STABLE TIMES

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Social Security Privatization: There Is a Role for Stable Value

By Robert Whiteford, Bank of America

"Forethought we may have... but not foresight"

Napoleon

While none of us can predict the future with any degree of exactitude, we can do our best to prepare for it. We know that over $33 trillion in promised Social Security benefits is expected to be paid over the next 75 years to the baby boom generation. And, despite the stock market's poor performance, about half of all Americans still favor investing a portion of their Social Security savings in stock market or private accounts, according to a recent *Washington Post-ABC News* poll. We feel that private self-directed accounts represent a significant opportunity for individuals to enhance their retirement security. For self-directed accounts to become a reality, it will be critical to develop investment options that protect against the downside for participants. Stable Value has a proven record in protecting investors against the downside of the market. While the focus has been on equity investments, I believe there is a role for fixed-income investments and, specifically, Stable Value.

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Retirement Issues Will Get the Spotlight in the 108th Congress

By Gina Mitchell, SVIA

When I first started working on pension issues they were considered about as interesting as Ben Stiller's droning homeroom roll call in *Ferris Bueller 's Day Off.* Well, much has changed since 1986.

Declining 401(k) balances and the stock market's daily ping-pong-like action provide a backdrop for the Administration and now the Republican majority to make permanent the increased tax deferral limits for pension savings. In fact, before Congress left town for the November elections, the House Committee on Ways and Means passed legislation that would accelerate the increase of the limits and make them permanent.

With the Republican Congress and Administration expect to see legislation making permanent the increased tax deferrals for pension savings enacted in the 108th Congress. It won't be easy or pretty since the Republicans may have to pass legislation with a straight party vote. Maintaining party unity isn't easy with a sluggish economy, budget deficit, unease from the war on terrorism, and potential conflict with Iraq. Not to mention the potential rhetorical pounding from the Democrats who may define themselves by taking Nancy Reagan's approach: "Just say no. . ." to most legislation the Republicans offer. In fact, the Democrats are in a perfect position to influence tax legislation

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AIMR Taps Paul Donahue

The talents and expertise of a tireless contributor to SVIA have been recognized by the Association of Investment Management and Research (AIMR). AIMR tapped Paul Donahue to serve as a member of their Performance Presentation Standards Implementation Committee. Paul serves as INVESCO Institutional Senior Manager for Fixed Income Product Development and Counsel for Fixed Income. Paul has written many articles on Stable Value and other topics in both finance and economics. He serves as co-chair of SVIA's Performance Measurement Task Force and as a member of the SVIA's Asset Allocation Task Force and SFAS 133 Working Group.

Save These Dates:

Hold October 15-16, 2003 for SVIA's National Forum. The Forum has been shortened by a day to get you back in the office. The 2003 Forum will be held at the Ritz Carlton in Washington, D.C. SVIA's conference rate at the Ritz Carlton is $275.

Social Security Privatization: There Is a Role for Stable Value

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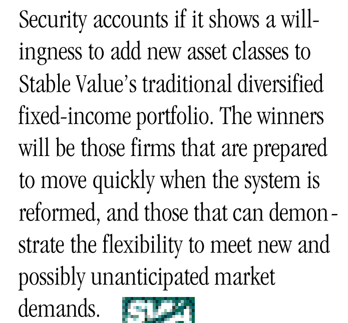
Stable Value investments should be a core investment option in any self-directed Social Security plan. Stable Value investments have delivered healthy investment returns with low levels of volatility. As investors typically prefer lower volatility (holding returns constant), Stable Value is clearly preferable to other more volatile fixed-income assets. Stable Value also produces higher earnings than other low volatility investment options like money market instruments. The combination of principal protection, low volatility, and steady, investment returns seems to best meet the needs of plan participants in the more conservative investment sector.

While the application for participants approaching retirement age is obvious, Stable Value should not be ignored as an investment option for younger participants. Market cycles between busts and recoveries for more volatile asset classes like equity and real estate have, on occasion, been prolonged. This may ultimately result in the need for workers to postpone retirement to a later date than anticipated or to invest more aggressively to try to offset negative portfolio adjustments. Stable Value reduces both of these risks making Stable Value a powerful and effective diversification vehicle for investors regardless of age.

To ensure that all Americans have the access to Stable Value's benefits in Social Security private accounts, Stable Value providers must actively participate in this debate. Through participation, Stable Value providers can educate the public and policymakers on how effective Stable Value is and the role it can play in private accounts. Without such participation, the terms of the new Social Security system will be dictated rather than influenced by Stable Value. While only a very small percentage of the Social Security obligations initially would be funded in self-directed accounts, it is estimated that $80 billion per year will flow into self-directed Social Security accounts, quickly creating a meaningful pool of assets.



The Stable Value sector can further increase its role in private Social Security accounts if it shows a willingness to add new asset classes to Stable Value's traditional diversified fixed-income portfolio. The winners will be those firms that are prepared to move quickly when the system is reformed, and those that can demonstrate the flexibility to meet new and possibly unanticipated market demands. SVIA

Retirement Issues Will Get the Spotlight in the 108th Congress

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by raising the cautionary flags of a rising federal deficit and tax equity issues. The approach did not help them maintain their slim Senate majority but it will help them get headlines and shape the edges of a Republican tax bill.

Investment advice has been building momentum for the past two years. In fact, Congressman John Boehner's (R-OH) bill passed the House but languished in the Senate. The bill allows financial services firms managing pension assets to provide advice. Expect his advice legislation to be incorporated as part of the Administration's 401(k) reform package that will be a major priority in the opening days of the 108th Congress. Advice legislation has a strong likelihood of enactment particularly with Senators Charles Grassley (R-IA) and Judd Gregg (R-OH) poised to take over the Finance; and Health, Education, Labor and Pensions committees respectively. These Senate committees were divided on their approach to advice legislation: Congressman Boehner versus Senator Jeff Bingham (D-MN) and

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Editor's Corner

Greg Wilensky, Alliance Capital Management

As I recover from several large holiday meals and the wonderful leftovers that come with it, I realize that my belly is as pleasantly stuffed with quality food as this issue of Stable Times is stuffed with quality articles.

Our modus operandi for the fourth quarter issue includes a very healthy dollop of articles recapping the SVIA Annual Forum. Whether you were unable to attend the conference or missed some sessions as a result of that important conference call or a little too much drinking at Buffalo Billiards, this is the place for you to catch up. Outside of our conference coverage, we have additional articles covering several issues percolating in Washington that can have major impact of the Stable Value industry—pension and Social Security reform—and an article that discusses the negative ramifications of trying to eliminate equity wash provisions for plans that want to offer both Stable Value and money market funds. I invite you to hop on that stationary bicycle with this issue of *Stable Times* and catch up on some industry news while working off your holiday feasts.

STABLE TIMES

Fourth Quarter 2002

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Highlights From Forum

This issue features many articles from SVIA's National Forum, "Navigating Demographics, Market Performance and Individual Choice to Create a Financially Secure Retirement," which was held October 15-17 in Washington, D.C. As you will read, the Forum provided a wealth of information on these trends. To find out more, check out the actual forum presentations on www.stablevalue.org.

Vying for Retiree Assets

By Randy Myers

Relatively few plan sponsors encourage retiring employees to leave money in the company 401(k) plan once they quit their jobs. With the first wave of the Baby Boomer generation rapidly approaching retirement age, however, plan sponsors may want to reconsider their passivity.

Many retirement specialists say retiring Boomers can benefit themselves as well as the remaining active participants in their 401(k) plans—and even the plans themselves—by leaving their money where it is. Boomers benefit because the typical 401(k) offers lower operating costs and better ancillary features, such as loan programs, than their most popular alternative, Individual Retirement Accounts. Active participants benefit because the more money a plan has, the more leverage it enjoys when negotiating fees and services from vendors. In addition, plan sponsors benefit, if only indirectly, because Boomers who maximize their retirement assets by leaving them in their 401(k) plan have more to spend in retirement, thus helping the economy and corporate profits.

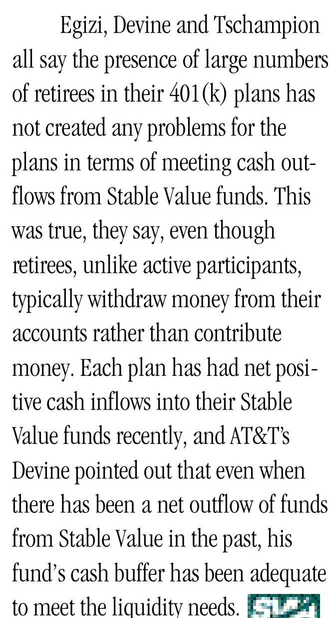
However, the prospects for holding onto retiree money aren't bright if current trends don't change. According to Brightworks Partners, a financial services consulting firm based in Old Greenwich, Connecticut, only about 27% of workers with account balances exceeding $25,000 leave their money in their 401(k) plan once they retire. By contrast, approximately twice that many take their money out entirely; 45% roll their money into an Individual Retirement Account, 7% take a lump sum distribution, and 9% purchase an annuity. The remaining 12% of retirees take out part of their account balances and leave the rest invested in the plan, or arrange for their money to be paid to them in installments.

It is possible for sponsors to do a better job of retaining plan assets report three plan sponsors. For example, at Eastman Chemical Co., a specialty chemicals and plastics company headquartered in Kingsport, Tennessee, more than 80% of retirees keep their money in the company's $1.1 billion 401(k) plan, according to Ralph Egizi, the company's director of benefits finance and foreign exchange. At telecommunications giant AT&T Corp., retirees hold 49% of the assets in that company's 401(k) plan, says Mark Devine, senior vice president of the company's AT&T Investment Management Corp. subsidiary. And at General Motors Corp., retirees represent about 29% of the participants in the company's defined contribution plan for salaried employees and 24% in the plan for hourly employees, according to Charles Tschampion, managing director of defined contribution plans for the automaker's General Motors Investment Management Corporation subsidiary.

All three companies attribute the high level of retiree participation in their retirement plans to efforts their firms have taken to attract and retain retirees as investors. AT&T has enhanced its loan provisions for plan participants, and also made financial planners available to departing workers. All three companies tout the flexibility of their plans in terms of the number of investment options available to participants. "We have 73 active investment options in our plan," says GM's Tschampion. "We make people aware of the benefits of staying with the plan," adds AT&T's Devine.

Not surprisingly, retired 401(k) plan participants tend to be conservative investors. At AT&T, retirees hold about 45% of their assets in Stable Value funds, versus 25% for active employees. At Eastman Chemical, retirees have about 54% of their assets in Stable Value, versus 38% for active employees. A comparable spread exists among participants in the savings plan for salaried employees at General Motors. Active employees in GM's hourly plan are nearly as conservative as their retired counterparts, though; they hold 38% of their assets in Stable Value, versus 48% for retirees.

Egizi, Devine and Tschampion all say the presence of large numbers of retirees in their 401(k) plans has not created any problems for the plans in terms of meeting cash outflows from Stable Value funds. This was true, they say, even though retirees, unlike active participants, typically withdraw money from their accounts rather than contribute money. Each plan has had net positive cash inflows into their Stable Value funds recently, and AT&T's Devine pointed out that even when there has been a net outflow of funds from Stable Value in the past, his fund's cash buffer has been adequate to meet the liquidity needs.



Retirement Issues Will Get the Spotlight in the 108th Congress

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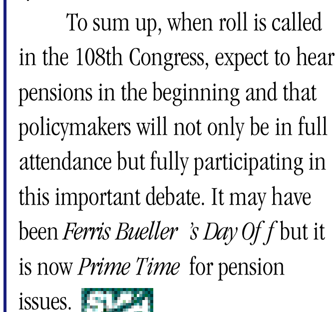
Susan Collins (R-ME)). Both comittees will be replenished with more conservative Republican members, thus making it more likely that advice legislation will be enacted and it will closely resemble Congressman Boehner's approach.

The debate is on when it comes to Social Security. Social Security is a priority for the Administration. While private accounts may be more of a covert move to mandated pension savings than an aid in reducing Social Security's projected shortfall for baby boomers, it will be a major component of the debate along with increasing payroll taxes and reducing benefits. The major components of reform should take shape over the next two years. However, enactment is not likely unless or until—depending upon your political persuasion—President Bush wins a second term in 2004.

Lastly, defined benefit plans will also be on the agenda since the whipsaw of the stock market has eliminated most corporations' pension funding surpluses and pushed their pension liabilities back into the red. Expect the Pension Benefit Guaranty Corporation to be back in the headlines along with a desire to revitalize and even restart the defined benefit system.

To sum up, when roll is called in the 108th Congress, expect to hear pensions in the beginning and that policymakers will not only be in full attendance but fully participating in this important debate. It may have been *Ferris Bueller's Day Off* but it is now *Prime Time* for pension issues.



Market Analysts See Stocks Poised to Overcome Pessimism

By Randy Myers

There's no denying that the past few years have been brutal for equity investors. The Wilshire 5000 stock market index posted a total return of—11% in both 2000 and 2001, then dived another 26.6% in the first nine months of this year—despite strong evidence that the U.S. economy was rebounding in the first half. Yet the outlook for equity investors is brightening, according to Putnam Investments economist David Kelly and Tulane University finance professor Peter Ricchiuti.

Kelly attributes the stock market's ongoing slump during the first nine months of this year, despite positive economic news, to negative investor psychology. "All year long people have not been in the mood to buy stocks," Kelly says. "We've gone from irrational exuberance to irrational pessimism."

It's not hard to figure out why, either. Since sailing through the overly hyped Y2K "crisis" unscathed, investors have had to grapple with the implosion of the technology stock bubble; a bitterly divided presidential election; a recession; the September 11 terrorist attacks; and, most recently, a wave of high-profile accounting scandals at what had been some of world's most respected corporations. But the recession is over. The US economy advanced at a 5.0% annual rate in the first quarter of this year and a 1.3% rate in the second quarter. Kelly predicts that with continued economic growth investor psychology will change for the better, too. Meanwhile, rising business productivity, low interest rates, lower levels of capital equipment depreciation and an employer-friendly compensation environment should allow US corporations to report healthy profit growth next year, as typically happens in the year after a recession.

Investors willing to venture into the stock market will find prices—by at least one important measure—that are the cheapest they've been in 17 years. Kelly explains that at the beginning of the fourth quarter, the stock market was trading at 17 times corporate profits as calculated by the Commerce Department using raw data from corporate tax returns. Expressed the opposite way, the earnings yield on stocks (earnings to price ratio) was 5.94%. Historically, that stock market's earnings yield has closely tracked the yield on 10-year bonds, but lately the 10-year Treasury has only been yielding about 4.29%. The 165-basis-point gap between the two measures, Kelly reports, is the widest it has been since 1985 and a sign that stocks, by this measure at least, are cheap relative to bonds.

Ricchiuti, who also serves as assistant dean at Tulane's A.B. Freeman School of Business, agrees. He sees other signs that the stock market may be poised to advance. For starters, the market's behavior over the past two years hasn't been as uniformly bad as market indices would suggest. In fact, Ricchiuti says, over the past 31 months more stocks actually rose in price than fell. But that didn't stop investor behavior during the summer from reflecting attitudes that typically prevail in the third and final stage of a bear market, when fear of deeper losses and recession become so worrisome that many investors simply give up on stocks, setting the stage for a rebound.

Kelly proclaims himself a strict proponent of maintaining a disciplined investment strategy and concluded his presentation by observing, "staying disciplined today means not being underweighted in equities." He adds: "I don't believe in efficient markets. In the short run, at least, markets are driven by emotion. Now more than ever is a time for people to be disciplined and diversified."

Kelly did concede that his bullish outlook could be clouded by at least two potentially disastrous developments—a war with Iraq, or another terrorist attack on the scale of what happened September 11, when hijacked jetliners downed the World Trade Center towers and crashed into the Pentagon. "I think the economy is strong," Kelly concludes, "but it's not invulnerable."

Capturing the Next Wave of Retirement Assets

By Randy Myers

The Stable Value industry has significant opportunities for growth in the burgeoning Individual Retirement Account (IRA) market. To capture it, however, the industry will have to do a better job of marketing to retirees and educating them about the advantages of Stable Value investing.

The first wave of the nation's 76 million Baby Boomers reached age 55 last year. As they begin to leave the work force, their focus will shift from accumulating retirement assets to managing the distribution of those assets, according to consultants Merl Baker and Ronald Bush of Brightwork Partners LLC, Old Greenwich, Connecticut. They say retirees will be looking for greater diversification in their retirement portfolios and for products, such as Stable Value funds, that can protect their principal and generate income.

Stable Value managers can't sit on their heels waiting for money to roll in. As Bush and Baker explain, the vast majority of Stable Value funds today are found only in defined contribution plans. Forty-five percent of retirees roll their 401(k) balances into an IRA. It was only in 1998 that the first Stable Value mutual fund was introduced for the IRA market, and there are still only about half a dozen such funds. What's more, retirees aren't especially loyal to the financial institutions that managed their qualified retirement plans; of those rolling their money into an IRA, only 28% stay with the same firm. Mutual fund companies do the best job of retaining qualified plan assets. They hold onto about 38% of the assets held by retiring savings plan participants, followed by securities brokerage firms at 31%, banks at 27%, insurance companies at 21%, and other financial services firms at 26%.

To capture its fair share of 401(k) money rolling into IRAs, Baker and Bush say, the Stable Value industry will have to broaden an institutionally focused marketing structure to embrace retail marketing as well. This will require the industry to develop relationships with the investment advisors and financial planners who assist retirees in managing distributions from their qualified retirement plans. The industry also will have to embrace direct marketing as a means of segmenting and targeting receptive retail customers, find ways to sustain its communications initiatives with investment advisors and retail investors, and build up the service infrastructure needed to

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Executives Defend Credit Rating Methodologies

By Randy Myers

It's not especially fun to be a credit rating agency just now. The economy is coming off a recession, business headlines are still littered with revelations of surprising high-profile accounting frauds, both the telecom and power marketing industries are in dire straits, and default rates on high-yield debt are at unprecedented levels. Rating agencies failed to predict all this turmoil, and as a consequence have come under an enormous amount of criticism and scrutiny. Critics complain on one hand that the agencies fell down on the job by failing to predict the collapse of fallen angels such as Enron. Yet, on the other hand, the agencies are now overcompensating and being too tough on other companies struggling through a difficult economic environment.

While not denying they missed problems at Enron, the ratings agencies are quick to point out that everyone else did, too, from Enron's board of directors to Wall Street equity analysts to the company's underwriters and its external auditors. If more corporations are seeing their credit ratings downgraded since Enron, the rating agencies add, that is more a reflection of deteriorating financial strength at those companies than any scheme on the part of the agencies to downgrade more aggressively. "We have not changed our methodology," says Christopher Mahoney, chairman of the credit policy committee for Moody's Investors Service. "We believe that ratings should provide a stable signal of relative credit risk using the traditional techniques of fundamental financial analysis." Robert Grossman, group managing director and chief credit officer for Fitch Ratings, adds that current trends in ratings activity actually mirror just what happened after the last significant economic downturn in 1991.

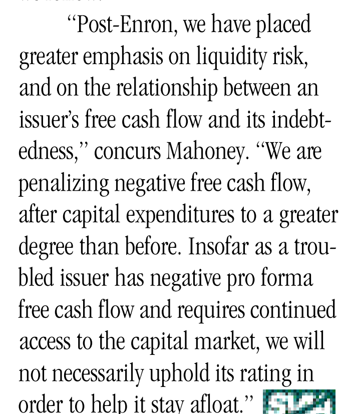
Grossman concedes; credit ratings in general are down. At the end of 2000, for example, about 42% of the companies followed by Fitch carried a Single A rating; today, only about 33% do. By contrast, 29% of the companies Fitch follows now carry a Triple B rating, up from about 22%. Triple B is the lowest of all investment grade ratings, one step above "junk" or high-yield status. Meanwhile, Fitch issued 150 credit downgrades during the third quarter of this year through September 25, but only 37 upgrades—a pattern that has held true in each of the last four quarters. Of course, the financial strength of many corporations has deteriorated during that time, too. In looking at 174 companies with a Single A rating as of December 31, 1999, Grossman found that the median company in that group had a higher debt-to-EBITDA ratio two years later (2.33x versus 1.80x), a higher total-debt-to-market-capitalization ratio (34% versus 29%), and a lower cash-flow-to-total-debt ratio (5% versus 7%). The cash flow ratios reflect cash flow after dividends and capital expenditures.

While insisting they've made no wholesale changes to the way they rate corporate creditworthiness, both Mahoney and Grossman say their firms have taken measures designed to make them more effective credit watchdogs. Moody's, for example,

- Has created a "chief credit officer" for its corporate finance group;
- Introduced new quantitative tools for use by its analysts;
- Intensified its focus on issuers' liquidity alternatives in the event of a credit shock;
- Conducted a rigorous post-mortem analysis of all investment-grade defaults since Enron;
- Undertaken a "rating trigger survey" to systematically identify rating triggers in corporations' financial and operating agreements;
- Conducted intensive reviews of certain volatile market sectors, such as telecom, merchant energy, technology and retail; and
- Begun reducing the number of companies it requires each of its analysts to follow.

While arguing that even these sorts of changes won't guarantee that credit rating agencies will catch future Enrons before they happen, Mahoney says there are red flags that analysts can and will watch for at companies they follow: aggressive accounting, arrogant management, negative free cash flow, opaque financial disclosures, excessive complexity in a company's business model or financial reporting, and serial acquisitions. "Obviously, there are good companies that have some of these qualities," Mahoney notes. "Nonetheless, I think if we had considered these prior to Enron, we could have done a better job."In the meantime, both Mahoney and Grossman report their companies continue to pay foremost attention to a company's free cash flow when determining how to rate its creditworthiness. "In the rating agency world, cash is still king," Grossman points out. "That's still the single most important metric we follow."

"Post-Enron, we have placed greater emphasis on liquidity risk, and on the relationship between an issuer's free cash flow and its indebtedness," concurs Mahoney. "We are penalizing negative free cash flow, after capital expenditures to a greater degree than before. Insofar as a troubled issuer has negative pro forma free cash flow and requires continued access to the capital market, we will not necessarily uphold its rating in order to help it stay afloat." SVIA



Capturing the Next Wave of Retirement Assets

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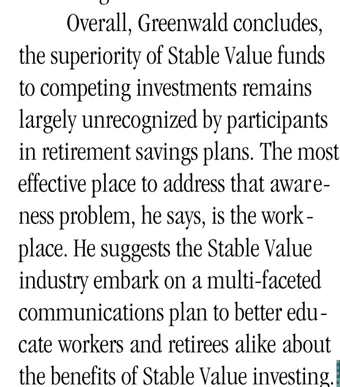
meet the needs of the retail marketplace.

Matthew Greenwald of Matthew Greenwald & Associates, Washington, DC, says the Stable Value industry also needs to focus more attention on educating consumers about Stable Value funds and their appeal. In a survey of more than 800 active and retired participants in retirement savings plans conducted on behalf of the SVIA, Greenwald found that only 7% of the respondents considered themselves "very knowledgeable" about Stable Value or interest income funds, versus 11% for bond funds and 21% for money market funds. Another 33% rated themselves "somewhat knowledgeable" about Stable Value funds, versus 49% for bond funds and 55% for money market funds.

Ironically, Greenwald found that active workers who participated in the survey were more interested in Stable Value than retirees, suggesting that the more exposure investors have to Stable Value, the more inclined they are to invest in it. In fact, he reports at the SVIA forum, when the typical attributes of a Stable Value fund were described to survey participants, approximately three-quarters of the respondents described the funds as "somewhat appealing" or "very appealing." Also encouraging was the finding that 58% of respondents said they favor a low-risk portfolio that pays out a steady stream of income over a moderate-risk portfolio offering potential for moderate returns or a high-risk portfolio offering potential for high returns.

Overall, Greenwald concludes, the superiority of Stable Value funds to competing investments remains largely unrecognized by participants in retirement savings plans. The most effective place to address that awareness problem, he says, is the workplace. He suggests the Stable Value industry embark on a multi-faceted communications plan to better educate workers and retirees alike about the benefits of Stable Value investing. SVIA



Bush Administration Seeks Cure for Social Security

By Randy Myers

Anyone paying attention to the Social Security system knows that while it is in fair shape right now, its future looks dicey. Absent any changes, outflows will begin to exceed inflows by 2017, according to Social Security Deputy Commissioner and Chief Operating Officer James Lockhart III, and by 2041 the Social Security trust fund will have disappeared. Because we still have not created a savings culture in this country, Lockhart warns, most future retirees will not be able to make up for a Social Security shortfall on their own.

"Doing nothing is not the right answer" to Social Security's ills, " Lockhart tells SVIA Forum participants. Unfortunately, he adds, it would not be practical for the federal government to borrow the funds needed to keep Social Security solvent. Over the next 75 years, he says, that would amount to $33 trillion, or five and a half times the current federal debt level.

Lockhart outlines four possible solutions to the Social Security problem:

(1) Raise payroll taxes,
(2) Slow or reduce Social Security benefits,
(3) Transfer money into the program from the government's general account, or
(4) Increase returns on assets held in the Social Security system by adding a "prefunding" component to the system.

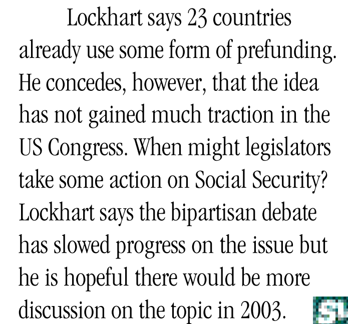
Under this scenario, US workers would be required to make annual payments into personal retirement accounts, where they would have the flexibility to choose their investments.

Prefunding may be the best possible solution, Lockhart says. Increasing payroll taxes is probably unworkable, he argues, because the Social Security tax rate is already quite burdensome at a whopping 12.4% on the first $85,000 of personal income, and would have to be boosted to about 20% to solve Social Security's financial woes. Another 10% increase would be required to ensure Medicare's solvency. "This would increase an already regressive tax," Lockhart says.

Cutting benefits, meanwhile, may not be palatable to the American public. For one thing, Lockhart says, President Bush has vowed that benefits to current Social Security participants won't be cut. "It's really our children and grandchildren who would be at threat," he says.

Finally, it is simply impossible to transfer enough money from the government's general account today to shore up Social Security for the long haul. Doing so, Lockhart says, would require a massive $3.3 trillion transfer on top of the $1.3 trillion the Treasury already owes Social Security (the net present value of Social Security's $33 trillion in benefit promises).

Lockhart says 23 countries already use some form of prefunding. He concedes, however, that the idea has not gained much traction in the US Congress. When might legislators take some action on Social Security? Lockhart says the bipartisan debate has slowed progress on the issue but he is hopeful there would be more discussion on the topic in 2003.



Investment Managers Seek to Advise 401(k) Participants

By Randy Myers

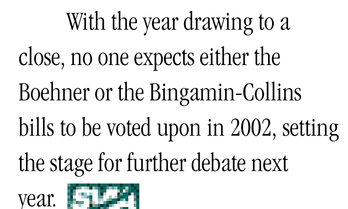
If the big financial services firms that manage 401(k) plans for corporate America had their way, they would be allowed to give participants in those plans detailed advice on how to invest their money. Critics argue that would be akin to letting the fox guard the henhouse, since those firms would have a financial incentive to recommend their own investment funds regardless of whether they were best for investors.

For the time being, the Employee Retirement Income Security Act makes the matter moot by prohibiting investment firms from giving such potentially conflicted advice. However, in a lively debate at the SVIA Forum, attorney Jon Breyfogle of the Groom Law Group argues that legislation sponsored by Representative John A. Boehner, (R-OH), would provide adequate conflict-of-interest safeguards to allow investment firms to give individualized advice to retirement plan participants. Passing that legislation, he says, would make advice available to more investors by increasing the number of companies providing advice. That, he said, would drive down the cost of advice and enhance its quality.

Under Boehner's Retirement Security Advice Act, investment managers providing advice to a retirement plan's participants would have to make comprehensive disclosures about the fees they receive for doing so, about other services they provide to the plan, and about any limitations to the scope of their advice. They would retain fiduciary liability for the advice they provide, although plan sponsors also would be liable for the prudent selection of their advice provider. The legislation, supported by most of the financial services industry including SVIA, has been received favorably in the House of Representatives but has not won comparable backing in the Senate, where Senators Jeff Bingamin (D-NM) and Susan Collins (R-ME) have introduced a competing bill. Called the Independent Investment Advice Act, one of its distinguishing features is that it would provide a fiduciary safe harbor for employers that offer investment advice through independent advisors.

However, the influential American Association of Retired Persons, represented in the SVIA debate by its director of federal affairs David Certner, opposes legislation that permits investment managers to also offer advice. "It seems clear to us," Certner says, "that you would not want to remove the conflict of interest prohibitions already in place. It seems ludicrous that we bring in independent advice in the defined benefit (pension plan) marketplace, which has sophisticated investors, but that we would not insist on independent advice for less sophisticated individual investors in the defined contribution plan market. Our sense is that if we are going to proceed down this path, let's do it right and make sure they (advice providers) have the interests of the participant at the top of their priority list."

With the year drawing to a close, no one expects either the Boehner or the Bingamin-Collins bills to be voted upon in 2002, setting the stage for further debate next year.



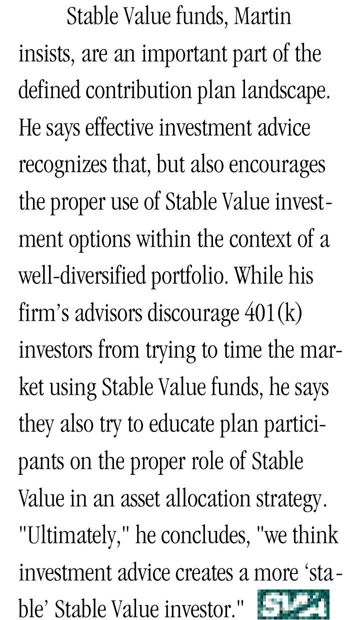
Investors Who Receive Advice Build Better Portfolios

By Randy Myers

For years, one of the biggest knocks against 401(k) plans has been that few participants have the financial savvy to properly invest their own money for retirement. Time and technology led to a partial solution in the late 1990s when independent companies such as mPower and Financial Engines developed powerful computer-based investment advice programs that could be delivered to plan participants economically via the Internet. Still, use of those systems has remained relatively low—many plan sponsors still don't offer them, and among plan participants who do have access to the programs, only about 20% to 30% actually take the time to try them out.

The good news, according to retirement services provider CitiStreet LLC, is that participants who do use advice become better investors as a result. A joint venture between financial services giants CitiGroup and State Street Corp., CitiStreet services more than 17,000 defined contribution retirement plans with more than seven million participants. Its CitiStreet Advisors subsidiary provides investment advice to participants in those plans, either online or through a call center in which CitiStreet advisors have access to work stations powered by Financial Engines. CitiStreet claims to be the first benefits provider to take advantage of a Department of Labor Advisory Opinion issued in December 2001 that allows benefits providers like it to offer investment advice to plan participants, provided the advice is based on the computer programs and methodology of a third-party independent advisor.

CitiStreet Advisors President Ray Martin says seven out of ten retirement plan participants who work with a CitiStreet advisor increase their savings rate as a result of that consultation, with the average increase about 150%. Meanwhile, 75% adjust their portfolios to align them more closely with their own risk profile. Advice users significantly increase the likelihood of reaching their financial goals in retirement, concludes Martin.



Stable Value funds, Martin insists, are an important part of the defined contribution plan landscape. He says effective investment advice recognizes that, but also encourages the proper use of Stable Value investment options within the context of a well-diversified portfolio. While his firm's advisors discourage 401(k) investors from trying to time the market using Stable Value funds, he says they also try to educate plan participants on the proper role of Stable Value in an asset allocation strategy. "Ultimately," he concludes, "we think investment advice creates a more 'stable' Stable Value investor."

Sponsors Cautioned to Minimize Risk When Offering Company Stock in 401(k) Plans

By Randy Myers

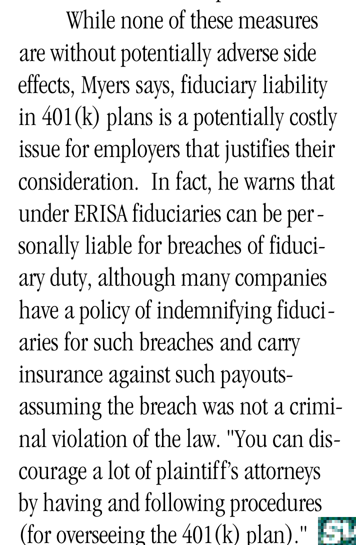
The high-profile bankruptcy filings by Enron Corp. and WorldCom in the past 12 months have called into question the wisdom of allowing participants in 401(k) plans to invest heavily in their employer's stock. When Enron imploded in a wave of accounting scandals in late 2001, its employees had approximately 60% of their 401(k) assets in Enron shares. Those shares became nearly worthless after Enron filed for bankruptcy protection in December 2001, leaving Enron workers approximately $800 million poorer.

WorldCom employees were dealt a similar blow when that firm became entangled in its own accounting fraud in June 2002. Participants in its 401(k) plan had about 32% of their assets in WorldCom stock, which also became nearly worthless. Since then, participants in both plans have filed a raft of lawsuits aimed at recovering some of their money, generally claiming, among other things, that their employers breached their fiduciary duty to their plan participants by not properly disclosing developments that would ultimately send their stocks crashing.

While none of those lawsuits have been concluded, attorney Donald J. Myers, head of the benefits practice for the firm of Reed Smith LLP in Washington, DC, says the suits have important implications for other plan sponsors. Myers notes that the Department of Labor in September filed a brief with the court handling the Enron litigation reinforcing the plaintiffs' arguments that Enron had a fiduciary duty to disclose corporate events that had a probability of affecting the company's stock price. As such, the Department of Labor has said, Enron may have had a duty to take some sort of action to protect plan participants.

Although Enron had appointed an "administrative committee" to oversee its 401(k) plan, Myers adds, the company itself retained some responsibility for the plan as the appointing fiduciary. The government's position in its brief, he says, is that appointing fiduciaries have an ongoing responsibility to make sure their appointed fiduciaries have the information they need to act on behalf of plan participants. "You can't just meet with them (the appointed fiduciaries) once a year," he reports.

Myers says it is not too soon for employers to begin devising strategies to reduce the risk of offering employer stock in their retirement plans. Possible measures include making the earliest possible public disclosure of problems that might adversely impact the company's stock price, appointing independent fiduciaries to oversee company stock in the retirement plan, minimizing the imposition of "blackouts" or "lockdown periods" during which plan participants cannot make trades in their 401(k) accounts, and lifting or easing requirements that employees hold company stock for specified periods of time before being allowed to diversify into other investment options.



While none of these measures are without potentially adverse side effects, Myers says, fiduciary liability in 401(k) plans is a potentially costly issue for employers that justifies their consideration. In fact, he warns that under ERISA fiduciaries can be personally liable for breaches of fiduciary duty, although many companies have a policy of indemnifying fiduciaries for such breaches and carry insurance against such payouts-assuming the breach was not a criminal violation of the law. "You can discourage a lot of plaintiff's attorneys by having and following procedures (for overseeing the 401(k) plan)."

529 Plans Retain Allure for Stable Value Providers

By Randy Myers

It isn't often that entire new markets open up for any product, but that's what's happened for Stable Value funds over the past few years as states across the country have launched dozens of new 529 college savings plans. Created by the Small Business Jobs Protection Act of 1996 and enhanced by the Economic Growth and Tax Relief Reconciliation Act of 2001, 529 plans are savings vehicles that investors can use to save for educational expenses. Investments grow on a tax-deferred basis and qualified withdrawals from the plans are not subject to federal income taxes. Many proponents believe Stable Value funds are a perfect investment for 529-plan accounts, especially in cases where the intended beneficiary is only a few years away from starting college and other more volatile investment options, especially equities, could be considered too risky.

Considering that the market for student loans is $50 billion annually, the opportunity in the 529-plan arena is substantial, says attorney William Montjoy, who from 1991 to 1994 was the founding chairman of the College Savings Plans Network. Today, in addition to running a private law practice, he also serves as general counsel of the Global Education Group that has US offices in Miami and provides private prepaid tuition insurance to foreign nationals. Montjoy says that while 529 plans are growing rapidly, they still constitute an immature market that is complex and confusing to many investors. Nonetheless, Stable Value funds have proved to be a popular investment option in the plans among the early adopters who have already opened accounts.

Greg Wilensky, a vice president and fixed income portfolio manager at Alliance Capital Management, joins Montjoy in the 529-plan discussion. Alliance manages a Stable Value investment fund for the 529 plan sponsored by Rhode Island. Known as the Collegeboundfund, assets in that plan grew from $10 million in October 2000 to $2.5 billion by September 2002 making it the largest single 529 savings plan in the country, Wilensky says. At that time, he adds, his firm's Stable Value fund accounted for about 5% of the plan's total assets. However, new inflows into the Stable Value fund were on the upswing; by the end of the third quarter, the Stable Value fund was attracting more than 25% of all new contributions to the plan. "The money's coming in faster every week," he said. "Part of this is being driven by current market conditions, but I think it's something that's going to continue."

Speaking to investment professionals in the audience who might be interested in winning a 529 plan mandate for their own firm, Wilensky explains that Alliance first had to help Rhode Island state officials understand how Stable Value works and sell them on the benefits of Stable Value investing. He said Alliance also had to work closely with the companies that would be providing the wrap contracts for the plan's Stable Value fund to make sure they were comfortable with the opportunity. Those contracts back up the Stable Value fund's book-value guarantee to investors, and the wrap issuers naturally had limited underwriting experience in the 529 marketplace.

Despite the hurdles, the 529-plan market looks to be well worth whatever effort the Stable Value industry puts into it. Citing projections that the market will grow from $10 billion last year to $16 billion this year and $140 billion by 2010, Montjoy expresses confidence that even those lofty numbers would be exceeded, since all previous projections have also proved low. "We've always undershot where this thing is going," he says. SVA

Sponsors Give Brokerage Windows High Marks

By Randy Myers

While conceding that only a small minority of 401(k) plan participants uses brokerage windows, employers who offer them in their plans give them high marks.

"It's been one of the more successful of the new investment options we've introduced," says Vernon Gollihugh, Director of Trust Investments for ALCOA Inc. ALCOA added a brokerage window to its retirement savings plan in 1989. Although it has captured only about 1% of plan assets, Gollihugh says it has been well received by those who use it, the majority of whom are salaried employees. With a brokerage window, participants in a retirement savings plan can invest in a nearly limitless array of securities, including individual stocks and almost any mutual fund available to retail investors.

Some retirement plan specialists worry that brokerage windows can make it too easy for plan participants to swap between Stable Value funds and competing fixed-income investments when interest rates are volatile. This would potentially strain the liquidity of Stable Value funds when rates rise quickly. Gollihugh says his plan has seen no evidence of that happening. In fact, he says, ALCOA has not even found it necessary to impose an equity wash rule on plan participants to discourage such arbitrage. Equity wash rules, a common feature in many defined contribution plans, require that transfers out of Stable Value be directed to an equity fund option for a stated period of time before that money can be invested in a fund that competes with Stable Value, such as a money market fund.

Though pleased with its brokerage window investment option, ALCOA has tried to head off abuse of the feature, or its unintentional poor use, by making it relatively cumbersome for participants to sign up to use it. It takes about two weeks to open a brokerage window account in ALCOA's plan, during which time the participant must take several steps to move the process forward. Also, the brokerage window does not show up on plan statements as an investment option along with the other investment options in the plan, Gollihugh says. However, ALCOA does not charge participants to use the brokerage window.

William Petrovic, Vice President and Treasurer of Roche Diagnostics Corp., says his company added a brokerage window to its 401(k) plan about a year and a half ago after acquiring another company that had it for its employees. With the brokerage window now accounting for less than 0.2% of contributions to the plan, he says, it has presented no problems for the plan or its Stable Value fund. Even though Roche does impose an equity wash rule on its plan participants, Petrovic says it has not been a contentious issue. Nor has it caused any extra work for Roche, since participants who might be impacted by the rule must deal with the plan's record keeper, Fidelity Investments, when they move money from one investment option to another. Petrovic adds that unlike ALCOA, Roche Diagnostics passes along to plan participants any fees levied by Fidelity for using the brokerage window in its plan.

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SWiVal: A New Idea for Stretching Retirement Savings

By Randy Myers

Most people who calculate how long their retirement savings will last consider two factors: the rate at which they plan to spend money in their retirement account, and the return they expect on whatever money remains in the plan. What they overlook, says Moshe Milevsky, a finance professor at York University's Schulich School of Business in Toronto, are the other major determinants of nest egg longevity: the sequence and volatility, not just the magnitude, of investment returns. At the Forum Milevsky introduces a collar strategy that he calls "SWiVal" for Stable Withdrawal Value.

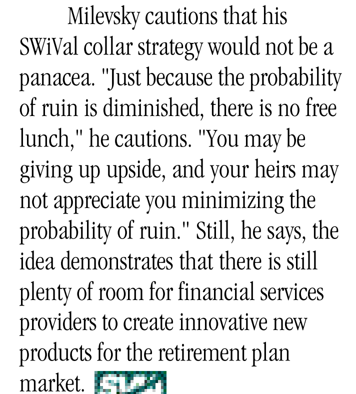
Milevsky demonstrates that the volatility of returns can have a big impact on how much an investment account grows over time. Suppose, for example, that one investor earns 10% per year on an investment account for two consecutive years, while the other loses 15% in the first year and earns 35% in the second year. For both, the arithmetic mean is the same: 10% per year. However, the arithmetic mean is a poor way to measure long-term investment returns because it ignores the impact of volatility on a total return. That's why multi-year total return figures for mutual funds and other investment accounts rely on geometric mean calculations. In this example, for instance, the first account enjoys a two-year total return of 21%, while the second, more volatile account generates a total return of only 14.75%. In fact, Milevsky says, the greater volatility in an investment account, the lower the geometric mean.

Milevsky also notes that the returns generated by an investment portfolio in the first decade of a person's retirement play a major role in determining how long that person's retirement portfolio will last. Good early returns greatly increase the number of years the portfolio will last, while poor returns greatly diminish its lifespan. Returns in subsequent decades don't have nearly the same impact. The point is easily illustrated by an extreme example: a portfolio that experiences a 100% loss in the first decade has no opportunity grow in the second.

The implications of all this are two-fold. First, the impact of volatility on long-term returns suggests that investors have an incentive to prefer assets, like Stable Value, that produce relatively stable results over those that fluctuate wildly. Second, the impact of the return sequence on long-term results suggests that investors could protect themselves from financial ruin—the complete depletion of their retirement savings prior to death—by hedging their portfolios in those important first years using financial derivatives. The basic strategy would involve purchasing a so-called "zero-cost collar" on the retiree's investment portfolio. The collar would establish a floor on portfolio losses in exchange for sacrificing some of the potential upside if the portfolio performed especially well.

In the financial markets, a zero-cost collar is created by purchasing a put option giving the owner the right to sell an underlying security at a specified price, while simultaneously selling a call option giving the buyer of the option the right to purchase the underlying security at a specified price. Properly structured, the cost to purchase the put option is exactly offset by the price received for selling the call option. Once in place, a collar protects the investor from wild swings in the value of the underlying security. If the underlying security falls dramatically in price once the collar is in place, the put option assures that the investor who bought the collar will still be able to sell the security for a good price. Conversely, if the underlying security rises in value, the call option will cap the profit that the collar buyer would earn.

There are no put or call options specifically designed for diversified individual retirement portfolios right now. Milevsky says he only came up with his idea recently. Although, in theory, it wouldn't be difficult to cobble one together using index options. Nonetheless, the logic of his concept seems unassailable. Using a Monte Carlo simulation, Milevsky calculates how long the investment portfolio of a 65-year-old woman would last under a wide variety of conditions, both with and without a collar. Assuming a 100% equity portfolio and relatively modest withdrawal rate, the woman faced an 11% chance of outliving her portfolio without a collar, but only a 5% chance with a collar. Assuming a moderate withdrawal rate, using a collar reduced her chances of financial ruin to 13% from 20%. Assuming an aggressive withdrawal rate, a collar reduced her chances to 24% from 29%.

Milevsky cautions that his SWiVal collar strategy would not be a panacea. "Just because the probability of ruin is diminished, there is no free lunch," he cautions. "You may be giving up upside, and your heirs may not appreciate you minimizing the probability of ruin." Still, he says, the idea demonstrates that there is still plenty of room for financial services providers to create innovative new products for the retirement plan market. 

Investment Advisor Promotes Stable Value Funds for 401(k) Plans

By Randy Myers

Stable Value investment professionals do not need consultant Stephen Brundage of JPMorgan/American Century Retirement Plan Services to tell them that Stable Value funds combine the best attributes of both money market funds and bond funds. But it was nice to hear him say that's exactly the message he and his colleagues routinely deliver to plan sponsor clients who rely on his firm to help them design their 401(k) plans.

"We say that a Stable Value fund is a stronger option than a money market fund in 401(k) lineups, and that if they have a money market fund in their plan, they should be thinking about moving to Stable Value," Brundage informs.

To its plan sponsor clients, JPMorgan/American Century provides a graph indicating that from January 1990 to June 2002, Stable Value offered "a better journey and destination than other conservative options." Specifically, the graph indicates that during that time period the typical Stable Value fund would have grown from $100 in value to about $240, in virtually a straight line. By contrast, the Lehman Intermediate Aggregate bond index would have grown to just a shade more—about $250-but with far more volatility. The typical money market fund, meanwhile, would have grown to only about $185.

For plan sponsors debating the addition of a Stable Value fund to their investment fund lineup, Brundage says, the biggest issues are

(1) Understanding the product's complexity and its risks,
(2) Worrying about how well participants will understand Stable Value, and
(3) Wanting to know if they can keep their money market fund and still add a Stable Value fund.

Fortunately, he says, his firm

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Stable Value, Money Market or Both?

Implications for Plan Sponsors and for the Stable Value Industry

Paul J. Donahue and Stephen F. LeLaurin, INVESCO Fixed Income

There has been a recent flurry of interest in a 401(k) plan design that offers a Stable Value fund and a money market fund, plus allows direct transfers between the money market and Stable Value funds. The potential of such a design to hurt participants by lowering the returns they earn from Stable Value funds and to threaten plan sponsor acceptance of Stable Value provides the impetus of this article. The article examines the appropriateness for a retirement plan of Stable Value, or money market, or both. We believe:

(1) Stable Value alone is a clear first choice.
(2) Stable Value and a money market fund with an equity wash is a defensible choice.
(3) Stable Value and a money market fund without an equity wash compromises the advantages of Stable Value, poses concern over fiduciary duty and appropriate disclosure, and could imperil sponsor acceptance of Stable Value.

The superiority of Stable Value over money market funds as a generator of retirement wealth is both undeniable and large. According to an analysis performed in 2000:

> *"Over the last twenty years, the yield on the Stable Value surrogate exceeds the yield on the money market surrogate by 22%, over the last ten years, by 38%. Differences in yield of this magnitude lead to significant differences in retirement accumulations; using the twenty year return numbers, per $100 per month invested, the Stable Value surrogate investment accumulation over a period of twenty years exceeds that for the money market surrogate by $10,513."* [1]

If this analysis were updated for the last two-years, Stable Value's advantage would have increased even more given the significant drop in money market rates.

In terms of the risk and return profiles, we believe Stable Value funds are clearly the superior conservative investment option. Anything the money market fund can do, Stable Value can do better. Participant dissatisfaction over a plan sponsor's selection of a money market fund to the exclusion of Stable Value is distinctly possible. It may also be legitimate to ask whether a plan sponsor choosing only a money market fund has met ERISA's "prudent expert" fiduciary standards.

Offering both Stable Value and money market funds without any transfer restrictions is a not a good choice. Veterans of Stable Value clearly know that this plan design gives rise to disintermediation risk for participants who stay in the Stable Value fund and to the sellers of the guarantee contracts ("wraps") which make Stable Value possible. While money market funds generate less wealth over time, in certain rare periods of rapidly rising interest rates and/or yield curve inversions, money market funds can offer a transitory return advantage. In such circumstances, participants can move money from the Stable Value fund to a money market with a higher return. This action can have the result of forcing down the future returns of those who remain in the Stable Value fund. Such reduction of Stable Value returns can serve to encourage more transfers until the Stable Value fund implodes and the wrap providers need to absorb the market to book deficit.

Plan design is the first line of defense against disintermediation. The most obvious plan design that avoids this risk is one that offers only a Stable Value fund and no competing option. A second responsible selection is the use of an "equity wash." An equity wash forces participants to expose withdrawals from the Stable Value fund to market risk by keeping the money they withdraw in equity or long-duration bond funds before being able to transfer to the competing fund. The purpose of the wash is to serve as a disincentive to disintermediation. The general increase in welfare to the Stable Value participants in dual choice plans is worth the headache of imposing/explaining the transfer restrictions. Of course, some participants will make the investment decision to use money market instead of Stable Value, perhaps because they don't appreciate its equivalent safety of principal and superior returns. It can be a challenge to clearly explain Stable Value so that these points come through, especially to participants who aren't investment savvy.

Some plan sponsors think that their plan participants should have their cake and eat it too. They insist on a plan design that has both Stable Value and a money market fund and that permits direct transfers (mainly to avoid the need to explain the transfer restrictions). What are the consequences of this decision? A "risky" plan with both options might necessitate a shorter duration Stable Value fund (to minimize book to market differences), or elaborate portfolio and wrap mechanisms that compromise efficient investment management. Forcing shorter durations alone could easily reduce the Stable Value yield advantage by 50%.

Issuers of wrap contracts may also insist on retaining more flexible contract termination provisions for themselves where direct transfers are permitted. A wrap contract that can terminate just when money market yields exceed Stable Value yields will lead to the total disappearance of principal protection in the Stable Value fund, turning the option into a short-term bond fund with potential market losses. This would come as a rude surprise to participants and could certainly subject plan sponsors to an unforeseen liability to make plan participants whole. Such provisions might even call into question the validity of book value accounting, or suggest disclosure to participants of this risk.

Finally, even after the increased protection of more restrictive investment guidelines and more expansive exit provisions, the residual risk is still greater and requires a greater risk charge. This further reduces the yield advantage of the Stable Value option by another 10%.

In total, plan sponsors may sacrifice half or more of the total yield advantage of Stable Value over money market funds when they choose to permit direct transfers between Stable Value and a money market fund. In normal yield environments, all participants will suffer from this loss of yield. Over the periods of time appropriate to consider for a program of retirement savings, the differences in wealth accumulation are meaningful: 2.5% in lost earnings potential over 20 years at typical interest rates. The sole potential beneficiaries of this yield give-up are participants who react quickly to interest rate changes to get slightly higher money market yields, and this will come at the further expense of participants who are slow to move. Even for these fast moving participants, it is likely to be a bad long run trade off.

Conclusions

- Given the clear superiority of Stable Value, we believe all plans should have Stable Value funds instead of money market funds.
- Having just money market funds will substantially reduce the wealth of all participants who seek out the conservative option.
- Offering both with an equity wash is ok.
- Having both without an equity wash will substantially

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[1] Paul J. Donahue, *What AICPA SOP 94-4 Hath Wrought: The Demand Characteristics, Accounting Foundation and Management of Stable Value Funds,* 16:1 Benefits Quarterly 44:46 (First Quarter, 2000).

Hurdles Outlined for Stable Value in Mutual Fund Platform

By Randy Myers

Over the past few decades mutual fund companies have introduced all sorts of products aimed at fixed-income investors: government bond funds, municipal bond funds, high-yield bond funds, even funds that invest in adjustable rate mortgages. But all of them, says Morningstar Associates LLC President John Rekenthaler, have merely been an asterisk to money market funds, which have come to be prized by investors for their implied guarantee of principal and dependable if generally modest returns. As of August 2002, Rekenthaler says money market funds held assets totaling $2.1 trillion, versus $1.1 trillion for all other types of fixed-income funds combined.

The most recent addition to the lineup of fixed-income mutual funds is the Stable Value mutual fund, the first of which appeared in 1998. Whether these funds can make a bigger dent in the dominance of money market funds, Rekenthaler says, will depend upon the response of the industry and investors to these issues:

- **Trading restrictions.** Will retail investors accept the trading restrictions, asks Rekenthaler, that most Stable Value mutual funds impose on their shareholders during periods of sharply rising interest rates?
- **Principal protection.** To what extent, Rekenthaler asks, will Stable Value funds meet their implicit guarantee to preserve a shareholder's principal?
- **Changes in the yield curve.** Although Stable Value funds have a long history of strong performance in all sorts of interest rate environments in the 401(k) marketplace, Rekenthaler says investors will want to see how the new Stable Value mutual funds perform across a full market cycle's worth of changes in the yield curve.
- **Management discipline.** Funds in other sectors of the fixed-income marketplace have been hurt in the past by rogue management techniques, warns Rekenthaler, typically when they invested too aggressively in an attempt to attract assets. Stable Value managers can't make that mistake.
- **Marketing.** Will the Stable Value industry be able to police its promises to investors, Rekenthaler asks, and avoid hyperbole and overselling?
- **Media perceptions.** To really gain headway, Rekenthaler suggests, Stable Value funds would have to occupy, in the minds of the media, the high road now held by money market funds. One challenge for the funds' operators, he says, will be to keep costs at levels that financial writers and investment analysts won't find excessive. "When you get over 100 basis points on a short-term investment, analysts and the media are going to have a problem with that," he says. "Seventy-five basis points is not cheap, but can be acceptable for a well-run fund. We like to see 50 basis points."

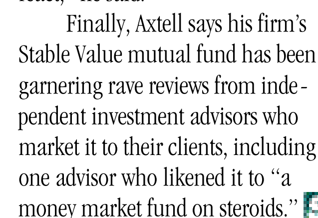
Rekenthaler himself has considerable ability to influence investor opinion. He oversees development and marketing of Morningstar ClearFuture, an internet-based service that provides investment research, education and guidance or advice to help individual investors plan for retirement. Speaking at the SVIA Forum, he said Stable Value mutual funds have much going for them in their bid for widespread acceptance by retail investors, primarily their high yields relative to money market funds and their low volatility relative to other types of bond funds. "But like many failed fixed-income products before them," he warns, "Stable Value is hard to explain and easy to oversell."

Rekenthaler's comments dovetailed with those made at the SVIA Forum by various investment firms that market Stable Value mutual funds. They report strong asset growth for their funds, but also indicate that the industry must continue to work hard to educate both investors and investment advisors about the unique attributes of the products. "We have ridden a wave of declining interest rates, and now will be looking at a rising rate environment," observes Daryl Dennis, vice president of fixed-income investments for ICMA Retirement Corporation, which launched its Vantagepoint Income Preservation Fund in December 2000. "Our industry will have to prove that it can perform in a difficult market." His firm's outlook for market conditions next year includes not only rising interest rates but also modestly higher inflation, modestly rising equity prices and a weaker dollar.

Dennis says the Vantagepoint Income Preservation Fund has drawn in approximately $460 million in assets. The fund is marketed exclusively to participants in public retirement savings plans and IRA investors. Thus far, the vast majority of its assets have come from the public plan market; the fund is offered in approximately 6,000 plans serving approximately 88,000 investors.

Deutsche Asset Management manages the world's oldest Stable Value mutual fund, the Scudder PreservationPlus Income Fund, and it also grew phenomenally in 2002. John Axtell, managing director and head of the Stable Value management group at Deutsche Asset Management, says the assets rose from $1 billion in January 2002 to $1.6 billion by September 2002. Some of the credit goes to their performance. The fund outperformed money market funds by a handsome margin.

Axtell says he sees tremendous opportunities for Stable Value mutual funds in the broker-sold small 401(k) plan market, in the IRA rollover market and in the 529 college savings plan market. He also said that while some industry observers worry about what will happen to Stable Value funds when interest rates do start rising, he believes a rising rate environment would actually be beneficial in that it would drive some investors into Stable Value mutual funds from traditional bond funds. "Retail investors will see bond funds producing negative returns and they will react," he said.



Finally, Axtell says his firm's Stable Value mutual fund has been garnering rave reviews from independent investment advisors who market it to their clients, including one advisor who likened it to "a money market fund on steroids."

Stable Value, Money Market or Both?

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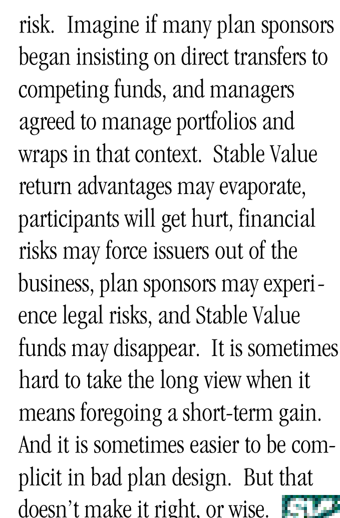
dilute or even eliminate the advantages of Stable Value, may raise questions about book value accounting, and create disclosure and fiduciary duty issues; it hurts all participants on average and may even create financial exposure for the plan sponsor.

A central problem for the industry with dual choice plans without washes is that it could put the very existence of Stable Value funds at risk. Imagine if many plan sponsors began insisting on direct transfers to competing funds, and managers agreed to manage portfolios and wraps in that context. Stable Value return advantages may evaporate, participants will get hurt, financial risks may force issuers out of the business, plan sponsors may experience legal risks, and Stable Value funds may disappear. It is sometimes hard to take the long view when it means foregoing a short-term gain. And it is sometimes easier to be complicit in bad plan design. But that doesn't make it right, or wise.



Data Reveals Positive Stable Value Growth & Cash Flows

By Kathleen Schillo, Hueler Analytics

In a time of market uncertainty, it is interesting to reflect upon the growth and cash flows of Stable Value. As of June 30, 2002, the Hueler Analytics Stable Value Pooled Fund Universe represented $50 billion in pooled fund Stable Value assets. As seen in the table below, assets for the funds represented in the Universe as of June 30, 2002 have more than doubled in the past five years resulting in a five-year growth rate of 125%. In the last year alone, these funds have grown by 21%.

Hueler Analytics Stable Value Pooled Fund Universe Growth Rates:

1 Year	2 Year	3 Year	5 Year
21%	42%	52%	125%

Hueler Analytics Stable Value Pooled Fund Universe Assets*

Date	Universe Assets
06/30/1997	22,375,274,379
06/30/1998	25,433,181,468
06/30/1999	33,101,549,090
06/30/2000	35,579,492,936
06/30/2001	41,653,940,398
06/30/2002	50,397,695,513

*Based on the pooled funds in the Universe as of 6/30/2002

The separate account market segment represented by the FIRSTSource market data shows that the average cash flow as of June 30, 2002 was once again positive. Prior to first quarter 2001, the average Stable Value cash flow into separate accounts had been negative for many years. Out of the last six quarters alone, three of the quarters have portrayed a positive average cash flow.

FIRSTSource Market Data:	2nd Qtr. 2002	1st Qtr. 2002	4th Qtr. 2001	3rd Qtr. 2001	2nd Qtr. 2001	1st Qtr. 2001	4th Qtr. 2000	3rd Qtr. 2000	2nd Qtr. 2000
95%	6.13%	5.06%	4.15%	9.62%	3.46%	10.08%	6.63%	5.48%	3.63%
75%	2.59%	1.27%	0.45%	4.65%	0.41%	5.15%	0.91%	0.64%	-0.55%
Average	1.09%	-0.24%	-0.81%	2.80%	-0.81%	2.67%	-0.73%	-0.97%	-2.03%
25%	-0.42%	-1.81%	-2.43%	0.66%	-2.51%	0.28%	-2.58%	-2.55%	-3.72%
5%	-3.29%	-5.24%	-4.68%	-2.17%	-4.92%	-4.93%	-8.07%	-6.15%	-7.46%

With the Dow Jones at 7286 on October 9th of this year, a level not seen since June of 1997, it is highly likely that the plans represented in FIRSTSource will once again portray a positive average cash flow in third quarter. FIRSTSource market data encompasses approximately 300 plans with $341 billion in total plan assets and $96 billion in Stable Value assets.

Brokerage Windows Get High Marks

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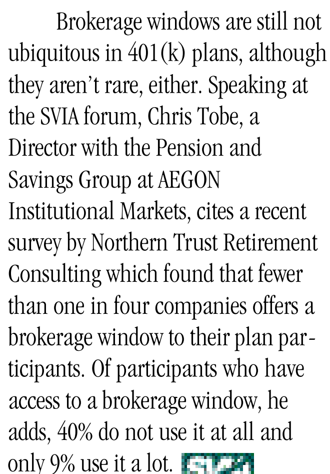

Brokerage windows are still not ubiquitous in 401(k) plans, although they aren't rare, either. Speaking at the SVIA forum, Chris Tobe, a Director with the Pension and Savings Group at AEGON Institutional Markets, cites a recent survey by Northern Trust Retirement Consulting which found that fewer than one in four companies offers a brokerage window to their plan participants. Of participants who have access to a brokerage window, he adds, 40% do not use it at all and only 9% use it a lot.

Investment Advisor Promotes Stable Value Funds

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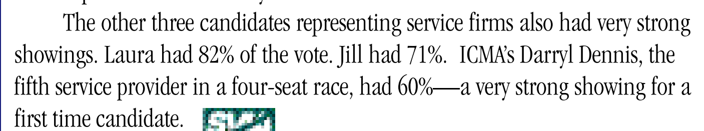
has had great success in overcoming those concerns, especially with money market returns at historic lows. So far this year, he says, his firm has convinced eleven plan sponsor clients to eliminate money market funds from their defined contribution plans in favor of Stable Value funds. "Right now this is a very easy sell for us," he concludes.

Six Elected to SVIA Board of Directors

SVIA members outperformed the general public in getting the vote out this election cycle. Seventy percent of the membership participated in our first election using the Internet. The elected members are: Karen Chong-Wulff, Dupont; Jill Cunniff, Gartmore Morley; Wendy Cupps, PIMCO; Laura Dagan, Dwight Asset Management; Ralph Egizi, Eastman Chemical; and Wayne Gates, John Hancock.

This election cycle clearly favored incumbents. Wendy and Wayne garnered 82 and 94 percent respectively. Our two plan sponsors candidates, Karen and Ralph were unanimously affirmed.



The other three candidates representing service firms also had very strong showings. Laura had 82% of the vote. Jill had 71%. ICMA's Darryl Dennis, the fifth service provider in a four-seat race, had 60%—a very strong showing for a first time candidate.