as noted, the portability of assets is becoming increasingly important, too. Sponsors also are interested in investment flexibility, low expenses, and the financial strength of the institution backing the stable value fund. Where they use collective funds, he said, they favor a shorter rather than longer put period—the length of time they may have to wait to receive their assets at contract value after exiting a fund.

Saeli noted that participants in government-sponsored defined contribution plans tend to allocate a higher percentage of their assets to stable value funds—about 30 percent of their deferrals—than do their counterparts in private-sector plans. "I think that's partly because public-sector employees have a little more aversion to risk than what we see in the private sector," he said.

Stable value allocations also may be higher in part because relatively few state or local governments—only about 10 percent—automatically enroll employees in their defined contribution plans, Crane observed.

In the private sector, automatic enrollment has helped to steer a high percentage of plan assets into target-date funds, which many plans use as their qualified default investment alternative when bringing employees aboard. Government plans have largely shied away from auto enrollment because the Pension Protection Act of 2006, which established a safe harbor for the practice, does not override the rules that prohibit many state and local governments from garnishing the wages of their employees.

Nonetheless, Crane said, increasing numbers of government plans are now designating target-date funds as their default investment option, too, and that is tending to reduce the use of stable value funds among younger plan participants.

Although there are more defined benefit plans than defined contribution plans in the government sector, Crane noted that the number of defined contribution plans is growing, which presents an opportunity for the stable value industry to grow, too. **SVIA**

An Inside Look at How America Saves

By Randy Myers

It should not be that difficult. For a defined contribution plan to work for you, says Jean Young, senior research analyst at Vanguard Group and lead author of its periodic report on retirement plan participant behavior, *How America Saves*, you simply need to save enough and invest appropriately.

Unfortunately, Young said at the 2014 SVIA Fall Forum, many individuals struggle with that challenge. Often, their struggles start with the imperative to “save enough.” In worst cases, they don’t save at all. Across the nearly 2,000 plans for which Vanguard provides recordkeeping services—a universe that covers 3.4 million participant accounts—about three quarters of eligible workers participate, Young said. That’s up from about two-thirds in 2004. Still, saving and saving enough can be two different things. On average, Young said, the participants in Vanguard plans are saving about 7 percent of their pre-tax income. (The median deferral is 6 percent, which has not changed for as long as Vanguard has been looking at that data.) The average has dipped a bit since 2008, but Young attributed that to the growing use of automatic enrollment by plan sponsors, who, when they embrace that feature, often set the default deferral rate at just 3 percent of pay. “The average should start coming back as plans use an annual (deferral rate) increase option,” she said.

About a third of the plans for which Vanguard provides recordkeeping services have adopted automatic enrollment, Young said, with 65 percent of those setting the default deferral rate at 3 percent of pay or less. Sixty-nine percent of the plans with automatic enrollment also have automatic deferral increases, and 95 percent use target date funds as their default investment option. Another 5 percent use a traditional balanced fund. Nine out of 10 employers in the Vanguard universe contribute to their employees’ retirement savings accounts, Young said, and when those contributions are factored in the average deferral rate jumps to 10.2 percent and the median deferral rate jumps to 9.2 percent. That may not be ideal, she suggested, but it’s not bad. “We say this population should be saving 12 to 15 percent or more,” she remarked, “but we’d be happy as a nation if everybody was saving 10 percent of their income for retirement.”

Young observed that every time Vanguard publishes a new edition of *How America Saves*, reporters ask her what story they’re missing. “This is the one they’re missing,” she said. “People in these plans are saving 10 percent of their income. I can’t get that story written.” So just how much have participants actually saved for retirement? In the plans for which it provides recordkeeping services, Young said, the average account balance in 2013 was \$102,000 and the median was \$31,000. Twenty-six percent of participants had account balances above \$100,000. Most of them were older, longer-tenured and higher-income employees. By contrast, 30 percent of participants—mostly younger, shorter-tenured, and with lower incomes—had account balances below \$10,000. The numbers are impacted by more than what people are saving.

“Every year about 15 percent of the participant base takes money from their plan, either rolling it over or cashing out,” Young said. “At the same time we have 10 percent to 15 percent coming in new and starting at zero. So you have higher balances leaving and being replaced by people with basically nothing in their accounts.”

While critics often complain that the average 401(k) account balance isn’t sufficient to support someone in retirement, Young argued that the average figure also is misleading because of the wide range of participants represented in that number. About 60 percent of participants are men. The typical participant earns \$70,000 a year, Young said, is 46 years old, and has eight years of tenure with his employer. If he continues to save 10 percent of his pay in a balanced portfolio for the next 20 years, she said, he should be able to rely on his savings and Social Security to replace 75 percent to 80 percent of his pre-retirement income after he stops working. “That’s another story none of the reporters want to write,” Young observed. In terms of how their assets are invested, Young said, plan participants held about 9 percent of their money in company stock at the end of 2013, plus 44 percent in diversified equity investments, 28 percent in target-date or other balanced funds, 7 percent in bonds, 8 percent in stable value and 4 percent in cash. Overall, equity accounted for about 71 percent of total account balances, up from 65 percent as recently as 2011. About 58 percent of the plans in the Vanguard universe offer a stable value investment option, Young said, little changed over the past nine years. However, the percentage of participants using stable value where offered has fallen since 2006, from about 40 percent to about 23 percent.

Based on a deeper dive into those asset allocation figures, Vanguard has calculated that about a third of participants appear to make portfolio construction errors, either by investing too conservatively or too aggressively. For example, 9 percent of participants allocate more than 20 percent of their plan assets to company stock. However, Young said, participants in general have more appropriately constructed investment portfolios today than they did in 2004. That year, only 37 percent used balanced strategies; by 2013, two-thirds had them. Another big change in the way plan participants are investing, Young said, is reflected in their enthusiasm for indexing. In 2004, about 28 percent of all the assets in plans for which Vanguard provides recordkeeping were indexed; at the end of 2013, the figure was about 50 percent. For many of the criticisms aimed at defined contribution plans today, Young seemed to suggest, there is an offsetting positive development. While half of plan participants don’t appear to save enough, for example, half do have strong savings rates. And while a third appear to make portfolio construction errors, that’s down from two-thirds not too long ago. Also, 40 percent are now wholly invested in a professionally managed investment, such as a target-date fund, balanced fund or managed account program, up from 7 percent in 2004. Finally, she said, evidence suggests that people are working longer on average, which not only gives them more time to save for retirement but also lessens the time their nest eggs need to last. **SVIA**

Roundtable: The Outlook for Retirement Income Security

By Randy Myers

One could argue that the private retirement system in the U.S. is improving. Average account balances in defined contribution plans have been rising lately, to somewhere around \$90,000 to \$100,000 depending upon which set of data you use. The growing trend of automatically enrolling workers in their plans is undoubtedly capturing some workers who in the past would not have participated in their plans. But in the view of David Certner, legislative counsel and director of legislative policy for government affairs at AARP, which advocates for people over 50, we're still suffering from a "troubling lack of progress" in ensuring retirement security for many Americans.

Certner was part of a three-person panel to speak on the subject of retirement security during the 2014 SVIA Fall Forum. He was joined by Karen Friedman, executive vice president and policy director for the Pension Rights Center, a nonprofit consumer organization, and Steven Kreisberg, director, collective bargaining, for AFSCME—the American Federation of State, County and Municipal Employees.

Forty years after passage of the Employee Retirement Income Security Act, Certner said, it's still the case that only about half of working Americans are covered by an employer-sponsored retirement plan, which can be a defined benefit plan or a defined contribution plan. And while many employers have managed the risk of funding a plan by switching from a defined benefit to a defined contribution model, that's simply pushed the risk onto individuals who are often ill-equipped to manage it. While innovative plan features like automatic enrollment and automatic increases of participant deferrals have improved defined contribution plans where they are offered, Certner said, many Americans still aren't saving enough for retirement, aren't saving at all, or aren't investing their savings wisely. For workers in the bottom third of the nation's income brackets, he said, Social Security still accounts for almost all of their income in retirement. Even for those in the middle tier, it remains their largest source of retirement income. That's one reason, he said, AARP supports the Social Security program.

Friedman credited ERISA with introducing safeguards that have helped to protect the pensions of millions of working Americans, but argued that it's time to reassess where the nation's private retirement system is heading. In particular, she lamented the ongoing loss of defined benefit pension plans, which provide a steady, insured stream of income retirees can rely on for as long as they live. Although increasingly unpopular among employers, Friedman observed that a study by the National Institute for Retirement Security, a non-profit research and education organization, indicates that defined benefit plans also have a significant positive impact on the economy that shouldn't be overlooked.

"They add billions of dollars to the economy because they provide (participants and beneficiaries) with reliable income month to month that allows them to keep buying goods and services," she said. There is no question, Friedman continued, that defined contribution plans have proved to be

a workable alternative for some people, mostly those with higher incomes who can afford to contribute at the maximum allowable levels and know how to invest that money, or who receive generous employer matches, and can resist the temptation to tap into their funds before they retire. "Still," she said, "50 percent of people have nothing to supplement Social Security, and millions who have saved haven't accumulated enough. According to a survey of consumer finances, half of all households have about \$59,000 in retirement plans, and those approaching retirement have a little over \$100,000."

The Pension Rights Center encourages employers who offer defined benefit plans to keep them, and advocates that employers who offer defined contribution plans improve them by embracing features such as automatic enrollment and automatic deferral increases—although Friedman cautioned that those measures alone would not resolve the nation's retirement problems. Ultimately, she said, the private sector may want to consider creating a new type of plan that marries the best features of defined benefit and defined contribution plans, perhaps paying out benefits in the form of an annuity. In that vein, she said her organization supports Sen. Tom Harkin's (D-Iowa) proposal to create privately run "USA Retirement Funds," which would give people who don't have access to a workplace retirement plan a chance to earn a safe, portable and secure pension benefit for life.

Kreisberg also remains a fan of the defined benefit retirement system, which benefits many of his organization's 1.6 million working and retired members. While government pension plans are often criticized as contributing to the financial woes of their sponsors, Kreisberg countered that it isn't because benefits are too rich but because of haphazard funding and urban decline.

Since most of AFSCME's workers earn modest wages—about \$45,000 a year, on average—Kreisberg said they would not find defined contribution plans a workable alternative to defined benefit plans because many wouldn't be able to save enough money and invest it properly. On the other hand, he said, it isn't likely that public employees will be the only working Americans left with defined benefit plans.

"We need new mechanisms, new ways of saving for retirement, and new ways of providing retirement income, perhaps combining the best features of Social Security with defined benefit plans," he said. By way of example, he said, the U.S. could look to Ontario, Canada, where the legislature recently approved a provincial pension plan aimed at supplementing the retirement income its residents receive from the Canada Pension Plan and other sources. The new plan is to be funded equally by employers and employees with contributions of up to 1.9 percent of pay each, and should be operational by 2017. Creating such a plan to supplement Social Security in the U.S., Kreisberg said, "might go a long way toward tackling our retirement income security crisis."

DC Plan Litigation: When Stable Value Becomes a Target

By Randy Myers

For three decades following passage of the Employee Retirement Income Security Act in 1974, defined contribution plans largely escaped the eye of class-action plaintiffs' attorneys. That all changed in 2006, when an Illinois-based law firm began filing lawsuits against plan service providers, typically alleging some violation of ERISA based on the fees being charged to plans. Later lawsuits targeted service providers and plan sponsors, arguing that one or more investment options offered to plan participants—usually in the form of mutual funds—was in some way imprudent. Now, say defense attorneys Eric Mattson and Mark Blocker, partners with the law firm of Sidley Austin LLP, the plaintiffs' bar is increasingly assessing whether it might bring claims against service providers or plan sponsors over the choice of stable value funds offered in defined contribution plans.

To gauge how successful such lawsuits might be, it makes sense to consider how defendants have fared in the lawsuits brought thus far. According to Mattson and Blocker, who spoke at the 2014 SVIA Fall Forum, service providers have generally fared well in the fee-centered cases, often because plaintiffs' attorneys have not been able to make the case that the providers were acting as fiduciaries when they earned the fees in question. By contrast, plan sponsors have not always fared as well in cases where plaintiffs alleged that some of their investment offerings were imprudently chosen—when the sponsor offered a mutual fund that charged, say, 80 basis points, when a comparable fund charging 40 basis might have been available. In 2011, Wal-Mart Stores and Merrill Lynch, a unit of Bank of America, agreed to pay \$13.5 million to settle a suit claiming that Wal-Mart negligently offered high-priced retail-class funds in its 401(k) plan rather than lower-priced institutional funds.

Blocker cited four reasons that plaintiffs' attorneys are now looking more closely at stable value funds. First, he said, they have recognized that stable value funds represent a sizeable chunk of the defined contribution plan marketplace. "Big dollars draw lawyers," Blocker said.

Second, stable value funds are not terribly well understood by either the plaintiffs' bar or the judges who adjudicate claims, which means plaintiffs' attorneys are prone to try to apply previous claims involving mutual funds to stable value funds—banking in part on the judiciary's unfamiliarity with the products.

Third, he said, stable value funds, conservative in nature, tend not to be the highest returning options in a plan's investment lineup, attracting scrutiny. Finally, lawsuits revolving around stable value funds represent a natural extension of the claims already being made against 401(k) plans. Blocker elaborated and said lawsuits targeting stable value investments are likely to make one or more of three claims: that the fund underperformed some benchmark, that it imposed excessive fees, or that offering it represented general imprudence on the part of a plan. He cautioned that while some plaintiffs' attorneys may not understand stable value funds very well, the plaintiffs' bar has become very conver-

sant with ERISA and "knows where to poke holes." And, he said, some of these lawyers are very well financed. Still, the idea that they will prevail in claims involving stable value funds isn't a given. Blocker outlined three exemplary cases, including one that has already been settled.

In *Abbott v. Lockheed Martin*, the plaintiffs allege that the stable value fund in Lockheed Martin's retirement plan delivered subpar performance because it held the bulk of its assets in short-term investments more commonly found in money market funds. Lockheed Martin has countered that the strategy and composition of the fund were fully disclosed, that the fund was listed as a stable value/money market fund, that the prospectus warned that the fund's returns may not exceed inflation, that there is no uniform definition of a stable value fund, that the fund's composition was prudent, and that even if the fund was effectively a money market fund it is acceptable to offer a money market fund in a 401(k) plan, as many plan sponsors already do. Blocker said the case is scheduled to go to trial within a few months.

In *Austin v. Union Bond & Trust Co.*, filed in May 2014, the plaintiffs make two claims. One is that stable value wrap providers in the stable value fund in question were earning extra, undisclosed and excessive compensation via the spread on synthetic GICs. The other is that wrap issuers manipulated the stable value fund crediting rate to their advantage, resulting in a rate that was low when benchmarked against a stable value index maintained by Hueler Companies. The defense in that case, Blocker said, is that there is no spread on synthetic GICs and no way for wrap issuers to earn a spread. He also noted that a stable value crediting rate is determined by a preset formula that cannot be manipulated, and that comparing the stable value fund in question to the Hueler Index is an inappropriate apples-to-oranges comparison. In short, Blocker said, "the plaintiffs have made allegations that make no sense." The defendants, in addition to Union Bond & Trust, include Principal Life Insurance Co. and Morley Capital Management.

Finally, in the already resolved *Tibble v. Edison International* case, the plaintiffs argued, among other things, that it was imprudent for Edison International's retirement plan to offer a money market fund rather than a stable value fund. The court ruled against the plaintiffs, holding that the plan sponsor had undertaken a prudent process in choosing the money market fund. "It maybe was not the choice you would have made, but it was a prudent process," Blocker said.

Blocker said that may not be the last salvo on that front. "We could see plaintiffs making an argument in the future that it is just flat-out imprudent to choose a money market fund when (plan participants) could earn a greater return on a stable value fund." Still, he suggested, the case should hearten plan sponsors and plan providers in that it validated the value of a prudent process in selecting investment options. **SVIA**

Invesco Strategist Sees Continued Slow Growth, Low Rates in the U.S.

By Randy Myers

The Federal Reserve may have just ended its massive quantitative easing program aimed at keeping interest rates low, but don't expect rates to spike significantly higher as a result, says Rob Waldner, chief strategist and head of multi-sector for Invesco Fixed Income.

Opening the second day of the 2014 SVIA Fall Forum on October 14, Waldner noted that while the U.S. economy is on solid footing it isn't likely to grow rapidly anytime soon, especially with a variety of structural factors, including demographic headwinds, limiting the potential for economic growth globally. Slow growth usually translates into modest interest rates.

Laying out his case for slow growth, Waldner explained that economic potential can be expressed as the product of available labor, labor utilization and productivity—or, in layman's terms, the number of people available to work, the number that actually participate in the workforce, and how productive they are.

From 1982 to 1990, Waldner said, GDP growth in the U.S. exceeded 4 percent annually. It's been trending lower ever since, and the outlook now is for growth to continue at about a 2 percent annual rate. Why? The labor force participation rate—the percentage of working-age Americans participating in the workforce—has been declining since 2000, and productivity has largely been flat. Meanwhile, with baby boomers edging into retirement, the number of available workers is expected to grow only modestly, too, over the next decade and a half. Finally, neither the government nor the private sector seems inclined to invest in capital projects right now, further constraining growth.

Some analysts have bemoaned the declining labor force participation rate, arguing that the economy is so bad that many Americans have simply given up looking for work—and that the unemployment rate is therefore even worse than the official number would suggest. Waldner said his firm's analysis suggests that the declining participation rate is primarily due to permanent factors, such as people choosing to retire early because they can or because of disabilities, rather than secular or cyclical reasons, such as the slow-growing economy. If so, the unemployment rate, which had fallen to 5.9 percent by September from its post-recession high of 10 percent in October 2009, is the best indicator of how tight the labor market is. And that performance suggests the labor market is tightening. While the general consensus—and the view of the Fed—has been that the U.S. will not reach “full employment” until 2015, Waldner said Invesco Fixed Income believes that could happen as early as the fourth quarter of 2014. Normally that would suggest interest rates should go higher, but the slow-growing economy, and a stretched-out economic cycle, are working to mitigate that.

Waldner said the U.S. economy appears to be just about midway through a normal cyclical pattern that will soon

see wages improving, but that the cycle is likely to be longer than the normal 6.4 years—perhaps as long as 9 or 10 years—due to the depth of the financial crisis that preceded it. He observed that Europe is early in its economic cycle, Japan is just behind the U.S. and China is late in its cycle. These differences are prompting different policies from central bankers around the globe. While the Fed has been winding down its stimulative quantitative easing program, he said, bankers in Europe and China are starting to ease while the Bank of Japan continues to try to stimulate inflation.



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Waldner said that as the U.S. yield curve continues to flatten, long-term interest rates in the U.S. should be “relatively well-behaved.” He characterized the 10-year Treasury note as “slightly overvalued” at its recent yield of about 2 percent. If the economy continues to grow at about a 2 percent rate and inflation remains at 2 percent or below, he said, the 10-year note would be fairly valued at a yield somewhere in the 2.5 percent to 3 percent range. He put the chance of yields rising much above that—to 4 percent or 5 percent—as unlikely. “The message is there won't be a big increase in long-term rates,” he said.

What does all this mean for fixed-income investors? Economic growth will continue to be slower than it had been prior to the Great Recession, Waldner concluded. Credit market fundamentals in the U.S. are good but mid- to late-cycle, so valuations are not compelling and volatility is increasing. With Europe earlier in its economic cycle, credit could perform a little better there over the next few years, with peripheral European bonds likely to tighten relative to core securities as fundamentals improve.

The trend toward a stronger dollar is likely to continue, which could be tough on emerging markets whose own currencies will struggle. Fixed-income investors should consider underweighting the short end of the Treasury yield curve, Waldner said. They also should favor the dollar over the euro, the yen and many emerging market currencies; position their portfolios tactically within market sectors; and seek alpha from security selection. **SVIA**

Making Retirement Savings Last

By Randy Myers

Helping Americans convert their retirement savings to income after they stop working is the new frontier in retirement planning, and the federal government wants to play a role. Among those searching for solutions is J. Mark Iwry, senior advisor to the secretary of the Treasury and deputy assistant secretary, tax policy, for retirement and health policy at the U.S. Department of Treasury.

Iwry brought his message to the Stable Value Association in October when he spoke at the SVIA's 2014 Fall Forum in Washington, D.C. He said that although many retirement plan participants seem to have grasped the fundamentals of accumulating assets for retirement, they still wrestle with how to draw down those assets once they stop working.

Managing longevity risk is particularly problematic. Either they plan for a typical life expectancy, Iwry said, and run the risk of outliving their assets if they live longer than the averages, or they hoard too much of their money and deny themselves a better standard of living. One way the Treasury Department is trying to help, he said, is by working with Department of Labor to remove impediments to making lifetime income options, including annuities, available in defined contribution retirement savings plans.



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Iwry called annuities an “elegant solution” to the problem of managing longevity risk. But he observed that even in plans where participants have access to an annuity in retirement, many opt for a lump sum benefit instead.

Iwry confessed that his enthusiasm for lifetime income options is a bit ironic; in the early 1990s he helped to shape rules allowing 401(k) plans to get rid of annuities as a payout option if plan participants weren't using them. The goal was to simplify plan structures that were becoming complex, but also to convince plan sponsors to give annuities a try by not forcing them to keep them in their plans if participants weren't using them. Now, the Treasury Department is being less subtle.

“We are now trying more affirmatively to encourage plans to consider putting lifetime income in one way or another, and that includes defined benefit plans,” Iwry said. He characterized defined benefit plans as “the lowest-hanging fruit when it comes to encouraging lifetime income” because

they are already required to have an annuity as their default payout option.

“What we have suggested through regulations is that DB plans focus more on the behavioral issues leading people to take lump sums, including the all-or-nothing problem,” Iwry said. He explained that many defined benefit plans present the payout choice as either an annuity or a lump sum, without explaining to participants they could split their benefit between the two, taking some in the form of an annuity and the rest as a lump sum.

“That is an offer that has had some minor technical impediments, and we've removed those in proposed regulations we are soon going to finalize,” Iwry said.

Iwry conceded that promoting lifetime income products in defined contribution plans presents bigger challenges, including figuring out how to treat deferred or “longevity” annuities under plan qualification rules. “We've got (rules), but people had questions about how some of them applied, so we resolved some of those questions some time ago in guidance,” Iwry said.

Specifically, Treasury spelled out that longevity annuities, which typically don't start paying benefits until the policyholder reaches age 80 or so, are now exempt from the tax rules requiring that participants begin taking required minimum distributions from retirement accounts at age 70½. Individuals can invest up to a quarter of their retirement account balance, or a maximum of \$125,000, in a longevity annuity without triggering required minimum distributions at age 70½. This applies both to defined contribution plans, such as 401(k)s, and to Individual Retirement Accounts. The annuities also are now allowed to offer a death benefit.

Iwry said the Treasury Department also continues to encourage the Department of Labor to strengthen the fiduciary safe harbor provided to plan sponsors who offer an annuity in a defined contribution plan. Elsewhere, it has issued guidance on how disability insurance premiums can be paid from a defined contribution plan account, and guidance aimed at making it easier for 401(k) plans to accept rollovers from other plans.

Iwry applauded the growing use of automatic enrollment and automatic escalation of participant deferrals by 401(k) plans, and encouraged plan sponsors and their service providers to “do more to make defined contribution and defined benefit systems more effective savings tools.” **SVIA**

Living with Target-Date Funds

By Randy Myers

Over the past decade, target-date funds have grown to account for about 20 percent of the assets in defined contribution plans. By some estimates, that figure could double by 2018. That makes figuring out how to thrive alongside target-date funds one of the most important challenges facing the stable value industry.

It also was the headline topic in October when seven leaders from the stable value industry participated in a roundtable discussion of the industry's challenges and opportunities during the 2014 SVIA Fall Forum. Participants in the discussion included Mark Auriemma, vice president, State Street Bank & Trust Co.; LeAnn Bickel, head of stable value contract administration, Invesco Advisors; Nick Gage, senior director, Galliard Capital Management; Susan Graef, principal, portfolio manager and head of the stable value management team, Vanguard Group; Aruna Hobbs, senior managing director, investments, for MassMutual; Mike Sipper, director, stable value investments, New York Life Investment Management; and Gary Ward, senior vice president and head of stable value, Prudential Retirement.

It will be important for stable value funds to become a part of the target-date landscape, was the panelist consensus. While stable value funds can't be incorporated into retail target-date funds that are structured as mutual funds and invest only in other mutual funds, they can be a component of custom target-date funds that larger plan sponsors build from their own core investment options. Many larger retirement plan sponsors have already built such funds. Bickel noted that her firm has a number of 529 college savings plans on its client roster, and they, too, offer stable value funds as investment options.

Galliard's Gage noted that about 15 percent of his firm's separate account clients already offer a custom balanced fund or target-date fund, and roughly half offer a managed account program. As those investment options become more popular, he said, they'll capture even more of plan participants' contributions to their retirement accounts. "That's why we're working with stable value issuers and our clients to make sure they utilize stable value within those products, so we are capturing those new dollars," he said.

Ward said Prudential Retirement sees target-date funds as a "huge opportunity" for the stable value industry over the long term as they become more popular not only in defined contribution retirement savings plans but also in other markets, including the 529 college savings plan market and perhaps in international and health savings markets, too.

New York Life agrees, Sipper said. He added that stable value issuers who want to move into the target-date space should do so with their eyes open to the associated risks. Among the factors his firm monitors, he says, are the size of the stable value allocation within custom target-date funds relative to the overall size of the stable value fund in the same plan, and the rebalancing risk associated with a target-date fund. He explained that target-date fund managers periodically rebalance their portfolios to keep them aligned

with their asset allocation targets, and if a particular asset class undergoes a period of sharp underperformance the fund manager may need to sell some better-performing assets—perhaps stable value—and reinvest the proceeds into the lagging asset class. Depending upon market conditions, this could be a stress on the stable value fund.

"We'll also look at the target-date fund and the asset classes involved," Sipper said. "We'll look at the ratio of the risky asset classes to the non-risky asset classes. And we'll look at diversification, not just at the asset-class level but also at the subsector level, to make sure those asset classes are truly diversified."

MassMutual's Hobbs noted that several factors work to mitigate the risks associated with having stable value funds in target-date funds. Rebalancing risk is offset in part, she said, by the fact that a target-date fund by nature is always moving over time toward a more conservative asset mix. She also noted that during periods when equity markets are going up, target-date funds do not experience a high volume of outgoing transfers the way a stand-alone stable value fund might.

Hobbs also noted that target-date funds don't come with any type of principal protection, and asked what issues if any that presents. Sipper said that because adding a stable value component to a target-date fund might mitigate some of its volatility, it could help investors stick with their investments during periods of market turmoil. Ward said it is incumbent upon stable value providers to articulate their product's impact on volatility in target-date funds.

The panelists generally agreed that it would be good if the stable value industry can devise a relatively simple and standard way to manage rebalancing risk within target-date funds so that their product remains palatable to wrap issuers and target-date managers. "We don't want to over-engineer the process," said State Street's Auriemma.

The panelists also weighed in on whether they are seeing some impact from the new rules for money market mutual funds, which among other things allow non-government funds to impose redemption fees or temporarily suspend redemptions if their liquid assets fall below 30 percent of their total assets. Bickel said Invesco had not heard from any plan sponsor clients on that topic, perhaps because money market funds have two years to comply with the new rules. She also noted that relatively few of Invesco's plan sponsor clients offer money market funds to their plan participants. On the other hand, she said, Invesco is talking with its clients about the makeup of the short-term investment funds they maintain within their stable value funds to see how those funds might be impacted by the rule changes.

Prudential, Ward said, is recommending that its plan sponsor clients use the debut of the new rules as an opportunity to reassess their investment lineup and their choice of a capital preservation product for their plans. **SVIA**