# STABLE TIMES

The quarterly publication of the Stable Value Investment Association

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## IN THIS ISSUE



# A Simple Choice for Plan Sponsors and 401(k) Investors: Using Stable Value

*Mark Foley, CIGNA Retirement & Investment Services*

Individuals drive defined contribution asset allocations daily through millions of independent choices. To gain insight into how stable value is used in the small and mid-sized market, *Stable Times* asked CIGNA Retirement & Investment Services' Mark Foley to share his company's experience. Analysis of the data suggests that while usage runs higher among older participants than younger ones, all age groups had noteworthy allocations to stable value. Plus, stable value is both available and sought after by small and mid-size 401(k) plans in addition to the largest defined contribution plans.

*A little background on CIGNA's defined contribution business*

CIGNA Retirement & Investment Services provides retirement solutions to approximately 3,500 plan sponsors serving some 1.2 million plan participants†. The firm focuses on bundled defined benefit, defined contribution and non-qualified plans for corporate and Taft-Hartley clients.

Most of our clients are fully bundled. In other words, they

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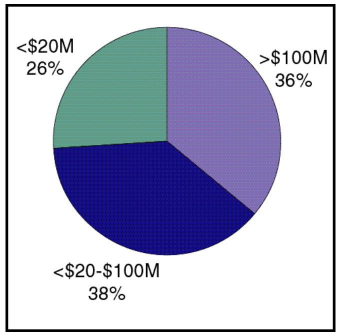
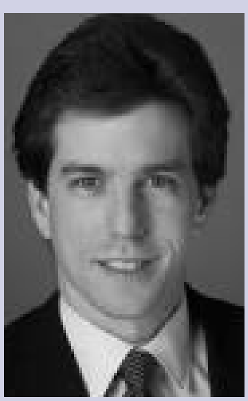
†Unless otherwise noted, all figures are as of December 31, 2001.

**CIGNA DC ASSETS BY PLAN SIZE**




# Editor's Corner

*Greg Wilensky, Alliance Capital*



This issue of *Stable Times* is far different from those you've seen in the past. In order to get a sense of what's going on in the world, SVIA has asked leaders from the economic and political communities to offer their opinions on issues that shape the stable value industry. These articles were meant to stimulate a dialogue among the membership. So, as you begin reading, I offer you the opportunity to respond to what you see with "Letters to the Editor." Please send your comments to Nick Caggia via email, nick@stable-value.org, or by mail to SVIA, 2121 K Street, NW, Suite 800, Washington, DC 20037. We look forward to publishing those in our next issue.

Also included in this issue, you will find economic forecasts from Alliance Capital, Bank of America, and JPMorgan Fleming. All three predict modestly rising interest rates over the next 6 to 12 months. If these forecasts are realized, it should create a rather hospitable environment for stable value funds versus other conservative investment options. Increasing interest rates would reduce or eliminate the return provided by market value bond funds while modestly increasing the return of stable value funds. While the increase in the return for stable value funds will generally lag the increase in interest rates (specifically money market fund yields), this lag should only modestly cut into the very sizable advantage (6% versus 2%) that the typical stable value fund currently offers versus money market funds.

# U.S. Economic Commentary and Forecasts: Three Perspectives

## Alliance Capital

*Joseph G. Carson – U.S. Economist*

The U.S. economy roared back in the first three months of the year, evident in the 5.8% annualized advance in Real GDP. Growth in Q1 was the fastest quarterly advance in four years, and ran far ahead of revised (upward) consensus estimates.

Equally impressive was the composition of growth. Real consumer spending jumped 3.5%, about half as fast as the Q4 performance, but still a relatively strong showing given that sales of motor vehicles tumbled almost 30% following the record sales late last year. Housing jumped 15%, the strongest quarterly gain in 8 years, thanks in part to very low interest rates and unusually mild weather. Defense spending jumped 20%, much more spending seems to be in the pipeline given that order bookings for military contractors are up 16% last year's levels.

### 2002 FORECAST BY QUARTER

| | 01:Q4 | 02:Q1 | 02:Q2 | 02:Q3 | 02:Q4 |
|---|---|---|---|---|---|
| Real GDP | | | | | |
| %Q/Q SAAR | 1.7% | 5.8% | 3.5% | 3.5% | 4.2% |
| GDP Deflator | | | | | |
| %Y/Y -0.1% | 0.8% | 2.1% | 2.6% | 2.6% | |
| Consumer Price | | | | | |
| Index %Y/Y | 0.7% | 1.6% | 3.0% | 2.8% | 2.8% |
| Fed Funds Rate | 1.8% | 1.8% | 1.75% | 2.3% | 3.0% |
| 3-Mo T-Bill (BEY) | 1.7% | 1.8% | 2.0% | 2.3% | 3.0% |
| 2-Yr Note | 3.2% | 3.3% | 3.8% | 4.0% | 4.5% |
| 10-Yr Note5.1% | 5.3% | 5.3% | 5.5% | 5.8% | |
| 30-Yr Bond | 5.5% | 5.5% | 5.7% | 5.9% | 6.0% |

Investment spending was weak, but not in the much maligned tech sector. Nonresidential structures took a big tumble, owing to the fact that many projects have been delayed or stalled as builders failed to secure insurance against terrorism. Business purchases of motor vehicles were also weak due to less travel. Surprisingly, business spending on information processing and related equipment rose at a 7.5% annualized rate in Q1, but when expressed in nominal dollars spending was essentially flat on a sequential quarter to quarter basis and off sharply from year ago levels.

The swing in the business inventory component accounted for about half of the rise in Q1 GDP. But that should not be surprising since, in every economic recovery over the post war period, the swing inventory positions have been a powerful and important contributor to economic growth. On average, the swing in inventory positions usually accounts for about half of the first year's gain in Real GDP, so the lift from in inventories in Q1 was in line with the historical performance. Even though the contribution from the inventory component was fairly large in Q1 business inventories were still liquidated, only at a slower rate than what occurred in Q4. That's encouraging because the big lift to production and jobs still lies ahead.

## Bank of America

*Mickey D. Levy, Chief Economist*
*Peter E. Kretzmer, Senior Economist*

The underlying structure of the economy has proved sound, and the combination of assertive countercyclical economic policies and rapid private adjustments has generated a healthy and rather typical rebound that is expected to gather steam in 2002. Real GDP growth is projected to exceed its sustainable trend, raising real interest

*continued on page 3*

### ECONOMIC AND FINANCIAL FORECAST FOR 2002

| | | [--------Treasury yields-----------] | | | | 3 mo |
|---|---|---|---|---|---|---|
| Qtr | RFF | 2-year | 5-year | 10-year | 30-year | Libor |
| 2002QI (actual) | 1.7 | 3.2 | 4.5 | 5.1 | 5.6 | 1.9 |
| 2002QII | 1.75 | 3.6 | 4.8 | 5.3 | 5.8 | 1.9 |
| 2002QIII | 1.9 | 4.0 | 5.0 | 5.5 | 5.9 | 2.1 |
| 2002QIV | 2.9 | 4.5 | 5.3 | 5.8 | 6.1 | 3.0 |
| 2002 (average) | 2.1 | 3.8 | 4.9 | 5.4 | 5.8 | 2.2 |

| | [-----------------------GDP components-------------------] | | | | | |
|---|---|---|---|---|---|---|
| Qtr | GDP | CPI | Jobless | PCE | NFI | DD |
| 2002QI (actual) | 5.8 | 1.4 | 5.6 | 3.5 | -5.7 | 3.7 |
| 2002QII | 3.3 | 3.5 | 5.9 | 3.1 | -0.5 | 2.7 |
| 2002QIII | 4.0 | 2.9 | 5.7 | 3.5 | 3.5 | 3.6 |
| 2002QIV | 4.7 | 3.0 | 5.6 | 3.3 | 6.8 | 3.5 |
| 2002 (average) | 3.0 | 1.8 | 5.7 | 3.5 | -5.5 | 2.8 |
| 2002 (Q4/Q4) | 4.5 | 2.7 | 5.7 | 3.4 | 0.9 | 3.4 |

*Notes: Interest and unemployment rates are averages; GDP, CPI, PCE, NFI, DD are annualized growth rates. Average annual growth and Q4-to-Q4 growth rates will differ significantly amid large quarterly growth swings.*

*Glossary: RFF = federal funds rate; Jobless = unemployment rate; PCE = consumer spending; NFI = nonresidential fixed investment; DD = final sales to domestic purchasers.*

## Bank of America

*continued from page 2*

rates, and nominal GDP growth is projected to accelerate well-above growth in productive capacity, potentially rekindling inflation pressures. The Fed will need to raise short-term interest rates this year. Failure to do so on a timely basis risks exacerbating future swings in interest rates and nominal aggregate demand, generating more erratic economic performance.

Real GDP is projected to grow about 4.0-4.5% from 2001 Q4 to 2002 Q4, a sharp reacceleration from its anemic 0.5% growth in 2001. This reflects only a modest acceleration of consumer spending growth, a typical cyclical rebuilding of inventories and moderate pick up in business investment in 2002 H2, firm residential construction, a sizable increase in government purchases and a modest deterioration in the trade deficit.

Led initially by the boom in zero percent financed auto sales, ex-auto retail sales and consumption of services have accelerated. Consumer spending is expected to continue to grow, which will restore business confidence and spur increases in production, inventories, and investment. The recovery will be sustained by growing demand, and will not be a short inventory adjustment, as skeptics contend.

As real rates rise with the recovering economy, the Fed must raise its funds rate target to drain excess liquidity. Typically, the Federal Reserve's transition from an easing to a tightening posture is currently receiving close market scrutiny, with accompanying gyrations in the yield curve. Failure to tighten and reverse its crisis-related easing eventually would generate excess demand and inflation, a recent concern in the bond markets. Moreover, with policy aggressively accommodative, prompt but steady reversal is preferable to a delayed but subsequently very sharp tightening. The latter would generate undesired wide swings in monetary policy, interest rates and demand that would harm economic performance. This scenario must be avoided.

## JPMorgan Fleming

*Gerard MacDonell, U.S. Fixed Income Ecomomist*

The U.S. economy has entered a solid recovery that shows little risk of stumbling into a renewed downturn or "double-dip." We expect GDP growth to average between 3% and 4% during the remainder of 2002, following the strong 5.8% advance recorded during the first quarter. Accordingly, short-term real interest rates will have to be renormalized, substantially higher, during the coming 12 to 18 months. We expect that long-term real yields will also rise significantly in anticipation of – and ultimately in reaction to – the coming Fed-tightening program.

However, the U.S. inflation backdrop remains very benign, which carries two implications. First, it means that the Fed has a strong incentive to allow the U.S. economy to gather strong momentum before taking back the monetary stimulus. Accordingly, we expect no Fed hikes before the August FOMC meeting, and we cannot rule out a delay until later in the year. Secondly, the odds of a major rise in long-term interest rates, exceeding 100 basis points, appear to be low.

The case for a sustained solid U.S. recovery can be distilled into four basic points:

- Macroeconomic policy is stimulative, with short-term real interest rates far below equilibrium and with government spending accelerating rapidly.
- Profits are recovering strongly in response to continued high productivity growth and sustained cost-cutting efforts within corporate America. By the second half of this year, improved corporate finances should spark a recovery in both hiring and capital spending.
- Consumer spending growth should remain firm throughout the remainder of 2002 and into 2003. The reason is that strong productivity growth is sustaining steady gains in aggregate pre-tax real income growth. Meanwhile, the federal government is cutting taxes.
- A continued reversal of the earlier inventory correction will continue to lift production growth. If inventory investment were merely to return to normal by the fourth quarter of 2002, domestic demand growth would receive a lift of more than a full percentage point during each of the next three quarters (on average).

Our current forecast for the Treasury yield curve is as follows.

### TREASURY YIELD CURVE PROJECTIONS

| | 5/10/02 | 6-months | 12-months |
|---|---|---|---|
| Fed Funds Rate | 1.75 | 2.25 | 4.00 |
| 2-year UST | 3.25 | 4.25 | 5.25 |
| 5-year UST | 4.55 | 5.15 | 5.85 |
| 10-year UST | 5.20 | 5.65 | 6.10 |
| 30-year UST | 5.66 | 6.00 | 6.25 |

## A Simple Choice

*continued from page 1*

receive integrated recordkeeping, investments, education and advisory services. CIGNA's bundled DC assets are almost evenly distributed among small, mid-sized and large plans. Nearly all of our bundled DC clients choose to have a stable value option.

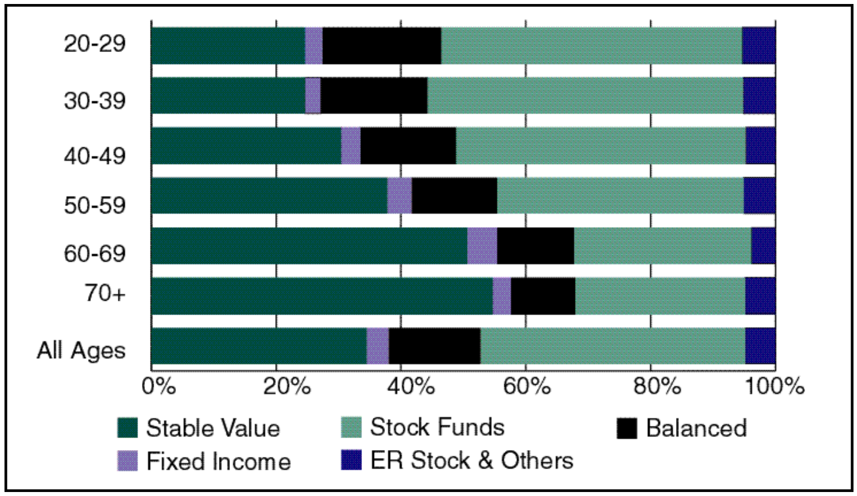
*How do participant allocations vary by age?*

Not only is stable value offered, participants take full advantage of it. Overall, participants allocate 35% of their balances to stable value. Nearly 50% is allocated to stocks, with the rest in balanced and fixed income options.

As illustrated by the graph, participant groups closer to expected retirement dates hold greater stable value allocations than their younger counterparts. Stable value holdings gradually increase and stock allocations gradually decrease among older cohorts. Even the youngest group of participants has a notable allocation to stable value.

The makeup of the stock holdings also supports the idea that, in aggregate, younger participants invest more aggressively than older ones. Participants in their 20s have the highest allocations to small cap, global, and international funds and to company stock. Among the older groups, allocations gradually trend away from these sectors toward higher concentrations in large cap funds.

**PARTICIPANT ASSET ALLOCATION BY AGE GROUP**




*Transfer experience*

Reviewing participants' transfer activity suggests stable value is likely to be a core holding rather than a tactical, short-term position.

Net transfers to and from stable value have been fairly low as a percentage of total stable value assets. With one exception, cash flows for the twelve months ending March 31, 2002 were neutral to slightly positive. Net monthly flows ranged from -0.02% to +0.56% of total assets. The one exception was, of course, September 2001 when net transfers into stable value exceeded 2.5% of total stable value assets.

*Why are plan sponsors using stable value?*

We have found plan sponsors use stable value for three main reasons.

The first is stable value's consistently positive long-term returns. Market volatility, particularly in the stock market, has reinforced the benefit of a plan option that gives participants some level of positive return regardless of market conditions.

Next and probably most important is participant demand. Stable value meets participants' needs for a safe, liquid funding option as part of their overall asset allocation strategy. Many if not most participants expect their plan to offer a "stable" or "guaranteed" fund.

Finally, plan sponsors recognize stable value's favorable risk/return characteristics. Sponsors could choose among stable value, money market funds and market-valued bond funds to provide the conservative choice in their investment lineups. Our clients find value in the blend of return and stability that stable value offers compared to these alternatives.

*How are plan sponsors using stable value?*

In addition to using stable value's as a core investment option, some plan sponsors also employ stable value's unique risk and return characteristics to meet additional plan needs. One approach growing in popularity is customized lifestyle funds. These are plan-specific funds, comprised to varying degrees of the actual options in the plan's own investment lineup. Several of our plans using lifestyle funds include their plan's stable value option as a core component of the fund.

*Importance of Communications*

Good participant communication translates into effective utilization of stable value. We believe our experience with higher allocation to stable value than other industry surveys, like the

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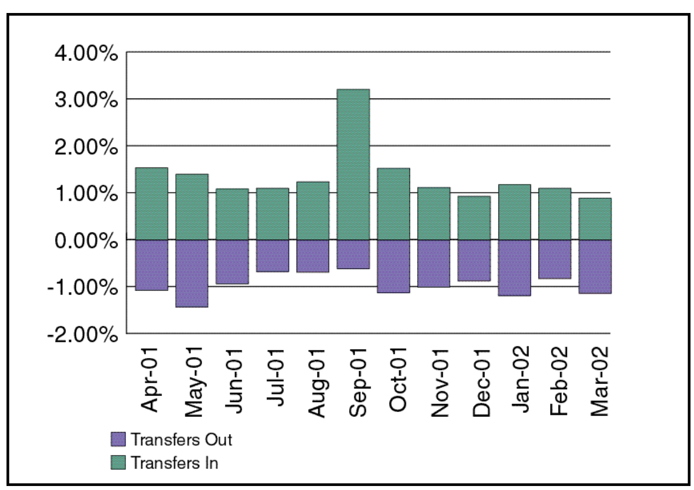
**PARTICIPANT TRANSFERS TO AND FROM STABLE VALUE, AS A % OF CIGNA'S TOTAL STABLE VALUE ASSETS**



# News from Washington, DC

*Nick Caggia, SVIA*

The collapse of the Enron corporation has sent shock waves from Houston to Wall Street to Capitol Hill. Wherever you are, the now infamous implosion of the energy giant has made headlines. American workers, already shell shocked by a turbulent equity market, have new reason to fear for their 401(k) lives. Congress, never missing an opportunity to wear a white hat, has pledged to "Protect Americas Pensions."

Of course there are many different opinions on how to accomplish this. For months, Congress has been investigating, meeting, and debating. Legislation has been introduced in both houses, and has been passed in the House. The Senate is still considering various courses of action, with an uncertain resolution. The Senate and House will likely be far different, with much of the important reconciliation work to be done in conference committee.

In order to capture the flavor of the debate on Capitol Hill, SVIA has asked various experts from different corners of Washington, DC, for their opinion. Those opinions can be found in the center of this issue (pages 6-13). SVIA thanks those who have participated in this venture and encourage members to respond to these pieces with "Letters to the Editor." Comments can be submitted to me via email, nick@stablevalue.org, or at SVIA, 2121 K Street, NW, Suite 800, Washington, DC 20037.

The chart below summarizes the legislation that is being considered in both houses.

| Provision | H.R. 3762 (Passed) | S. 1992 (reported from Health Committee) |
|---|---|---|
| **Investing in Employer Securities** | | Allows plans to permit elective deferrals to be invested in employer securities, or to make employer contributions in employer securities; but, prohibits a plan from doing both. |
| **Vesting** | Allows investors to divest themselves of employer stock held in their plan as a result of employer contributions after holding those contributions for three years. (Rolling three years) | Allows investors to divest themselves of employer stock held in their plan as a result of employer contributions after three years of service. |
| **Investment Options** | Requires employers to offer three other investment options and quarterly opportunities to choose among such options. | Requires a plan offer three investment options in addition to employer securities. |
| **Advice** | Would provide ERISA and Internal Revenue Code exemptions for:<br><br>(1) The provision of investment advice to plan or participants,<br><br>(2) The sale, acquisition, or holding of investments pursuant to this advice, and<br><br>(3) The receipt of fees for the advice or the investments. | Exempts plan sponsors from fiduciary liability for plan investments only if the plan designates an independent investment advisor, who shall be fiduciaries with respect to such investments. |
| **"Blackout" Periods** | Requires plan administrators to provide 30 days notice of a suspension of activity. | Requires plan administrators to provide 30 days notice of a suspension of activity. |

# A Simple Choice

*continued from page 4*

annual EBRI/ICI survey, proves how critical communication is. A key part of our bundled services proposition is targeted education and communications, which guide participants to an asset allocation model based on life stage and investor profile. The point here is not to recognize CIGNA but to demonstrate how effective participant education coincides with robust stable value allocations. Simply put, stable value works when investors make the choice.

*Conclusions*

Based on our experience, we found that regardless of plan size:

- Stable value is a core holding among participants of all ages,
- Usage is higher among older participant groups, and
- Participants of all ages have noteworthy allocations to stable value.

The data also suggests that –

Stable value continues to meet participants' needs. Given a wide range of investment alternatives, participants still voluntarily choose to allocate a notable portion of their balances to the asset class.

Stable value can have a place in all participants' portfolios, regardless of age. The value for participants in or near retirement is evident. Yet even young participants far from their retirement dates can benefit from having some of their retirement savings invested in a plan option with low volatility, stable returns, and guarantees of principal.

There is room in the stable value marketplace for multiple approaches to meet plans' and participants' needs. We found plan sponsors want a variety of product solutions to deliver stable value to their participants. Regardless of plan size or employer type, a one-size-fits-all approach does not work.

# Guidelines for Pension Reform: Build on Success of the Voluntary System

*Rep. Bill Thomas (R-CA), Chairman, House Ways and Means Committee*

Retirement income is often compared to a three-legged stool supported by Social Security, personal savings, and employer-provided pensions. However, for millions of seniors, the retirement stool is standing on one or more sawed off legs. According to the Employee Benefit Research Institute, the average middle-income senior receives 81% of his or her retirement income from Social Security. Only seven percent is derived from pensions and eight percent from personal savings.

Social Security is (and will always be) an important source of retirement income. However, strengthening the other two legs can make the difference between a barely adequate retirement and a secure retirement. Consequently, pension policy should focus on increasing pension coverage and encouraging workers to save more.

Last year, one of the most comprehensive pension reform bills was signed into law. Because of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), workers have more opportunities to save, portability has been improved, and regulatory obstacles have been reduced. These reforms will have an important effect on pension coverage and savings. We now need to build on the success of last year's law, keeping several principles in mind as we move forward.

## Do No Harm

First and foremost, is to do no harm. In an attempt to legislate in the name of "protecting" workers and "strengthening" pensions, a well-intentioned Congress can often create more problems than solutions. A recent survey shows that 41% of Americans believe that Congress starts out with good intentions, but ends up making things worse. The precipitous decline in the number of defined benefit plans is a prime example. Over the years, onerous regulations have made these plans difficult and expensive to administer, causing employers to abandon them in favor of less burdensome options. Pension policy should reflect the reality of a voluntary pension system. Employers will weigh the costs and benefits of sponsoring a pension plan. Any policies that tip the scales in the wrong direction will reduce opportunities for retirement saving. Accordingly, future policies should reduce regulatory burdens to the greatest extent possible, without sacrificing worker protections. In particular, several of the provisions that were dropped from EGTRRA because of procedural rules in the Senate would reduce regulatory burdens for small businesses and encourage them to adopt new pension plans. These provisions were included in the Pension Security Act of 2002 and should be enacted into law.

## Let Markets Work

Second, any future changes to pension laws should minimize market interference. Every investor has a right to assess his or her investment goals and assume a level of risk that is appropriate and consistent with those goals. Attempts to insulate investors from market risk would be a mistake. For example, proposals to "insure" individual investment decisions would significantly drive up costs for plan participants, create severe moral hazard problems, and limit the possibility for upside gains. There are fundamental differences between the concept of insuring defined benefit plans and defined contribution plans. Defined benefit plans are insured primarily against the risk of the plan sponsor's bankruptcy – not poor investment decisions. Moreover, plan sponsors must comply with strict funding requirements, and poor investment performance often triggers additional contributions. This model could not be applied to defined contribution plans without imposing significant restrictions and costs on plan participants.

## Provide Investment Knowledge

Third, an informed and educated investor is better able to make sound investment decisions in the best interest of his or her financial security. Research has found that many workers underestimate the amount they need to save each year to support a certain standard of living during retirement. Similarly, many workers are not informed about basic investment principles. The Pension Security Act of 2002 would ensure that employees have access to investment education. It would also allow service providers to offer investment advice to plan participants as long as all fees and potential conflicts of interest are disclosed. Employees who prefer to receive retirement planning services from a non-affiliated adviser would be allowed to pay for these services using pre-tax dollars.

## Encourage Saving

Finally, tax provisions that discourage saving should be reformed. EGTRRA provided a good start by raising the contribution limits on individual retirement accounts (IRAs) and qualified pension plans, but more needs to be done. For example, the income limits on deductible IRA contributions create a significant impediment to saving among middle-income workers. The scheduled increase in the income limits should be accelerated, and the marriage penalty should be eliminated. Ultimately, all saving should be taxed in the same manner as 401(k) plans and deductible IRAs. This tax treatment would boost saving and encourage long-term economic growth.

Increasing pension coverage and encouraging workers to save more will even up the three-legged stool of financial security. These adjustments will create true retirement security once Social Security is reformed and a fourth leg of stability is added through Medicare modernization.

# Close the Investment Advice Gap for U.S. Workers

*Rep. John Boehner (R-OH), Chairman, House Education & the Workforce Committee*

Enron workers may be the victims of criminal wrongdoing. But we already know they're the victims of outdated federal pension laws.

In February, as legislators and investigators sifted through the rubble of what was once the Enron Corporation, President Bush called on Congress to pass legislation to renew the rattled confidence of American workers in the nation's pension system. A key component of such reform, the President said, should be modernizing outdated pension laws to create greater parity between rank-and-file workers and senior company managers in terms of the options available to them for protecting their retirement savings.

"If it's okay for the sailor," the President noted, "it ought to be okay for the captain."

The President was right on target. That's why he's made clear that any meaningful pension reform legislation passed by Congress must include measures to close the investment advice gap between rank-and-file workers and their counterparts in upper management.

What exactly is the "advice gap?" Most wealthy individuals and senior executives can easily hire their own professional investment adviser to warn them when they've got too many eggs in one basket, but few working families can afford such a luxury. Many employers would like to give their workers access to investment advice as an employee benefit. But outdated federal law, enacted more than a quarter century ago before the 401(k) had even been invented, unintentionally allows employers to be sued for doing so, effectively barring most U.S. companies from arming their workers with such tools.

The result of this flaw is that millions of rank-and-file workers today simply have to fend for themselves, with little or no access to quality investment advice that can help them manage their 401(k) plans.

This fundamental inequality escaped popular scrutiny for years but was suddenly catapulted into view by the Enron collapse. Enron's employees had numerous opportunities to sell their company stock and move their retirement savings into safer investments, but they had no access to professional investment advice through their job. How many Enron workers might have been able to preserve their savings if someone had simply been there to warn them that they needed to diversify?

Outdated federal laws have created "haves" and "have-nots" in the workplace when it comes to investment advice. At Enron, the haves were able to preserve their retirement nest eggs. The have-nots, by contrast, lost it all.

The advice gap represents the single most urgent issue for Congress to address as it moves to renew worker confidence in the pension system in the wake of Enron's fall.

Long before the Enron collapse, the House Committee on Education and the Workforce began a bipartisan process aimed at modernizing the 1974 Employee Retirement Income Security Act (ERISA), the principal federal law governing employee pension plans. The world today is much different than it was when ERISA was enacted. Before the birth of the 401(k), few could have predicted workers would one day have such direct control over their retirement savings. Thus, few could have foreseen the importance of structuring the law to ensure that employers could provide workers with access to investment advice.

Last November, the House took the first step toward closing the advice gap by passing the Retirement Security Advice Act with significant bipartisan support, and we passed it again this month as part of the Pension Security Act, based on President Bush's 401(k) reform proposal.

The bill would update ERISA to encourage employers to provide workers with access to advice but would also include new safeguards to protect workers. The bill includes important disclosure requirements and new fiduciary protections to ensure that workers receive advice that is solely in their best interest. Under the bill, an employer that hires an advisory firm cannot have a financial interest in the adviser, and the advice given cannot benefit the employer.

These are significant protections. President Bush has endorsed the measure and made it a central component of his pension reform package. The Departments of Labor, Treasury, and Commerce, along with a broad array of employers and employees, have endorsed the bill.

Despite this substantial support, the Senate has refused to act on the measure – and is instead considering an alternative proposal that offers false hope to workers and would actually discourage employers from providing investment advice benefits to their employees. The proposal, offered by Sens. Jeff Bingaman (D-NM) and Edward Kennedy (D-MA), would prohibit employers from hiring investment professionals who are best positioned to provide high quality advisory services. It would significantly increase the cost and administrative burden required of employers to provide advice benefits.

As a former small businessman and employer, I know few employers would provide investment advice for workers under the Bingaman-Kennedy approach. Instead of opening the doors to security and advice for millions of workers, it would leave millions in the same situation they're in now – with no advice at all. It would tear the heart out of meaningful pension reform.

President Bush has called on the Senate to follow the House in passing the Retirement Security Advice Act. Closing the advice gap is a vital step Congress must take to renew confidence in the pension system and help working families prepare for a safe, secure retirement. Let's make sure that we take that step in the weeks ahead – not a step backwards.

# Targeting Reforms to the Lessons on Enron

*Senator Judd Gregg (R-NH), Ranking Member of the Senate Health, Education, Labor, and Pensions Committee*

"Mandatory diversification," "caps," and "joint-trusteeship" are among the terms and solutions being offered as Congressional responses to the collapse of Enron and the tragic loss of its employees' retirement savings. Regrettably, the lessons of Enron and the solutions being proposed in the United States Senate have little relation to each other. In this article, I would like to address the guiding principles that we in Congress must follow in the aftermath of the Enron collapse, the things we must not do, and discuss what we should accomplish to protect pension plan participants from a future Enron-like collapse.

## Lessons Learned

I feel very strongly that what happened at Enron was a travesty, but nothing in the Enron debacle demonstrates a need to abandon longstanding pension policy. Indeed, for every Enron, there is a Microsoft, Wal-Mart, or Proctor & Gamble where clerks and rank-and-file workers retire with a million dollars or more in their retirement accounts. The purpose of our efforts, now as in the past, should be to preserve workers' choice and opportunity to create wealth. Further, we want to address the democratization of corporate ownership so that companies are incentivized to bring their employees into the corporate culture as owners.

We must also be sensitive to the fact that small companies and startup businesses have different needs, different responsibilities than large companies, and we should not end up chilling the willingness of small businesses to offer pension plans.

## The Wrong Direction

In addressing the lessons of Enron, we should not revert to the "Washington knows best" mentality. Nor should we use the issue as an excuse to dramatically expand into other areas that are old-time agendas of various interest groups.

What must not occur as a result of any legislation coming out of Congress is a chill or limit on the willingness of companies to give their rank-and-file employees significant access to an ownership interest. It is a simple fact that businesses are more willing to create and contribute to pension plans when company stock is an option. The greater the restrictions on company matches in stock, the less employees will contribute on their own, and the less they will participate in any fund option, stable value or otherwise.

It is well documented that increasingly onerous regulation of defined benefit plans during the 1980s had devastating effects on the willingness of employers to maintain those plans. Mandatory diversification and other prohibitions on employee and employer choice are the types of burdens that take defined contributions plans down the same path. They will frustrate the fundamental goal of securing employee wealth, and must be opposed.

## Bottom Line Reforms

Any bill we enact must give individuals more opportunity to invest, and more information and flexibility to manage their portfolios. There are ways to address these issues by making sure employees have the ability to dispose of company stock effectively, and have the information they need in order to make intelligent decisions on how long to hold company stock or any asset in their portfolios. President Bush has put forward several credible reforms and I am confident that the details on diversification will be worked out.

The single most effective reform we could enact is one that puts individual plan participants in touch with qualified investment advisors. A bill that becomes law will only be successful if it makes investment advice 1) available, 2) accessible, and 3) affordable. Most of the components for a workable compromise have already been introduced into the debate, but it will take political will and business support to get the job done.

The House has already passed an investment advice bill that eases the current prohibited transactions rules for plan sponsors and administrators and sets out very clear rules to protect workers from fiduciary breaches. Plan sponsors are certainly more likely to make investment advice more available under the House approach. However, that bill has the disadvantage of permitting what appear to be conflicts of interest by advisors who could profit from the investment decisions of their clients. In the wake of the Enron and Arthur Andersen scandals, "conflicted advice" can be a damaging political accusation.

An alternative approach offered by Senators Bingaman and Collins encourages access to independent investment advisors by creating protections for employers to avoid liability. Their bill has been criticized as being unworkable because few investment advisors currently exist who would satisfy the definition of "independent," and the added costs would be prohibitive to employers and employees alike. As a result, the approach probably would not make significantly more advisors available to participants.

The key elements of these two bills are not mutually exclusive. Only the degree of advisor independence is in debate.

A partial solution to differing opinions, and improved accessibility

*continued on page 9*

## Targeting Reforms

*continued from page 8*

to advice, may be found in Internet-based advice vehicles and a recent reinterpretation of the prohibited transactions rules by the Department of Labor. In only a few years, the share of plan participants using on-line advice vehicles has risen from almost zero to eight percent. The SunAmerica opinion letter issued by the Labor Department last December recognizes acceptable circumstances where such computer models can be programmed to provide objective advice, even when the company providing the advice vehicle offers funds that may be selected by the computer. Congress should adopt further incentives to expand upon these developments.

Finally, the issue of affordability must also be addressed or none of these reforms will have any meaningful effect. Experience shows that individual plan participants forgo advice if it would cost them as little as $50 per year. The House of Representatives is considering a reasonable bi-partisan approach that would allow plan participants to use pre-tax salary deductions to purchase investment advice. Other incentives should be developed as well.

To conclude, it is fair to say that most of us in Congress want a bill that expands employee access to retirement savings and that doesn't impose needless costs and risks. It must be one that is based on the lessons learned from Enron, not a wish list of failed ideas. I will be working to ensure that it protects employee choice and opportunity, and I call on everyone committed to a stable pension system to join in the effort.

# Congressional Overreaction to the Enron Bankruptcy

*By: Robert C. Shepler, Manager of Government Relations for Financial Executives International*

Over the course of the last several months, I have watched Congress overreact to the bankruptcy of the Enron Corporation by proposing radical changes to our nation's pension laws. These changes aim to protect employees from losing retirement assets by placing restrictions on retirement accounts and employers who sponsor such accounts. Incredibly, these new restrictions come on the heels of significant changes to the retirement system in summer of 2001 that sought to ease restrictions and broaden access to retirement plans. I, for one, do not believe these new changes will do anything to prevent future "Enrons" and will likely have the effect of lowering the overall retirement wealth for millions of Americans.

One of the problems with the collapse of the Enron Corporation is that it created many victims, victims whose portfolios declined due to the rapid decrease in the price of Enron stock during the autumn of 2001. These victims were not only Enron employees but also every investor who owned Enron stock outright, or as part of a family of mutual funds. All of the victims lacked the necessary information to make informed choices about whether Enron was a good buy.

Historically, Enron's stock price and profit reports made the stock seem appealing, but as we have since learned, those figures were conjured by persons wishing to game the system. What is even more shocking is that the rating agencies, who are privy to insider information, did not downgrade Enron stock until just days before Enron's earnings restatement.

Fortunately, the bill that passed the House on April 11, (H.R. 3762) did not include many of the more radical changes some Members of Congress had initially proposed. These included: caps on the percentage of company stock that a plan participant could hold in their retirement account; changes to fiduciary rules and responsibilities; and restrictions on the ability of a company to impose a transaction suspension period, more commonly known as a "blackout." Instead, the House passed bill, which to a great extent mirrors the president's proposal, would require:

- Quarterly pension benefit statements to all plan participants that participate in defined contribution plans. This notice could be disseminated in an electronic form.
- Thirty day advance notice to plan participants of a plan "blackout." Notice could be provided electronically.
- New diversification requirements for all participants in defined contribution plans. Participants must be allowed to diversify out of any employer provided match in company stock after three years of holding the match. Current law does not place any diversification standard on employer matches in company stock to a 401(k) plan. This provision does not apply to Employee Stock Ownership Plans (ESOPs) that are held by private companies, or to "pure" or leveraged ESOPs.
- Greater access to professional investment advice. Prohibited transaction rules would be relaxed to allow employers to make professional investment advice more readily available to their employees. Employees would be able to purchase such advice using pre-tax dollars.
- Restrictions on the ability of company executives to sell stock options during retirement plan "blackout" periods. Executives would be prohibited from selling employer securities if more than 50% of the participants in the retirement plan are restricted from trading due to a "blackout."

*continued on page 10*

## Congressional Over reaction

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Many in the business community applaud the House for moderating the bill but question whether even this response was necessary. After all, it was a lack of information and fraudulent financial statements that caused plan participants to lose assets they were saving for retirement, and not the failure of the pension system. These new requirements could have the unintended effect of reducing the amount of retirement income that people have the ability to accumulate and could lead to the decline in popularity of the 401(k) plan.

Employers that currently match employee contributions in company stock may be less inclined to do so if employees will be allowed to diversify within three years of holding the stock. Many employers contribute company stock to the retirement plans of their employees to create a sense of employee ownership, to create employee loyalty, and to tie performance of the employee to the bottom line of the company. If employees are able to diversify more quickly, the culture of employee ownership will be eroded and the incentive for the company to contribute in stock will be diminished. While well meaning, Congress' actions will lead to smaller matches by companies to retirement plans and less earning potential for employee retirement accounts.

Another troubling aspect of the House bill deals with restrictions on the ability of company executives to sell employer securities during plan "blackouts." This provision gained much attention after the president popularized the saying, "What's good for the captain is good for the crew," meaning that the executives should be required to follow the same rules as rank and file employees. However, if an executive does participate in the retirement plan that is under a "blackout" then they too would be restricted from trading within their account.

Unfortunately, Congress has written the laws surrounding retirement plans so that many executives are unable to contribute to qualified retirement plans due to income limits. These limits have given rise to alternative retirement plans and the granting of stock options to upper level management which have perpetuated the myth that executives do not act in the best interest of their employees.

The idea behind this provision is to keep management from behaving in an inappropriate manner when deciding to impose a "blackout." However, I would argue that the current fiduciary standard provides adequate protection for plan participants by requiring that all plan decisions be made in the best interests of the plan participants. Therefore, if a "blackout" is imposed to keep the stock price from falling due to a massive sell off by employees – as is alleged to have happened at Enron – I would argue that fiduciary duties have already been breached and current remedies should be available to all affected plan participants.

In closing, Congress' reaction to the Enron debacle is understandable, but their response is neither rational nor necessary. Congress should focus on legislation dealing with financial reporting and more transparency in financial statements and not on the pension system that has continued to provide retirement income to millions of Americans.

## Employee Ownership: A Successful Defined Contribution Solution

*David Wray, President of the Profit Sharing/401(k) Council of America*

Before Enron, the success of the defined contribution system and its employee ownership programs were so routine and universally accepted that it barely registered with the public. Most debate focused on how to increase participation in these programs so that more American workers could create a financially secure retirement. Now the point of contact has shifted. Instead of discussing how we can improve plans to help more employees, we are discussing the risk that employees face by participating at all.

While the defined contribution system may be under attack, its record still stands. Today there are more than 700,000 companies offering these plans, with approximately 60 million eligible participants who have accumulated $2.3 trillion in retirement assets and who have rolled over at least $1 trillion more into IRA accounts. And, employer stock is an integral part of many these programs.

The majority of America's largest and most successful corporations use employer stock in defined contribution plans to provide substantial retirement wealth for millions of American workers. Companies with employee ownership -- like Procter & Gamble, Microsoft and Texas Instruments -- are among the best places in America to work.

According to the Department of Labor's most recent information (1998):

- Three hundred thirty billion dollars of the total defined contribution assets are invested in employer stock.
- The average dollar value of employer stock per participant ranges from $10,140 to $27,244.
- There are between 17 and 20 million U.S. employees participating in ESOPs or other defined contribution plans holding employer stock.

*continued on page 11*

## Employee Ownership

*continued from page 10*

- Seventy to seventy-five percent of participants in plans that are invested in employer stock are in companies that also maintain diversified plans, indicating that such plans tend to complement rather than substitute for diversified plans.

This is truly a success. However, in the face of current discord it is important to restate the reasons for this success:

- The regulatory framework ensures sound decision-making. A plan administrator who fails to follow the fiduciary responsibility rules is personally liable to the plan for all losses suffered as a result. This rule alone is enough to prevent the majority of problems.
- The largest account balances are owned by management. When the president of a corporation has money in a plan, special attention is focused on its success and security.
- Plans benefit the bottom line. Companies reap a huge reward when they offer a defined contribution plan -- employees who are more attached to the status of the company, more motivated to do well and more likely to stay. Companies also use these plans to attract high-quality employees, building a stronger workforce from the get-go. And to get the most out of the plan it must be attractive to employees and well managed.

Even knowing these facts, detractors of employer stock and the defined contribution system continue to cite the Enron case as a cause to restrict such plans.

### The Enron Facts

Like all Americans, I am troubled by the Enron bankruptcy and the plight of Enron employees who were heavily invested in Enron stock. However, policymakers should base their decisions on the facts -- not the emotion -- surrounding the case.

The truth is that Enron employees were let down by their leadership, who managed the enterprise at least recklessly, if not unethically. In addition, most of those who lost significant portions of their retirement account balances were not Enron employees at all, but employees of other companies. And in fact, the $1.4 billion lost was comprised of over $1 billion from the inflated increase in the stock's value over three years. The employees' original investment was $371 million. Had the company made its true financial situation available, the stock value would have appreciated at a normal rate.

Also, contrary to popular belief, Enron employees could sell their stock at any time. There are two exceptions:

- Employees under the age of 50 could not sell their company contributions in company stock, which equaled six percent of the total stock held by the plan.
- Employees could not sell their stock during the change of recordkeeper blackout period from October 29 to November 12. However, the price of the stock had lost most of its value before that time – from its high of $90.56. During the blackout period the Enron share price went from $13.81 to $9.98, a drop of $3.83.

### Plan Sponsorship is Voluntary

Employers will continue to provide meaningful retirement-benefit programs only so long as they have the flexibility to design and fund plans that take into account their unique business needs and the needs of a changing workforce. One has only to look at the decline of the traditional defined benefit pension system -- there are only 35,000 such plans left -- to see the results of government over-regulation on a voluntary employer-provided benefit program. And without defined contribution plans, most employees would not save for retirement at all. Only in these partnership arrangements can employees receive the assistance they need to begin saving within a framework they can understand.

### Conclusion

While Enron events have shaken the confidence of policy makers, participants and the media, Enron cannot be allowed to provide a toehold for those who seek to weaken the defined contribution system. Enron is not typical of companies working to build a partnership in the workplace and should not be held up as an example. Nor should one single failure be used to reverse nearly 100 years of successful practice.

## Pension Reform Legislation Threatens Retirement Security

*The ERISA Industry Committee*

On April 11, the U.S. House of Representatives responded to the problems highlighted by the collapse of Enron Corp. by targeting the nation's private pension system. The 255-163 vote on the Pension Security Act (H.R.3762) culminated a months-long lobbying campaign initiated by The ERISA Industry Committee (ERIC) that was successful in taming some of the more rowdy proposals that first emerged in the House.

However, even though ERIC was able to win several important policy battles along the way to final passage, the core provisions of the bill still threaten to reduce the retirement savings of American workers. What's more, a Senate committee bill contains a plethora of onerous provisions that would only compound the problem.

To be sure, many Enron employees watched the value of their

*continued on page 12*

## Pension Reform Legislation

*continued from page 11*

401(k) accounts – heavily invested in company stock – evaporate as the corporation unraveled. But the misfortunes of those employees occurred for a multitude of complex reasons entirely distinct from retirement security policy, ranging from opaque financial transactions that obfuscated the company's value, to a risk-seeking corporate culture that apparently encouraged employees to over-invest in company stock. In fact, research shows that in most instances average returns in plans with investments in employer stock significantly outstrip average returns in plans that do not contain stock.

Imposing cumbersome rules on 401(k) plans will do nothing to prevent corporate malfeasance from occurring in the future, but will instead reduce retirement savings.

Legislation (S.1992) cleared by the Senate Health Education, Labor, and Pensions Committee on March 21 would drive many employers away from plan sponsorship. The bill mandates that all defined contribution plans hold elections to choose employee representatives for joint employer-employee boards of trustees, authorizes duplicative and uncapped damages against 401(k) plan fiduciaries, and guarantees attorneys' fees by requiring all plan fiduciaries to purchase liability insurance. It is hard to imagine provisions that would work more effectively to drive employers away from the voluntary pension system

Sen. Kennedy's bill also imposes a de facto cap on the ability of employees to invest in their own company. Under the bill, an employer could either make matching contributions in employer stock, or allow employees to invest their own money in employer stock – but not both. While not a cap on the percentage on allowable investment in employer stock, the affect of Sen. Kennedy's proposal is the same. The bill then creates the mirage of a "safe harbor" exception to the de facto cap for employers able to provide an exceptionally generous defined benefit plan.

The House comprehensive modification of the rules governing private pension and saving plans, while clearly less intrusive than the Senate committee bill, still requires:

- New diversification rights for defined contribution plans holding employer stock. If enacted, the bill will permit employees to sell employer stock acquired by matching contributions after either three years of service, or after a rolling three-year holding period. ERIC played a major role in improving these new rules by conceiving of a three-year rolling period and pressing for its inclusion in the final package.
- Employer stock acquired with employee contributions or elective deferrals would be immediately diversifiable. The new diversification rules would be phased in over five years and would apply only to publicly traded employer stock not held in employee stock option plans that are not part of a 401(k) plan ("freestanding ESOPs").
- Quarterly benefit statements. Every employee in an individual account plan would have to receive a quarterly statement listing the value of investments allocated to the individual account, an explanation of any restriction in the "right" to direct an investment, and an explanation of the importance of portfolio diversification. Freestanding ESOPs would be excluded from this requirement.

In addition, employees in participant-directed individual account and cash balance plans to which the quarterly notices requirements discussed above do not apply must receive an "investment education notice" at the time of enrollment and annually thereafter explaining generally accepted investment principles, such as diversification and risk management.

- Notice of and limitations on "blackout periods." The House-passed bill would require plan fiduciaries to make a written determination that any blackout period is done in accordance with ERISA's stringent fiduciary rules. In addition, liability protection under ERISA § 404(c) would not apply during a blackout unless the fiduciary meets an nonexhaustive list of requirements including consideration of the reasonableness of the blackout, compliance with the 30-day advance notice requirement, and fidelity to ERISA's standard of care.
- Prohibitions on insider selling during 'blackouts'. Directors, officers, and other corporate insiders could not buy or sell any employer stock during a time when more than 50% of the company's employees are restricted from selling stock in their 401(k) plans.

In addition, H.R.3762 creates two new avenues for employees to obtain investment advice. The first provides a prohibited transaction exemption under ERISA for qualified investment advice service providers. The second will allow employers to use pre-tax payroll deductions to purchase investment advice.

The nation has already seen the effects of over-regulation in the shrinking of the defined benefits pension system. With the action now poised to shift to the Senate Finance Committee and the Senate Floor, ERIC will continue to be a moderating force in a legislative debate that has too often slipped toward hasty overreaction.

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and effectiveness, and the role of those benefits in the American economy.

# Expanded Liability Not the Answer: New Mandates Would Threaten the Future of 401(k) Plans

*James Delaplane, American Benefits Council*

In response to the 401(k) losses suffered by Enron employees, a deluge of legislation has been introduced to "fix the problem" of company stock concentration in 401(k) plans. By putting forth overbroad responses, however, legislators are threatening to disturb the conditions that make defined contribution plans so successful.

Congressional Democrats advocate a broad restructuring of our defined contribution plan system as the way to address Enron. Perhaps most problematic are the specific proposals to substantially expand employer liability in pension suits. These changes could devastate the voluntary employer-sponsored retirement system.

In the Employee Retirement Income Security Act of 1974 (ERISA), Congress specifically designed remedies to compensate retirement plans and participants for plan losses suffered by reason of a fiduciary's failure to act prudently and exclusively in the interest of participants. ERISA's structure has always ensured that participants are authorized to recover plan losses and obtain equitable relief. ERISA also authorizes various federal agencies to bring civil and criminal actions against plan fiduciaries who mismanage plan assets.

Many of the recent legislative proposals would radically rewrite ERISA's remedies regime, exposing employers and service providers to ill-defined and uncapped claims for new forms of damages. Under some of the measures, persons could be sued even if they had no discretion or control over the plan or its investments, and damages would extend to losses not incurred by the plan. Several of the Democratic bills extend their remedy changes to all ERISA suits, including those involving retirement, health, and disability plans. Additionally, several of these bills would also make employers liable for plan losses during transition suspension (so-called "blackout") periods.

These bills expose employers to new, expansive damages. The Democratic legislation would allow participants to directly recover "any losses" resulting from a breach of fiduciary duty. This "any losses" approach would allow participants to seek compensatory and consequential damages even if there are no losses to the plan. Employers would likely be crippled by lawsuits seeking punitive or pain-and-suffering damages for every purported fiduciary violation.

Plaintiffs' lawyers will respond to such a change by asserting far-reaching fiduciary claims based on such things as an employer's failure to disclose information, financial conflicts of interest, and even denials of benefits claims. Many claims will be brought as class actions on behalf of all plan participants and the damages that could be awarded under many of the bills would not be subject to any limitations.

These bills create vast new classes of defendants. Democrats also seek to permit suits against non-fiduciaries who participate in or conceal a fiduciary breach. This provision significantly and unjustifiably extends ERISA liability. ERISA broadly defines a fiduciary to include any person who has any discretion or control over a plan's administration or its assets. Thus, any bill that seeks to permit suits against non-fiduciaries creates liability for persons who have no control over the plan. This provision will encourage many costly suits against "deep pocket" service providers such as plan administrators, financial service and actuarial firms based on speculation that they were aware of fiduciary wrongdoing.

Many bills would make employers responsible for the prudence of participants' investments during plan suspensions. Transaction suspension periods are a normal and necessary consequence of changing 401(k) plan administrators or merging acquired employees into an existing retirement plan. Under current law, employers are bound by their fiduciary duty to act prudently and solely in the interest of participants both when initiating and during such periods. Yet, the employer is generally not responsible for the prudence of employees' investment choices. This protection is absolutely critical to the growth of 401(k) plans.

Many of the legislative proposals would impose liability on employers for the investment performance of employee accounts during these suspensions, even when employers act prudently. This would place employers in the perilous position of "second-guessing" employees' investment choices. If employers left employees' investment allocations undisturbed, they could potentially be liable for losses occurring during the suspension. If they overrode "risky" employee allocations, they could potentially be sued for gains employees failed to achieve. Imposition of such a vast new responsibility will certainly deter employers from initiating retirement plans and will drive existing plan sponsors from the system.

While there is no denying the tragic results faced by Enron's 401(k) participants, Congress must resist overbroad responses. The American Benefits Council urges a more prudent retirement policy response – one focused on providing 401(k) participants with the information, education, and professional financial advice they need to wisely exercise their investment responsibilities. Expanded liability will only serve to reduce the number of working Americans with access to a workplace retirement plan.

# What Price a STIF?

*Judy Markland, Landmark Strategies*

During the1990's, the practice of using a STIF or cash component of a stable value fund became almost universal. Because the STIF and cash flows on contract maturities pick up the first layer of contract withdrawals, their presence produced lower risk charges and therefore a higher interest rate on the stable value contracts. For most of the 1990's this also meant a higher stable value portfolio rate.

In the 21st century, however, things are different. Yield curves are steeper, increasing the cost of substituting a STIF for longer-duration contracts. Stable value fund cash flow volatility is higher and more likely to be the result of changes in stock prices than interest rates, lowering risk charges. Today, the cost of the STIF may well be greater than its benefit. Perhaps it's time to reevaluate the use of fully-guaranteed contracts instead of STIFs.

## Where We've Been

Looking back, it's easy to see why STIFs became so prevalent. In the early 1990's, blended rates on SV portfolios were well above the yields available on new stable value investments, as chart 1 illustrates. Using a STIF to pay benefits and transfers prolonged the life of the higher-rate contracts already in the fund. Also, as SV funds grew, the number of contracts in most funds ballooned. It became both a logistical and administrative hassle to tap so many contracts for small routine fund outflows.

In the second half of the 1990's, the gap between portfolio and new investment yields narrowed appreciably. However, yield curves flattened at the same time, so the cost to the portfolio of investing in short-term assets was relatively small.

Many stable value issuers now require that a fund contain a STIF as a condition of underwriting the withdrawal risk. Most, if not all, issuers consider a stable value fund without a STIF or comparable reliable cash flow buffer to be high risk. Contract risk charges have often been estimated on the basis of this level of protection, and funds without a STIF may find it difficult to find a diversified portfolio of providers.

## Where We Ar e

A STIF makes sense for the SV fund only if the aggregate risk charge reductions on the stable value contracts in the portfolio exceed the average yield sacrifice for holding the short-term assets. The cost of cash relative to the medium-term assets in the SV portfolio going forward is now higher than in the 1990's, while the risk of losses on the first layer of stable value fund withdrawals has shrunk over time.

*Higher relative costs of the STIF* The yield curve during the last half of the 1990's was exceptionally flat in historical terms, as can be seen in Chart 2. Many think that the short-to-medium term segment of the curve is quite steep currently; in fact, it's not that far above the 22-year average. With rising interest rates expected, there is little likelihood that we'll see the same degree of flatness in yield curves going forward that we experienced in the late 1990's. Spreads of 150 basis points or more between 3-month and 5-year Treasuries imply a significant yield sacrifice on the STIF relative to medium-term contracts.

*Lower charges for bearing withdrawal risk.* When buffers were first introduced, DC plans and stable value cash flow risks were both very different. As recently as 1993, the size of the average stable value fund was about 70% of all the plan's equity funds combined. The phenomenal returns on stocks during the second half of the 1990's changed that picture dramatically, however. Even after two years of negative stock returns, the average plan's equity holdings as of 9/30/2001 were four times the size of the average stable value fund.

Stable value's large allocation percentage was a major stabilizing influence on cash flows. Inflows to stable value funds in 1993 were large and a negative cash flow history was rare. Had all 1993 participants opted to increase their total stock allocations by five percent with funds from the stable value option, about seven percent of SV assets would have been withdrawn. The same decision today would move 20% of the assets out of the fund. Day-to-day SV cash flow volatility is higher today simply because the stable value fund is so much smaller relative to the rest of the plan.

Note that this higher level of cash flow volatility hasn't necessarily increased the risk of loss to those bearing withdrawal risks. When SV cash flows were routinely large and positive, the only factor

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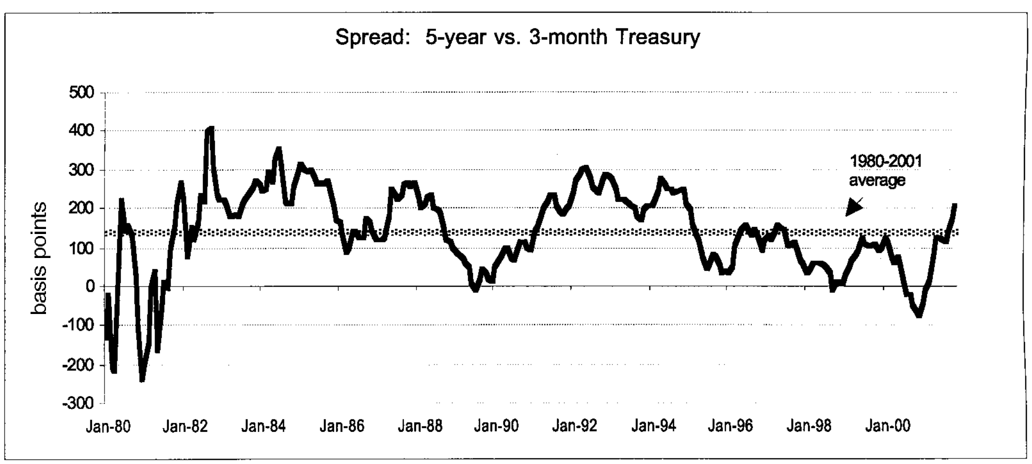

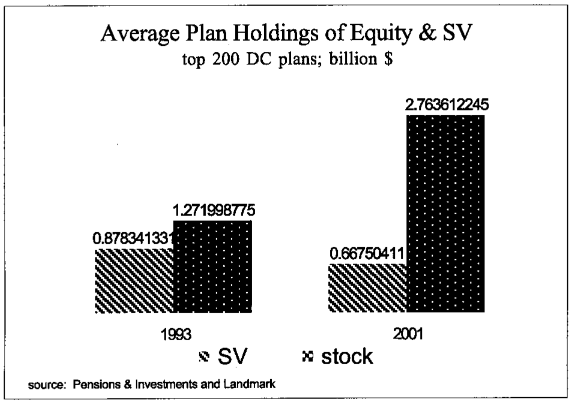


## What Price a STIF

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other than a plan event deemed strong enough to produce negative cash flows was interest rate arbitrage. Risk charges consequently assumed that paying withdrawals would result in losses on stable value contracts, most of which were then non-participating.

Today's higher level of volatility is influenced primarily by stock price changes. Sustained stock price declines on balance produce inflows to SV funds, and sustained stock price increases produce outflows. Since there is no solid evidence that stock prices have any positive correlation with rising interest rates, the induced cash flow volatility is as likely to produce gains as losses on stable value withdrawals – except of course, in the low-probability extreme interest rate rise scenario. Experience on the first or "buffer" layer of withdrawals will be cyclical, but there is little reason to expect aggregate losses in this portfolio tier over time. It is in the deeper layers of the SV portfolio - those that are only likely to be tapped when market rates are well above the SV portfolio rate - where those bearing the withdrawal risk can expect losses on balance.

Moreover, withdrawal risk derived from company stock can be diversified across an issuer's entire portfolio of contracts – unlike the systematic withdrawal risk from a major interest-rate run-up. The volatility of an individual stock is twice as high as that of the market as a whole. In fact, market movements account for less than 20% of the volatility of an individual stock price. SV cash flow volatility due to plan-specific factors like rumored lay-offs or participant demographics are also diversifiable by the SV issuer. This means that the aggregate level of withdrawals is smaller for the issuer than for the plans, so the issuer has a lower liquidity cost.

### Where we're going???

Stable value has gradually evolved from an asset class where financial institutions assumed the market value risks on contributions and withdrawals to one where the fund itself is assuming a great deal of interest rate risk through STIFs and participating contracts. However, the economics of the situation appear to be changing. There is renewed potential for financial institutions to diversify withdrawal risks assumed on a non-par basis, thus providing a significant benefit to client funds. There is also a greater relative cost to the fund of maintaining its own liquidity base. We encourage the industry to answer the following questions:

What is the likely volume and relative probability of equity-induced stable value withdrawal volatility relative to interest-rate-induced volatility?

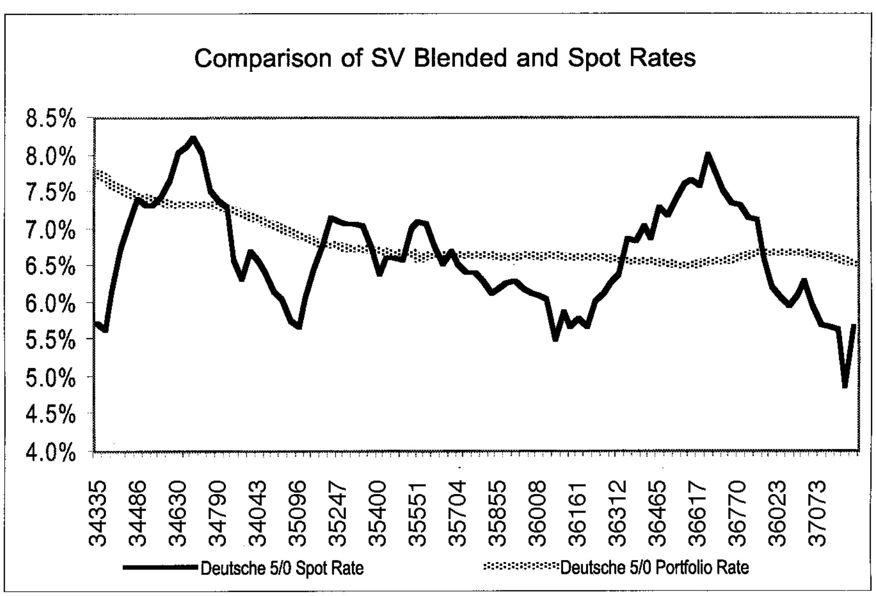
What is the correlation of equity-induced withdrawal activity with interest rate movements and is it the same in rising and falling interest rate periods?

How much of the equity-induced cash flow volatility is expected to come from company stock funds or sector funds? How well diversified are those risks in the issuer's portfolio?

What are the relative costs of maintaining a STIF in a stable value fund likely to be going forward?

Is there value to using non-participating guaranteed contracts to assume the first tier of withdrawal risk?

Eliminating the STIF does create a need for a mechanism to pay transfers and benefits without tapping multiple contracts. Surely a creative manager can solve that problem in return for a higher portfolio yield - or a provider in return for a greater market share. SVA



# SVIA Looks at Changes & What They Mean for the Stable Value Community

*Gina Mitchell, SVIA*

The nature of retirement investing has gradually and significantly changed over the past 12 years. We have moved from an institutional fund platform that tailored funds specifically for defined contribution plan sponsors to a mutual fund supermarket with ready packaged funds. In 1990, institutional funds held 91% of all 401(k) assets. Mutual funds held only nine percent. By 2000, things changed: mutual funds commanded 44% of 401(k) assets and institutional funds held 56%.

Throughout this evolution, one thing has remained constant: stable value's core as an investment option. Stable value has had a significant role in 401(k) plans even when the equity market went in the ozone during the nineties. Now, it is being rediscovered as the equity market scrambles back and forth like a nervous spider who built his web in the front door to your house. Stable value has had a constant presence during the investing public's love-hate relationship with equities. It has survived the investment education campaigns emphasizing the benefits of a long-term horizon in retirement investing. It has also survived during a period where participants still believe that stocks will produce double-digit returns, year-in and year-out. It has even survived the mutual funds' marketing and sales blitz for direct contact with 401(k) investors.

SVIA's Sixth Annual Investment and Policy Survey found that investments in stable value had grown by 15% in 2001. Assets have reached $261 billion, and the survey found the current asset allocation to stable value is 29%, which is a peak over the past five years.

Recognizing the importance of the evolving trends, threats and opportunity in the retirement market, the SVIA formed a Task Force to identify the major issues before the stable value community and to develop a strategic plan for the Association to help the membership deal with these issues. The Task Force is part of the Membership Committee and is chaired by Pacific Life's John Milberg.

The Task Force has drawn representatives from SVIA's four membership segments: issuers, managers, plan sponsors, and wrappers. They are listed below.

Despite their unique vantage points, the task force members have found unanimity in identifying the big picture issues:

- The threat of a sustained period of rising interest rates.
- The affect on investments and withdrawals of the retirement of the baby boomer generation.
- How asset allocation models and financial planners view and treat stable value.
- Market breath and depth of stable value providers.
- The move to a mutual fund format of 401(k) investment options and IRA rollovers.
- Potential limitations or restrictions on investment choice through legislative, regulatory or accounting mandates.

The Task Force is now looking to prioritize the issues and develop a plan for successful resolution in time for the SVIA National Forum, "Navigating Demographics, Market Performance and Individual Choice to Achieve a Financially Secure Retirement," on October 15-17, 2002.

## Task Force on Mission & Environmental Assessment

John Milberg, Pacific Life, Chairman

Jim Aguilar, Principal
Gary Bacchiocchi, MassMutual
Peter Bowles, FMC
Robert Capaldi, Black Rock
Karen Chong-Wulff, Dupont
Rick Cook, GE Financial Assurancee
Mark Devine, AT&T
Nat Duffield, Halliburton
Doris Fritz, Fidelity
Bruce Goode, Goode Investment Management
Aruna Hobbs, Financial Aegon
Henry Kao, UBS AG
Robert Leary, AIG
Paul Lohrey, Vanguard
Marc Magnoli, J.P. Morgan Chase & Company
James McDevitt, State Street Bank & Trust Company
John Moroney, Rabobank International
Ken Quann, New York Life
Steve Schaefer, Allstate
Kevin Smith, Prudential
David Starr, Dwight
Robert Whiteford, Bank of America

# Assets Grow to $261 Billion in 2001 Reports Stable Value Funds Sixth Annual Investment and Policy Survey

*Gina Mitchell, SVIA*

Unlike most other assets in defined contribution plans, stable value did not experience a decline in terms of assets and had positive returns. According to SVIA's Stable Value Funds Sixth Annual Stable Value Investment and Policy Survey, Stable Value funds proved to be the one consistent, positive performer for most 401(k) participants.

The survey covers more than 120,000 defined contribution plans with over $261 billion in Stable Value assets. Data was collected from four distinct manager segments: external managers, internal managers, bank and investment company pools and full service life insurance companies.

The survey, which provides data on Stable Value funds for 2001 and 2000 found:

- Allocations to stable value rose to 29.1% at year-end

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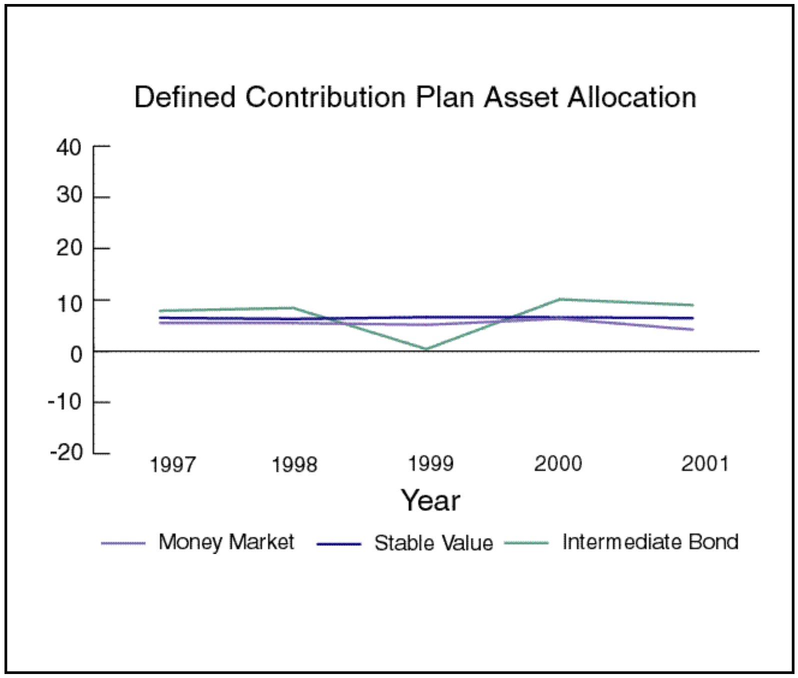


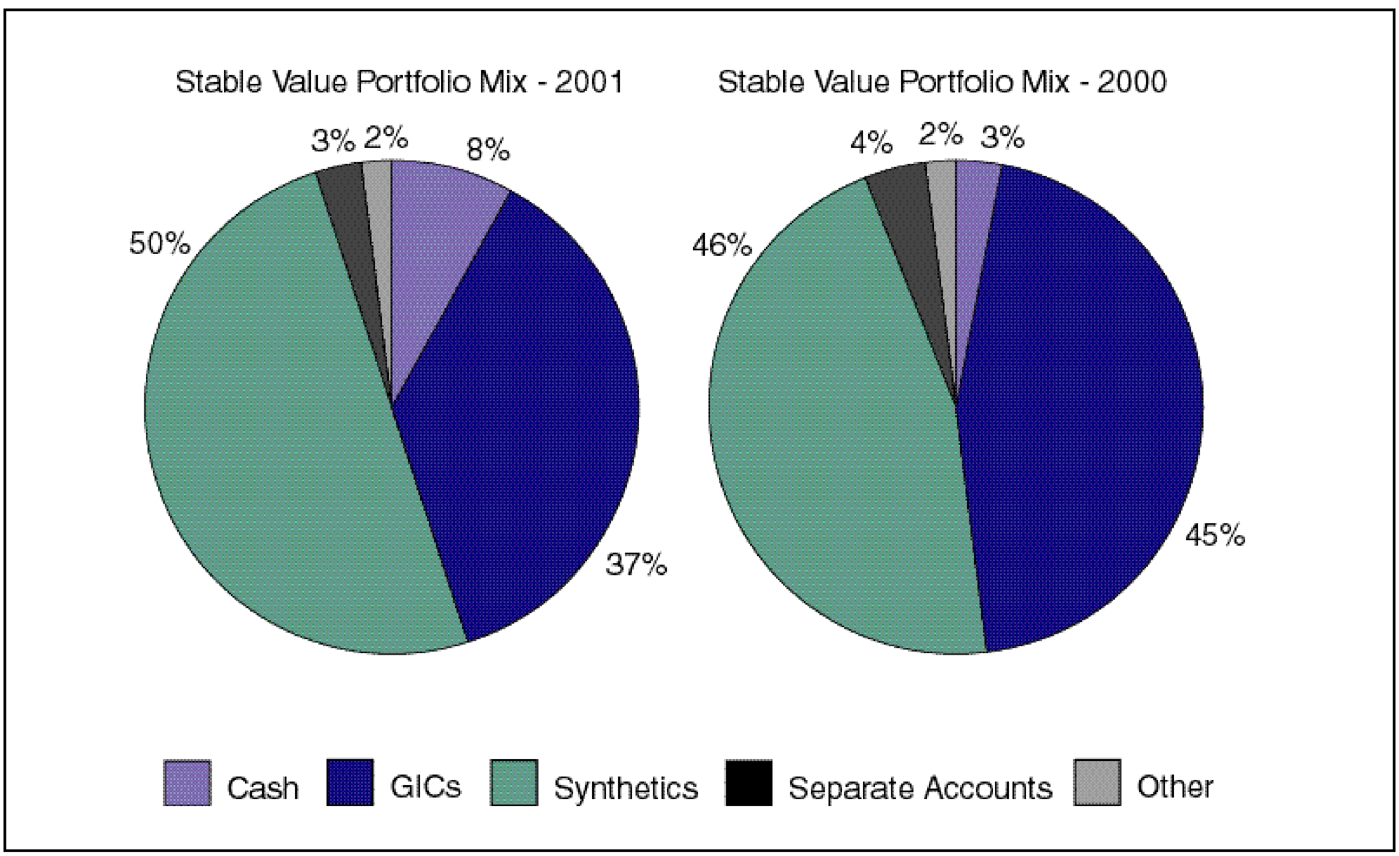

## Sixth Annual Investment and Policy Survey

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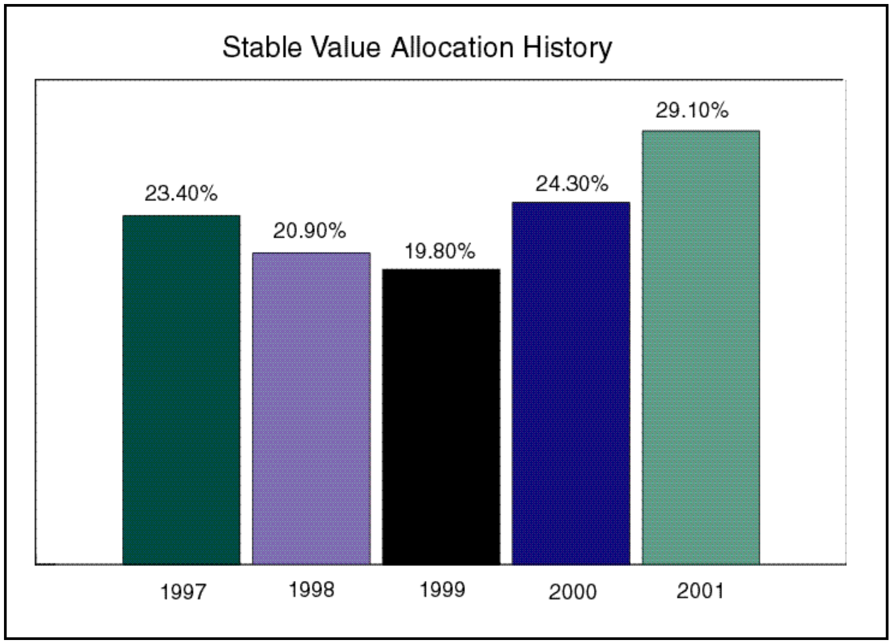
2001, the highest allocation in the six-year history of the survey.

- Increased allocations plus positive returns also produced a 15% growth in stable value assets over the previous year.
- Stable value consistently outperformed money market funds. Stable value returns for 2001 were 6.45%. Over the past five years, Stable Value returns have ranged from 6.25% to 6.75% outperforming money market funds by an average of 125 basis points per year.

The survey reports a change in the Stable Value fund portfolio mix. For 2001, the survey found an asset mix of 8% cash, 37% GICs and other life company general account guaranteed products, 50% synthetics, 3% separate accounts, and 2% other. For 2000, the survey found an asset mix of 3% cash, 45% GICs, 46% synthetics, 4% separate accounts and 2% other.

The Sixth Annual Stable Value Investment and Policy Survey will be posted on the SVIA website to maximize your ability to use the data. The results are available in both pdf format and an excel file.

Additionally, a summary spreadsheet of the different market segments will be available to allow data comparisons not presented in this tabulation. These items are located in Members Only at the following address: www.stablevalue.org/Members/AssocInitiatives/surveys.htm.




# FASB Exposure Draft on SFAS 133 Implementation Issues Stable Value's Contract Value Reaffirmed for Plan Sponsors

*Emily Bates, AEGON*

On May 1, the Financial Accounting Standards Board (FASB) issued an Exposure Draft, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, which reaffirms contract or book value for synthetic GICs held by plan sponsors. This amendment preserves the existing stable value accounting treatment for fully benefit responsive investment contracts purchased by defined contribution plans, including health and welfare and pension plans.

Or in plainer English, the Exposure Draft, reaffirms AICPA Statement of Position 94-4 (SOP 94-4). The FASB had provided interim relief with FAS 133 Implementation Issue C19 when SVIA first raised concerns.

As you may recall, the accounting treatment for synthetic GICs was called into question when issuers were instructed to report synthetic GICs at fair market value with the release of FAS 133 Issue A16. A16 indicated that a synthetic GIC was a derivative and should be accounted for at fair value by the issuer of the contract. Auditors of defined contribution plans began to question if A16 should also apply to purchasers of synthetic GICs.

Because of this uncertainty, the SVIA and its members sought clarification from the FASB and AICPA that preserved and upheld contract or book value as defined in SOP 94-4.

All comments on The Exposure Draft, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, are due before July 1. SVIA will be sending a letter in full support of FASB's clarification and preservation of SOP 94-4 for purchasers of synthetic GICs. The Exposure Draft is available at http://accounting.rutgers.edu/raw/fasb/draft/ed_amend_st133.pdf. For more information, please contact SVIA's Gina Mitchell (202-261-6528) or me at (502-560-3088).

# Automatic 401(k) Enrollment and Its Influence on Savings

*Judy Markland, Landmark Strategies*

*Highlights from Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance, by James J. Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick, Working Paper 8655, National Bureau of Economic Research, December 2001.*

In this paper the authors study the impact of plan structure on participant behavior in a large sample of plans which underwent change. They examined the effect on participant behavior of changing many different features of 401(k) plans and discovered one standard common denominator: a large portion of participants inevitably follow the path of least resistance in their 401(k) investing. Because of this, plan sponsors greatly impact the savings and investment choices of participants through plan structure and plan rules. This is especially true in the case of automatic enrollment (AE).

Most 401(k) plans require that the participant actively elect to participate. However, a growing number of plan sponsors have begun to enroll employees automatically unless they specifically opt out of the plan. (A Hewitt survey reported that 14% of plans had AE in 2001, twice as many as in 1999.) A major reason for adopting AE is to increase the participation of lower salary workers and reduce discrimination testing problems. The Treasury department has issued several rulings supporting the use of the practice for both newly hired and existing employees who are not participants.

When the path of least resistance is being enrolled automatically, participation rates rise substantially and stay higher. The table below gives the comparative participation rates by job tenure.

Without automatic enrollment there is a significant increase in participation over time, but the introduction of AE raised participation by more than 30% even after 36 months. The study also found that there was little increase in plan drop-out rates relative to pre-AE levels; the path of least resistance was to stay enrolled.

The default rate for automatic enrollment in the three plans studied is much lower than the match rate – two to three percent versus a six percent match. Prior to automatic enrollment only 11-20% of those who participated did so at this lower rate. However, after enrollment became automatic 42-71% of participants opted for the default rate.

The effect on asset allocations is similar. Before AE, participants allocated 10-18% in the conservative option (stable value or money market); after AE the conservative option held 48 to 81% of assets. Unlike participation rates, however, there was a tendency for the allocations to the conservative option to be reduced over time.

The authors conclude that automatic enrollment can be a highly effective tool for promoting retirement savings but that plan sponsors need to be responsive to the employees' tendency towards the path of least resistance. If promoting retirement savings is the goal of AE, the program should include higher default rates and a more aggressive investment mix.

**Effect of Adding Automatic Enrollment on 401(k) Plan Participation (employee participation rates)**

| | Company B hire date | | Company C hire date | | Company D hire date | |
|---|---|---|---|---|---|---|
| tenure (months) | Before AE | After AE | Before AE | After AE | Before AE | After AE |
| 6 | 26.4% | 93.4% | 35.7% | 85.9% | 42.5% | 96.0% |
| 12 | 37.8% | 95.7% | 40.2% | 85.3% | 49.6% | 96.6% |
| 18 | 47.7% | 97.0% | 44.3% | 86.0% | 56.6% | 97.2% |
| 24 | 54.1% | 97.6% | 49.8% | 85.7% | 61.7% | 99.1% |
| 30 | 60.0% | 98.0% | --- | --- | 65.6% | 98.8% |
| 36 | 64.7% | 98.8% | --- | --- | 69.0% | 100.0% |

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# FIRSTSource Data for 4th Quarter 2001
# Stable Value Cash Flow at a Glance

*Kathleen Schillo, Hueler Companies*

| FIRST Source Market Data: | 4th Qtr. 2001 | 3rd Qtr. 2001 | 2nd Qtr. 2001 | 1st Qtr. 2001 | 4th Qtr. 2000 | 3rd Qtr. 2000 | 2nd Qtr. 2000 | 1st Qtr. 2000 | 4th Qtr. 1999 |
|---|---|---|---|---|---|---|---|---|---|
| 95% | 4.15% | 9.62% | 3.46% | 10.08% | 6.63% | 5.48% | 3.63% | 1.82% | 10.25% |
| 75% | .45% | 4.65% | 0.41% | 5.15% | 0.91% | 0.64% | -0.55% | -3.85% | 3.97% |
| Average | -.81% | 2.80% | -0.81% | 2.67% | -0.73% | -0.97% | -2.03% | -7.58% | 1.75% |
| 25% | -2.43% | 0.66% | -2.51% | 0.28% | -2.58% | -2.55% | -3.72 | -10.33% | -1.18% |
| 5% | -4.68% | -2.17 | -4.92% | -4.93% | -8.07% | -6.15% | -7.46% | -19.06% | -5.32% |

| Asset Class | 12/31/2001 | 12/31/2000 |
|---|---|---|
| Stable Value/GIC | 26.03% | 20.96% |
| Balanced Funds | 4.84% | 5.29% |
| Company Stock | 22.75% | 25.65% |
| Equity | 34.35% | 38.17% |
| Fixed Income | 2.27% | 1.23% |
| International Equity | 2.36% | 2.80% |
| Life Cycle Funds | 2.32% | 1.73% |
| Money Market/Short Fixed Income | 1.45% | 1.42% |
| Other | 3.62% | 2.74% |

According to Hueler's FIRSTSource Market data it appears that while first quarter 2001 and third quarter 2001 showed the strongest positive cash inflows into stable value in years, fourth quarter 2001 cash flows were more in line with recent trends. While second and fourth quarters didn't show significant positive stable value inflows, it is important to note that the allocation to the Stable Value Asset Class as a percent of all Plan Assets rose from 21% as of 12/31/00 to 26% on 12/31/01. Approximately half of the allocation increase can be attributed due to cash flows, with the remaining half being attributed to the negative returns of equity investments. With all of the proposals in Congress and attention from the media related to company stock in 401(k) plans, it will be interesting to see if first quarter 2002 shows a positive shift once again into stable value. FIRSTSource Market data encompasses approximately 340 plans with $354 billion in total plan assets and $92 billion in stable value assets.