SVIA STABLE TIMES

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Stable Value Performs "Admirably and As Advertised" through Financial Crisis

By Randy Myers

Stable value funds proved to be one of the few success stories during the financial crisis of 2008-09. At a time when most asset classes were tumbling, stable value funds continued to generate consistently positive returns for their investors.

"Stable value performed admirably and as advertised," SVIA president Gina Mitchell told industry participants as she opened the organization's 2010 Spring Seminar in April.

Disclosing the results of a quarterly SVIA survey of 27 stable value managers, Mitchell reported that from the fourth quarter of 2008 to the fourth quarter of 2009, crediting rates for stable value funds—the rates actually paid out to investors—ranged in a fairly narrow band, from an average 3.97 percent at the start of the period to 3.33 percent at the end. At their low point in the second quarter of 2009, crediting rates averaged 3.12 percent.

On a total book-value return basis, stable value funds earned an average of 4.75 percent in 2008, Mitchell reported, and 3.52 percent in 2009. By contrast, money market funds earned 0.7 percent and 0.03 percent, respectively. The credit quality of the fixed income portfolios underlying stable value funds also remained high throughout the crisis, Mitchell said, averaging AA or better.

While the market value of those fixed income portfolios fell to an average of 95.56 percent of book value at the end of 2008, Mitchell said that ratio climbed back to 101 percent by the end of 2009. The market-to-book ratio is a closely watched metric in the stable value industry, since stable value funds guarantee that their investors can make withdrawals at book value, except in certain predefined circumstances, regardless of their fund's market value.

Investors in 401(k) plans were not oblivious to the safe haven offered by stable value funds at the height

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Prudential Strategist Argues for Moderation by Fed in Raising Interest Rates

By Randy Myers

With the worst of the financial crisis apparently behind us, the Federal Reserve may try to push interest rates higher toward the end of this year, says Robert Tipp, chief investment strategist for Prudential Insurance Co.'s Prudential Fixed Income unit. But he wouldn't advise it. A more prudent course, he argues, would be to wait at least until the middle of next year before contemplating any tightening of rates, giving the U.S. economy more time to reach what he calls "a profile of rip-roaring growth."

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401(k) System Passes "Trial by Fire"

By Randy Myers

Not so long ago—the 1980s, to be precise—it was commonly argued that the self-directed, largely participant-funded 401(k) retirement system would implode if the financial markets experienced a severe crisis. Individual investors, the theory went, would not have the sophistication or the stomach to successfully negotiate a dramatic upheaval in the financial markets.

This theory was tested once in the bear market of 2000-2002 following the bursting of the dot-com stock bubble and more dramatically in 2008-09, when the credit crisis triggered by the mortgage-market meltdown sent both stock and bond prices

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Moderation in Raising Interest Rates

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Although the economy has certainly improved over the past several quarters, Tipp told participants at the SVIA's 2010 Spring Seminar that it still has a long way to go before unemployment levels get back to acceptable levels. Demand for credit remains low too, he said, mitigating the need for higher rates to head off overspending by the public.

Continued fragility in the real estate market also argues against a rising rate environment, Tipp said. Delinquency rates on both residential and commercial mortgages continued to climb at a dramatic rate through the end of 2009, he noted, and to the extent that it leads to further weakening of the real estate market, it will prove a drag on the economy.

Besides, Tipp said, interest rates already have climbed dramatically since the depth of the financial crisis, with yields on the 10-year Treasury bond near 4 percent in early April versus about 2 percent in December 2008.

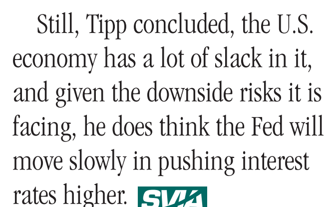
An environment of rising inflation could always tilt the Federal Reserve toward higher interest rates, but Tipp said that with modest demand for credit, continued high unemployment rates, and a fragile real estate market, the Fed may be worried as much if not more about the potential for deflation right now, rather than inflation. And in fact, he noted, core inflation rates remain low at the moment.

While promoting a cautious approach to raising interest rates, Tipp also argued that the U.S. economy is in better shape than many pundits think, which could eventually lead to a rising interest rate environment. For example, he said, U.S. GDP should grow at about a 3.2 percent rate this year and a 2.8 percent rate in 2011, outperforming both the Euro zone and Japan, with inflation staying well under control.

While the federal budget deficit has soared since the onset of the financial crisis, he noted, the Congressional Budget Office currently projects that it will shrink dramatically as a percentage of GDP over the next four years, from over 9 percent this year to about 2.6 percent in 2014. "I know we feel bad about our debt load, but we're better off than the European Union and Japan," Tipp said. "It's also important to remember as we look at those budget deficit numbers that part of that was intentional. We were in a recession and a couple of wars. When the deficit has climbed in the past, people projected that it would remain that way, but it didn't. We heard the same talk in the Reagan years, but it didn't happen. The system turns out to be better than we think, the economy performs better than expected, the numbers improve, and once again disaster is averted."

While the United States does look to be in bad shape in view of its unfunded state pension liabilities, budget deficits, and demographic Social Security and Medicare problems, Tipp observed, Europe suffers from all of those problems to at least the same degree, if not more so. "They have a more rapidly aging population," he said, "and less money set aside for pension obligations than we do."

Still, Tipp concluded, the U.S. economy has a lot of slack in it, and given the downside risks it is facing, he does think the Fed will move slowly in pushing interest rates higher. SVIA



SVIA "As Advertised"

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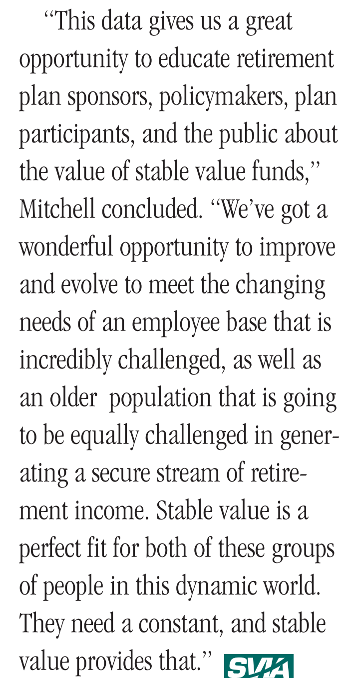
of the financial crisis, Mitchell noted, transferring billions of dollars from stock funds and other asset classes into stable value funds. According to the Hewitt 401(k) Index, stable value funds accounted for 22.7 percent of the assets in 401(k) plans in January 2008 but rose to 32.3 percent by the end of the year. That jump reflected declining values for other assets classes, positive returns for stable value funds themselves, and inflows of new money.

"This data gives us a great opportunity to educate retirement plan sponsors, policymakers, plan participants, and the public about the value of stable value funds," Mitchell concluded. "We've got a wonderful opportunity to improve and evolve to meet the changing needs of an employee base that is incredibly challenged, as well as an older population that is going to be equally challenged in generating a secure stream of retirement income. Stable value is a perfect fit for both of these groups of people in this dynamic world. They need a constant, and stable value provides that." SVIA



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"Trial by Fire"

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plummeting. Some 401(k) investors reacted by shifting money out of stock funds and into stable value funds, but most simply left their investment strategies untouched. In 2009, stock and bond markets began to recover much of the ground they had lost, and by year-end, assets in 401(k) plans totaled $3.34 trillion, up from $2.67 trillion at the end of 2008 and within striking distance of the $3.73 trillion held at the end of 2007.

"What happened is that the 401(k) system was an island of stability amid the chaos," David Wray, president of the Profit Sharing/401(k) Council of America, told participants at the SVIA's fifth annual Spring Seminar in April. "It was the one place in the American financial system that was stable."

To be sure, some of that stability was earned by the hard work of the retirement plan industry, including plan sponsors and plan providers who undertook what Wray called a "tremendous educational effort" to convince plan participants not to sell at the bottom of the market. "We gave participants permission to do nothing," Wray said. "They were as panicked as anybody else. Plan providers who have call centers were fielding hundreds of thousands of calls per day from participants wondering what they should do with their retirement portfolios. The common theme was, stay the course. And they did. They did not bail, and the system did not collapse." Among retirement plan participants whose accounts are managed by Vanguard Group, for example, Wray said the number of workers who pulled out of their plans while still employed rose to only 3.1 percent in 2008, just slightly above the normal rate of about 2.5 percent.

Wray noted that total assets in the U.S. retirement system, including all types of defined contribution and defined benefit plans both public and private, has increased over the past 15 years to $16.04 trillion from $5.91 trillion.

"There are ups and downs in there, but we are setting aside money in this country—more per capita, and in real terms, than any other society," Wray said. "This is the most successful system in the world. It works."

Wray dismissed the notion that defined contribution plans are a weak link in the U.S. retirement system, arguing that if people begin saving early for retirement and allow their contributions and earnings to compound throughout their working lives, most will wind up with sufficient retirement assets. "It's just time and arithmetic," he said. "If you compound money for 40 years at 5 percent, you'll have a lot of money. The key is how people live in retirement with what they have accumulated."

While many policymakers are worried about how people will manage their savings in retirement—and worried that they won't be able to do a good job of it—Wray said those concerns are misplaced, too. "My own personal view is that people can do it just fine," he said. "They're doing it now."

Wray said defined contribution plans remain the model for the future, and he noted that there is tremendous interest among policymakers outside the United States in transitioning their own retirement systems from the defined benefit to the defined contribution model.

Wray noted that throughout the recent financial crisis, 401(k) plan participants held the percentage of their salaries they were deferring into their 401(k) plans fairly steady. He said he suspects that once the numbers are in for 2009, they may show that deferral rates actually rose that year. "People realize they need less debt and they need to save more money," he said. "And a 401(k) plan is a great place to save money."

That sentiment may help to explain why hardship withdrawals from 401(k) plans increased only slightly during the financial crisis. "There was not a massive flight out of the system," Wray said, "which back in the 1980s people absolutely predicted would happen."

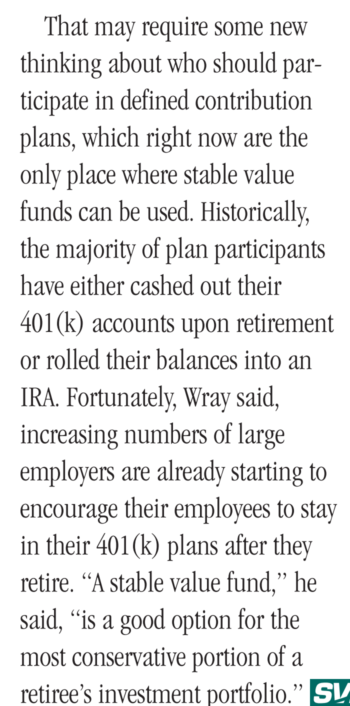
It wasn't just plan participants who stayed cool during the crisis, Wray added. "Plan sponsors were thinking the same way. They could have bailed as well. They could have terminated their plans. To my knowledge, there was not one single plan termination through all of this, except where companies filed for bankruptcy."

While 14.8 percent of plan sponsors did suspend their matching contributions to their 401(k) plans during the financial crisis, and 3 percent reduced their match, Wray noted that another 4.7 percent increased their match, and 76.8 percent left their policy unchanged. Approximately half of those who did suspend their match had either restored it, or planned to do so, by the first quarter of 2010.

Wray called stable value funds, which are available only to participants in defined contribution plans and certain college savings plans, one of the features that make 401(k) plans special. "My view has always been that you need a fixed income investment where the principal does not fluctuate," he said. "From a participant standpoint, this is a special deal; they get security, plus a bond rate of return. Where else can you get that?"

Nonetheless, Wray said the stable value industry must do a better job of promoting the benefits their product brings to the marketplace, not just for investors saving for retirement but also for those who have already stopped working and are looking for a secure source of retirement income.

That may require some new thinking about who should participate in defined contribution plans, which right now are the only place where stable value funds can be used. Historically, the majority of plan participants have either cashed out their 401(k) accounts upon retirement or rolled their balances into an IRA. Fortunately, Wray said, increasing numbers of large employers are already starting to encourage their employees to stay in their 401(k) plans after they retire. "A stable value fund," he said, "is a good option for the most conservative portion of a retiree's investment portfolio." SVIA



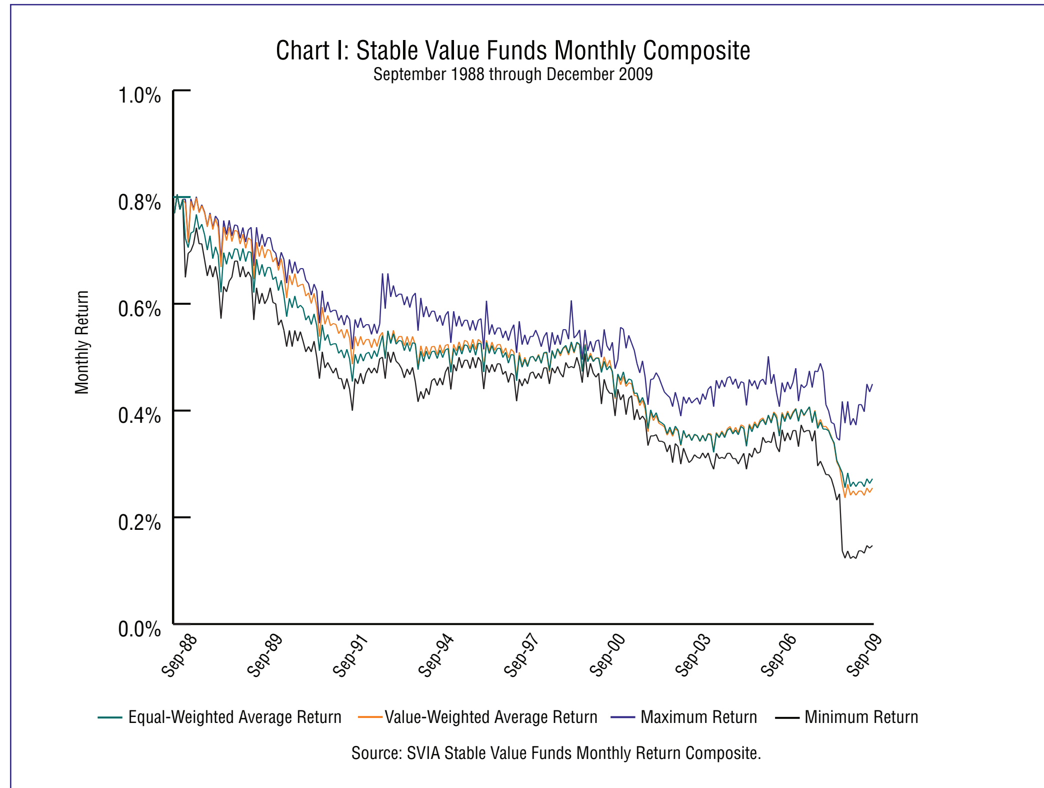
SVIA Stable Value Composite Introduced

By Gina Mitchell, SVIA

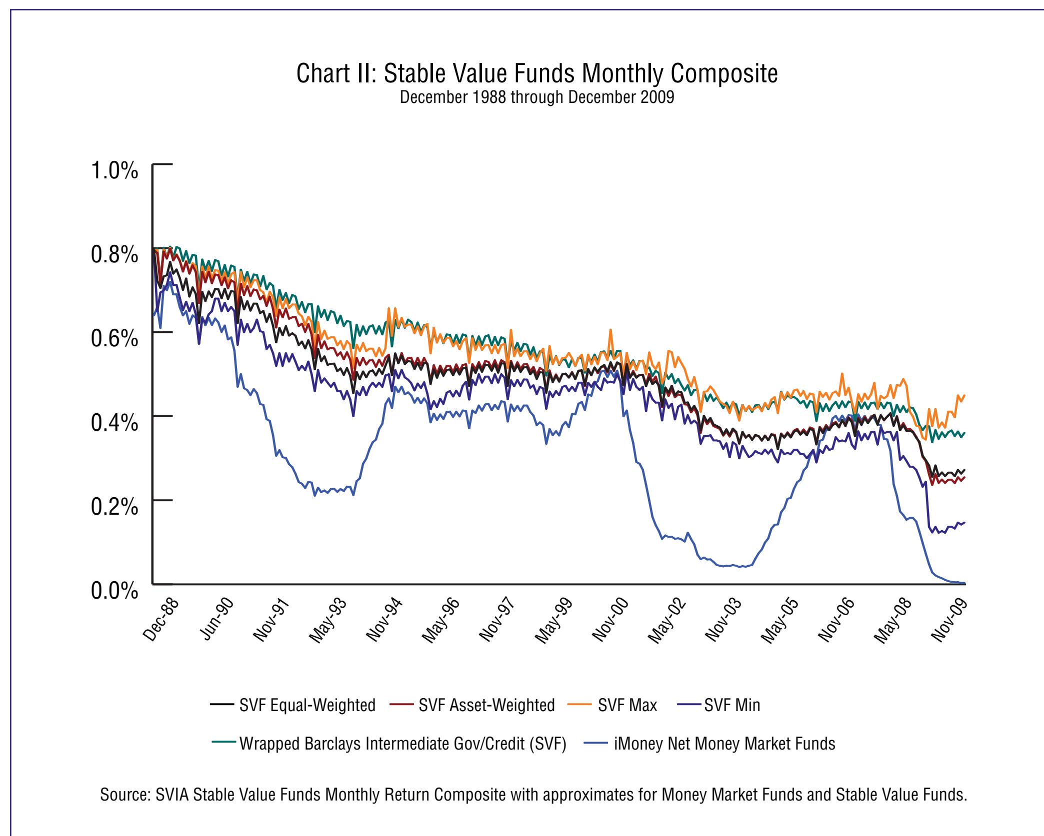
A question that always comes up with any investment is, "What are the returns?" The answer to that question typically looks at past performance as the most important indicator.

Most stable value funds have created a model to illustrate past performance for the stable value asset class. Many simulate stable value performance based on a model that wraps a bond fund index.

SVIA can now help answer the return question based on actual stable value performance across a broad cross section of investment management styles and assets. This answer is based upon the research of Professors David Babbel, Ph.D., and Miguel Herce, Ph.D. They reviewed stable value performance from September 1988 through 2009. Using their research, which tracks nine stable value fund complexes, the professors have created SVIA's Stable Value Composite. The Composite includes a cross section of life insurance: general accounts and separate accounts, pooled funds, and externally managed separate accounts that comprise a significant chunk of all stable value assets. The assets covered in this research have grown over 21 years from $359 million to $236.5 billion.



Source: SVIA Stable Value Funds Monthly Return Composite.



Source: SVIA Stable Value Funds Monthly Return Composite with approximates for Money Market Funds and Stable Value Funds.

The Composite (Chart I)

Chart I focuses solely on the Composite. It provides views of

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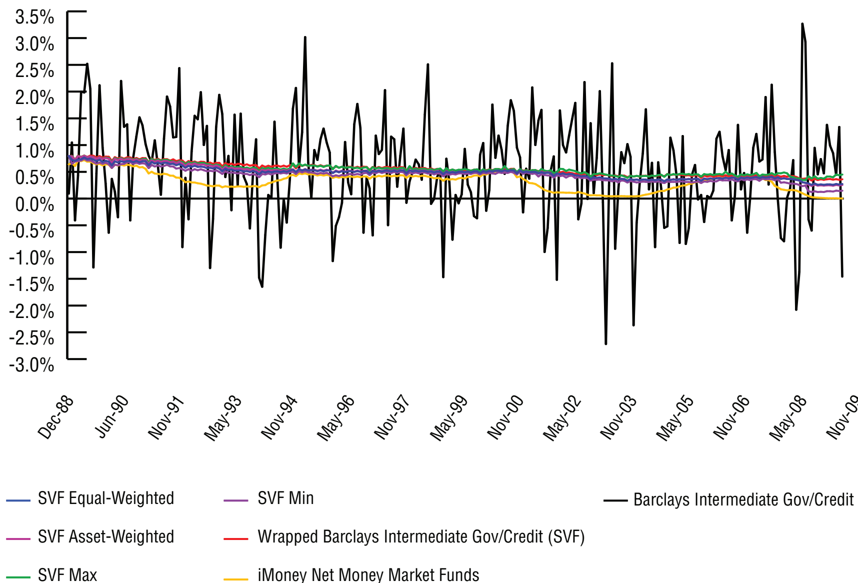

Stable Value Composite Introduced

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the Composite: equal-weighted or average return, value-weighted or asset-weighted return, maximum return, and minimum return. The maximum and minimum were provided to illustrate the range of returns within the Composite. As expected, the averages—both the equal-weighted and asset-weighted averages—fall within this range and for the later years and months of the Composite were closely aligned.

The Composite Compared to a Wrapped Index and Money Markets (Chart II)

Chart II compares the Composite to historical returns of the Wrapped Barclays Intermediate Government/Credit Index, which some have used as a proxy for stable value performance, and money market returns. The Wrapped Barclays Intermediate Government/Credit Index tracks the maximum return of SVIA's Composite rather than the asset- or equal-weighted averages of the Composite.

When money market returns were added (iMoney Net Money Market Funds), Chart II shows that the Composite—the stable value asset class—continues to significantly outperform money market funds in most market cycles, as Professors Babbel and Herce documented with their research.

The Composite Compared to Intermediate Bonds (Chart III)

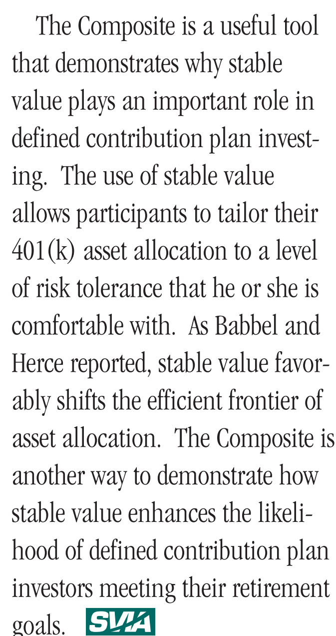

Chart III rounds out the illustration on stable value returns by adding the Barclays Intermediate Government/Credit return series, which demonstrates the volatility of bond returns.

The Composite is a useful tool that demonstrates why stable value plays an important role in defined contribution plan investing. The use of stable value allows participants to tailor their 401(k) asset allocation to a level of risk tolerance that he or she is comfortable with. As Babbel and Herce reported, stable value favorably shifts the efficient frontier of asset allocation. The Composite is another way to demonstrate how stable value enhances the likelihood of defined contribution plan investors meeting their retirement goals. SVIA

Professors Babbel and Herce are currently updating "A Closer Look at Stable Value Funds Performance" to include January through December of 2009. The study is available at SVIA's website, www.stablevalue.org.

Investors Look to Stable Value

By Gina Mitchell, SVIA

Defined contribution investors have taken all that the financial markets have thrown at them: an historic market upheaval and a prolonged recession in a low-interest-rate environment with increased volatility. Unlike most investors, defined contribution investors have an investment that has withstood the market's battering: stable value. And, according to SVIA's Stable Value Quarterly Characteristics Survey that was launched in the last quarter of 2008, these investors have found refuge from the market's storms with stable value.

The Characteristics Survey tracks key factors such as assets under management for 27 stable value managers. The survey shows that at the height of the crisis, investors placed $347 billion in stable value funds. Assets under management increased from 2.5 percent to 9 percent over the next five quarters. Assets under management declined only once, in March 2009 by less than one percent. Assets grew over the time frame of the survey from the $347 billion in December of 2008 to $440 billion as of March 2010.

The survey demonstrates the increasing importance of stable value to investors and shows why they use stable value as a cornerstone in their asset allocation. No other investment offers stable value's unique combination of

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JPMorgan Chase Teams with Barclays to Develop Stable Value Index

By Randy Myers

While stable value funds emerged from the recent credit crisis relatively unscathed—none lost money, and returns held well above those on money market funds—the crisis did have some fallout. Specifically, the market value of many stable value portfolios temporarily fell below book value during the crisis, prompting many wrap issuers to push for tighter, more conservative investment guidelines. (It should be noted, however, that stable value funds routinely have market-to-book ratios below 100% due to normal fixed income market movements.)This has led to push-back from most stable value wrap contract issuers to tighten investment guidelines. Which has, in turn, led to tension from some stable value managers who worry that tighter guidelines could compromise their ability to leverage their investment expertise, distinguish themselves from their competitors, and reduce expected returns for plan participants.

In an effort to help retirement plan sponsors and their consultants make better sense of the changes taking place, JPMorgan Asset Management has been working with Barclays Capital Research to develop a customized index suitable for benchmarking stable value portfolios. They are calling it the "Stable Income Market Index."

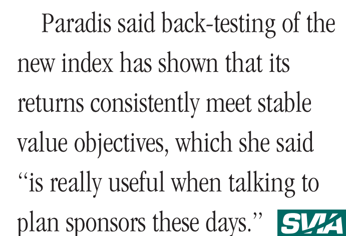
"We think it [the index] is important to help reduce the uncertainty that exists now among plan sponsors and the consulting community," Victoria Paradis, a managing director at JPMorgan, told participants in the SVIA's 2010 Spring Seminar. "These people are being told their funds are looking at new duration, sector, and quality constraints, and it is difficult to get their arms around what that means. We're hoping to remove some of the industry backlog with respect to wrap negotiations to see if we can come up with some common ground."

At present, there is no single and widely accepted market value benchmark for stable value funds, Paradis noted. Unlike the typical stable value portfolio, she said, common single fixed income benchmarks may have long unsuitable durations or unrealistic sector concentrations. And custom benchmarks, reflecting a particular manager's unique investment style, don't allow for easy comparison between differently constructed portfolios.

In developing the new index, Paradis said, JPMorgan and Barclays started not by looking at the existing indices or sectors that stable value managers tend to favor but rather at the return and risk objectives they pursue: outperforming cash and minimizing portfolio risk as measured by the market-to-book-value ratio.

What they came up with, she said, is a solution that blends three existing Barclays Capital indices in the following proportions: a 65 percent allocation to Barclay's 1-to-5-year Government/Credit Index, a 30 percent allocation to its Agency Fixed-Rate Mortgage-Backed Securities Index, and a 5 percent allocation to its Asset-Backed Securities Index. Importantly, the new index does not include any allocation to home equity asset-backed securities.

"The index is designed to illustrate portfolio characteristics that are of most interest to those underwriting the risks of these funds," Paradis said. "It has a better, much lower risk profile than other broad market indices like an intermediate aggregate or aggregate index. It also reflects a realistic investment opportunity set that is efficient from an interest rate positioning perspective, and it is broadly diversified."



Paradis said back-testing of the new index has shown that its returns consistently meet stable value objectives, which she said "is really useful when talking to plan sponsors these days." SVIA

Investors Look to Stable Value

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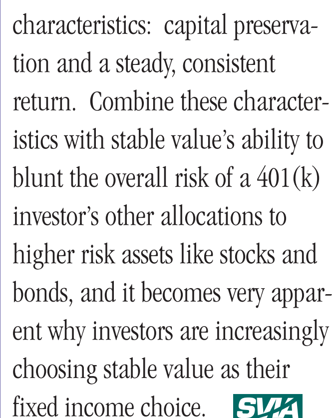
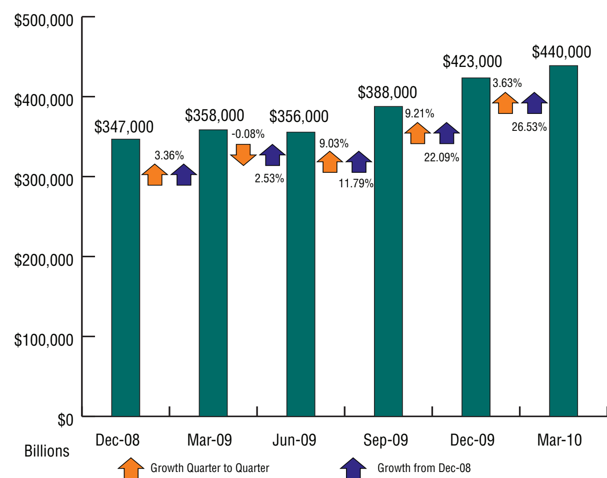


characteristics: capital preservation and a steady, consistent return. Combine these characteristics with stable value's ability to blunt the overall risk of a 401(k) investor's other allocations to higher risk assets like stocks and bonds, and it becomes very apparent why investors are increasingly choosing stable value as their fixed income choice. SVIA



Source: SVIA Stable Value Quarterly Characteristics Survey through March 2010. Twenty-seven stable value managers participated in this survey.

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Stable Value Funds Seen Coping If Interest Rates Start to Rise

By Randy Myers

The long downward trend in interest rates since the early 1980s has been beneficial to the stable value industry. Now, many economists believe that trend is in jeopardy, prompting questions about how the industry will respond.

Declining rate environments favor stable value funds because their crediting rates—the actual earning rates posted to investors' account balances—react more slowly to changes in interest rates than do yields on competing money market funds. This is often referred to as a "lag effect" of stable value crediting rates lagging changing market rates. Speaking at the SVIA's 2010 Spring Seminar, Karen Edgerton, senior vice president with AEGON Stable Value Solutions Inc., pointed out that rarely over the past 20 years have existing stable value fund crediting rates lagged money market yields. Even rarer have been investment yields available to stable value portfolios that have lagged money market yields. The former is true because money market yields generally do not move up fast enough to overcome the lag effect, and the latter is true because it is unusual for yield curves to be inverted for long periods of time. That has given the stable value industry a leg up on the money market industry in the competition for investor assets.

Now, however, economists fret that growing federal budget deficits will prompt a flood of borrowing by the U.S. government, driving interest rates higher for years to come. "We do expect them to rise, we're just not sure when and at what magnitude," Edgerton said. "As they do, stable value crediting rates will lag. And the ability for retirees and terminated vested (retirement plan) participants to move into competing funds is there. We have concerns about how that population will react, and also about the possibility of mass movements of money out of stable value funds at a time when the market value of the underlying assets may not be sufficient to fund those redemptions."

Still, Edgerton said, there are mitigating factors that should temper any fallout from a rising rate environment. For example, most stable value funds prohibit direct transfers into competing funds, such as money market funds. They also contain corridor provisions that limit the percentage of a contract that may be paid out at book value as a result of participant withdrawals following certain employer-initiated events, such as a significant early retirement program or layoff. Beyond that, she said, participants have repeatedly demonstrated that they like what stable value funds offer. Over time, she said, "We've seen at most plus or minus 10 percent movement in and out of the funds, mostly correlated to equity markets performance."

Edgerton also noted that stable value managers, as plan fiduciaries, work hard to keep their products attractive for retirement plan participants, which should serve them well in a rising rate environment.

If rates were to rise very sharply, Edgerton conceded that stable value funds could sustain a reduction in market-to-book ratios within their investment portfolios. Under one theoretical scenario she examined, funds could experience this reduction if rates jumped by more than 4.5 percentage points in a single year. That's unlikely but not impossible; rates jumped nearly that much in March 1980 and by 5.57 percentage points in July 1981, she said.

Stable value managers can mitigate interest rate risk by adjusting the duration of their portfolios and by taking the demographic characteristics of plan participants into consideration when doing liquidity planning and liability profiling, Edgerton said. Hedging interest rate risk also is an option.

John Axtell, managing director and head of stable value for Deutsche Bank, said it's also worth noting that while interest rates have been in a general downtrend over the past two decades, there have been several shorter periods of rising rates along the way. During those periods, stable value funds have performed well, with market-to-book-value ratios generally fluctuating within a manageable range.

Beyond thinking about how they might react to a sustained rise in interest rates, Axtell said stable value managers and wrap providers should be asking how stable value funds are likely to perform if inflation becomes an issue. Like interest rates, inflation has been fairly benign over the past two decades. The last period of high inflation occurred between January 1977 and December 1982, with the annual rate of change in the U.S. Consumer Price Index topping out above 14 percent in the second quarter of 1980. In 1981, the Federal Funds rate reached 19 percent as the Federal Reserve battled to bring inflation under control.

This was a stressful period for stable value funds, Axtell said, noting that a hypothetical Barclays Intermediate Aggregate Index covered by a wrap contract would have seen its market-to-book-value ratio fall to 82 percent in 1981 before climbing back above 100 percent the next year.

What wrap issuers would like to know now is how plan participants are likely to react if such a scenario would unfold again. While it is difficult to theorize, he said, it is known that during that period from the late 1970s to the early 1980s, yields on money market funds and three-month Treasury bills were periodically higher than stable value yields.

Wrap issuers also would like to know, Axtell said, how stable value managers today would react in such a situation. "One idea often floated," he observed, "is that we should just go to shorter durations with our investment portfolios."

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401(k) Industry Moves Toward Benchmarking

By Randy Myers

For years, smart companies have benchmarked their performance against their peers to identify opportunities for improvement in a variety of areas, from how efficiently they manage their inventory to how quickly they collect on their accounts receivable. One area they have often overlooked, especially if they were not a very large employer, has been their 401(k) plan.

That's starting to change, says Ryan Alfred, who in 2007 cofounded, with his brother Mike, the 401(k) benchmarking firm BrightScope.

"In the past, a plan sponsor willing to contract with a consultant to do a benchmarking study would typically be a larger sponsor, with at least $100 million in assets," Alfred told participants at the SVIA's 2010 Spring Seminar. "Now we see plans as small as $1 million in assets willing to pay a couple of thousand dollars for a benchmarking study from an independent third party to figure out exactly how they stack up in the marketplace."

This new appetite for benchmarking is reflected in the rapid growth of BrightScope, which already employs about 25 people, maintains data on more than 40,000 retirement plans, and hopes to have 75,000 plans in its database by the end of this year.

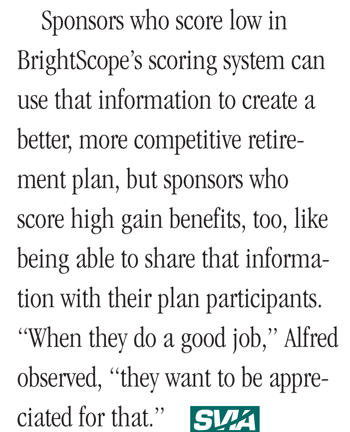
Former money managers, the Alfreds say they're driven by a desire to fill a market need critical to the financial well-being of retirees and the success of their retirement savings plans. "We want to add value for decision-makers," Ryan Alfred said, "so they can properly benchmark the expenses and performance of their plans and ultimately make decisions that positively impact participant outcomes."

Retirement plan advisors are a primary customer group for BrightScope, using its services not only to benchmark plans for their clients but also to identify plans that might be amenable to a sales pitch. Alfred said retirement plans with $1 million to $100 million in assets are serviced by about 10,000 advisors, with about 2,000 of those controlling the bulk of plan assets. Of that group, he said, about one-third have now implemented some form of benchmarking through third-party providers such as BrightScope.

In the past, plan sponsors who did try to benchmark their plans often relied exclusively on data from their plan providers, which was more limited than what a third-party provider like BrightScope can offer. Now, sponsors are looking to do a more thorough analysis.

"Before, they were typically looking at their investment performance, their match structure, and participation rates," Alfred said. "But they were not looking at the plan holistically, and they certainly did not have enough fee benchmarking information. Now they're benchmarking fees, and they're also starting to measure outcomes." He defined outcomes as the ability of the plan to generate retirement income for plan participants.

Unlike its competitors, BrightScope makes its plan ratings available free to the public. The company assigns a numerical score for each plan that it tracks, basing that score on more than 200 data points in a number of broad categories such as plan costs, the generosity of the company match, and the quality of the investment menu. Plan sponsors and advisors who wish to see more—and benchmark their plan against a customizable universe of other plans—can do so for a fee. BrightScope's "plan management dashboard" can show them how various aspects of



their plan stack up against those of their peers. Inputting data on their own plan is relatively painless; BrightScope's database can pull data from most major record-keeping platforms.

Sponsors who score low in BrightScope's scoring system can use that information to create a better, more competitive retirement plan, but sponsors who score high gain benefits, too, like being able to share that information with their plan participants. "When they do a good job," Alfred observed, "they want to be appreciated for that."

Stable Value Funds Seen Coping

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And indeed, he said, that would help. While the hypothetical wrapped Intermediate Aggregate Index saw its market-to-book ratio fall to 88.8 percent at the height of the high-inflation, high-interest period from 1977 through 1982, he said, the ratio would have fallen to only 88.8 percent for a wrapped version of the shorter-duration Barclays 1-5 Year Government Credit Index. However, that improved minimum market-to-book ratio would have come at the expense of a 50-basis-points reduction in the average annual return for the 33-year period from January 1977 to January 2010.

"Fortunately, inflation expectations have inertia," Axtell said, explaining that many economists believe the Consumer Price Index would have to rise for an extended period of time before triggering significant inflation expectations.

That would give managers ample time to adjust their portfolios.

Just in case economists are wrong, he said, stable value managers should be developing strategies now to manage through periods of inflation should they materialize. Options include not only shortening the duration of investment portfolios, he said, but reallocating portfolio assets among different sectors of the fixed income market, hedging via futures and options contracts, and allocating some assets to Treasury Inflation-Protected Securities, or TIPS.

When Deutsche Bank recently modeled how a hypothetical re-allocation strategy along these lines might affect returns for a wrapped Barclays Intermediate Aggregate Index portfolio, Axtell said, the market-to-book ratio fell to only 92.7 percent instead of 82 percent. The reallocated portfolio also enjoyed an average annual return for the 33-year period ending 2010 that was 34 basis points higher than the plain vanilla Intermediate Aggregate portfolio.

New Players Join Stable Value Wrap Community

By Randy Myers

Wrap capacity in the stable value industry finally appears to be expanding.

Wrap contracts guarantee book value withdrawal rights for investors in stable value products. When the credit markets froze in 2008, the banks and insurers that issue wrap contracts began to reassess the risks embedded in that business. In many cases, they stopped writing new contracts as they analyzed the market to reassess risks.

Today, wrap capacity remains far more constrained than it was prior to the credit crunch. But as participants at the SVIA's 2010 Spring Seminar learned, three insurers—Aviva plc, Prudential Financial, and Mutual of Omaha—have recently brought new capacity to the market and are writing new stable value business.

Aviva, which is wholly new to the stable value market, is offering a bundled synthetic GIC in which it both manages the underlying assets and provides the wrap contract. "We felt comfortable coming out with this structure," Eric Hasenauer, managing director and head of sales for the company's Aviva Investors North America Inc. subsidiary, told seminar participants. "A lot of capacity generated today comes in the form of bundled offerings, and we thought this would be attractive to the market given the fact that plan sponsors can custody the underlying assets."

Hasenauer noted that plan sponsors also benefit from the synthetic GIC structure because it requires issuers to hold less capital than a traditional GIC would. Those lower internal expenses can be passed along as savings to plan sponsors, Hasenauer said, and also can allow for greater flexibility in setting investment guidelines.

Hasenauer said the higher fees that wrap contracts are commanding in the wake of the credit crisis helped convince Aviva to expand into the stable value marketplace. Aviva entered the market with $10 billion in wrap capacity, he said, and has "billions more earmarked behind that" to expand in the future.

One of the biggest internal challenges to launching the business, he noted, was simply educating other decision-makers within Aviva about the market's risks and opportunities. Another challenge, he said, was learning to understand the regulatory environment in each state where the company wishes to operate. Aviva hired third-party experts to help it with the legal and administrative aspects of launching the business, he said, while building its own internal staff and infrastructure.

Like AVIVA PLC, Mutual of Omaha recently launched a synthetic GIC business, although in its case it is not managing the underlying portfolio internally but instead is working with third-party asset managers. The company was already a provider of traditional GICs and funding agreements. The synthetic GIC business, said Mutual of Omaha's Marty Fleishman, vice president for retirement plans, represents new wrap capacity the company has brought to the market.

"We are writing far bigger wrap contracts than we ever did in traditional GICs," he confirmed after the seminar. "But we are not cutting back on traditional GICs. We don't see this as a replacement for that business, but a supplement to it."

Fleishman, who joined Mutual of Omaha in April 2009 to launch the stable value wrap contract business, said the company currently offers under $10 billion in wrap capacity, but added that he is hopeful of being able to offer more as the business proves itself. He conceded that the company had developed a contract with conservative terms and conditions that do not appeal to all stable value managers but are attractive to some. As of mid-April 2010, the company had contracts in place with two managers and was in advanced negotiations with three more.

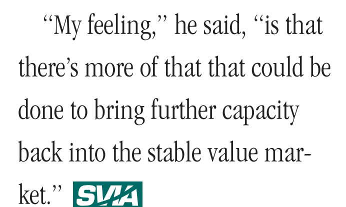
Prudential has a long history of operating in the stable value marketplace, beginning by offering traditional GICs and later introducing separate account and synthetic GICs as part of its full-service retirement plan administration platform.

About a year ago, the company began offering its separate account and synthetic GIC businesses as stand-alone products to stable value managers, bringing additional capacity to the wrap marketplace.

William McCloskey, vice president with the company's Prudential Retirement unit, said Prudential's total book of wrap business now exceeds $10 billion and is "not yet within sight" of its upper bounds. Since expanding its role in the stable value market, he said, the company has put about half a dozen new wrap contracts in place.

"McCloskey added that Prudential took its product through a "de-risking process" that involved creating investment strategies and contract provisions suitable for the current conservative investment climate.

"My feeling," he said, "is that there's more of that that could be done to bring further capacity back into the stable value market."



Wrap Issuer Makes Case for Tighter Stable Value Investment Guidelines

By Randy Myers

The push by wrap issuers for more conservative stable value investment guidelines may have heightened the tension between issuers and fund managers, but it doesn't appear to be threatening their symbiotic relationship. In a panel discussion at the SVIA's 2010 Spring Seminar, for example, one leading fund manager conceded that his company was in agreement with most of the changes being imposed by wrap issuers.

Issuers began pushing for tighter investment guidelines in the wake of the 2007-08 credit crisis, which temporarily drove the market value of many stable value funds below their book value. Had stable value investors exited those funds en masse at that point, wrap issuers could have been called upon to make up the difference between the market and book values of their accounts. That didn't happen—investors actually flocked to stable value funds rather than fleeing them—but it convinced wrappers that their business was riskier than they once imagined.

Robert Whiteford, managing director in the Global Structured Products Group at wrap issuer Bank of America, told seminar participants that the push for more conservative investment guidelines is critical to the long-term health of the stable value industry.

"A lot of people believe we (wrap issuers) are getting tough just because we can," Whiteford said, alluding to the recent scarcity of wrap capacity as banks and insurance companies have sought to bolster their capital reserves. "That's not the case. Historically, we looked at this business as having a low level of risk, but that has changed in a big way."

Prior to the credit crisis, Whiteford explained, wrap issuers implicitly assumed that stable value managers would structure their portfolios to ensure a "manageable" level of investment risk. Instead, he said, some took more risk in a bid to generate higher yields for investors. "There also were isolated circumstances where managers were living within the letter of their investment guidelines, but not so clearly within the spirit of their guidelines," Whiteford said. "While everything worked out pretty well, thanks to the diligence and hard work of a lot of people, it is a different world now. It's not as safe as it once was."

The upshot, Whiteford said, is that wrap issuers are pushing for investment guidelines that eliminate or reduce the use of some of the riskier assets that had found their way into stable value portfolios, such as non-investment-grade securities or exotic asset-backed securities. Many are also seeking to eliminate currency risk and leverage from stable value portfolios and are pushing for greater diversity and transparency in those portfolios.

"I don't believe any wrapper is taking advantage of the dearth of wrap capacity to make changes," he said. "I think all these risk changes are necessary. We have to look at the risk characteristics of our products and manage that risk, and the economics of the business, in a way that makes sense. What we're trying to do is consolidate the risks in this business and prepare ourselves for future growth."

Erol Sonderegger, director of client portfolio management for stable value manager Galliard Capital Management, said his firm is "on board" with about 80 percent of what wrap issuers are demanding, though he fears the pendulum may have swung too far on the remaining 20 percent.

He criticized, for example, the tendency for some wrap issuers to "over rely" on credit ratings when determining which securities a manager should be allowed to hold in an investment portfolio. "Rating agencies are what got the financial industry into a lot of trouble in the last couple of years," he said, alluding to their willingness to assign investment-grade ratings to mortgage-backed securities and collateralized debt obligations that proved to be extraordinarily risky. "While ratings are important yardsticks, just like benchmarks, I think we should think this through a bit and be a little flexible."

Sonderegger also encouraged wrap issuers to allow managers to incorporate into their investment guidelines sufficient flexibility to work out of investment positions that become stressed. "We believe that stable value still has a tremendous value proposition," he said, "and that within that, active management of stable value is as strong as ever. Prudent active management proved its worth during the crisis."

Even with the more restrictive guidelines being imposed, Sonderegger concluded, "there is still plenty of room for stable value managers to add value" for their clients.

During a question-and-answer period following the panel discussion, one seminar participant, a stable value manager, complained that her stable value fund was being subjected to the same investment guideline pressures being brought to bear on others, even though her fund, which included an allocation to high-yield fixed income securities, never saw its market-to-book-value ratio fall below 100 percent during the financial crisis. Subjecting the entire industry to the same uniform investment guidelines, she said, "is hurting managers like us who have had good experience, decades of experience, managing fixed income assets, and it is making all managers seem very generic."

Whiteford said he was sympathetic to that argument and urged managers who believe they are being reined in unfairly to make "a strong, cogent, analytical case" to their wrap issuers as to why they should be allowed to pursue

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Survey Confirms Trend Toward More Restrictive Wrap Contracts

By Randy Myers

As the stable value industry has moved to tighten wrap contract terms for stable value funds over the past two years, it has gotten some pushback from an important constituency—employers who make the ultimate decision on whether to include stable value funds in their 401(k) plan investment lineups.

"We're getting some resistance from plan sponsors," Tony Camp, vice president of the Stable Value Product Group for wrap issuer ING, told participants at the SVIA's 2010 Spring Seminar. "Some have actually surrendered their stable value option in favor of a money market fund, and that's something that, several years ago, nobody thought any plan sponsor would do."

The contract changes being pushed by wrap issuers have been designed to assure the long-term sustainability of stable value funds by lessening the chances that issuers will have to step in and make good on the book-value withdrawal guarantee their contracts offer to plan participants. For example, wrap issuers have sought to classify a broader array of investments as "competing funds" that can't take exchanges directly from stable value funds and also to expand the definition of employer-initiated events that can minimize a wrap provider's obligations. That has led some plan sponsors to complain that they and their plan participants don't have as much control over their assets as they would like.

"Maybe we're being too conservative," Camp suggested.

To get a better handle on how different factions of the stable value community view contract issues, the SVIA recently polled a group of 21 stable value managers, 18 wrap issuers, and eight plan sponsors. Among the highlights, the survey found that while only about half of all managers and wrap issuers thought their industry should adopt standardized wrap contract terms, 75 percent of plan sponsors favored that idea.

Not surprisingly, the survey also found that issuers take a broader view of what constitutes a competing fund; 89 percent counted self-directed brokerage options as competing funds, for example, versus only 38 percent of plan sponsors. One area where that trend didn't hold true: only 33 percent of issuers said they consider TIPS funds—funds that invest in Treasury Inflation-Protected Securities—to be competing funds, while 50 percent of plan sponsors said they view them that way.

A clear majority of all respondents—70 percent—said they would support the development of standardized equity wash rules for the stable value industry. Equity wash rules require that transfers out of a stable value fund must go into an equity fund for a predetermined period of time, usually 90 days, before being moved into a competing fixed income fund. This protects the remaining value of the fund for the participant and discourages arbitrage by retirement plan participants between stable value and competing funds.

In addition, 49 percent of respondents said they had temporarily lowered their crediting rate formula in the recent past in a bid to bring the book value and market value of their stable value portfolios into closer alignment. By contrast, only 4 percent said they had changed their crediting rate permanently.

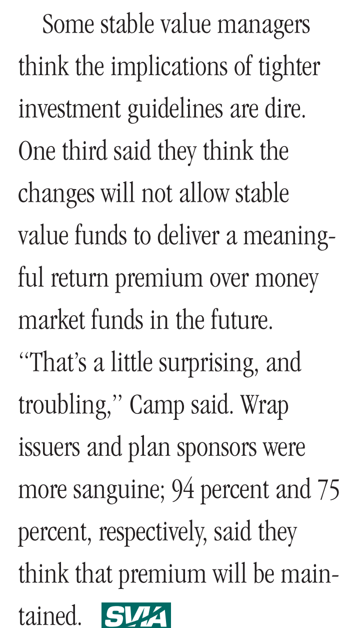
Even more respondents—70 percent—said they had changed their investment guidelines for new pieces of business they'd undertaken, and 74 percent said they had done so for existing mandates.

Two-thirds of wrap issuers indicated that they have stopped providing wrap contracts for several types of investment strategies. Most significantly, six of 18 said they had stopped wrapping core fixed income strategies, and 12 said they had stopped wrapping core-plus strategies.

Approximately half of all stable value managers and wrap issuers said they had changed their investment guidelines in a broad range of areas, including duration cap, overall credit quality minimums, single-security exposure, sector exposure limits, and sector credit minimums. They also said they had made a significant reduction in the use of non-benchmark sectors such as high-yield bonds and emerging market debt.

Stable value issuers, who have been pushing for more restrictive investment guidelines, were most enthusiastic about all these changes; 83 percent said the changes would be beneficial to the stable value industry in the long term. Three-quarters of plan sponsors agreed with that view, but only 52 percent of stable value managers agreed.

Some stable value managers think the implications of tighter investment guidelines are dire. One third said they think the changes will not allow stable value funds to deliver a meaningful return premium over money market funds in the future. "That's a little surprising, and troubling," Camp said. Wrap issuers and plan sponsors were more sanguine; 94 percent and 75 percent, respectively, said they think that premium will be maintained.



Financial Reform Legislation Could Affect Some Stable Value Products

By Randy Myers

The sweeping financial reform legislation being debated by Congress in April makes no specific mention of stable value funds, but it could have an impact on the stable value industry nonetheless if the legislation becomes law.

Both the Wall Street Reform and Consumer Protection Act passed by the House in December and the Restoring Financial Stability Act introduced by Sen. Christopher Dodd, (D-CT), in April call for close regulation of the over-the-counter derivatives market. Among other things, they call for OTC derivatives, including swap contracts, to be cleared by a clearinghouse and traded on an exchange or swap execution facility.

While there would be exceptions to those requirements, Thomas D'Ambrosio, a partner with the law firm of Morgan Lewis & Bockius LLP, notes that any regulations issued in compliance with those bills could apply to stable value products, depending upon how the regulations are worded.

D'Ambrosio has been working with the SVIA to track the progress of the legislation and its likely impact on the stable value industry. The potential link between the two stems from the way the bills define swap contracts. Addressing the SVIA's 2010 Spring Seminar, D'Ambrosio said the House bill describes a swap as, among other things, an agreement which provides for payments to be exchanged between two parties based on the value of some underlying asset.

"This is the clause we thought was potentially problematic with respect to some stable value products, particularly the wrap agreement, because the wrap agreement normally covers a pool of securities and provides for the issuer to make a payment to the plan under certain conditions related to the market values of the pool of securities covered by the contract," D'Ambrosio said.

An interest rate swap, he said, would clearly qualify as a swap under the wording of the House bill. But he said there is also a legitimate concern that regulators could look at stable value wrap agreements, see that they are guaranteeing the value of securities in a stable value portfolio, at least at certain points in time, and conclude that they are "very much like" the type of arrangement Congress is trying to cover with its legislation.

"This is not set in stone, and it's always subject to the regulation that comes out," D'Ambrosio stressed. "But just on its face, the swap definition has language that, I think, is broad enough to pick up some stable value products."

The types of products most likely to be considered swaps, he said, are wrap contracts and separate account GICs, since their payouts are identified as relating, potentially, to a basket of securities.

The proposed legislation would apply to two types of market participants, D'Ambrosio noted: swap dealers and so-called "major swap participants." The bills define the latter as, in essence, anyone who maintains a substantial net position in swaps, excluding those held primarily for hedging or whose failure to perform under the terms of its swaps would cause significant losses to its counterparties.

"If the bills' definitions of swaps remain as originally drafted, I think, wrap contracts will become 'swaps' and the sellers of wraps are certainly dealers. Sellers may even be major swap participants," he said. "Purchasers (plan sponsors) may not be major swap participants, however. It's hard to see how the failure of one of those would create significant losses at a wrap provider." He also said he did not think trustees would be considered major swap participants.

Market participants covered by the regulations, D'Ambrosio said, would have an obligation to submit their swaps to a clearinghouse. If no clearinghouse accepted the transactions, they would have to report them to a regulator.

While both the House and Senate bills provide some exemptions from clearing, D'Ambrosio predicted those exemptions would be hard to get. He speculated, however, that clearinghouses may not want to clear stable value products due to the level of customization they feature, including differing crediting rate formulas.

If passed, D'Ambrosio said, the legislation would introduce new compliance costs for covered entities that, in the case of stable value products, might lead to higher fees and hence lower crediting rates.

While the Senate bill includes exclusions on new capital and margin requirements for existing swaps, the House bill does not, D'Ambrosio said. If the House view prevailed, it would mean that market participants would find themselves having to post additional margin on contracts already on their books. "This would be a significant concern if stable value is not excluded," he said.

Through mid-April, D'Ambrosio said, the stable value industry had not been successful in convincing either the House or Senate to write into their legislation an exemption to the proposed new swap rules for stable value products. Assuming nothing changed on that front, he said, the industry may want to try to get a statement on the subject into the legislative history of the bills.

The industry also might want to lobby the Securities and Exchange Commission and the Commodity Futures Trading Commission, the regulators who wind up drafting the actual

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SV Investment Guidelines

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their preferred investment strategy. "I believe all wrappers will look at it and give it the right time," he said. "But they are going to have to make the case to a number of other people in their organization who are going to be skeptical."

Marc Magnoli, executive director of JPMorgan Chase's Stable Value Products Group and chair of the SVIA, added, "Our concern as wrap providers is, how bad will things get if they get bad again? We do understand that managers have different styles, but once guidelines are written, we don't have any control over what goes on in the portfolio. We want a situation where managers can't create portfolios that, when things go bad, look like the portfolios we had in the last crisis. We believe it is prudent and appropriate to have preservation of principal as a foundation principle on which stable value portfolios are managed. SVIA

Financial Reform Legislation

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regulations, to make some accommodations for stable value, he said. For example, he said, the industry could push for regulations worded so that a separate account insurance product issued by an insurer and regulated by a state is not considered a swap.

D'Ambrosio warned, however, that neither the House or Senate bills, as proposed, give either commission a general right to exclude any market participant from the provisions of the legislation. SVIA

EDITOR'S CORNER

Risk Control and the Coming Stable Value Surge

By Robert Whiteford, Bank of America

"Take calculated risks. That is quite different from being rash."
George Patton

The quote shown above is an odd one considering the source, but I believe that it may be appropriate advice for several groups of participants in the stable value market—the wrap providers and the asset managers. All of us in the stable value business have a strong interest in creating additional wrap capacity. The best way to do so is to demonstrate that the risk that the wrappers undertake is well monitored and controlled. While no one rashly entered into risky wrap agreements prior to the financial crisis, we did discover that wrapper risk was higher than previously thought. The rash action would be to ignore all that we have learned. Wrappers are paid to take risk, but that risk must be calculated as closely as possible and controlled.

Historically, the stable value business was viewed as one in which there was little risk of loss for any of the parties involved. It was very common for consultants, and even some asset managers, to openly express the opinion that the wrappers were being paid for nothing more than an accounting treatment. The perception was that there was no chance that a loss would ever be incurred. The unfortunate events of 2008 disproved this. Market-to-book-value ratios fell to unheard of levels, and true market prices for the underlying portfolios were often difficult to determine. The reality is that there is considerably more risk than was previously thought.

To increase wrap capacity, wrappers need to demonstrate that risk has been successfully and meaningfully reduced. This doesn't mean that the wrappers are trying to eliminate all risk, but it does mean that the risk must be reduced to the level that makes wrap risk management teams comfortable, while providing the affordable protection that wraps bring to stable value.

The good news is that the wrappers and asset managers have made great progress in reducing risk in a way that should allow the existing wrappers to increase capacity in the future. Successful risk control will also make the wrapper business more enticing to new participants. New investment guidelines have been constructed to more faithfully reflect the mission of stable value funds, which is to produce a good, steady investment return while investing in high quality, liquid investments that can withstand a severe market storm. Additionally, wrap contracts have been revised to better control credit risk and to reduce or eliminate the impact of events that fall outside the benefit-responsive purpose of the wrapper. Finally, reporting required by wrap contracts has been materially improved: this allows the wrappers to better monitor the portfolios that they wrap and to more quickly determine the effect on wrapped portfolios when an asset is downgraded or defaults.

I am extremely pleased with the progress that the participants in the stable value industry have made to find real, substantive solutions. This hasn't been easy for the asset managers, as each wrapper has its unique set of concerns. There is still more work to be done, but great progress has already been made. We need to keep at it. New capacity to meet the increasing demand by 401(k) plans should follow.