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JPMorgan Economist Anthony Chan Sees Little Chance of Recession

By Randy Myers

The Federal Reserve is raising short-term interest rates. The once white-hot housing market is cooling. Economic growth is slowing, and the stock market may have already notched all the gains it's going to register this year. Economist Anthony Chan's assessment of the U.S. economy may sound gloomy, but in an April 3 address to the Stable Value Investment Association's 2006 Spring Seminar, Chan assured industry executives that his outlook for the economy is actually quite benign.

Chan, Managing Director and Chief Economist for JPMorgan Private Client Services, doesn't discount the impact of the Fed's rate-tightening agenda or the slowing of the housing market on the U.S. economy. He told his audience there are several reasons why neither should trigger a recession. First, he said, the Fed is near the end of its rate-tightening cycle. Following 15 quarter-point hikes that put the federal funds target rate at 4.75 percent in

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Automating the 401(k) Plan: Providers Say It May Be the Key to Success

By Randy Myers

For much of the past two decades, defined contribution retirement savings plans have been trying to transform American workers into de facto investment professionals. To a large degree, they've failed. While assets in defined contribution plans have grown mightily—from $1.4 trillion in 1994 to $3.2 trillion by year-end 2004, according to the Investment Company Institute—the average 401(k) plan account balance at year-end 2004 remained a paltry $57,000. That is hardly enough to make a meaningful dent in the average retiree's standard of living. Retirement plan providers believe they've come up with product and plan features that will make 401(k)s and other defined contribution plans work, even for investors who can't or won't make smart retirement savings decisions for themselves.

The need for better results is undeniable. Speaking at the Stable Value Investment

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Stable Value Industry Sets Sights on Growth

By Randy Myers

For years, stable value managers have pointed to the graying of America as a long-term source of growth for their industry. Older investors worry about conserving principal, and few products offer better principal protection than stable value funds while still providing inflation-beating returns. Yet despite the encouraging demographics—the U.S. Administration on Aging projects that the number of Americans 65 years old and older will approximately double over the next 30 years, to about 76 million—leaders in the stable value industry say the industry shouldn't be content to sit back and wait for retiring baby boomers to come knocking at their door. Speaking in April at the Stable Value Investment Association's 2006 Spring Seminar in Henderson, Nevada, they encouraged the industry to probe the limits of the marketplace for new opportunities.

James McDevitt, Senior Vice President with State Street Bank & Trust Co., is among the industry leaders suggesting that now is no time to be complacent. He noted that while statistics show older

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Anthony Chan

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March, Chan said, the Fed is likely to halt its campaign after one or two more increases that would leave the target at most at 5.25 percent. Sometime in 2007, he predicted, the Fed will actually start to lower short-term rates, something it has historically done, on average, just 4.75 months after it stops raising rates.

Chan said the Fed should be able to stop raising interest rates soon, even though the economy isn't sliding into a recession. In part, Chan explained, this is because the Fed began raising rates early in the economic cycle, to head off even a whiff of inflation. And it has worked, he said. Despite soaring energy prices, most companies have virtually no pricing power and "the economy has become more inflation resistant."

To be sure, that might be a tough sell to anyone who fills up an SUV each week or has tried to buy a house in the past couple of years. Gasoline prices are at or near record highs, and so are housing prices in much of the country. Recently, though, the housing market has begun to slow. Although it remains high by historical measures, the National Association of Realtors' Pending Home Sales Index fell 0.8 percent in February from the prior month and was down 5.2 percent year-over-year.

Housing is a critical component of the U.S. economy, Chan conceded, noting that over the past five years, 40 percent of employment growth has been attributable in some way to what's been happening in the housing market. Nonetheless, he sees no evidence of a housing "bubble" and projects that the current slowdown in the housing market shouldn't be sufficient to trigger a recession. Historically, that has happened only after housing sales have fallen by 25 percent to 35 percent, he said. By contrast, Chan is looking for a slowdown of only 5 percent to 8 percent.

Even the recently inverted yield curve in the bond market—it had reverted to a modestly positive curve by the time Chan spoke in April—isn't a harbinger of recession, Chan said. He said short-term rates historically have had to climb about 28 basis points above long-term rates before an inverted yield curve prefaces an economic slump.

Factoring in all the variables, Chan said he expects the economy to grow somewhere between 3 and 3.2 percent this year, as measured by real Gross Domestic Product. He also expects inflation, as measured by the Consumer Price Index, to rise about 3 percent year-over-year. He expects returns of about 4.2 percent for the Standard & Poor's 500 stock index and returns of 4.75 percent to 5 percent for the 10-year Treasury note. He predicted this will mark the fifth consecutive year in which international equities outperform domestic equities.

Automating 401(k) Plans

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Association's 2006 Spring Seminar in Henderson, Nevada, Doris Fritz, a Vice President in Fidelity Investment's FIRSCo Investment Consulting Services group, highlighted participation and contribution rates among the 8.6 million participants in the nearly 11,000 defined contribution plans administered by Fidelity. Based on 1994 plan data, about 34 percent of the eligible workers don't participate in their plans, Fritz said. A whopping 91 percent don't contribute the legal maximum amount ($15,000 in 2006), and many don't even contribute enough to take full advantage of their employers' matching contributions. Finally, 21 percent of participants stash all of their retirement savings in a single investment option, which suggests that their portfolios are probably not adequately diversified.

Better results are possible, Fritz said, and one way to get them is to automate the defined contribution plan experience. In recent years, about 10 percent of Fidelity's plan sponsor clients have introduced an automatic enrollment feature to their plans,

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Industry Growth

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participants in 401(k) plans historically have invested more heavily in stable value funds than younger investors, there's no guarantee that trend will continue, especially with increasing numbers of plan sponsors now choosing to make lifestyle funds the default investment option for their plans. "Among people in their 20s and 30s," McDevitt said, "a lot don't have any allocation to stable value. They may get used to the idea of not being in conservative investments."

Even investors who do appreciate stable value's unique combination of low volatility and bond-like returns may not have access to stable value investments in retirement, McDevitt added, if they choose to roll their assets out of their 401(k) plans at retirement and into Individual Retirement Accounts. Stable value funds are not available in Individual Retirement Accounts.

None of this suggests that the stable value industry faces a bleak outlook. Its assets grew from $159 billion in 1996 to $419 billion in 2004. Despite the potential for changing trends, most industry experts believe the aging of the U.S. population will, in fact, boost demand for stable value investments. Meanwhile, the business community's waning affection for traditional defined benefit plans is expected to continue to funnel more American workers into defined contribution plans, where stable value funds have a big share of the market. Currently, stable value funds account for more than 20 percent of total defined contribution plan assets.

William Gardner, a Portfolio Manager with Dwight Asset Management Co., also told attendees at the SVIA seminar that some increasingly popular design features in 401(k) plans, such as automatic enrollment and automatic deferral increases, should help fuel continued growth in that arena.

Where else might the stable value industry find new opportunities? McDevitt cited a number of potential markets, including 403(b) retirement savings plans, which are similar to 401(k) plans but are offered to employees of educational institutions and certain non-profit organizations rather than corporate employees. McDevitt also cited non-U.S. markets and even, perhaps, the mutual fund market, if the industry should decide to address the book-value accounting issue with the Securities and Exchange Commission. Cracking those markets would, in some cases, require the help of regulators. For example, current Internal Revenue Service rules do not allow 403(b) plans to invest in commingled stable value funds, limiting the opportunities in that market. And, of course, the SEC doesn't permit mutual funds to employ the book-value accounting methodology that underpins the stable value industry in employer-sponsored retirement savings plans.

Beyond expanding the reach of stable value products into new markets, the stable value industry has opportunities to grow in other areas, according to Richard Cook, Chairman of the SVIA and Manager of Marketing and Sales for Genworth Financial's Institutional Stable Value Group. With the ranks of the retirees swelling, he noted, a number of insurance companies who participate in the stable value industry, including Genworth, have developed annuity products for defined contribution plan participants who want to assure themselves a guaranteed stream of income in retirement. Genworth's ClearCourse variable annuity is accessible to defined contribution plan participants just like any other investment option. It invests in a portfolio of stocks and bonds and guarantees a minimum amount of lifetime retirement income regardless of how the underlying portfolio performs. While not a stable value product, Cook said it demonstrates how insurers can leverage their stable value expertise to further serve the defined contribution plan marketplace.

"Stable value product construction is better than ever, and participant demand is at historic levels," Gardner concluded in his Spring Seminar presentation. "While the limitations on access to stable value products are significant, changes to retirement plan design and delivery may provide revolutionary opportunities for the industry." SVIA

Automating 401(k) Plans

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meaning that eligible employees are automatically enrolled and can opt out only if they take specific action to do so. Based on studies by the Investment Company Institute and the Employee Benefit Research Institute done in July 2005, 66 percent of eligible employees were participating prior to automatic enrollment. The figure increased to 92 percent with automatic enrollment.

Of course, getting people into their retirement savings plan is only part of the battle to assure they enjoy a financially secure retirement. Another key requirement is getting them to save at an appropriate rate, using an appropriately diversified asset allocation strategy. One way to do that, Fritz said, is to offer participants the chance to enroll in an automatic deferral increase program, in which the percentage of their pay shunted into their retirement savings plan goes up automatically each year until it reaches a predetermined ceiling. About 6,700 Fidelity-run plans have introduced this feature, she says. Where plan participants use it, the aver-

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Automating 401(k) Plans

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age deferral rate grows from 4 percent of salary to 14 percent, according to "Save More Tomorrow: Using Behaviorial Economics to Increase Employee Savings," by Richard M. Thaler and Schlomo Benartiz.

John Doyle, Vice President and Director of Marketing and Communications for plan provider T. Rowe Price Retirement Plan Services, says 22 percent of his firm's plan sponsor clients have adopted automatic enrollment for their plans, about twice the percentage that had done so just two years ago. Some plan sponsors are now taking this approach a step further by annually re-enrolling participants who have opted out of their plans in the past. They re-enroll them either on the plan's anniversary date or the individual's eligibility date. "We call that auto harassment," Doyle quipped at the Spring Seminar. "When I first heard about this, it seemed to strike me as a difficult hurdle for participants and an issue of liability for plan sponsors. But if you think about it, this is what employers do with health plans and other benefits. So why not try to push people to participate in their plan, and get them to proactively say 'no' on an annual basis if they really don't want to do it?" Doyle said the first plan to add this option was a law firm, suggesting that it was comfortable with any potential legal ramifications of its decision.

About 11 percent of T. Rowe Price's plan sponsor clients have adopted automatic deferral increase programs for their retirement savings plans, Doyle said. The increases really are automatic, too. Under the T. Rowe Price model, they take effect unless the participant takes specific action to opt out of the program. "The only true success in this area seems to come from defaulting participants into the (deferral increase) option," Doyle explained. He compared it to organ donor programs in Europe, where participation rates leapt to about 85 percent from 15 percent or less once people were required to opt out of the program rather than into it.

Where employers use automatic enrollment, Doyle encourages them to set the beginning deferral rate at 5 percent or 6 percent of salary, rather than the 3 percent that is more commonly used. A 3 percent deferral rate isn't adequate for the vast majority of plan participants, he says, and T. Rowe Price has found that setting the rate twice as high doesn't have any significant impact on the number of new hires who opt out of the plan.

Doyle also noted that however helpful automatic enrollment and deferral increase features may be in bringing new employees into a retirement plan, they do nothing for existing employees. That oversight, he suggested, needs to be corrected. "If we don't look at employees who are already participating in these plans, and address some of their issues, we're not going to have a real impact on the retirement system for 30 years," Doyle warned. "That is where our challenge is."

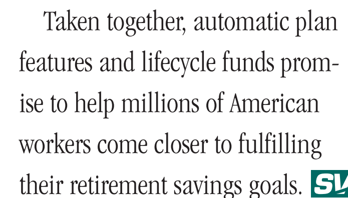
To get things rolling, Doyle said T. Rowe Price has been talking to its clients about extending automatic features to cover all plan participants. One way to do that would be to perform a plan "conversion" in which all employees would be "re-enrolled" in the plan. Existing employees who don't bother to re-enroll proactively would then be defaulted into an age-appropriate lifecycle fund, or, as T. Rowe Price calls them, retirement date funds.

"What we're suggesting as a best practice is to look at some reason to re-enroll participants on an interval basis, and to default their portfolios to an age-based investment option," Doyle says.

To help make sure investors put their money to use wisely, an increasing number of plan sponsors are offering age-based or target-date lifecycle funds as an investment option in their plans. Typically offered in a series, each lifecycle fund provides a diversified portfolio of stocks and bonds targeted to when an investor plans to retire. The closer the targeted retirement date, the more conservatively the portfolio is structured. Plan participants simply pick the fund with the retirement date closest to their own.

T. Rowe Price has found plan sponsors receptive to offering lifecycle funds as investment options; about 25 percent to 30 percent of the company's clients do so, and where they are offered the funds have captured about 11 percent of plan assets. A smattering of plans—21 at last count—have introduced an "all or nothing" policy for those funds, meaning that if participants choose one of them, they can't invest any of their assets in other funds. The intent, Doyle said, is to help people realize that the funds are designed as a one-stop source for an appropriately diversified investment portfolio.

Taken together, automatic plan features and lifecycle funds promise to help millions of American workers come closer to fulfilling their retirement savings goals. SVIA



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Stable Value Managers Embrace New Guidelines Affirming Book-Value Accounting

By Randy Myers

The stable value industry had something to celebrate other than the New Year this past December. The Financial Accounting Standards Board issued formal guidance on accounting for stable value funds: FSP AAG INV-a, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide on December 29, 2009.*

The FSP clarified that contract value—stable value accounting—is appropriate as long as, among other things, all the investment contracts in a stable value fund meet certain conditions qualifying them as "fully benefit responsive." The FSP also requires that the investment contracts be reported at market value. Lastly, managers of stable value commingled funds, which are essentially pools of assets from two or more defined contribution plans, must conduct and report two sensitivity analyses showing how the pools react to changes in interest rates and changes in withdrawals. The new guidelines take effect for annual financial statements covering periods ending after December 15, 2006.

Benefit-Responsiveness

The FSP specifies that an investment contract is considered fully benefit-responsive if it meets several specific criteria. Some of these criteria are straightforward. For example, permitted participant-initiated transactions, such as withdrawals, must be allowed at contract value. Other criteria introduce new complexity to the accounting and reporting process. For example, the new guidelines say that if an event occurs which makes it no longer probable that participants can access their stable value fund at contract value—maybe the contract issuer or wrap provider experiences a significant decline in creditworthiness—then the contract is no longer deemed fully benefit-responsive. The FSP reinforces this point by adding that a contract is only benefit-responsive if it is not probable that any event will happen that would limit the ability of the fund to transact at contract value with the issuer. It cites, by way of example, a bankruptcy filing, merger, or offering of early retirement incentives by the plan sponsor, as well as several other possible scenarios.

The directive isn't as clear as it might sound. Speaking in April at the SVIA's 2006 Spring Seminar in Henderson, Nevada, Steve Kolocotronis, Vice President and Associate General Counsel for Fidelity Investments, cautioned that determining whether a particular adverse event makes contract value no longer probable will have to be decided on a case-by-case, facts and circumstances basis. For example, he said, even a decline in an issuer's creditworthiness may not make it probable that a fund would not be able to realize full contract value for an investment contract it had issued.

To provide his audience with some idea of the sorts of contracts that might not meet the new definition for being fully benefit-responsive, Kolocotronis listed four examples. They included contracts that provide no benefit payments prior to the maturity date of the contract, that limit the percentage of benefit payments allowed during a calendar year, that preclude the payment of benefits within a specified period following termination of the contract, or that limit the percentage of a participant's account that can be transferred to another investment option during a calendar year.

Kolocotronis said he can't predict how auditors will deal with such contracts once the new rules take effect or say whether they will require the contracts to be amended or reported at fair value rather than contract value.

Brian Gallagher, National Audit Partner for Big Four accounting firm Deloitte & Touche, advised the SVIA audience that if stable value managers think they might have a problem qualifying any of their contracts as fully benefit-responsive, they should bring it to the attention of their auditor as early as possible. A solution should be worked out, he said, before reporting deadlines pressure the auditor into a decision.

Wrap Valuation

Assigning values to wrap contracts is a thorny issue the SVIA task force is trying to make less so by coming up with a standard valuation method that could be adopted throughout the industry. Although that work is ongoing, James McKay, Director of Stable Capital Management for Ameriprise Financial, said the task force is evaluating three methodologies. One methodology is based on an income approach, a second is based on a market approach, and a third is based on a replacement-cost approach. The income approach would involve using either option-pricing models or Monte Carlo simulations to value wrap contracts, and the task force has found that while more testing needs to be done, the Monte Carlo approach can produce disparate results while using the same assumptions. A market approach would rely on knowing the actual fees paid for wrap contracts, while the replacement-cost approach would look to the current cost to

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How Large Plans Are Incorporating Stable Value Investments in Lifecycle Funds

By Randy Myers

Lifecycle funds are the belle of the 401(k) plan ball right now, with plan sponsors adding them to their investment fund lineup at a phenomenal rate. Even though many of the funds have only been on the market for a few years, more than half of plan sponsors now offer these new investment vehicles, according to *Plan Sponsor* magazine's 2005 Defined Contribution Survey.

For the stable value industry, this isn't particularly exciting news. Stable value isn't participating in much of the lifecycle party. But it's not being shut out, either. Stable value can be incorporated into lifecycle funds if those funds are composed of institutionally managed separate accounts and/or commingled funds rather than regulated mutual funds. As it happens, many of the nation's largest 401(k) plans use institutional vehicles for their 401(k) plans. Not only do these funds typically offer lower investment management fees than mutual funds, but they also can be custom tailored to the client's needs. Now, some enterprising plan sponsors are using institutional funds to create their own low-cost lifecycle funds and are incorporating stable value products into the mix.

Anne Lester, a portfolio manager in the Global Multi-Asset Group at JPMorgan Asset Management, says her firm recently assembled a suite of lifecycle funds for a new plan sponsor client with $2.8 billion in 401(k) assets. Addressing the Stable Value Investment Association's 2006 Spring Seminar, Lester said this client's 401(k) plan had $950 million invested in stable value assets when it hired JPMorgan as record keeper. JPMorgan will map those assets into target-date lifecycle funds it creates for the client, using stable value as a proxy for fixed income.

Meanwhile, JPMorgan also has created a series of "SmartRetirement" date-based lifecycle funds and "SmartMix" risk-based lifestyle funds that are structured as commingled pension trust funds. They are available to qualified employee benefit trusts and government retirement plans. Through the end of February, four clients had invested $860 million in the SmartMix funds, five clients had invested $299 million in the SmartRetirement funds, and another three clients had committed to invest $298 million in the SmartRetirement funds, Lester said.

JPMorgan's analysis of stable value as a proxy for either cash or fixed income illustrates why stable value can play a role in lifecycle funds, especially those funds aimed at conservative investors who will soon be retiring or who have already stopped working. Over the 10-year period ended December 31, 2005, Lester noted, stable value investments outperformed Treasury bills by an average of 2.3 percent annually, and with slightly less volatility. Meanwhile, stable value also matched the performance of the Lehman Brothers Aggregate bond index over that time period, with substantially less volatility, and outperformed that benchmark in shorter time periods.

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Book-Value Accounting

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replace a wrap contract. Apart from settling on a methodology, stable value managers may need to convince their wrap providers to help them in assigning values to their wrap contracts. It is a sensitive issue. Some wrap issuers have expressed a reluctance to assign and disclose values for individual wrap contracts, saying they would prefer to value only their entire book of business with an individual manager.

Sensitivity Analyses for Pooled Funds

One of the more intriguing elements of the new accounting guidance is the requirement that stable value managers conduct two separate "sensitivity" analyses for pooled stable value funds. The analyses will have to be done using varying assumptions for market interest rate changes and fund cash flows. Kim McCarrel, a Senior Account Manager with INVESCO's fixed income division, explained that a pooled stable value fund will have to project its crediting rate for four quarters under two different cash flow scenarios and four dramatically different interest rate scenarios. The cash flow analyses assume no cash flows with an immediate withdrawal by participants of 10 percent of the fund's assets. The different interest rate scenarios include a 25 percent increase in current market yields, a 25 percent decrease, a 50 percent increase, and a 50 percent decrease. To help the industry comply with this requirement, the SVIA task force has created a sample disclosure form, including suggested footnotes for explaining the methodology used in creating the sensitivity analyses. It is now soliciting feedback from the accounting community, after which it plans to finalize its recommendations and present them to the SVIA members. SVIA

Probing the Boundaries: Assessing Alternate Markets for Stable Value

By Randy Myers

Some people think it's time for the stable value industry to move beyond the 401(k) comfort zone.

To be sure, nobody is complaining about the 401(k) market; it is home to the vast majority of the approximately half trillion dollars that investors have entrusted to stable value managers. It's just that there are numerous other markets in which investors could potentially benefit from the unique value proposition-bond-like returns paired with the low volatility of a money market fund-that stable value investments offer. Aruna Hobbs, head of Aegon Institutional Markets' Pension & Savings Group, told attendees at the Stable Value Investment Association's 2006 Spring Seminar that potential avenues of expansion for the stable value industry include other defined contribution plans similar to 401(k)s. These include 403(b) retirement savings plans that cater to employees of educational institutions and certain non-profit organizations, the newly introduced Roth 401(k) plans that made their debut this year, multi-employer Taft-Hartley retirement savings plans operated for union workers, 401(a) plans funded solely by employee contributions on an after-tax basis, and even, perhaps, defined contribution retirement savings plans outside the United States. In addition, Hobbs said, the stable value industry should consider opportunities to serve participants in Health Savings Accounts (HSAs), which are a fairly new wrinkle in the health benefits arena, and in lifecycle funds outside the mutual fund market.

403(b) Plans

Kappie Bogart, Director of Stable Value Accounts for Aegon, said 403(b) plans are a $600 billion market that is growing at 9 percent annually. Stable value investments account for only about $29 billion, or just under 5 percent, of those assets, according to the Ninth Annual SVIA Investment and Policy Survey. However, 80 percent of 403(b) assets are invested in annuities, many of which have attributes similar to stable value. The leading 403(b) provider, TIAA-CREF, has over $155 billion in annuities that have some characteristics in common with stable value.

The small current market share for stable value funds can be attributed at least in part to interpretations of Internal Revenue Service rules that appear to prohibit 403(b) plans from investing in annuity contracts while allowing investment in commingled funds. Some industry executives believe stable value could be made more accessible to 403(b) plans.

As Joseph Chadwick of The Chadwick Group Inc. reported last year in the *Stable Times*, the State of Georgia won a private-letter ruling from the IRS in 2002 that allowed the state to offer a stable value fund in its 403(b) plan. It had already been using stable value in two other retirement savings plans it sponsored, one a 401(k) and the other a 457 plan. (A 457 plan is similar to a 401(k) but is generally offered by state and local governments rather than corporations. Private companies can offer them, too, but only to a select group of highly compensated or executive-level employees.) After convincing GIC and wrapper issuers to agree to new underwriting conditions, finding a willing custodian, and attending to some accounting mechanics, Georgia finally began offering the stable value fund to its 403(b) plan participants in 2004.

While the IRS private-letter ruling is binding only on the plan sponsor who received it, it suggests that other plan sponsors willing to embark on the same course of action might be able to offer commingled stable value funds in their 403(b) plans. Bogart identified AIG, Fidelity Investments, and ING as major players in the 403(b) marketplace, although TIAA-CREF is by far the dominant participant, with about half of the university market.

Apart from the prohibition against commingled funds, stable value managers would confront other challenges in moving into the 403(b) market, Bogart warned. For example, they would be faced with a system in which the plan itself is actually a contract between the participant and the vendor, not between the employer and the vendor. Under IRS Revenue Rule 90-24, participants can generally transfer their plan assets from one provider to another with no tax ramifications, possibly raising cash flow issues for stable value managers. Also, stable value funds sold in the 403(b) market would need to

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Lifecycle Funds

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Lester said one potential downside to including stable value in an aggressive equity-focused fund is that money managers may look for a fixed income portfolio's volatility to function as a counterweight that moves in the opposite direction of stocks. That counterbalance may come in handy if the stock market drops and bonds have immediate gains. The counter-argument is that the modest volatility of stable value is a timeless anchor to help stabilize total fund returns over the long term. SVIA

Assessing the Boundaries

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comply with SEC Rule 151, also known as the "safe harbor" rule, which among other things requires that crediting rates be reset no more than once per year and that funds have a minimum floor rate. A few religious organizations' 403(b)(9) plans have claimed exemption from SEC rule 151 and added stable value portfolios to their investment lineup.

Bogart said the IRS announced in 2004 that it was going to change many 403(b) rules to make the plans function more like their 401(k) cousins, but backlash from plan providers stalled the initiative. Nonetheless, she said, the IRS remains committed to making changes. It is possible the IRS could announce the rules this year. If so, many of the hurdles to offering stable value funds in 403(b) plans could disappear.

401(k) Plans with Roth feature

Roth 401(k) plans function much like traditional 401(k) plans, although employee contributions are made on a post-tax, rather than pre-tax, basis. In exchange, distributions from a Roth 401(k) are tax free, whereas distributions from a regular 401(k) are taxed as ordinary income.

There are no major barriers to offering stable value funds in Roth 401(k)s; indeed, most plan sponsors who adopt them are expected to offer the same investment lineup they make available in their existing 401(k) plan. Doris Fritz, Vice President in Fidelity Investment's FIRSCo Investment Consulting Services group, explained that one of the reasons employers have been slow to offer the Roth feature is because the enabling legislation, the Economic Growth and Tax Relief Reconciliation Act, sunsets in 2010. There's no assurance Congress will extend its provisions. If it doesn't, most industry observes guess that existing Roth 401(k)s will be grandfathered but probably won't be permitted to take any new contributions.

Beyond that uncertainty, choosing between pre-tax and post-tax contributions essentially forces investors to project whether their tax rate will be higher or lower in retirement than in their working years. This may keep some participants from participating in the new Roth accounts.

HSAs

One of the more intriguing potential markets for the stable value industry is the health care market. Health Savings Accounts were created by the Medicare Modernization Act of 2003. HSAs are available to individuals who have a high-deductible health plan—one with a minimum annual deductible of $1,050 for an individual, or $2,100 for a family—and who do not have access to Medicare or another health plan. HSAs are ostensibly a tool for saving pre-tax income to fund later medical expenses. Some benefits experts predict that many people will use them as another tax-advantaged savings account. Unused balances in HSAs aren't forfeited, but roll over from year to year. And in addition to paying for qualified medical expenses, assets in an HSA can be used to pay for long-term care premiums.

Mike Norman, a principal with Galliard Capital Management Inc., told attendees at the SVIA Spring Seminar that about 29 percent of large employers plan to start offering high-deductible health plans, or HDHPs, this year. On average, he said, the plans cost employers about 18 percent less than a PPO (preferred provider organization) and 13 percent less than an HMO (health maintenance organization).

While most HSAs to date have offered only limited investment options, such as low-yielding money-market funds and passbook accounts, providers are beginning to introduce others. "Less than 5 percent of U.S. consumers have an HSA now," Norman said, "so the market has huge growth potential. It is estimated that in the next five years, more than six million users will have more than $79 billion in these accounts."

Like most potential new markets, however, the HSA market presents challenges for stable value managers. Because they aren't considered qualified plans under tax law, the book-value accounting treatment used by stable value funds could be problematic. Also, under current law, individual participants can only contribute $2,700 per year to an HSA, and families only $5,450. This means that account balances could be small, at least in the early years. Finally, because HSAs are relatively new, there is little historical data available to predict how investor behavior might impact cash flows and asset allocation decisions within the accounts.

Despite the obvious hurdles, stable value executives say it's important for the industry to explore new market opportunities like these. "While we primarily think about the defined contribution plan marketplace as being about 401(k) plans, its scope is actually quite broad," said Hobbs. "As an industry, it is important that we keep abreast of developments in these other arenas." SVIA

Evaluating Manager Performance

By Randy Myers

After years of debate, the stable value industry continues to search for a uniform way to evaluate the performance of stable value managers. Despite the slow progress, Victoria Paradis, a leading advocate of enhancing manager evaluation within the industry, hasn't given up hope that it will get done. Speaking at the Stable Value Investment Association's 2006 Spring Seminar, Paradis, a former SVIA Chair and a Managing Director with JPMorgan Asset Management, said she still believes the industry can develop a framework for evaluating manager results that will be meaningful not only to its plan sponsor clients but also to the community of pension consultants who help those clients select investment managers for their retirement savings plans.

"Manager comparability is and will remain a challenge for the industry," Paradis said. "But we have made progress. Today, market value reporting of fund performance is far more common than it was years ago. In fact, it's become very common because market value returns are the most useful measure of investment decision-making success. However, it's not a complete solution because there is such a wide range of underlying management strategies. I do believe we can provide a framework for evaluating a stable value manager that recognizes that fund design, not just investment decisionmaking, is critical to determining a fund's success." Paradis cited three key components of performance: fund structure, investment policy, and a manager's own investment performance.

Historically, the performance data reported by managers was the book-value returns generated by their portfolios—the actual returns produced for retirement plan participants. But while the industry generally agrees that book-value returns are the sole measure of performance for participant reporting, many concede they are a poor way to compare one stable value manager to the next. That's because book-value returns can be influenced by a raft of factors outside the managers' control, from investment constraints imposed by the client to the trading patterns of plan participants and the resulting impact on cash flows.

Brad Bennett, a Senior Portfolio Manager with Standish Mellon Asset Management, stated that cash flows can have significant impact on stable value fund performance. He illustrated with an example. He compared the performance of two theoretical stable value funds identical in nearly all respects. Each had a starting yield of 6.5 percent and reinvestment rates of 5.5 percent, although one reinvested $20 each year and the other reinvested nothing. After two years, the fund without any reinvestment had an annualized return of 6.5 percent, while the other earned just 6.31 percent. The entire difference was attributable to the differing cash flows.

While marking a stable value fund's underlying portfolio to market can eliminate the distortions caused by external factors, market-value reporting still doesn't solve the measurement conundrum because there remains such a wide variety of management styles. Managers may have a preferred way of packaging underlying fund components to manage withdrawal risk. Different managers labor under distinct investment policies with differing duration and quality characteristics, permitted investment sectors, and market benchmarks. As a result, when evaluating a manager, it is useful

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The Annual Forum is just around the corner.

Remember to save October 10-12, 2006 for the Forum. The October Forum will be held at the Ritz Carlton in Washington, D.C.

Stable Value Managers Find Prudent Ways to Boost Returns

By Randy Myers

With the yield curve relatively flat and credit spreads tight in recent months, it is difficult for stable value asset managers to bolster returns through plain vanilla strategies such as duration extension and investing in credit-sensitive securities. But as three stable value managers explained at the Stable Value Investment Association's 2006 Spring Seminar in Henderson, Nevada, there are other ways to improve investment performance without assuming significant additional risks. The strategies used by these managers include: investing in non-U.S. dollar bonds hedged against currency risk; overlaying a fixed income portfolio with currency and non-dollar, fixed income futures; and exploiting term, credit, volatility, and transactional liquidity premiums in the bond market.

Stable value manager AllianceBernstein has used hedged, non-dollar sovereign bonds to boost returns in its stable value portfolios. Greg Wilensky, Director of Stable Value Investments for the company, explained that the strategy involves simultaneously buying non-dollar bonds, selling U.S. Treasuries, and selling foreign exchange forward contracts to hedge currency risks. While hedged, non-dollar sovereign bonds do not always outperform other stable value assets, Wilensky noted that they have provided very consistent returns if the investments are limited to situations in which hedged, non-dollar bonds offer incremental carry after adjusting for the foreign exchange contracts. This generally occurs when foreign-yield curves are relatively steeper than the U.S.-yield curve, regardless of overall yield-curve levels.

To demonstrate the potential of this strategy, Wilensky compared a wrapped portfolio of bonds tracking the Lehman Brothers Intermediate Aggregate Bond Index to a comparable portfolio in which an average of 10 percent of the assets were shifted into the "positive carry," hedged, non-dollar-bond positions. Over the 15-year period from 1991 through 2005, the blended portfolio that included the non-dollar securities provided an annualized excess return of 20 basis points relative to the U.S.-only portfolio, with only 28 basis points of tracking error. A crediting rate simulation for the same portfolios, looking at the same 15-year period, showed that the blended portfolio would have yielded a higher crediting rate about 80 percent of the time.

Deutsche Asset Management began using an innovative alpha overlay strategy in its stable value mutual fund in 1999, where it generated positive returns for five consecutive calendar years. While that fund has since been converted to a short-term bond fund, Deutsche Senior Portfolio

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Evaluating Manager Performance

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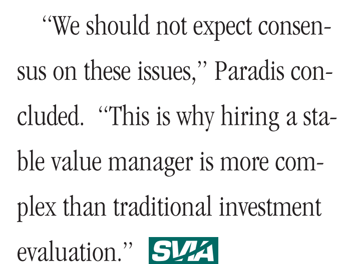
to analyze the success of the fund structure and investment policy, in addition to the underlying investment performance.

Finally, there is no single market benchmark appropriate for the entire stable value industry. In fact, there is no consensus on whether an individual manager should be held accountable to a single, standard-market benchmark or a custom benchmark. "The value of a single benchmark can be lost," observed Ben Allison, a Senior Stable Value Portfolio Manager for Invesco Institutional, "when unique-plan issues force a change to the portfolio that is not based on the manager's investment outlook."

Allison suggested the industry may need to rely on a combination of benchmarks, with the possibility that a given fund's allocation to each could be adjusted over time as appropriate. Paradis, however, warned that a customized benchmark precludes manager comparability because plan sponsors and consultants cannot evaluate managers against any peer group. One compromise solution, she suggested, might be to use a single benchmark but allow a manager to adjust it to reflect the duration of their portfolios.

Paradis suggested that coming up with a performance measurement framework that adequately accounts for these issues would be valuable for the entire stable value industry. It would, she said, help plan sponsors assess whether the book-value performance delivered to participants was attributable to fund design or their manager's investment prowess. By answering that question, sponsors could better decide where to direct their remedial efforts. If, for example, a manager's portfolio was outperforming her fund's market benchmark but the book-value return was underperforming her peer group, it would suggest that the problem might lie in the fund's design.

"We should not expect consensus on these issues," Paradis concluded. "This is why hiring a stable value manager is more complex than traditional investment evaluation."



Prudent Ways to Boost Returns

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Manager Brett Gorman said his firm began offering this "enhanced stable value" strategy to its defined contribution plan clients last year. On January 1 of this year, the strategy was implemented for a $610 million stable value fund Deutsche manages on behalf of one of its clients.

Deutsche's strategy involves taking tactical long and short positions in fixed income futures and foreign currency markets in major developed markets around the globe. The strategy is designed to generate marginal return predominantly in the form of alpha-returns attributable to the inherent value of the securities in the overlay portfolio-rather than beta-the volatility of the markets in which the securities trade. The overall target, Gorman said, is 100 basis points of excess return, with only a 1 percent increase in volatility.

Not all alpha overlay strategies would be appropriate for a stable value fund, Gorman cautioned. In a stable value environment, he said, managers must be able to employ robust risk controls, trade in highly liquid markets, and strive for a net position that has a low correlation to the U.S. fixed income market.

The stable value managers at PIMCO, one of the largest specialty, fixed income managers in the world, have developed yet a third approach to boosting portfolio returns. PIMCO's approach relies not only on traditional active-management strategies, such as sector selection or duration management, but also on seizing what it calls structural opportunities in the market. Over a five-year time period, said PIMCO Vice President Bret Estep, the firm expects the latter approach to add as much as 30 to 50 basis points of additional returns annually.

In broad strokes, the PIMCO approach seeks to capture term, credit, volatility, and transactional liquidity premiums in the bond and cash markets. The cash market is important to PIMCO because it often uses bond futures in its stable value portfolios as a substitute for actual bonds. The use of futures allows the firm to achieve the same exposure to bonds but with only a small collateral deposit, leaving the firm with a sizeable amount of cash to invest.

One way PIMCO seeks to enhance the returns on its cash position is to invest not in three-month Treasury bills, the traditional risk-free marker, but in six-month or 12-month T-bills or even investment-grade corporate securities of comparable maturity. These investments provide a higher yield, Estep explained, while exposing the fund to only a modest amount of additional risk. PIMCO also seeks to capture what it calls a transactional liquidity premium by including in the cash portion of its portfolio securities that aren't immediately redeemable. They might, for example, settle three days after trading rather than one day later. By doing this, PIMCO avoids paying the liquidity premium embedded in the price of more liquid securities.

In the bond market, PIMCO captures a credit premium by adding to its portfolio securities that are just slightly lower in credit quality—say Double-A or Double-A-Plus—than the Triple-A rating of the Lehman Aggregate Bond Index. Finally, it seeks to capture a volatility premium by exploiting what it says is the common mispricing of options. For example, Estep said, PIMCO believes most investors pay an excess premium for price stability, and it seeks to take advantage of that inefficiency by "selling" volatility. It can do this by selling fixed income options or purchasing securities with embedded options, such as mortgages.

All of these strategies involve marginal risk relative to a more traditionally managed stable value fund. This reinforces the importance of full disclosure and communication between portfolio managers, stable value managers, pension plan sponsors, and participants. It also requires that procedures and systems be in place to appropriately evaluate, price, and manage those risks and ensure that the fund is adequately compensated on a risk-adjusted basis. SVIA

SVIA is pleased to announce the Second Spring Seminar will be held April 15-17, 2007 at the Charleston Place Hotel in Charleston, South Carolina. Hold these dates to learn the latest developments affecting stable value fund management during the home and garden tour season in beautiful, historic Charleston.

The Editor's Corner: *The Better Way*

"There is always a better way." Thomas Edison

By Robert Whiteford, Bank of America

The Stable Value Investment Association's Spring Seminar in Henderson, Nevada this April was a breath of fresh air. I know that the expression is a bit tired, but the subjects covered at the Seminar were not. The conference focused on the future.

Stable value has contributed a lot toward enhancing the quality and return of defined contribution retirement accounts. It has also helped to improve the lives of retirees. One look at the growth figures for the stable value market makes it clear that it has been a true success. Still, I fear that many in this industry are overly comfortable with the current state of our business. I think of other businesses like steel, automobiles, or even retail brokerage services, that were slow to innovate. Each of them became dinosaurs, lumbering slowly along while more dynamic competitors raced ahead. I don't want to see that happen to us. There is a lot of life left in stable value and plenty of room for us to find better ways to help others while improving the health of this industry. The conference speakers could have been responding to my concern. Many of them are doing their best to improve on stable value performance and to find new, useful applications.

I'm sure that there are those who see no need to change. Stable value growth numbers are good. An aging society is more likely to up the percentage of their savings that they invest in stable value. Defined benefit plans continue to decline. The rise in automatic enrollment and increased pension publicity are expected to raise retirement savings. It all looks good now, but that can change. There is an increasing trend toward making lifestyle funds the default option for defined contribution plans. Plans continue to add new savings options. IRAs still rake in savings dollars - none of which can currently be invested in stable value. Also remember that the future will bring new, unforeseen challenges as well.

Several asset managers spoke at the conference about new investment strategies that they have developed to add value. Among the strategies they detailed were: currency-hedged, non-dollar bond investments; currency and non-dollar futures overlays; and investments that take advantage of term, volatility, and liquidity market premiums. I'm sure that there is plenty of debate about which strategies best serve stable value plan participants, but I think that it is encouraging that people are searching for new ways to increase returns.

A number of speakers showed great depth of knowledge on several new possible markets for stable value assets. 403(b) plans have the potential for significant future growth, although there are currently several obstacles to adding stable value in all its forms. Workers in the educational and other non-profit sectors utilize 403(b) plans. Roth 401(k)s, a new innovation, are another potential source of new asset growth. It seems likely that Roth 401(k) assets will soon be found in commingled stable value funds. Although some Taft-Hartley (union) plans have utilized stable value funds for some time, they were mentioned as another area of potential future growth. 401(a) plans and Health Savings Accounts (HSAs) were also discussed by the presenters. 401(a) plans are funded by employee contributions on an after tax basis. HSAs are a useful tool for saving pretax income to fund later medical expenses. They are a small but growing investment vehicle. There was even a suggestion that stable value mutual funds may one day be revived to allow IRA investors the opportunity to invest in stable value. Finally, several people suggested that stable value markets may develop outside of the United States.

I know that there are people in the stable value world who are content to sit back and let someone else do the development work. They may be fooling themselves by thinking that they will benefit from the efforts of others. Many of the new markets mentioned have complexities that are apparent only after significant research. Product development takes time and real effort - even if someone else has already blazed the trail. Additionally, some new markets may not need very many service providers. We have seen this before. Latecomers received nothing for their efforts but bills from their consultants. Essentially, I am saying that anyone who feels that their business needs to grow should be doing their best to examine new opportunities now. It is easy to wait for someone else to make the effort, but that may result in missing an opportunity altogether. I've often heard people say that they want to be second into a market. That kind of thinking more often lands them in fifth place competing for the leftovers. There are always better ways to provide stable value. We need to find them.