STABLE TIMES

The quarterly publication of the Stable Value Investment Association

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IN THIS ISSUE

SVIA Announces New Chairman and Elects Seven Board Members

Nick Caggia, SVIA

The Stable Value Investment Association (SVIA) has elected a new chairman along with seven new and returning members to its Board of Directors. The board members were elected to three-year terms on the 21-member Board, which serves as SVIA's governing and policymaking body.

Eric Kirsch, CFA, Managing Director and head of the North America Fixed Income Investment Group at Deutsche Asset Management, has assumed the role of Chairman of the SVIA Board. In his role with Deutsche Asset Management, Kirsch is responsible for overseeing the management of active fixed income funds, stable value and bond index funds with over $40 billion in assets. Eric joined Deutsche Asset Management in 1980 and has over 15 years of investment experience relating to fixed income portfolios as well as experience in employee benefit trust administration. In addition to his role on the SVIA Board, he is also a member of the Association for Investment Management and Research. Eric replaces Bill Gardner, who assumes an ex-officio role with

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Tax Law Makes College Savings Plans More Attractive

Randy Myers

College savings plans are finally coming of age. They won new tax breaks in the latest federal tax law, and have been embraced by every state in the nation. According to Diana Cantor, Executive Director of the Virginia College Savings Plan, all 50 states now have a college savings plan in place or have enacted the necessary enabling legislation, up from approximately 30 states just two years ago. Together, these developments present varied opportunities for parents saving for their children's education.

College savings plans, also known as 529 plans after the section of the IRS code that created them, have attracted relatively little interest from parents until now. Speaking at the Stable Value Investment Association's 2001 National Forum in Washington, D.C., in October, Cantor noted that although there were 1.5 million active 529 accounts with more than $9.5 billion invested at the start of this year, a survey by Harris Interactive found that only 8% of parents knew what the

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More State Governments Embrace Defined Contribution Plans

Randy Myers

The defined-contribution-plan revolution that swept through corporate America over the past few decades is finally gaining a foothold in the public sector. With this new wave of popularity comes an opportunity to introduce stable value products to another segment of the investing public.

As with most attempts to break new ground, this one won't be easy, warns Phil Suess, a principal with Mercer Investment Consulting.

"The stable value industry has a challenge as it pursues these state retirement plans," Suess said in an address to the SVIA Forum. "To date, the emphasis of the people administering these plans has mostly been on market value products, not book value products. Their understanding of stable value is much more theoretical than practical." By way of example, Suess noted that in Florida, plan administrators preparing the launch of that state's defined contribution plan this year chose not to include stable value funds

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New Members Elected to SVIA Board

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the Board as immediate past Chairman.

The newly and re-elected officers are:

- **Donald J. Butt, Vice President, Qwest Asset Management Company, Englewood, CO**
  Don has worked for Qwest (formerly US West) for over 30 years. In his present position, Don is responsible for the investment management of the $5 billion Qwest Savings & Investment Plan (401(k)) and Qwest's award-winning Retirement Education Programs. He formerly served as Chairman of SVIA.
- **Robert Fox, Executive Director, Cultural Institutions Retirement System, New York, NY**
  Bob is responsible for three employee benefit plans with combined assets of $1 billion covering 15,000 active, vested and retired members from 350 participating employers. He has previously served as Chairman of the Pension Plan Committee of the National Assembly of National Voluntary Health and Social Welfare Organizations.
- **Robert A. Madore, Vice President and Senior Portfolio Manager, T. Rowe Price Stable Asset Management (TRPSAM), Baltimore, MD**
  Bob manages a number of TRPSAM's largest separately managed stable value portfolios as well as the $3.4 billon T. Rowe Price Stable Value Fund. Bob brings more than 20 years of stable value investment experience to the SVIA Board.
- **Marc Magnoli, Vice President, Insurance and Pension Derivatives Group, J.P. Morgan, New York, NY**
  Marc heads the stable value and structured derivative team covering pension and savings plans as well as other institutional investors in need of stable value solutions. Marc has over 12 years of experience in the stable value industry as a portfolio manager, an issuer of stable value products, and a pension investment manager of a Fortune 500 company.
- **Kim McCarrel, CFA, Senior Account Manager, PRIMCO Capital Management, Portland, OR**
  Prior to her position with PRIMCO, Kim was head of Wyatt Asset Services' stable value consulting practice, and before that she was a portfolio manager and analyst with Qualivest Capital Management. She is a returning member of the board, serving a previous three-year term.
- **James F. McDevitt, FSA, Senior Vice President and Stable Value Product Manager, State Street Bank, Boston, MA**
  Jim is responsible for the development and issuance of synthetic guaranteed products at State Street Bank, which currently total $12 billion in assets. Prior to joining State Street in 1992, McDevitt had over 20 years experience in the insurance industry and employee benefit consulting. Jim is also returning for a second three-year term on the SVIA Board, where he serves on the Executive Committee.
- **James McKay, CFA, Portfolio Manager, American Express Trust Company, Minneapolis, MN**
  Jim has served in his position as Portfolio Manager since 1992. He will begin his second term on the Board and currently leads the SVIA Government Relations Committee.

Many thanks go to SVIA's retiring Board members: James Curry, Union Carbide Corporation; Bill Gardner, Dwight Asset Management Company (becoming ex-officio); Susan Graef, The Vanguard Group; C. Robert Krebs, NISA Investment Advisors, LLC (ex-officio); and, Karen Watson, CFA, Baxter International, Inc.

2002 SVIA National Forum

October 15-17, 2002
SAVE THE DATE!

Editor's Corner

Greg Wilensky, Alliance Capital Management Corp.

With this issue of *Stable Times,* we bring the year to a close in traditional fashion by highlighting the SVIA National Forum held in Washington, D.C., in October. While world events and concerns about airport availability/travel safety caused the absence of several familiar faces, the conference was well attended and (as you will read) very informative. Amtrak was certainly a big winner, as the wave of people from the New York metropolitan area that normally sees each other in the airport terminal, decided to take the Acela into downtown Washington D.C. rather than face the potential trek from BWI or Dulles airports. I certainly enjoyed the ride. Besides educating the attendees, the National Forum gave members of the stable value community the opportunity to catch up with old friends, former colleagues (who are now customers, suppliers or competitors), and make new contacts.

As always, the planning committee did an excellent job of covering current stable value topics (e.g., performance presentation, FAS 133 issues, international stable value opportunities, etc.) as well as tapping respected speakers from outside the stable value community to discuss broader topics that could materially impact the stable value market (e.g., 529 plans, social security reform, retirement savings trends, etc.). For those that missed the conference (or missed some sessions taking advantage of a great exercise facility), Stable Times will provide the highlights. We welcome the many articles to this issue from Randy Myers and Vicky Paradis as well as contribution from your hardworking SVIA staff.

Defined Contribution Plans

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among its investment options. One trustee described stable value products as "esoteric."

All that said, the opportunity in public funds can hardly be dismissed.

From 1991 to 1999—the most recent data available—assets in so-called "457" government retirement plans more than tripled to $49 billion, according to the National Association of Government Deferred Compensation Administrators. What's more, 11 states now offer so-called "match plans" to their 457 plans, often in the form of 401(a) plans. Match plans allow government employers to match employee contributions to their 457 plans. Employers provide the match in 401(a) plans because contributions made to them do not count against federal limits on 457 plan contributions.

Suess cited several reasons for the increasing popularity of public defined contribution plans, including term limits on legislators. Within many state legislatures, these limits have effectively erased the institutional memory of defined benefit plans, including their history and their features. Term limits also have reduced legislators' political concerns about the long-term consequences of their actions, which makes it easier for them to embrace changes that workers might oppose. In the executive branch, meanwhile, political leaders have become increasingly interested in saving money, just like their counterparts in the corporate sector. Defined contribution plans typically cost less to fund than defined benefit plans.

Other factors driving the popularity of defined contribution plans in the public sector include lobbying by the financial services industry, which sees public funds as a relatively untapped but potentially lucrative market, and the rousing performance of the stock market during the 1990s. As stocks soared and private sector employees recorded big gains in their 401(k) plans, public sector workers began looking for opportunities to do the same. They were also attracted to the portability of defined contribution plans; upon leaving a job, assets in those plans can usually be rolled over into an Individual Retirement Account.

Stable value vendors seeking to break into the public sector retirement plan market should bear in mind that their customers will be contending with different issues than administrators of corporate plans. Many public administrators will be unfamiliar with defined contribution plans in general. They will be more accustomed than their private sector counterparts to managing money internally, and less accustomed to contracting the job to vendors, such as stable value managers. Because their defined contribution plans will be relatively new, the plans will also draw more scrutiny from participants than they might in the corporate sector. Finally, because public sector employees and plan administrators are more accustomed to defined benefit plans, they may react more strongly to market fluctuations in their account values. This could benefit stable value vendors, since their products feature a book-value guarantee.

Caggia Joins SVIA Staff As Manager

Gina Mitchell, SVIA

On October 24 Nick Caggia joined the SVIA staff as Manager. Nick recently served as Director of State Relations for the National Association for Home Care and as Managing Editor of the association's weekly newsletter.

Originally from New Jersey, Nick moved to Washington in 1993 to attend the Graduate School of Political Management of The George Washington University. While pursuing his Masters' Degree, Nick worked for his several Representatives on Capitol Hill, including Bill Pascrell (D-NJ8) and the Democratic National Committee. His education and experience make him a perfect fit for a position that will require him to provide service to SVIA's membership, manage publication of Stable Times, lobby Congress, coordinate activities related to SVIA's Annual Forum, and relate SVIA's mission to prospective allies and the press.

In the course of his duties, Nick will be in contact with the membership. Please welcome him warmly.

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College Savings Plans

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plans were and only 1% were using them.

That may soon change. The Economic Growth and Tax Relief Reconciliation Act of 2001 makes the plans more attractive by specifying that withdrawals for educational purposes will be entirely free of federal income taxes beginning in 2002. Previously, earnings were simply tax-deferred until withdrawal, much like the earnings in a 401(k) plan or Individual Retirement Account.

The new federal law also increases limits on qualified room and board expenses, and improves the portability of the plans by expanding the definition of a family member to include first cousins; allowing annual rollovers from one qualified tuition program to another; and permitting tax-free rollovers from Coverdell Education IRAs into 529 plans. Finally, the new law makes it possible for private sponsors, such as colleges and universities, to launch their own qualified tuition plans. Soon, some investment professionals predict, 529 plans will become to college savings what 401(k) plans are to retirement savings.

"We're going to see explosive growth in this market, particularly as a result of the new tax law," predicts attorney Mark Weisberg, a partner and co-chair of the employee benefits department of Katten Muchin Zavis in Chicago, who spoke with Cantor at the SVIA Forum.

While stable value investment options play a big role in the 401(k) industry, accounting for about 23% of the assets held in those plans (SVIA Fifth Annual Investment and Policy Survey), they could attract an even greater percentage of 529 assets with appropriate education. Parents (or grandparents) saving for a child's college education have a shorter investment horizon than workers saving for retirement, which makes the return and principal stability that comes with stable value products all the more attractive.

The Commonwealth of Virginia, which has included stable value investment options in one of its college savings plans, has already reaped the benefits of that decision.

"Since the stock market's downturn, our portfolios have outperformed those of most other state college savings plans due in large part to the fact that we have stable value in our plans," Cantor said.

Weisberg says private institutions that set up their own 529 plans may find stable value products quite appealing because of their return and principal stability. "Private institutions don't have the whole state standing behind them," he said at the SVIA Forum in Washington. "They will want to make sure they will be able to meet their (benefit) obligations."

Two Kinds of Plans

College savings plans come in two main varieties: prepaid tuition plans and savings plans.

Savings plans are similar to defined contribution plans, and, as such, work much like 401(k) plans. With them, a family invests money, selects an investment portfolio offered by the operator of the plan (usually a state), and reaps whatever gains or losses that portfolio achieves over time. Some savings plans do, however, guarantee a minimum rate of return.

One of the Virginia plans described by Cantor is an example of a savings plan. Called the Virginia Education Savings Trust (VEST), it allows families to save for all sorts of college costs, including tuition and fees, room and board, textbooks and computers. Participants can invest in one of seven different balanced or lifestyle investment options with varying risk and return objectives. The most conservative portfolio is invested 100% in stable value investments. The most aggressive allocates 5% of assets to stable value investments, 15% to fixed income, 20% to international equity, 20% to small cap/mid cap equity, and 40% to large cap equity. These portfolios automatically migrate over time towards a more conservative investment mix.

Prepaid tuition plans, also known as tuition account programs, are similar to a defined benefit plan. There are two types. With the first—prepaid unit plans—families buy units that represent a fixed percentage of tuition costs. In Ohio, for example, 100 units equals one year's tuition and fees at an Ohio state school. Any private institution that sets up its own 529 plan must structure it as a prepaid plan.

With the other type of prepaid plan—a contract plan—families purchase a specified number of years of tuition. The price they pay depends upon the age of the child and the type of payment plan chosen, lump sum or installment. The pre-purchased tuition is guaranteed to increase in value at the same rate as college tuition, thereby insulating participants from the inflation associated with college tuition.

In addition to its VEST program, Virginia also offers a prepaid plan called the Virginia Prepaid Education Program, or VPEP. Participants prepay future college tuition at today's prices. Their payments are invested so their growth will cover future college tuition and mandatory fees at any Virginia public college or university. Benefits may also be applied toward the cost of tuition and fees at private Virginia schools, as well as most colleges and universities nationwide, although without the guarantee that the plan will cover the total costs at out-of-state or private schools. Unlike a savings plan, prepaid plans do not allow participants to use funds for educational expenses other than tuition and fees.

Both of Virginia's plans offer investors the same favorable state and federal tax benefits, including federal tax exemption on earnings (beginning in 2002), a Virginia tax exemption on earnings, and a Virginia income tax deduction for every dollar invested.

After the Terror: Tragedies Spur Few Credit Rating Downgrades for Life Insurers

Randy Myers

Insurance losses attributable to the September 11 terrorist attacks on the World Trade Center and the Pentagon have been estimated at anywhere from $30 to $75 billion. Whatever the final number, it promises to be the largest insurance loss in world history by a sizeable margin, dwarfing the previous record of $15.5 billion attributable to Hurricane Andrew in 1992. Insurance losses attributable to man-made events pale even more in comparison: $125 million for the Oklahoma City federal building in 1995, $510 million for the bombing of the World Trade Center in 1993, and $775 million for the Los Angeles riots in 1992, according to a recent report in Money magazine.

While the attacks will clearly impact property and casualty insurers, they aren't likely to have a dramatic effect on life insurers, which issue the GICs and also provide book-value guarantees for synthetic GICs. Speaking at SVIA Forum, Robert Riegel, Managing Director of the Life and Health Insurance Team at credit rating company Moody's Investors Service, estimated the September 11 losses to life insurers at $2 to $5 billion, or only about 2% to 3% of the life industry's surpluses.

Riegel said Moody's Investors Service had put "about 20-plus" insurance firms under review for a possible credit rating downgrade since September 11, but that none were life insurers. Mark Puccia, Managing Director of the Financial Services Group at Standard & Poor's, said S&P had put a comparable number of insurers on credit watch, while Douglas Meyer, Senior Director of Insurance for Fitch Inc., said his firm had put 17 insurers on "rating watch," only two of them life insurers. "We see no insolvency threats on the life insurance side," Meyer said.

In fact, the ratings professionals said, the terrorism of September 11 could have a positive impact on both life insurers and property and casualty companies once their losses are behind them. On the life side, Riegel said, the attacks could prompt people to reassess their coverage needs and purchase more insurance. On the property and casualty side, the losses sustained this year could lead to a dramatic hardening of the market next year, which could make 2002 a good one for property and casualty profits.

In keeping with that analysis, Meyer said Fitch has a negative outlook on the life insurance industry at the moment, but could revise it to stable by year-end. Puccia said S&P had a "slight negative outlook" on the life industry, noting that it had lowered ratings on three life companies during the first half of the year and expected a comparable number for the second half. Moody's carried a favorable outlook on the life insurance industry. "We give insurance companies high (credit) ratings relative to other financial institutions," Riegel said, citing the generally good quality of the assets on their balance sheets and the tax-advantaged nature of insurance products, which helps to maintain consumer demand for them.

Update on Stable Value Manager Performance Comparison Measures and AIMR Discussion

Victoria Paradis, JP Morgan Fleming Asset Management

The Association for Investment Management and Research (AIMR) has received and reviewed the SVIA Performance Measurement Task Force materials. These materials include the Task Force draft report as well as the Spring 2001 article in the Journal of Performance Measurement. AIMR commended the amount of effort that the stable value industry has already put into this project.

According to our interpretation of a preliminary discussion with AIMR, AIMR will engage in a process to expand their Performance Presentation Standards (PPS) to include stable value and its unique issues. This process will include establishing a committee of volunteers from AIMR and the stable value industry. Gina Mitchell has recruited SVIA member volunteers for this committee, which include: John Axtell from Deutsche Asset Management, Paul Donahue from PRIMCO Capital Management, Bill Gardner from Dwight Asset Management, Vicky Paradis from JP Morgan Fleming Asset Management, and Klaus Shigley from John Hancock Financial Services.

The Implementation Committee will review all standards, including return calculations, composite creation, performance presentation, and disclosures, to identify and address the unique issues faced by stable value investments. Based on AIMR's full schedule, they expect an early 2002 initial meeting of the Implementation Committee.

Based on the initial dialogue, we confirmed our understanding of a few critical, initial issues.

- First, stable value managers can be AIMR compliant

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Benna Says Employers Should Give Up 401(k) Gatekeeper Role

The Man Who Invented the 401(k) Plan Thinks It's Time to Re-Invent It.

Randy Myers

Ted Benna, who gained IRS approval for the first 401(k) plan in 1981, is now president of the 401(k) Association and a consultant to the defined contribution plan industry. Speaking at the SVIA Forum, Benna said the current 401(k) model in which employers select the investment options menu their plan participants can choose from, and then leave participants to pick according to their own understanding of investment principles, simply isn't working as well as it could or should.

Most workers aren't investment experts, Benna said, arguing that even the new online investment advice services available to many of them won't change that. One problem is that use of the advice services is voluntary, and only about 10% to 20% of the people who have access to them actually use them. What's more, those who do use the models tend to be those who are most knowledgeable about investing. The people who really need help, he said, aren't getting it.

Based on his experience working for plan sponsors, Benna doesn't think that allowing employers to make investment decisions for plan participants is the answer, either. What would work, he suggests, is a model in which participants would be given access to a menu of professionally managed lifecycle portfolios developed according to sound investment principles. The portfolios would gradually become more conservative as investors neared retirement age. Plan participants could simply pick a portfolio timed to their retirement date and designed to reflect their tolerance for risk: aggressive, moderate or conservative. However, participants who wished to do more could still select their own investments from a mutual fund window.

With these structured portfolios in place, Benna says, employers and plan providers could be offered a fiduciary safe harbor from liability for the performance of participants' portfolios. Participants, meanwhile, wouldn't be compelled to learn the ins and outs of investment strategy.

"It makes no sense for employers to bear responsibility for how you invest your money for retirement," Benna said. "I believe we are headed for a system in which the employer no longer has that gatekeeper role."

To gain their fiduciary safe harbor, plan sponsors and providers would have to ensure that their 401(k) plans meet several important criteria, Benna added. For example, he suggested that participant-paid expenses for the structured portfolios could not exceed 75 basis points. Additional participant-paid fees to access the fund window could not exceed $150. If participants chose to invest in the structured portfolios, they would only be allowed to choose one. Participants who stay in a structured portfolio for at least 20 years, Benna suggested, should receive a 7% guaranteed minimum average annual return. Finally, an IRA option would exist allowing participants to retain their 401(k) portfolio if they change jobs or their employer is sold.

As an alternative to this model, Benna said participants could simply be permitted to invest in IRAs under the same rules that now apply to SIMPLE-IRAs. Employers could pick a single financial entity to receive all new deposits, but participants could transfer the money they accumulate to any other financial organization annually without penalty.

Not everyone believes that Benna's ideas will take root. Dallas Salisbury, Chief Executive Officer of the Employee Benefits Research Institute in Washington, D.C. and also a speaker at the SVIA Forum, put the odds "somewhere close to zero percent." Among other things, he said he wouldn't expect plan sponsors to be interested in sponsoring a benefit program for which they received little credit from their employees.

But Benna suggested that in as little as 8 to 10 years the 401(k) market could evolve to embrace the new model he's described. In the meantime, he encouraged vendors of stable value products to think about how they will retain their share of the 401(k) market if, in fact, the industry changes in the ways he envisions.

"Clearly, we are already moving rapidly into a period where individuals are going to be in control of their retirement assets outside of the 401(k) market," Benna said, noting that many of the baby boomers now approaching retirement are likely to roll their 401(k) assets into IRAs once they quit work. As that happens, he said, "IRAs will be king, not 401(k)s."

"We're going to see change," Benna concluded. "The biggest challenge the stable value industry faces is keeping the dollars you've been used to capturing in 401(k) plans as control moves to the individual rather than the corporation." SVIA

Performance Comparison Measure

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today by following current PPS. Excluding traditional GICs from marked to market performance reporting is consistent with current AIMR standards. Alternatively, if firms calculate marked to market returns for GICs and disclose the methodology, that would be consistent with AIMR-PPS.

- Second, historical data collection is a challenge for most stable value managers. According to AIMR, that's the case for all asset classes, so stable value is not unique. When changes to the standards have been made historically, the changes are usually forward-looking so they can be accessible to all affected firms. SVIA

Market Expert Sees Glimmer of Hope for Stock Market

Randy Myers

It's awfully hard to make a bullish case for the stock market right now, with stock prices tumbling for most of the past 18 months and the economy seemingly on the verge of a recession. But Peter Richiutti, Assistant Dean at Tulane University's A.B. Freeman School of Business, isn't above trying.

Speaking at the SVIA Forum, Richiutti said that while the market appears "pretty fairly priced, maybe a little underpriced," he added that by one important measure it is as cheap as its been in his 23 years in the investment business. (Prior to joining academia, Richiutti managed a $3 billion investment portfolio for the state of Louisiana as its Assistant Treasurer and Chief Investment Officer. Before that, he had a successful career on Wall Street.)

The measure to which Richiutti referred is the stock market's earnings yield relative to the yield on the 10-year Treasury note. Over time, he explained, the stock market has proved to be fairly valued when the inverse of its price-to-earnings ratio, or earnings yield, is about equal to the yield on the bellwether U.S. Treasury long bond. When the earnings yield is significantly above the yield on the long bond, stocks have turned out to be underpriced.

At recent levels, Richiutti said, the price/earnings ratio for the stock market, as represented by Wall Street earnings estimates for the companies in the Value Line Index, stood at 16.1. Dividing that ratio into the number one to get the market's earnings yield produces a result of 6.2%. By comparison, the yield on the bellwether 10-year US Treasury note recently stood at 4.54%. With that kind of return on bonds, Richiutti's analysis indicates, the stock market could support a price-to-earning ratio of 22, or roughly 37% higher than its current level.

To be sure, Richiutti noted, many securities analysts may still be revising their earnings estimates downward, which would raise the market's price-to-earnings ratio and make it appear more expensive—or less cheap—than it currently looks.

In the meantime, Richiutti also noted that while the terrorists' attacks of September 11 may hasten the U.S. economy's slide into a recession, economic incentives put in place by the government since then could help the nation pull out of that recession faster than it would have otherwise.

Finally, Richiutti reminded his audience that since 1956 the average bear market only lasts about 12 months. By that measure, the current market downturn could be over by March 2002, since the major stock market indices hit bear territory in March 2001. Before that can happen, though, Richiutti said the bear market will have to enter its third and final phase in which fear of deeper stock market losses and a recession become so worrisome that investors give up on stocks, setting the stage for a recovery.

Rise of "Instividual" Market Reinforces Need for Advice

Randy Myers

The marketplace of investors was once neatly divisible into two groups: institutions (banks, mutual funds, insurance companies and pension funds) and individuals. Today, financial services firms increasingly find themselves catering to a new hybrid: the "instividual" market. According to Peter Starr, a managing director for consulting firm Cerulli Associates Inc., financial services firms seeking to win over this sector will have to meet a wide range of demands for investor education and advice.

Speaking in October at the SVIA Forum, Starr explained that the instividual market consists of individual investors saving for retirement through institutional channels such as 401(k) plans, as well as individuals investing for retirement through Individual Retirement Accounts. While IRAs are ostensibly retail vehicles, the assets they hold are commonly invested in mutual funds run by institutional investors.

By 1999, Starr noted, the IRA market had already grown bigger, at $2.5 trillion, than either the defined benefit plan or defined contribution plan markets. He estimated that between 2000 and 2010, another $4.6 trillion will flow from institutional 401(k) programs to individual retirement accounts as retiring baby boomers "rollover" their retirement assets into plans that give them more control of their assets.

These rollover investors want investment advice, Starr said, but in many cases can't afford the retail cost. He noted that only 3% of rollover IRA investors have account balances above $100,000, while 85% have account balances under $20,000. The former can easily access investment advisors, but the latter generally cannot. While the lower account-balance investors do have access to online investment advice, those services are best suited to the relatively few investors who require little customization of their advice and/or have the interest and ability to manage their money without the help of a human advisor.

The gap between cheap online advice and expensive one-on-one advice is the one that financial services vendors must try to fill, Starr said, but he predicted that the window of opportunity will narrow with time. Among retirees with assets in excess of $250,000, 74% already use an advisor, and among those with assets ranging from $50,000 to $100,000, 62% do. The challenge, of course, is to find ways to provide advice economically to those with modest account balances.

"The large number of rollover investors who will be looking for advice on how to convert their savings into retirement income and on other financial issues facing retirees will flock to providers who are able to offer them advice at a price they can afford," Starr said. The winning firms, he added, will likely find it necessary to implement all or most of the elements of what he calls a scalable advice product

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The "Save More Tomorrow" Plan: Using Psychology to Encourage Saving for Retirement

Randy Myers

Employers who sponsor defined-contribution retirement plans face two big challenges with regard to participant behavior. One is convincing workers to save enough money, and the other is convincing them to invest what they do save appropriately. Employers can do both, suggests professor Richard Thaler, by understanding the psychological tendencies of the typical investor.

Thaler is the Robert P. Gwinn Professor of Behavioral Science and Economics at the University of Chicago Graduate School of Business. In an address to the SVIA Forum, Thaler described two profound psychological tendencies among retirement investors. One is that they typically invest more in a particular asset class when given increasing numbers of investment options within that class. The other is that while they are reluctant to authorize immediate increases in the amount of money they save for retirement, they are quite willing to authorize increases that are phased in over time. The obvious implications for employers are that they should carefully tailor the number and type of investment options they make available to participants in defined contribution plans, and offer ways for employees to commit now to increasing their savings levels later.

Thaler's findings stem in part from an examination of asset allocation behavior by workers at a California university and by pilots for a U.S. airline. The university employees, who had one stock fund and four fixed income funds to choose from in their defined contribution retirement plan, invested just 34% of their assets in stocks. By contrast, the airline pilots had five stock funds and one fixed-income fund to choose from and invested 75% of their assets in stocks.

To see how they might respond to alternative investment options, Thaler asked the participants in the university plan how they would allocate their retirement savings if given three different scenarios with only two investment options each. In the first scenario, their plan would offer one stock fund and one bond fund. In the second, the plan would offer a stock fund and a balanced fund (a portfolio of both stocks and bonds). In the third, the plan would offer a bond fund and a balanced fund.

Under each scenario, Thaler discovered a strong tendency for plan participants to split their retirement savings 50-50 between the two investment options, regardless of the makeup of the funds. Other studies examining the asset allocation question in slightly different ways produced similar results.

In still more studies, Thaler found that workers are reluctant to commit more to their retirement savings plans when those increases would take effect immediately, but more willing to do so if the increases would be phased-in over time. His response was to develop what he calls the Save More Tomorrow Plan, or SMarT Plan, which he has already helped to implement at two companies.

In the first implementation, a manufacturing company was seeking to increase the amount of money its employees were saving for retirement. Using the SMarT Plan, they would agree to increase their savings rate by a fixed percentage (i.e., 3%) per year, with each increase linked to a future salary hike. The increases would continue for three years unless participants chose to drop out of the plan.

In the first implementation of the SMarT Plan, all 315 of the plan's participants first had an opportunity to meet with an investment advisor who reviewed their savings plan and recommended increased savings where appropriate. While the advisor's professional training told him to recommend that workers save the maximum 15% of salary, he typically recommended only 5% increases when he sensed resistance to the larger number.

Of the 286 participants who met with the financial advisor, only 79 accepted his advice to increase their rate of savings—a 28% acceptance rate. The 207 who declined to accept that advice were then offered the SMarT Plan as an alternative. Of that number, 162—or 78%—agreed to participate in the SMarT Plan. Four opted out before receiving their second raise, and 33 more did so before receiving their third raise. That still left 125 out of 207 workers participating, and the results were impressive for the SmarT Plan. After three years, the participants who had taken no advice of any kind were still contributing the same amount to their retirement plan as they were at the start of the implementation—less than 7%. Participants who took the financial advisor's advice were saving 8.7% versus 4.4% at the start of the effort. Participants who stayed in the SMarT plan were saving 11.6% of their salary versus 3.5% at the beginning.

PWBA Extends Plan Sponsor Deadlines after Ter rorist Attacks

Randy Myers

The U.S. Labor Department's Pension Welfare Benefits Administration implemented a number of policy changes following the September 11 terrorist attacks in New York City and Washington, D.C., in an effort to help corporate pension plan sponsors.

In a presentation at the SVIA Forum, Ann Combs, Assistant Secretary of the PWBA, said one of the first measures taken was to extend the deadline for filing Form 5500 or Form 5500-EZ. As explained on a PWBA Web site, the deadline for forms due between September 11, 2001, and November 30, 2001, was extended an additional ten months. Those Form 5500/5500-EZ filers who were under an extension that would expire between September 11, 2001, and November 30, 2001, were given an additional 120 days to file.

SVIA Supports Proposed Exception to SFAS 133 Urges Expeditious Adoption

Gina Mitchell, SVIA

SVIA recently encouraged the Financial Accounting Standards Board's Derivatives Implementation Group to expeditiously finalize the "Scope Exceptions: Contracts Subject to Statement 35, Statement 110, or Statement of Position 94-4" contained in Statement 133 Implementation Issue Number C19.

The scope exception for synthetic GICs held by defined contribution plans clarifies that book value accounting continues to be the appropriate valuation mechanism for this important asset held in defined contribution plans' stable value funds. Book value is the appropriate valuation mechanism because it is the amount that defined contribution plan investors actually receive if they withdraw from the stable value fund of the defined contribution plan.

SVIA cautioned FASB in its November 19 letter that without this important clarification, some auditors would have applied fair value accounting required in SFAS 133 Implementation Issue A16 for issuers to defined contribution plans with devastating results to these plans and the plan participants who use stable value funds. This application would have misled and confused plan participants, the principal users of pension plan financial statements. It could also have provoked expensive legal action as plan participant account balances could have been affected due to the accounting change.

SVIA stated it is appropriate to make a distinction in the SFAS 133 accounting for synthetic GICs between issuers and defined contribution plans because defined contribution plans and their participants are entitled to receive the book or contract value of their stable value investment while issuers are subject to different payment and valuation risks.

The exception that FASB has provided for synthetic GICs held by defined contribution pension plans preserves this increasingly important investment option. In these uncertain and volatile times, the consistent and predictable returns of stable value are more valuable than ever to the thousands of plan sponsors who offer them and the millions of plan participants, beneficiaries and retirees who benefit from stable value.

According to SVIA's Fifth Annual Investment and Policy Survey for year-end 2000, 23% of defined contribution plan assets were allocated to stable value funds. The Association's members manage more than $225 billion in more than 115,000 defined contribution plans. The survey found that the $225 billion in stable value funds had an asset mix of 5% cash, 40% guaranteed investment contracts (GICs), 51% synthetics GICs, 3% separate accounts, and 1% other.

Members are encouraged to keep a copy of SVIA's letter and the proposed FASB exception handy to answer any accounting or audit questions that may arise concerning calendar year-end pension plan audits. A copy of the letter is available at www.stablevalue.org in "Members Only."

The scope exception is available by accessing FASB's website at http://accounting.rutgers.edu/raw/fasb/tech/index.html, then going to the Derivatives Implementation Group link, then to Guidance on Statement 133 Implementation Issues and scrolling to Issue C19.

Tax Act Expands Contribution Limits to Retirement Plans

Randy Myers

Workers can save more for retirement under terms of the Economic Growth and Tax Relief Act of 2001, which was signed into law by President Bush earlier this year.

Bill Sweetnam, benefits tax counsel in the Office of Tax Policy at the U.S. Department of the Treasury, outlined the tax law's impact on retirement savings during a speech at the SVIA Forum. Among the highlights of the legislation, he discussed, were these:

- Elective deferral limits for 401(k), 403(b) and 457 plans increase to $11,000 for 2002, $12,000 for 2003, $13,000 in 2004, $14,000 in 2005 and $15,000 in 2006.
- Elective deferral limits for SIMPLE IRA's and SIMPLE 401(k)s increase to $7,000 for 2002, $8,000 for 2003, $9,000 for 2004, and $10,000 for 2005.
- The annual contribution limit for Individual Retirement Accounts, which had been $2,000, increases in a series of stages to a maximum of $5,000 by 2008.

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and service delivery model. Under this model, financial services firms will offer higher degrees of personalization as account balances go up in size. For example, self-directed investors and those with low account balances ($50,000 and under) might receive mass-customized or online advice; "validators" and mass market accounts ($50,000 to $150,000 in assets) might receive limited advice; and "transactors" and advice seekers, as well as those with high account balances ($150,000 and up) might receive personal advice as needed or on a recurring basis, depending on their directions.

Taking Stable Value Overseas: Evaluating the Opportunity

Randy Myers

Transferring its domestic success to overseas markets remains an alluring proposition for the stable value industry, according to Robert McCormish, President and Chief Executive Officer of Certus Asset Advisors, a subsidiary of Mellon Financial Corp. He warns, however, that it will be a difficult and expensive undertaking.

"You can't go there alone," McCormish told attendees at the SVIA Forum. "The industry really needs to go en masse."

That said, there are compelling reasons to venture overseas, McCormish conceded. For starters, he projects that the stable value industry will enjoy only flat to negative growth in the U.S. in the years ahead, partly because the baby boomer generation will soon start to retire in earnest. The first boomers turned 55 this year, and as they leave the work force they'll begin to draw down the assets they've accumulated in 401(k) plans and other defined-contribution retirement accounts, including the approximately 23% of that money now held in stable value funds. In many cases, they're also likely to roll retirement assets into Individual Retirement Accounts, where stable value funds are a relatively rare commodity.

While this makes the notion of finding new revenue sources overseas appealing, it could be some time before traditional stable value funds establish any sort of beachhead on foreign shores. Even in Japan and the United Kingdom, where market dynamics are most similar to those in the U.S., accounting and cultural barriers must be overcome before retirement investors are likely to embrace the products.

"Nationalism and protectionism are two of the hurdles to breaking into these markets," added Guy Hudson, director of sales, marketing and product development for Mellon Institutional Asset Management, the umbrella organization for Mellon Financial's asset management business. "In France, for example, 68% of investment assets are in fixed-income securities, which should be favorable for the stable value industry, and 80% of the population believes that their current pension providers will not be able to provide for them in 10 to 15 years. But the French are also reluctant to allow external advisors for their fixed-income funds. And if you look at Europe on the whole, you find there are 15 different states but many more cultures. You find legal and regulatory barriers to entry, and a currency, the euro, that is still very immature. Finally, you find that banks are the major distributors of mutual funds, which has negative implications for U.S. stable value providers unless they are affiliated with one of the gorilla global financial services firms."

Despite all that, Hudson concedes the opportunity abroad is too big to ignore. "Although Europe is shifting to an equity culture more in line with what we already have in the U.S., investors there still put significant amounts of their money into loans and bonds," Hudson said. "This suggests they would be receptive to the benefits that stable value products have to offer. However, you've got to know the market, and you can't go in with a one-size-fits-all model."

McCormish said the stable value industry's most immediate opportunity lies in the European medium-term note (EMTN) market. More than 15 U.S. insurers are already active in that market, led by AIG SunAmerica. Market-wide issuance of new product is expected to top $20 billion next year, and total outstanding issuance could reach as high as $100 billion within the next few years. Customers for the notes are principally institutional investors in Europe, Japan and Australia.

Stable value vendors can also search for creative ways to use stable value products to meet overseas needs, McCormish said, as his firm did when it created a ¥7 billion (approximately $58 million) dynamically hedged stable value fund for the Japanese market. The fund was an offshoot of a stable value product that had been using U.S. bonds as the base investment. Certus developed and launched the Japanese fund using stable value products as the base investment so that Japanese defined benefit plans could take advantage of book value accounting. The fund is denominated in yen but does not employ a full currency hedge, which would have erased the yield advantage of U.S. versus Japanese fixed income investments. Instead, it seeks to take advantage of active currency management. This allows investors to enjoy upside potential from the currency hedge, McCormish said, plus a base return from the underlying stable value product.

Launching the closed-end fund required the use of an offshore trust. Certus was able to use one that had already been established in Dublin, Ireland, by an affiliate of its parent company. In McCormish's view, any company venturing overseas should have a similar on-ground presence outside the U.S. Even with the help it had, he noted, Certus had some trouble communicating its message to its intended customers. And despite its success in getting the product off the ground, McCormish said Certus won't consider the Japanese fund a successful deal unless it is renewed upon expiration in July 2003.

In addition to seeking an on-ground partner, McCormish recommended that firms venturing overseas think carefully about their own capabilities and the needs of their prospective clients before attempting a deal.

"You have to ask what the investors are interested in, and if you don't know, you can't put together a product that will succeed," he warned.

Saving for Retirement: The Great American Struggle Continues

Randy Myers

After spending much of his adult life studying the pension industry and the retirement savings habits of American workers, Dallas Salisbury, Chief Executive Officer of the Employee Benefits Research Institutute (EBRI), has come to a rather depressing conclusion. Addressing the SVIA Forum, Salisbury warned that "the vast majority of Americans, if they don't start saving soon, will never be able to retire."

Part of the problem, Salisbury said, is the declining prevalence of traditional, defined-benefit pension plans. From 1977 to 1997, the percentage of non-government U.S. workers participating in defined benefit plans fell from about 38% to about 21%, according to U.S. Department of Labor data. While the number of workers covered by defined contribution plans rose during that period of time by a comparable amount—to approximately 25% from about 7%—that's less than reassuring when you consider that participation in the plans is voluntary, and, at many companies, inadequate. To illustrate, Salisbury said, EBRI data indicates that in 1999 less than 2.5% of workers earnings between $40,000 and $60,000 per year contributed to their 401(k) plans at the maximum levels allowed by law. Even among workers earnings more than $100,000 per year, only about 40% did so.

Drawing on data from the January 2000 Federal Reserve Bulletin, Salisbury also noted that the median value of 401(k) accounts for families that had no other pension plan available to them was only $12,000. In older families where workers have had more time to save—those where workers were between the ages of 55 and 64—the median family account balance was still just $22,000. While more recent EBRI studies have indicated that average account balance in 401(k) plans is higher today—$58,774 as of 2000—that's still quite small in comparison with the amount of money the average retiree will need from retirement to death.

In a wide-ranging presentation at the SVIA Forum, Salisbury cited a number of important and sometimes surprising findings about how American workers save for retirement, and also offered his views on recent major developments in the retirement savings arena. Among the highlights:

The presence of a defined benefit plan increases, rather than decreases, participation in defined contribution plans. As noted earlier, Federal Reserve data published in January 2000 indicated that the median account balance in 401(k) plans, where that was the only retirement plan available to workers, was $12,000. But among workers also covered by a defined benefit plan, the median 401(k) account balance was $25,000. "The absence of a defined benefit plan is absolutely predictive of lower retirement assets," Salisbury said.

While investment advice services are increasingly available to participants in defined contribution plans, only a small portion of workers use them. "Less than 10% of those who have access to investment advice take advantage of it on a regular basis," Salisbury said.

Higher contribution limits for defined contribution plans, which take effect next year under the Economic Growth and Tax Relief Reconciliation Act of 2001, aren't likely to benefit the majority of workers already contributing less than the maximum allowable amounts to their retirement plans. "For the vast majority of participants, these changes in limits are totally irrelevant," Salisbury said.

Workers appear to underestimate the risk of holding their employer's stock in their defined contribution plans. The evidence? When comparing asset allocation trends in 1999, EBRI found that in plans which include company stock as investment option, investors tend to use that stock as a substitute for stable value investments and bonds rather than as a substitute for equities, which is the more rational decision.

Employers can do a number of things to improve the rate at which their workers save for retirement, beyond offering a defined benefit plan to complement their defined contribution plan. High on his list: match employee contributions with employer contributions in defined contribution plans, and make participation in those plans automatic unless employees formally elect to opt out of them.

The Myth of the Three-Legged Stool

Randy Myers

For as long as most Americans can remember, their hope for a financially secure retirement has centered on the dependable "three-legged stool" of Social Security, pensions and personal savings. Yet for most Americans, this three-legged stool has proved to be little more than a myth, says Teresa Ghilarducci, Associate Professor of economics at the University of Notre Dame.

One of the featured speakers at the SVIA Forum, Ghilarducci explained that only a minority of the nation's elderly actually have realistic access to all three of these sources of income. Dividing the senior population into quintiles based on 1998 levels of income, Ghilarducci found that for the bottom three quintiles, Social Security alone accounted for 82.1%, 80.5% and 63.8% of income, respectively. In none of those groups did personal savings account for more than 7.3% of income, and for the poorest group it accounted for less than 1%. What's more, the percentage of retirement income accounted for by Social Security has gone up for every group since 1980, while the percentage of income accounted for by pensions has remained

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One Man's Approach to Social Security Reform

Randy Myers

Defined contribution plans have become a popular retirement savings vehicle for millions of working Americans. Sam Beard thinks the concept behind them could help rescue the nation's Social Security system, too.

The founder and president of Economic Security 2000, a non-profit educational organization, Beard also serves on the President's Commission to Strengthen Social Security—a bipartisan group that President Bush created in May 2001 to recommend ways to put Social Security back on sound financial footing.

Addressing the SVIA Forum, Beard said it was his view—he made it clear that he was not speaking for the President's Commission—that the country can no longer afford the defined benefit promise held out by the current Social Security system. He noted that in 1935, the year that the Social Security Act was signed into law, the U.S. had 40 workers, and their tax dollars, supporting every retiree covered by the new government pension plan. By 1997 there were only three workers for each retiree, and by 2030 he predicts we will have fewer than two workers per retiree.

Cutting Social Security benefits and simultaneously raising Social Security payroll taxes would be one way to restore solvency to the system, Beard said, but not an attractive one; the necessary tax increase would be onerous, and millions of seniors would be forced to live below the poverty level. Privatizing Social Security is another unpalatable option, he said, since it could leave millions of retired Americans financially destitute if their self-directed investment programs soured.

A better solution, Beard argued, would be to simultaneously shrink the defined benefit promise of Social Security and add a defined-contribution component to the program. Under that new component, each working American would have the opportunity to set aside $1,000 per year in a personal retirement account, with some of the money contributed by the government and some by the worker.

Because most Americans know little about investing and because this is a safety-net type of retirement plan, Beard said, the accounts would have to be managed conservatively, albeit not as conservatively as the current Social Security system. Rather than allow individuals to manage the plans as they see fit, the way most do now in 401(k) programs, he said the Social Security accounts should be managed by carefully screened institutional investment firms. "People could choose their managers, but the managers would then run huge, collective, diversified pools of money," Beard said.

Distribution options would also be carefully controlled, Beard said, so that a retiree couldn't waste a life's worth of Social Security savings on, say, a new boat. "You couldn't take the money and run," he said. "This money should be thought of as a trust fund that you draw down at a rate of maybe 5% a year, which will for the most part keep your principal intact, and then that principal would go to your kids. Or perhaps you buy an annuity, or do something in the middle—buy an annuity with half the money, and draw down 5% of the remainder per year."

Beard said the system he's described isn't without precedent. Chile, he said, set up a U.S.-style retirement system before the U.S., and embraced the defined contribution concept about 20 years ago. In fact, he added, about 40 countries now have government-sponsored defined contribution retirement systems, all in response to the same sort of demographic trends that have weakened the current U.S. system.

While conceding that nobody thinks Social Security can be reformed overnight, Beard seemed genuinely optimistic that its problems will, ultimately, be resolved.

"Most big ideas to change in this country take 10 to 20 years to take hold," Beard said. "In 1980, our political leaders began warning that the entitlement system was going broke. We're now 20 years down the road. And while the number one agenda item in this country is now terrorism, it's also true that the person most excited about Social Security reform in this country just happens to be the President of the United States."

Three-Legged Stool

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stagnant.

One consequence of these trends, Ghilarducci said, is that people have come to rely on the job market as a fourth source of retirement income. But with the nation on course to enter a recession, she warned, that may not be an option in the near term. In addition to robbing people of the ability to find jobs after retirement, a recession could harm retirees by hobbling the stock market and the returns people earn on their retirement assets.

Compounding the bleak outlook for many retirees, Ghilarducci said, is a trend among employers to shift more and more health care costs onto workers and retirees alike. She attributed this to employers embracing a new employment contract that's steering them away from a model of corporate paternalism toward one of individual responsibility. Unfortunately, she said, that model has limitations. It is attractive in up markets, when it fattens returns in defined contribution plans, but less so in down markets. It is similarly attractive when older workers can easily find jobs, but less so when the labor market becomes soft.

"This recession is going to be very different," Ghilarducci concluded, because "never before have so many Americans had so much control over their retirement savings."

If the "individual responsibility" model can't deliver retirement security, she added, the government will have to provide basic benefits. Other measures that could help, she said, would include the creation of multiple-employer benefit plans that would make it easier for small employers to offer retirement benefits (akin to the system that now exists for various trade unions), and rewarding employers in some way for paternalistic behavior.