SVIA STABLE TIMES

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IN THIS ISSUE

Many of the articles that appear in this issue of Stable Times highlight speakers and topics from this year's SVIA Annual Forum held in Washington, D.C. on October 20-21, 2005.

Cappiello Sees Stock Rally Once Interest Rates Stabilize

By Randy Myers

It is easy to be bearish on the US stock market as 2005 drew to a close. An unprecedented wave of bad weather has wreaked devastation on the Gulf Coast. Soaring oil prices are squeezing consumers and threatening to ignite inflation. Housing prices in some parts of the country are so high they are prompting fears of a bubble. The Federal Reserve continues to push interest rates higher, and the federal deficit, to some minds, has swollen out of control. Certainly the market's performance through the first 10 months of 2005 was no cause for celebration; through October 20, the Standard & Poor's 500 stock index was down about 2.8 percent for the year, the NASDAQ Composite off nearly 5 percent.

But Frank Cappiello, chairman and managing director of investment advisory firm Montgomery Brothers, Cappiello LLC, is bullish. Speaking at the SVIA Forum, the prominent market analyst cited a litany of reasons to show why investors shouldn't be pessimistic. While Hurricanes Katrina and Rita caused an estimated $150 billion to $200 billion in damages to the Gulf Coast, Cappiello said, cash flowing into the area to aid in its recovery insures that those disasters, despite the human tragedy, would prove nothing more than a hiccup for the economy. History supports the argument, he said, noting that three months after Hurricanes Andrew in 1992, Hugo in 1998, and Charles and Ivan in 2004, most of the economic impact of those storms had been mitigated, and a year later, was virtually nil. (In fact, a week after Cappiello spoke, the U.S. Commerce Department reported that the nation's gross domestic product grew at a strong seasonably adjusted 3.8 percent annual rate during the third quarter, despite the impact of Hurricanes Katrina and Rita.) History also suggests, Cappiello said, that any housing bubble that might be developing in this country is regional, not national, and could be cured "without a lot of stress." He also noted that

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Fitch Ratings Warns Defaults on High-Yield Bonds May be Poised to Rise

By Randy Myers

For the past two years, default rates on high-yield corporate bonds have hovered at their lowest levels since the mid-1990s. The good times may be set to end.

Data compiled by credit-rating agency Fitch Ratings shows that only 1.5 percent of high-yield bonds defaulted in 2004, and only 1.4 percent defaulted during the first nine months of 2005. When bonds did default, investors were able to recover substantial portions of their assets: 61.5 cents on the dollar in 2004, and 53.9 cents in the first nine months of 2005. By comparison, 16.4 percent of corporate high-yield bonds defaulted in 2002, the single worst year in the past two-and-a-half decades. That year, the average recovery was just 22.5 cents on the dollar.

Most recently, though, default-rate trends have been moving in the other direction, with both the number of issuers defaulting and the dollar volume of defaulted issues more than doubling from the second quarter to the third quarter of this year.

Several factors have worked in bondholders' favor over the past couple of years. First, the economy began to improve in 2003 and picked up steam thereafter, creating a better overall business environment. Meanwhile, the Federal Reserve Board kept short-term interest rates low (even with a 300-basis-point increase over the past year and a half), which made it easier for companies to get credit to finance their debt. Even now, says Fitch managing director Mariarosa Verde, it remains a borrower's market. Companies with below-investment-grade debt ratings of CCC, CC and C in the Fitch rating system have been accounting for a growing share of the total corporate debt issuance for the past four years, from

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Editor's Corner

By Steve LeLaurin, INVESCO Institutional

Well, here we go again. Another issue of *Stable Times,* designed and written to educate and entertain the world about that onion that is "stable value." (You know, you keep peeling away the layers, only to find more and more and more … ok, it's a tired metaphor, but an accurate one.)

Ordinarily, we publish a fourth quarter issue shortly after the completion of our "National Forum" held annually in D.C. This 4Q issue typically records the many sessions that occur at that conference. As usual, we began the creation effort even before the October event with all good intentions, enlisting the talented help of Randy Myers to act as note-taker and scribe. His task was to absorb and recount and articulate several days worth of a significant volume of "onion-peeling."

This year we just didn't seem to get our 3Q issue out of the word processors and into print. So instead, we decided to take Randy's formidable work and add to it with a number of additional articles for this 3&4Q issue. We've got a FASB update, a report of the new slate of directors on the SVIA Board, a stable value performance article, a new look at equity washes, and more. As a companion piece to the one on trading restrictions/equity washes, Bob Whiteford has included a discussion of a survey of the industry's views on brokerage and mutual fund windows.

We tried to take a look at 5500 reporting of stable value investments (or rather, we asked Randy to do such an article). But we were dismayed that it was so difficult to get a handle on the issues and facts. He dug and scratched and interviewed, even finding someone at the DOL to talk to him … but interestingly enough, this Labor Department official was unable to comment "on the record." Despite this inside connection, despite a number of us in the industry trying to offer insights, we still found this to be a very difficult subject to get our collective hands around. So we've tabled that for another day.

This ends up being a pretty hefty issue, at least in terms of size if not gravity. Who knows … perhaps it is enough for a big tureen of onion soup.

Correction

In the last issue of *Stable Times*, (Volume 9, Issue 2, Second Quarter), two versions of an article were printed in error. A preliminary draft, "New GICS Offer Inflation Protection to Stable Value Funds," by Randy Myers was mistakenly included. Please disregard this article in your *Stable Times* library. Please use the article reviewed and approved by the *Stable Times* Editorial Board, "Stable Value Managers Tap Growing Array of Tools to Hedge Against Inflation," by Randy Myers on inflation protection tools available to stable value managers.

A World Without the SVIA?

By Randy Myers

In the classic film *It's a Wonderful Life,* the heavily burdened George Bailey learns what the world would have been like if he hadn't been born. Seeing the good he's done, he regains his zeal for life. Addressing the SVIA Forum, outgoing SVIA Chairwoman Victoria Paradis considered what the financial world would be like without the SVIA. She concluded that like George Bailey, it has played an important role for many people, not just its own members. In a worst-case scenario, she says, a world without the SVIA might have resulted to a world without stable value investments. If so, millions of stable value investors might be lamenting the lower returns they'd be earning on money market funds right now, or the increased volatility they'd be experiencing with bond funds.

Paradis noted that the stable value industry relies on favorable regulation, legislation and accounting rules to preserve its unique book-value accounting in what has increasingly become a fair-value world. Over the past several years the SVIA has been instrumental in championing its role in the financial marketplace. In the future, she said, maintaining the industry's complex framework will require that the industry continue to speak with a consolidated and powerful voice.

The SVIA's accounting and communications committees both serve

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Cappiello Sees Stock Rally

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on a national level, housing prices have risen every year since 1960, illustrating the odds against a national housing market crash.

On the oil front, Cappiello said, rising prices have made drilling for alternate sources of crude-such as those trapped in the tar sands of Canada--more economically viable, which will help to temper prices going forward; he expects crude prices to stabilize in the neighborhood of $50 to $55 a barrel over the next 12 months.

Cappiello also said that higher energy prices and rising interest rates have dampened the mood of the American consumer, but they haven't sent them running. Cappiello said he expects retail sales to be down by a manageable 5 percent during the always important Christmas shopping season this year. At the same time, business executives remain confident as ample supplies of cash are on hand to fuel investment in new opportunities, such as mergers, when they present themselves. One reason for their optimism, he added, is that corporate profits have risen for seven straight quarters, a trend he sees continuing for the foreseeable future.

On top of all this, Cappiello added, stock prices aren't terribly high right now relative to corporate profits, with the S&P 500 valued at just over 14 times the per-share earnings of its component companies.

The key to the stock market's performance from here out, Cappiello said, will be the Federal Reserve Board's interest rate actions. Over the past year and a half, the Fed has raised the federal funds rate-the rate at which banks lend balances at the Federal Reserve to other banks--to 4 percent from 1 percent. Cappiello said that while bumping the rate higher could put the US economy at risk, if not of a recession, then at least a downturn. He believes the Fed won't push rates substantially higher. Once short-term rates have stabilized, he added, the stock market should be poised for a significant rally, something he said he hoped might happen as soon as 2006. In fact, he said investors can look for the Dow Jones Industrial Average, which sat at 10,344.98 at the close of trading on October 26, to be above 11,000 sometime in the first quarter of 2006.

Cappiello is less bullish on corporate bonds than he is on stocks, arguing that the outlook for that market changed for the worse with the bankruptcy filing of auto parts maker Delphi Corp. Although executives at ailing General Motors Corp. have denied considering bankruptcy as a solution to that company's financial woes, Cappiello pegged the chances of a Chapter 11 filing by GM at about 30 percent. "There is greater risk in the corporate bond market now than there was last year," Cappiello said, adding that the failure of commodities broker Refco Inc. decimated the value of its bonds. It also illustrated that there are dangers in the corporate bond market right now. Cappiello said he was more favorably disposed both to US Treasury bonds and to foreign sovereign bonds, noting that the latter can also provide investors with a hedge against the U.S. dollar. SVIA

Amplification

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World Without SVIA?

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that effort, Paradis said. Their efforts are buttressed, she said, by the sheer size of the stable value industry, which exceeds $400 billion. Regulators and legislators alike appear to have recognized that rulings adverse to the stable value marketplace would have a negative impact on the investment activities of millions of retirement plan investors, Paradis said.

The industry has faced challenges in recent years. Adverse regulatory decisions on accounting for stable value mutual funds effectively shut down that fledgling business just several years after its launch is just one example. Still, Paradis insisted that significant growth opportunities remain. Growth of stable value's primary market, defined contribution retirement plans is expected to grow. The consulting firm Cerulli Associates expects the defined contribution market to enjoy asset growth of 9 percent annually over the next several years with assets reaching $4 trillion by the year 2010. While stable value should grow simply as a slice of a bigger pie, Paradis also said the industry has a chance to increase its market share. It can do that, she said, both by winning assets from other conservative investment options and by gaining representation in the lifestyle funds that are becoming increasing popular in defined contribution retirement plans.

To make this growth happen, though, Paradis said the SVIA will need a continued long-term financial commitment from its members, along with active, thoughtful voices willing to tackle the challenges and opportunities the industry faces. SVIA

SVIA Elects Six New Officers

SVIA members elected six new officers to the Board of Directors at the end of October. The new Board members, who will serve on the Board for three-years are: Jackie Bell, DuPont; Tony Camp, ING; Ralph Egizi, Eastman Chemical; Bret Estep, PIMCO; Vicky Paradis, JPMorgan; and Dylan Tyson, Prudential.

Two incumbents, Ralph Egizi and Vicky Paradis, were elected to the Board for a second term. The new slate of Directors will start their term on January 1, 2006. To learn more about SVIA's Board and its activities, check SVIA's website, www.stablevalue.org. SVIA

Fitch Ratings Warning

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10 percent in 2002 to 20.1 percent in the first nine months of 2005. Fitch's ratings of CCC and C indicate a high risk of default. The C rating is the lowest Fitch rating that Fitch assigns other than the DDD, DD and D ratings, which are assigned to bonds that have already defaulted.

Speaking at the SVIA Forum, Verde said this new trend is troubling for a number of reasons. First, she said, it would be reasonable to hope that during a period of economic expansion, CCC-rated borrowers, who are most prone to default, would account for a decreasing, not increasing, portion of total debt issuance. The theory is that operating improvements should lift borrowers' credit ratings. "Credit availability has been the key to depressing the default rate, but if operating improvements don't follow, it may just defer some of the defaults," Verde said. She also noted that there will be three times as many high-yield issues maturing than there were in 2005. With interest rates rising, some of those issuers will find it more difficult to refinance their debt than they have in the recent past.

"With fewer investment grade companies," Verde concluded, "even in a period of strong economic growth, we can expect more defaults." SVIA

Social Security 101

By Randy Myers

Just about everybody concedes that the Social Security program is in trouble. Within 12 years, says Michael Tanner, director of the Cato Institute's Cato Project on Social Security Choice, it will start taking in less money through payroll taxes than it pays out in benefits. By 2041, it will be legally and financially unable to pay promised benefits. At that point, Congress will have only three options: allow benefits to be cut by 25 percent or more, increase Social Security payroll taxes to meet the promised obligation, or borrow to meet the obligation.

The magnitude of the problem is staggering. Social Security is already the single biggest item in the federal budget, Tanner said at SVIA's Forum. Without any changes, he said, Social Security will account for 29 percent of the budget by 2020 and 34 percent by 2030. "By the middle of the century," he said, "the entire budget would be Social Security, Medicare, Medicaid, and interest on the national debt. There would be, for example, no defense spending."

But the Social Security problem is much more immediate than that, Tanner warned. While the "Social Security Trust Fund" will allow the program to meet its full obligation from 2017 through 2041, he noted, that trust fund merely consists of government bonds-debt the government owes itself. "The only way to turn those IOUs into cash is to raise taxes, cut spending or borrow," he said. "Those are the same choices we'd face if there were no trust fund at all. That is why non-partisan analysts generally agree that Social Security's financing problems begin with the payroll tax deficits in 2017, not when the trust fund runs out in 2041." As early as 2027, Tanner added, the federal government would have to redeem $220 billion in bonds from the trust fund to pay that year's Social Security benefits.

As if all this weren't bad enough, Tanner also argues that Social Security's payout system is flawed, often discriminating, albeit not overtly, against working women, divorcees, African Americans and younger Americans. The real rate of return on the public's Social Security "investment" had been falling for all retirees for a long time, he said, from 1.13 percent for a single male with median wages born in 1970, for example, to 0.86 percent for that same single male born in 2000. The illustration assumes no change in the law and retirement at age 65. This decline has occurred despite repeated increases in Social Security payroll taxes, from 2 percent in 1937 to the 12.4 percent rate that's been around since 1990.

Because the problems facing the Social Security system are so monumental, Tanner warned there will be no easy solutions. Unfortunately, he said, debate on the issue thus far has been short on facts and high on rhetoric, emotion and fear-mongering, leading to much confusion among the public. "Every Congressman, and every American, needs to learn about Social Security, the problems it faces and the solutions that have been proposed," he said. "Doing nothing isn't an option. Without action, benefits will eventually be cut by more than 25 percent. If you don't have a reform plan, you're for benefit cuts, because that's what the law prescribes."

Tanner argues in favor of President Bush's proposal to allow American workers to invest at least part of their Social Security contributions into private accounts-even if it won't do anything to make Social Security more solvent-citing research indicating that people who feel they have an ownership stake in their investment program do a better job of managing it. In fact, he said, a good first step would be to rebate to workers the Social Security payroll taxes they're paying in now that exceed current benefit requirements, so they could reinvest that money on their own. That, he conceded, would boost the budget deficit by about $70 billion a year, but he argued that it also might provide some much needed discipline for federal legislators who have been pushing the federal deficit higher and higher in recent years. "If Congress is going to spend like a drunken sailor," he said, "you have to take the bottle away from them." SVIA

Former CBO Director Urges Multiple Changes to Put Elderly Programs on Sounder Footing

By Randy Myers

If there's any funding crisis more frightening than the one facing the Social Security system, it is the one confronting Medicare, the federal health insurance program for those who are disabled or over the age of 65. Economist Dan Crippen, director of the Congressional Budget Office during President George W. Bush's first term, says it will take a mix of innovative and difficult measures to bring either one under control.

To put the size of the two programs in perspective, Cridden told the SVIA Forum that Social Security spending currently equals about 4 percent of the country's gross domestic product while Medicare equal about 2 percent. By the year 2030, however, both are projected to equal about 6 percent of GDP. Medicaid, the federal health program for low-income citizens, is also facing dramatic growth and a funding crisis of its own. Now equal to about 1.5 percent of GDP, it will equal about 4 percent by 2030. The general demographic issue of an aging population with fewer workers for each retiree generating higher costs for these programs is well known. However, the acceleration in the relative growth rates for Medicare and Medicaid versus Social Security is surprising to most people. This relative acceleration is driven by the fact that health care inflation (which drives Medicare and Medicaid costs) is significantly higher than the broad inflation measure used to index Social Security payments.

While President Bush has been a strong advocate of creating individual savings accounts within the Social Security program, that proposal presently seems dead in the water, perhaps in part because, as Cridden noted, it wouldn't do anything to solve Social Security's funding crisis since Social Security will be paying out more than it takes in through payroll taxes.

Other options exist that would bring the program back onto sound fiscal footing, but not without some pain. Raising the retirement age, Cridden said, would save the Social Security program $72.6 billion between 2006 and 2015, while constraining increases in initial benefits would save $103.6 billion over the same time period.

Solving the Medicare and Medicaid problems, Cridden said, will require government to understand where the programs incur most of their costs, and, therefore, where there is potential to realize the greatest savings. A study of Medicare payments between 1995 and 1999 showed that 84 percent of Medicare benefits went to just 20 percent of Medicare participants. Medicaid is similarly lopsided, with 25 percent of participants consuming about 70 percent of the benefits. Reducing what these most needy citizens cost the government doesn't depend on stripping them of their health care benefits, Cridden said, but rather on finding ways to provide care to them more efficiently and effective-

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Former SEC Chief Harvey Pitt Urges Wall Street to Police Itself More Strictly

By Randy Myers

As a one-time top government regulator, former Securities & Exchange Commission Chairman Harvey Pitt is unimpressed by the government's ability to regulate ethical business behavior.

Pitt, now the CEO of global business consulting firm Kalorama Partners in Washington, D.C., led the SEC from 2001 to 2003 when it adopted dozens of new rules aimed at preventing future business scandals like those that brought down Enron, WorldCom and other high-profile companies at the turn of the decade. Many of those rules were prompted by Congress' passage of the Sarbanes-Oxley Act of 2001, which Pitt characterizes as "hastily and badly produced legislation." It led, he says, to an increasing reliance on rules to enforce standards of behavior as well as a "pernicious and destructive" competition between various prosecutors to punish wayward behavior. It hasn't stopped the parade of scandals, as evidenced by the kickbacks and other bad behavior of insurance brokers, trading abuses at mutual fund companies, and, most recently conflicts of interest in the pension consulting industry. "We also now have pension funds investing in hedge funds, which is a disaster waiting to happen," Pitt says.

The best solution to bad corporate behavior, Pitt told the SVIA Forum, is not government intervention, and that also applies to attempts to protect the interests of retirement plan investors. Rather, he says, the financial services industry should take proactive measures to clean up its own behavior. Accordingly, he offered several "rules of thumb for success" for corporations in the post-Sarbanes-Oxley world:

- Understand that when scandals tarnish one company, they tarnish everyone in the industry.
- Don't start caring more about your company's profits and your personal paycheck than you do about your customers' success.
- Make good ethics a top-down priority. "You can't set a tone just with procedures and policies," Pitt said. "You need to instill a culture of truth, transparency and fairness at every corporate level. When you learn of a problem, you must follow up and keep records. There's not such thing as a de minimus ethical break; there have to be consequences."
- "Hope for the best but plan for the worst. Bad things happen to good companies."

Asked whether he thought the SEC examination of pension consultants would lead to changes in that industry, Pitt said it would if the industry allows it. If pension consultants, their customers and business partners simply wait to see how the inquiry plays out, he said, the government will respond with legislation and/or regulation that addresses the worst fact patterns uncovered, rather than industry norms. "If you wait," he said, "the government will dictate to you what should be done by your industry." He encouraged the industry to come up with its own best practices, denounce past behavior that didn't measure up, and demonstrate that its best firms have implemented standards and practices that exceed what the government requires. SVIA

Retirees Advised to Consider Postponing Social Security Withdrawals

By Randy Myers

The conventional wisdom is that workers who are planning to rely on both Social Security and their own savings in retirement should try to get by on Social Security first. Withdrawals from their savings account, which are likely taxable should be delayed. That's especially true if those savings are sheltered in an IRA or employer-sponsored defined contribution retirement plan, as the money there can continue to grow tax-deferred until it's finally needed. (Money in those accounts is only taxed upon withdrawal.)

But the conventional wisdom isn't right for every retiree. Speaking at the SVIA Forum, Jim Mahaney, a marketing director with Prudential Financial's retirement group, said retirees should determine whether they might be better off tapping their savings account first and postponing the date when they begin taking Social Security benefits.

For many people, Mahaney said, delaying Social Security benefits can provide higher cash flow in retirement. The reason lies partly in the fact that workers who delay taking their Social Security benefits receive a higher benefit. But more importantly, it reflects the favorable income tax status accorded Social Security benefits. For example, under federal tax laws, if a married couple's annual combined income-defined as 50 percent of their Social Security benefits plus all other income-is $32,000 or less, none of their Social Security benefits are subject to federal income tax. If their combined income is between $32,001 and $44,000, up to 50 percent of their Social Security benefits are taxed. If their combined income is $44,001 or higher, up to 85 percent of their Social Security benefits are taxed. By contrast, all withdrawals from an IRA, 401(k) plan or similar retirement account are taxed as ordinary income.

At the very least, Mahaney said, couples should consider postponing Social Security benefits for at least one partner in the marriage. To make up for the forfeited Social Security income until Social Security benefits begin flowing-assuming that income is needed for living expenses-he said they may want to consider purchasing an annuity. Naturally, the cost of purchasing that annuity and the income it can generate must be factored into the decision about when to start taking Social Security benefits. SVIA

Putting Elderly Programs on Sounder Footing

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ly, such as treating them outside of an expensive hospital environment when it's possible and when they desire it.

Cridden said he anticipates that Congress eventually will turn to a variety of measures to save the Social Security, Medicare and Medicaid programs, from reducing Social Security benefits and increasing taxes to enacting major Medicare reform. "We also need to rethink our immigration policy," Cridden added, noting that the more workers the nation has supporting retirees through payroll taxes, the more sustainable social programs will be. SVIA

Public Pension Problems an International Issue

By Randy Myers

For all the dire predictions about the fiscal health of the U.S. Social Security system-see "Social Security 101" elsewhere in *Stable TImes* — the program is in better shape than many of its counterparts in other parts of the world. Italy, for example, has an unfunded retirement plan liability equal to about 400 percent of its gross domestic product. Much of Europe is in similar straits. By comparison, the unfunded liability of the U.S. Social Security systems is about 150 percent of GDP, according to Richard Hinz, a pension advisor for the World Bank and formerly director of the Office of Policy and Research for the U.S. Department of Labor's Pension and Welfare Benefits Administration. Thanks to the widespread problems, he says pension reform has become a worldwide phenomenon. And while some common approaches have emerged, he says different countries have experienced much different outcomes.

Hinz told the SVIA Forum, that typical problems with public pension systems around the world include an inability to deliver the expected benefits, uneven and unfair distribution of costs and benefits, and poor management of assets, particularly in the developing world. Successful reforms are important, he said, not only because of moral imperatives but because the burden of meeting the needs of the elderly can make other social objectives unaffordable and lead to macroeconomic instability, as it did in Brazil in 1998.

At the root of many countries' pension problems, Hinz said, are rising life expectancy rates and declining birthrates that are converging to replacement levels. With more elderly and fewer people of working age, it becomes increasingly difficult to sustain pension systems, especially those like Social Security which operate on a pay-as-you-go, or PAYGO, model, meaning that current workers pay for the benefits of today's retirees.

Several types of reforms are options for troubled retirement systems, Hinz says. They include changing the provisions of the existing system, which he calls the "facelift" of pension reform-pushing out the retirement date, for example, or reducing benefits. Other reforms including transforming from a PAYGO defined benefit system, such as the Social Security system, to a defined contribution type of plan; privatizing some elements of the plan, such as asset management or recordkeeping; and diversification of the plan into multiple "pillars," each representing a different level or type of benefit. Such pillars might include non-contributory social assistance for the lifetime poor; a publicly financed and managed pay-as-you-go system to provide basic income protection; a mandatory funded individual account system with a direct link between contributions and benefits; voluntary retirement savings, either individual or occupational; and family and intergenerational support for the elderly. Different combinations of pillars can work, Hinz said, depending upon the characteristics of the country involved.

Australia, which has one of the developed world's best-funded (though not debt-free) pension systems, offers a means-tested minimum benefit to provide a retirement safety net for the country's poor, and requires employers to make mandatory contributions to a defined contribution plan set up for workers. With no explicit licensing process, many types of investment funds are available in that country: employer-sponsored funds, individual or collective arrangements and retail funds.

Sweden, which also has a relatively healthy national retirement system, several years ago replaced its PAYGO defined benefit system with a PAYGO "notional defined contribution" or NDC system in which 16 percent of workers' wages are credited to individual retirement accounts. Another 2.5 percent of wages goes to fund individual retirement account. Benefits are paid out as annuities. Other countries that have reformed or are reforming their retirement programs, Hinz said, include Kazakhstan, Poland, Mexico, Hong Kong, the United Kingdom, China, Russia, Brazil, India and Nigeria.

Hinz said the changes rippling through the pension world present opportunities for the global pension industry, though some will be challenging. For example, he says, there are few passively managed index funds for emerging markets, but only because developing them in thin and volatile markets is difficult. Similarly, many countries have pension systems that don't allow for retail products such as those developed in the US for 401(k) plans; instead, asset managers will have to develop wholesale products which may be sold only through a competitive licensing process. In addition, many countries have undertaken reforms that require the issuance of full or partial annuities at retirement age, but do not have markets in place to provide them. He also noted that it will be a challenge for annuity providers to get a handle on mortality rates in many developing countries. In developing countries, fixed-income instruments with durations beyond 3 to 5 years are also rare. SVIA

Fitch Ratings Maintains Stable Outlook on US Life Insurance Industry

By Randy Myers

Despite a significant change in credit fundamentals for the U.S. life insurance industry, Fitch Ratings continues to have a stable outlook for the sector.

Fitch last changed its rating on the life insurance industry in September 2002, when it upgraded its outlook to stable from negative. At that time, its pessimistic assessment had been in place for four years.

At the SVIA Forum, Fitch managing director Julie Burke said the insurance industry continues to benefit from a good balance sheet: strong statutory capitalization, moderate use of debt leverage, good asset quality and a stable, long duration liability profile. Of the approximately 200 mostly large, diversified insurance companies in the Fitch universe, only a handful carry BB (moderately weak) or B (weak) financial strength ratings. More than 120 are rated AA (very strong), with most of the rest rated A (strong).

The number of ratings downgrades in the life insurance industry exceeded the number of upgrades over the past five years by a sizable 2-to-1 margin in the first half of 2005. Burke said that a change has occurred and the outlook now is for downgrades and upgrades to be about equal.

Looking ahead to 2006, Burke also made several other predictions including an uptick in mergers and acquisitions in the life insurance industry, moderate credit-related bond losses, an uptick in real estate-related delinquencies, a shake out in the variable annuity market, and rising reinsurance costs. She also expects still more compression of the interest-rate spread that insurance companies earn on monies they receive from policy premiums, versus payments on variable annuities and other floating-rate products. SVIA

After String of Good Years, Stable Value Funds See Opportunities, Challenges

By Randy Myers

Stable value funds have held a healthy share of retirement plan dollars through the first five years of this decade. Equal to just 17.5 percent of plan assets at year-end 2000, it jumped as high as 27.1 percent by year-end 2002 and was still holding at 22 percent of plan assets as of November 2005, according to the Hewitt 401(k) Index. The index tracks assets in the 401(k) plans managed by Hewitt Associates, a large defined contribution plan recordkeeper. The popularity of stable value funds during this period has been attributable not only to volatility in the stock market-which tanked badly in 2000 and 2001-but also to a favorable interest rate environment in which stable value returns have handily outpaced those for money market funds and CDs. With short-term interest rates on the rise now-the Federal Reserve Board on November 1 raised the Federal Funds rate 25 basis points to 4 percent, and hinted that more increases could be in the offing-stable value fund managers are bracing for a possible change in market conditions that could impact not only how they manage their funds but also how investors perceive them.

Should interest rates continue higher quickly, stable value investors could be disappointed in the short term. "If we continue to get Fed Fund rate increases," said Tony Camp, vice president of ING's Stable Value Product Group at the SVIA Forum, shortly before the Fed's last move, "it will get retirement plan participants thinking that rates are moving up. They will wonder why their stable value rate isn't moving up in lock-step." Returns on stable value funds don't move up as quickly in a fast-rising rate environment as market rates, of course, but they don't move down as quickly in a fast-declining rate environment, either. The crediting rate formulas used to determine their payouts tend to smooth short-term interest-rate volatility.

Even as they contend with a changing rate environment, Camp said, stable value managers recognize that they've got increasing competition for the average investor's wallet in the form of college tuition plans, Roth IRAs, personal debt, Health Savings Accounts and Health Reimbursement Accounts.

Of course, other factors could work to keep investors in their stable value funds. With the first wave of Baby Boomers reaching retirement age, they may be eager to include more conservative investment options, such as stable value funds, in their retirement portfolios. And because stable value funds are no longer available in mutual fund form in the IRA market, some retirees who might have been expected to swap money out of their 401(k) plans and into an IRA might now leave it there, where they can still get access to stable value investments.

From a money management perspective, stable value managers will be keeping a close watch on the overall health of the bond market should the rate environment turn volatile. Many stable value funds consist of a portfolio of bonds backed by a book-value guarantee, or wrap contract.

"This is probably not a good time to reach for yield," said Camp, a sentiment echoed by Susan Graef, a principal and fixed-income portfolio manager with Vanguard Group. Antonio Luna, a fixed-income portfolio manager for T. Rowe Price Trust Company and co-manager of the T. Rowe Price Stable Value Common Trust Fund, also echoed that sentiment. "In our shop," he said, "we're trying not to be too cute. Not too long ago, credit spreads (spreads between US treasury bonds and other bonds) were wide. Now, squeezing out alpha is tougher. We're spreading our bets across many different strategies."

IRAs and 401(k)s: How Employers Can Help Retirees Make It on Their Own

By Randy Myers

In a world where American workers must increasingly fund their own retirement, it is widely accepted that many will fall short of their goals and either have to work longer, or live less lavishly, than they had hoped in old age. On paper, of course, that shouldn't be necessary. Stacy Schaus, personal financial services practice leader at consulting firm Hewitt Associates, notes that a worker who starts contributing 6 percent or more of their salary to a 401(k) plan at age 25, and earns a real rate of return of at least 4 percent, will be able to replace at least 70 percent of their pre-retirement income with that nest egg beginning at age 65. With Social Security making up the balance of their pre-retirement income, that should lead to a reasonably comfortable retirement.

Of course, many people don't start funding a retirement plan at age 25, fail to save 6 percent or more of their salary, withdraw money prematurely from their accounts, choose investments that carry excessive fees, or otherwise mismanage their accounts. What's more, Schaus told the SVIA Forum, nearly half of retirement plan participants take a cash distribution when they do retire, forfeiting the tax-deferral benefits that would accrue to any balance they left in their plan-or rolled over into an IRA-until they really needed it.

Plan sponsors can help employees make better use of their 401(k) plans, Schaus said, by providing them with more education on the negative impact of cashing out their accounts at retirement. They also can encourage retirees to continue taking advantage of tax-deferred investing by leaving their money in their plan or rolling it into an IRA after they stop working.

Sponsors who want to encourage retirees to stay in their employer's plan, she said, can do so by providing flexible distribution options, allowing retirees to consolidate assets from IRAs and other qualified plans into their employer's plan, introducing alternative income-producing investment options, offering an investment advice service to retirees, and communicating to them upon retirement about the benefits of staying in the plan.

Sponsors who don't want to encourage retirees to stay in their plan can still help them, Schaus said, by educating them on the value of keeping the money in some other tax-deferred investment vehicle outside the plan, such as a rollover IRA or an annuity. Sponsors also can provide access to rollover support via one or multiple providers, making it easy to complete a rollover by developing a simplified rollover process. Finally, employers can help by not allowing retirees to cash out of their plan online. Instead, they can require retirees to call a representative who could encourage them to roll their assets into an IRA or some other qualified plan.

Employees need to become better educated about managing retirement income risk, agrees Keith Hylind, vice president of retirement income strategies for MetLife. He told Forum attendees not only that plan sponsors have a role to play in providing that education, but that help is available to them, too. "As a group, they (employees) look to employers to provide outlets to education and advice," he said. "Financial services firms have the tools and resources to help."

Insurers Tout Annuities as Defined Benefit Plans Become Increasingly Rare

By Randy Myers

For decades, American workers relied on two principal sources of retirement income: Social Security benefits and employer-paid pension plans. Both promised retirement benefits for life. Today, Social Security is playing a dwindling role in meeting the American worker's retirement income needs (see "Social Security 101" elsewhere in *Stable Times*), and defined benefit pension plans are becoming increasingly rare. In their place have sprung up defined contribution plans, in which the worker's retirement benefit depends largely on how much he is able to save for himself and how well he manages what he does save through retirement. Combine this responsibility with ever-longer life expectancies, and many workers risk of outliving their retirement savings.

To ensure that retirees have sufficient income, insurance companies have launched a drive to market annuities to workers saving for, or about to enter, retirement. Annuities provide the purchaser with a lifetime income stream. The theory behind the push is that by using at least a portion of their savings to fund an annuity, investors can be guaranteed at least some income no matter how long they live. Many of these new products have been tooled specifically to appeal to participants in defined contribution plans.

The chance of outliving your retirement savings is not insignificant. Speaking at the SVIA Forum, Keith Hylind, vice president of retirement income strategies for MetLife, reported that a 65-year-old man has a 50 percent chance of living beyond the age of 85 and a 25 percent chance of living beyond the age of 92. A 65-year-old woman has a 50 percent chance of living beyond the age of 88, and a 25 percent chance of living beyond the age of 94. That's a long time to fund a retirement. Over such long periods of time, inflation risk is a real concern, too. At just a 3 percent annual rate of inflation-about the historical norm-prices double in 24 years. The impact of inflation can be even worse in the healthcare arena, where many retirees ring up high costs. Healthcare inflation has been running at more than twice the average inflation rate.

To help workers cope with longevity and inflation risk, MetLife has developed a suite of annuity products with a wide array of features. Some provide immediate income, others defer payouts. Some provided a fixed income, others variable payouts. Some can be offered as a distribution option in a defined benefit plan or defined contribution plan, or as part of an IRA rollover. Another-what MetLife calls its "Personal Pension Builder"-is offered as a supplemental retirement savings plan intended to complement an existing 401(k) plan. Workers can make recurring contributions to the product while they are employed, then choose from a variety of payout options when they retire.

Insurance company Genworth Financial also is targeting the retirement market with a product it calls ClearCourse, which is designed to be offered as an investment option in 401(k) plans. Plan participants can allocate some or all of their retirement savings to ClearCourse, just as they would to any other investment option.

James Templeman, vice president and group variable annuity product development leader for Genworth's GE Life and Annuity Assurance Co. division, explained that monies investors steer into ClearCourse go into a separate account which invests in a balanced stock-and-bond portfolio managed by GE Investments. The product provides investors with a guaranteed minimum lifetime stream of income, although the actual payout can exceed the minimum depending upon how well the Total Return Fund has performed. Investors can start taking a monthly payout when they reach their plan's designated retirement age, or at a later date of their choosing. Because the Total Return Fund maintains a relatively constant allocation to equities-about two-thirds of total fund assets, Templeman said-it provides investors with a long-term hedge against inflation risk.

Annuity products such as those offered by MetLife and Genworth may or may not outperform a portfolio of stocks, bonds or mutual funds a retirement plan investor might assemble on their own. However, annuities assure the investor of receiving some level of guaranteed income for as long as they live.

Stable Value Managers Advised to Look to Wholesaling to Crack Small Plan Market

By Randy Myers

Stable value managers face a challenge in trying to capture a bigger share of the market for small retirement plans. Unlike large plans, which often look to the entire universe of money managers to choose their investment options, and sometimes choose them directly, small plans typically rely on a broker to find a plan provider and then choose their investment options from those offered by that provider. In many cases, the resulting investment lineup will consist primarily of funds proprietary to that provider.

"If you visit one of these small-plan companies, you might find a CEO, his brother the CFO, a couple of people who are close to them, and 30 other people running around the shop floor," said Brian Haendiges, head of the institutional business group at financial services firm ING, speaking at a breakfast roundtable during the SVIA Forum. "These are people busy doing the work that's their business." While they are interested in maximizing their own retirement savings, he said, they have little time to discuss the details of different types of investing options, particularly those as nuanced as stable value funds.

That being the case, Haendiges said stable value managers looking to gain market share among small plans may want to focus their efforts on selling on a wholesale basis to the providers who service that segment of the market. Among the financial services firms that do big business with small plans are insurers ING, John Hancock, Hartford and Principal, as well as mutual fund companies American Funds and Fidelity Investments. ING services approximately 20,000 plans with as few as 10 and as many as 2,500 participants, and assets ranging from $200,000 to $50 million. Its typical client, Haendiges said, has 25 to 250 participants and $500,000 to $5 million in plan assets.

Haendiges warned that most plan providers servicing the small-plan market already have a proprietary stable value product or provide one through an alliance with another stable value manager. Where supplant-

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Trading Restrictions Easing for Self-Directed 401(k) Accounts

By Randy Myers

It is a bit ironic. Even as employers have been saddling their 401(k) plans with a slew of new rules designed to prevent abusive trading (see "401(k) Plans Wrestle with New Trading Restrictions," Stable Times, Second Quarter 2005), financial institutions that "wrap" stable value funds to back up the funds' book-value guarantee are, in some cases, quietly relaxing their demands for a common plan restriction known as an equity wash.

An equity wash is a plan provision that prevents a 401(k) investor from transferring money out of a stable value investment into a directly competing investment such as a money market fund. Instead, the participant must first route the transfer into an equity investment option for a predetermined period of time-usually 90 days-and only then move it into the competing fund. The rule is meant to discourage participants from pulling money out of stable value investments en masse when short-term interest rates rise sharply. During periods of rising rates, returns on money market funds tend to jump more quickly than returns on stable value funds. If mass arbitrage were allowed, it could hurt the returns of long-term investors in the stable value fund since the fund's manager could be forced to sell assets at depressed prices, perhaps below their book value, just to meet redemption requests. Wrap providers, because they could be on the hook for ensuring the fund's ability to meet redemption requests at book value, also might charge higher fees for their insurance contracts if this arbitrage were permitted, further reducing returns to long-term stable value investors.

Historically, the only competing investments subject to equity wash rules were money market funds and short-term bond funds. During the 1990s, however, increasing numbers of plan sponsors began adding self-directed accounts to the investment options in their 401(k) plans. Some plans gave investors access to a wide range of retail mutual funds through so-called "mutual fund windows," while others went a step further by offering self-directed brokerage accounts.

Either way, participants with access to these self-directed accounts, or SDAs, suddenly had another way to tap into money market funds and short-term bond funds. Theoretically, they could do so even when interest rates were rising sharply, thereby sidestepping the equity wash rules designed to prevent interest-rate arbitrage. Recognizing this threat, wrap providers soon began to insist that SDAs also be subject to an equity wash rule.

Over the past decade, the arbitrage threat presented by SDAs, at least on paper, has proved negligible in practice. For starters, relatively few 401(k) plans even offer SDAs-less than 20 percent, according to a number of surveys. Even where they are offered, few participants actually use them; many plan sponsors report that the money in SDAs accounts for only a few percent or less of total plan assets. As a consequence, wrap providers are showing some willingness to forego equity wash requirements for SDAs in some plans. However, they still insist on making that decision on a case-by-case basis.

"We don't have a one-size-fits-all policy," confirms Aruna Hobbs, head of the pensions and savings market at wrap provider AEGON Institutional Markets. "In a perfect world, we would like to have an equity wash because there is potential, even if it is very remote, for self-directed accounts to offer a competing option under very egregious conditions. But we realize there are other issues to consider. If a plan wants to introduce a brokerage window, we can take some comfort from the usage trends in the industry and perhaps come up with some trigger level where we will implement trading restrictions at a later time--if, for example, use of the

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FASB Clarifies and Affirms Stable Value Accounting in Draft Guidance

By Gina Mitchell, SVIA

The Financial Accounting Standards Board (FASB) is poised to take a historic step for the stable value industry in the New Year. FASB will issue guidance on stable value accounting-the foundation for stable value funds.

FASB will formalize previous accounting guidance and practices for stable value funds when it finalizes guidance. The proposed guidance, FSP AAG INV-a or Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide, applies to all stable value funds that issue financial statements, despite the title.

A little about stable value funds

First, let's talk a little about stable value funds. Stable value funds are the largest conservative investment in defined contribution plans, with over $419 billion invested as of December 31, 2004. Stable value funds provide a unique combination of benefits:

- Safety of principal invested, hence the name 'stable value,'
- Stability and steady growth of principal and earned income,
- Benefit-responsive liquidity, meaning plan participants transact at contract value.

Stable value funds gain principal protection through the use of benefit responsive investment contracts that allow the plan's participants to withdraw their investment at contract value — principal investment plus accrued income — at any time under the terms of the retirement plan.

Contract value can differ from market value, which is how most other investments are measured, either positively or negatively. Because of this, stable value funds are unique in two ways. They remain 'stable' despite fluctuations in the financial market. The chart below illustrates this point. Stable value also has a different accounting treatment that recognizes this difference called contract value. That accounting treatment, which was first formally recognized by the ACIPA, was articulated in SOP 94-4. Plus, there is a long history of accounting compliance that follows the principles outlined in SOP 94-4 for all stable value funds.

Stable value funds are a key element in providing retirement security for plan participants because they are designed to provide safety of principal and relatively high income. According to Hewitt 401(k) Index™, which tracks defined contribution

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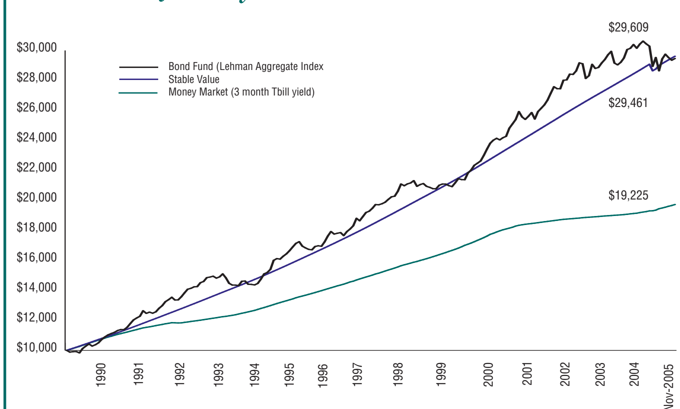
Growth of $10,000

January 1990 - November 2005



FASB

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asset allocations, stable value has been one of three core investments for 401(k) investors netting roughly 20% to 25% over the life of the index as the following chart shows.

Formalizing Accounting Literature and Practice is Major Achievement

The proposed FSP (Financial Accounting Standards Board Staff Position) is important because it upholds contract value accounting for stable value funds. It builds on SOP 94-4, which provided guidance for defined contribution plans and now provides definitive guidance for all types of stable value funds. FASB provides this guidance by directly addressing commingled or pooled stable value funds and amending guidance for employee benefit plans in SOP 94-4 and, health and welfare plans in SOP 92-6, and repealing a directive under FAS133. The proposed FSP:

- Tweaks SOP 94-4's definition of a fully benefit responsive investment contract,
- Establishes a criteria and the limited circumstances that contract value can be used,
- Requires new financial statement presentation for stable value funds, and
- Enhances qualitative and quantitative disclosures for these funds.

The proposed guidance is also a major achievement because of the times we live in. In the wake of Enron, WorldCom, and the failure of Arthur Anderson, accountants clearly have taken a more conservative and by the book approach to audits. For stable value funds, this resulted in some accounting firms questioning stable value commingled or pooled funds' reliance on SOP 94-4 since this document governed employee benefit plans, not commingled or pooled funds, despite past reliance on SOP 94-4 for commingled funds. Further, the audit guide for investment companies, which covers audit procedures for commingled funds, requires that all commingled funds must carry their investments at market value. The AICPA sought FASB's guidance as to whether the criteria for benefit responsive investment contracts as defined by SOP 94-4 applied, or whether market value accounting as defined by the Investment Company Act of 1940 should be used.

Despite a full and demanding agenda, the FASB took up this project, developed in depth knowledge of the issues underlying stable value investments and reflected that understanding in a relevant document. SVIA supports issuance of the FSP. We believe it is conceptually sound, and will promote relevant and meaningful financial reporting to the investment community. Its issuance will enable investors to continue to receive the important benefits of investing in stable value funds.

Comments on the FSP were due on September 19. The FSP can be viewed on FASB's website, www.fasb.org under "FASB Staff Positions" and all comments on the FSP, including SVIA's are also posted on FASB's website under "Comment Letters." It is anticipated that FASB will review all comments and issue a final FSP in January 2006. SVIA

Trade Restriction

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window goes up significantly and there are more opportunities for arbitrage. But in every situation, we will work with the fund manager to find a solution that the manager and the plan sponsor can live with."

"We look at each situation on a stand-alone basis," echoes Jon Fraade, managing director at wrap provider AIG Financial Products Corp. "There is no absolute rule for self-directed accounts. If someone comes to us with a wonderful underwriting opportunity for a strong plan with lots of positive cash flow, we can make a risk decision we are comfortable with, and, in some cases, forego the equity wash. That being said, in the vast majority of cases, there is an equity wash in place that protects us from that potential arbitrage."

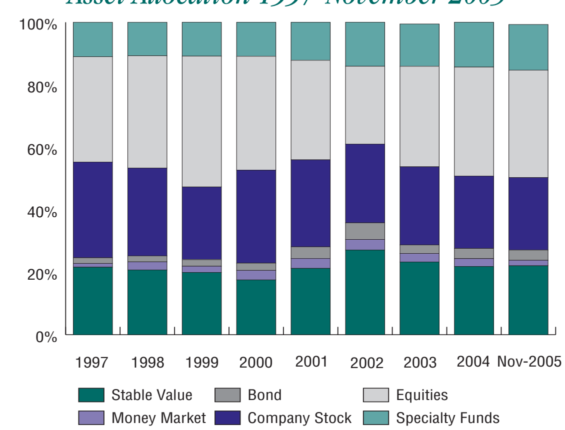
Steve Butters, managing director with wrap provider IXIS Capital Markets, says his firm also considers SDAs on a case-by-case basis, looking at, among other things, whether there are other disincentives in the plan that could discourage investors from arbitraging interest rate, such as higher fees to use the self-directed account.

To be sure, plan sponsors and their stable value managers should recognize that wrap providers who agree to forego an equity wash for a self-directed account may try to account for the potential increase in risk they're assuming in another way. They may, for instance, try to modestly bump up the price they charge for the wrap contract. Plan sponsors and stable value investment managers simply need to decide whether that's a trade-off they are willing to make, especially if there are no wrap providers who will allow a wash-free self-directed account without a fee increase. Alternatively, some wrapper providers might not increase the wrapper fee, but they might require more restrictive investment guidelines that reduce the expected returns for all participants.

In the current climate, that's always a possibility. As long as self-directed accounts continue to be used by only a few 401(k) investors, there would seem to be little chance, in most plans, that they could trigger the amount of arbitrage that would be needed to have a meaningful impact on stable value funds or their investors. SVIA

Core Investment in Defined Contribution Plans

Asset Allocation 1997-November 2005



Source: Hewitt 401(k) IndexTM Observations 1997 to November 2005. Hewitt 401(k) Index allocation to stable value ranges from 20% to 25% over time

Cracking Small Market Plan

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ing the proprietary or alliance fund is unlikely, he said, outsiders trying to break in might want to pitch themselves as a supplementary stable value manager who could add diversity to the provider's proprietary product. Breaking into the small plan market through brokers could be tougher still, he said, but suggested that any manager trying to do so would probably want to focus on the larger brokers, on the chance they might be more readily able to find a home with their clients for non-proprietary investment products. SVIA

A Higher Performance Hurdle for Stable Value as the Fed Hikes Rates?

(This may not be the same old interest rate cycle)

By Victoria M. Paradis, CFA, Managing Director, JPMorgan Asset Management

Stable value funds typically have a natural return advantage versus cash or money market funds. This advantage occurs when the yield curve is positively sloped, intermediate maturity investments backing stable value have a higher yield than cash alternatives. However, when short-term rates rise and the yield curve flattens or inverts, stable value's structural return advantage diminishes and could disappear.

In recent years, defined contribution plan participants have grown accustomed to the typically generous out-performance of their stable value fund versus their next-best conservative option, usually money market funds. A notable change in relative performance can create communications challenges for plan sponsors and withdrawal risks for managers if funds do not live up to participant performance expectations.

We could be facing these circumstances soon as the Federal Reserve continues on a path of raising short-term interest rates. Stable value funds will be increasingly vulnerable to underperforming money market funds if the Fed does not pause anytime soon at neutral policy, but instead heads straight toward tight monetary policy.

Despite the higher potential obstacles for stable value funds going forward, this article makes the case that underperformance is not inevitable. A broader range of investment strategies are available to today's funds that may not have been possible during past cycles.

Where have we been?

The stable value investment community has comfortably delivered heroic investment results versus money market funds for several years. Short-term interest rates, as evidenced by the Federal Reserve Board's Fed Funds target rate, have hovered at multi-decade lows since October 2001, when the Fed first lowered the target rate below three percent, including 12 months at the all-time low of one percent. As short-term interest rates hit new lows, intermediate rates also fell, though not by quite as much. The yield curve remained relatively steep for much of that time, with five-year Treasury yields ranging from a low of 2.03 percent in June 2002 to a high of 4.15 percent in August 2005. Investors consistently earned comfortable margins versus cash simply from investing in longer maturities. In addition, with credit spreads over Treasuries, stable value funds typically produced outsized relative returns. This heroic performance cycle, however, is winding down.

The stable value industry clearly has weathered many interest rate cycles before. Yet the current environment may not be the same as previous interest rate cycles. The Fed has achieved remarkable success and credibility in its campaign to combat inflation and inflationary pressures, so intermediate rates have remained low, and could continue to stay low. Meanwhile, short-term rates are likely to continue rising.

Where are we today?

Stable value fund returns have drifted lower, reflecting a dilution of higher returns from previous interest rate environments. Current yields on new stable value investments have remained stubbornly low despite rising short-term rates. As spreads have compressed, many investments going forward may arguably offer less compelling risk-adjusted return enhancement opportunities.

The implications are not insignificant. A sustained unfavorable yield curve means there is little room for error in managing stable value funds. Yet, what constitutes an "error" is an open question. Should stable value funds brace for inevitable underperformance versus money market funds, or should funds employ strategies to achieve higher long-term returns? With benefit responsive contracts that absorb market fluctuations, what is the ultimate definition of risk in a stable value fund?

I suggest that a fund's risk profile should minimize the likelihood of not meeting participant expectations. Coming from the recent favorable interest rate environment, virtually any stable value strategy has exceeded expectations. Yet going forward, the hurdle of participants' return expectations will be higher. The following are thoughts on minimizing the risk of underperforming money market funds in more challenging times. I frame this in terms of the two primary goals of stable value funds:

1. The most important stable value objective is preservation of principal. This goal is met with properly-structured benefit responsive contracts, which are achievable for a wide range of investment strategies.
2. The second objective is to generate competitive, responsive returns, which in turn are driven by the underlying investment strategy. Going forward, this will be the key differentiator among strategies.

Ultimately, the determinant of successful long-term returns hinges on developing an underlying investment strategy that answers questions centered on classic fixed income investing principles, including the following:

What is the optimal duration strategy?

- Is shorter better- in order to be responsive to rising rates? It may be useful to note that generally a shorter fixed income portfolio duration (e.g. two years) is more responsive to changing intermediate interest rates than a longer (e.g. four year) duration. However, short stable value duration is not more responsive to changing cash yields. If two to five years, interest rates are stable while cash yields rise, a short duration strategy may not be beneficial. Yield curve analysis can be useful in evaluating risk-return efficiency over time, as there are arguable "sweet spots" on the curve.
- Is it better to invest with a longer duration to generate higher long-term returns? How long is reasonable? How long is too long? To give some perspective, according to the Ninth Annual Stable Value Investment Association Investment Policy Survey as of December 2004, the industry average duration was three years, with the longest reported duration at eight years for an in-house managed plan.
- Yield curve positioning has been particularly relevant recently. Short duration assets have been punished with underlying market losses as the yield curve has flattened. "Bar belled" or "tiered" structures that had allocations to short-duration portfolios, for example, may have underperformed funds with the flexibility to avoid the worst-performing part of the yield curve.

While duration and yield curve positioning are quantifiable, visible measures of a fund's risk-return profile, other characteristics, namely sector allocation, may be a more significant differentiator of future success.

What is the optimal sector strategy?

A portfolio limited to the highest-credit-quality, simplest fixed income sectors has appeal for stable value. Yet such a strategy may unnecessarily compromise long-term potential returns. Instead, we suggest that participants can expect to benefit from higher potential returns and reduced portfolio volatility by investing in a diverse range of instruments that do not move in lockstep. Fortunately, funds have many choices in order to diversify.

Sector diversification does not necessarily mean heading into below-investment-grade territory. Clearly,

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Brokerage and Mutual Fund Window Survey Results

By Robert Whiteford, Bank of America

This past summer the SVIA conducted a survey to determine how the stable value industry handles brokerage and mutual fund windows as alternative investment options. The response was good as 33 industry firms replied to the survey. The largest sectors represented in the survey, with 10 respondents each, were the plan sponsors and the asset managers. Eight wrap providers and five GIC issuers also responded.

What did we learn from the responses? While there is not complete consistency throughout the answers, there is a concern that the brokerage and mutual fund windows heighten transfer risk, and, not surprisingly, the service providers: the wrap providers, the GIC issuers, and the asset managers are most concerned with the transfer risk. Despite the concern with the risk of transfers to competing funds through the brokerage and mutual fund windows, many have been added to plans or funds that already had stable value funds. Finally, the equity wash is still considered to be an effective tool for reducing transfer risk.

To support these conclusions we need to closely examine the questions and responses.

Survey participants were asked: "Do the plans/funds where you do business that have a stable value fund offer a brokerage window or mutual fund window?" Over half of all the responses fell into the "some but not all" category. Of the respondents who committed to a yes or no answer, those who answered affirmatively outnumbered the negative respondents by over a two to one ratio. Brokerage and mutual fund options seem to have gained wide acceptance.

The survey also asked: "To what degree are brokerage and/or mutual fund windows considered competing funds in the plans/funds where stable value funds are also present?" A "competing fund" is one that has many of the same characteristics as a stable value fund. These characteristics could include high credit quality and short to medium duration assets. Most frequently, money market funds and short duration bond funds would be categorized as competing funds. This question expands on the last one. The most significant responses are those of the wrapper providers. Seven of eight of the wrappers answered in the two highest categories. That would seem to indicate that wrappers are wary of the transfer risk that brokerage/mutual fund options potentially present. Half of the asset manager responses were also in the highest category, although a significant three of ten said that none of their plan sponsor clients consider brokerage/mutual fund options to be competing funds. The plan sponsors and the GIC issuers were more divided in their responses.

"If the brokerage/mutual fund window is considered a competing fund, is an equity wash required to transfer money from the stable value fund to the brokerage/mutual fund window?" This is an important question. A common feature of stable value contracts, the equity wash is a contract provision that requires transfers to investment options that have similar characteristics to stable value funds to be first invested, for a limited period of time, in equities. The thought behind this provision is that plan participants who invest in stable value are less likely to consider an investment in equities. The equity wash reduces the possibility of the GIC issuer or wrap provider being "gamed" through timed transfers to or from similar investment options. The brokerage and mutual fund options almost universally open access to a range of money market funds, short duration bond funds and even other stable value funds - all of which are considered competing investment options. The most important thing that we can learn from this question is that asset managers and wrap providers overwhelmingly require an equity wash when they perceive the brokerage/mutual fund accounts to be competing funds. If we combine the answers of these two groups we find that 16 firms require the equity wash while only one does not. One other said that it would depend (on the situation). GIC issuers also indicated, by a three to one margin, that an equity wash is necessary. Plan sponsors were more ambivalent as four require the equity wash while three do not. It seems clear that the service providers are more concerned with the risk of transfers to brokerage or mutual fund investment options than are plan sponsors.

The result? It seems that the majority of service providers see the need to protect themselves against competing fund transfers. It also serves that the equity wash continues to be the risk mitigation tool of choice. Plan sponsors are ambivalent about limits on transfers, and they seem to employ equity washes only when required to do so.

Higher Performance Hurdle

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below-investment-grade securities modest amounts can benefit long-term returns and in fact reduce overall portfolio risk, yet they may create notable participant communication challenges and sector risk exposures.

Instead, a wide range of tools -- whether broader access to investment grade credit, the ability to invest in privately placed investments, or the effective use of derivatives -- can better manage risk and enhance returns. The goal is to generate additional cushion or downside protection against a rising interest rate environment.

The vehicle is often critical to effectively deliver broader sector access.

In considering broader access to sectors, it is often advantageous to consider a fund vehicle, such as a mutual fund or commingled fund, to obtain optimal benefit. Specifically, credit sectors, including BBB rated investment grade bonds, are most effectively accessed when portfolio holdings are highly diversified. Conservative strategies should avoid concentrated credit positions. So, to the degree a fund vehicle can deliver exposure to hundreds of credits, name-specific volatility is reduced. The net result is an expanded overall opportunity set which tends to perform better with less volatility.

Fund vehicles often can more effectively access sophisticated exchange-traded or over-the-counter derivatives tools such as credit default swaps, options, and interest rate swaps. When used in conjunction with an overall portfolio strategy, these instruments can offer downside risk protection to a portfolio, as well as return enhancement.

Finally, there are investment sectors that cannot practically be accessed directly, such as privately placed mortgage or corporate loans. These investments are typically high quality, but are relatively illiquid individually. However, a fund vehicle can deliver the investment merits of these sectors in a highly diversified way that offers far better liquidity than directly placed loans.

Going forward, expect that successful stable value strategies will need to be nimble. This means that they should position for changing yield curve shape, as well as duration. In addition, management strategies should benefit from focusing on minimizing overall portfolio volatility through broader access to sectors and tools. The strategies should be the most likely to succeed at addressing participants' expectations and meeting the rising performance hurdle for stable value funds in the future.

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