SVIA STABLE TIMES

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401(k) Investors Need to Act on What They Can Control to Build Retirement Income

By Gina Mitchell, SVIA

A recent report by the Congressional Research Service (CRS) is notable not so much because it provides a definitive answer on how much money workers will need when they retire, as its title implies, but because it confirms many observations that have become gospel for those in the 401(k) field. The report, "Retirement Savings: How Much Will Workers Have When They Retire," is commendable because it brings these observations into the retirement policy debate.

Two out of Three Isn't Bad

CRS observes, "Starting to save while young and doing so consistently every year is perhaps the single most effective way to assure that one reaches retirement with adequate savings." CRS reports that Americans have significant control over two out of three factors in retirement savings: their contribution rate and the age at which they begin to save. In fact, Putnam Investments reached a similar conclusion in its 2003 and 2004 studies. They said that participant-deferral rates were the most important determinant in building retirement wealth.

The Wild Ones: What Investors Can't Control

CRS cautions, "Unfortunately, we cannot safely assume that the rates of return over the next 20, 30, 40 years will be 'average.'" Some investment experts are sounding alarm bells to wake investors up to even more vexing complexities that make building a retirement nest egg difficult.

Vanguard's founder, John C. Bogle, says, "The investment community is ignoring the reality that the costs of financial intermediation are devastating

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Congressman Looks for More Transparency and Disclosure in 401(k) Fees

By Gina Mitchell, SVIA

The U.S. Constitution promises all men the right to life, liberty, and the pursuit of happiness. Congressman George Miller (D-CA) is trying to ensure that 401(k) investors, plan sponsors, and regulators understand that these basic freedoms do not currently extend to the 47 million Americans who have invested $2 trillion in 401(k) plans. Congressman Miller wants to ensure that 401(k) investors have information to assess and understand the costs associated with their 401(k) plans.

Where Are the Fees?

Witnesses testified in his March 6th hearing on 'hidden fees' that fees were not so much hidden, as the hearing's title implied, but hard to find and pin down for most 401(k) investors. The General Accounting Office (GAO) reports that, "The fee information that ERISA requires 401(k) plan sponsors to disclose is limited and does not provide participants with an easy comparison of investment options." GAO explains that plan sponsors are required to pro-

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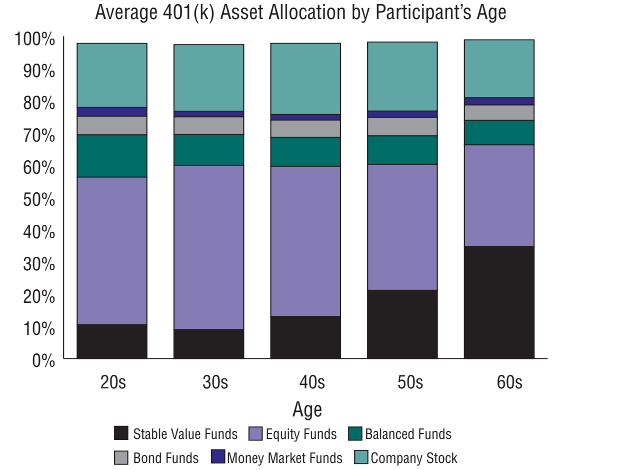
Average 401(k) Asset Allocation by Participant's Age



Source: Investment Company Institute, Appendix, August 2006, Volume 12, Number 1A, Perspective

Editor's Corner

By Chris Tobe, AEGON Institutional Markets

In my "corner" of Kentucky, we are usually at a racetrack when we talk about something that "broke well from the gate and is well-positioned going into the first turn." But that same description can apply to the progress of stable value funds this year.

The overall growth of the defined contribution (DC) markets continues to drive our industry forward. Even with flat to slightly shrinking allocations in the first quarter of 2007, stable value balances continue to grow with the booming DC markets. And while the current uncertainty around stable value as a default option under the Pension Protection Act may cause the asset class to lose marginal market share to the new lifecycle funds, the use of stable value in these same lifecycle funds will minimize the impact over time (at first, primarily with larger plans).

Stable value also continues to deliver in many forms. Plans like those of the Federal Reserve and University of California have generated great results with diversified portfolios of general account GICs. Other large plans have delivered with portfolios exclusively wrapped with synthetics. Some plans and pooled funds use combinations of wraps and diversified general account portfolios as well as versions of separate account stable value.

SVIA, the parent organization of this publication, remains influential and important to all of us in the industry. Challenges from the SEC, FASB, GASB, and DOL have been met with energy and a common purpose. While we have not always gotten everything we desired, we are far better off through industry cooperation rather than each of us lobbying with our individual firms.

This issue of *Stable Times* touches on issues both inside and slightly outside our niche in the industry. We peer inward – beneath synthetic wraps – to innovations in bond portfolios, where managers using small 5 to 10 percent allocations to non-traditional asset classes have added value. We examine the broader DC world and the attention being paid to fees. We focus on broader behavioral analysis of 401(k)s and how allocation, transfer, and contribution trends can affect participation.

I hope the information within this issue helps you keep pace with the stable value industry. As a long-time reader and some-time contributor to *Stable Times*, I recognize that the value of this publication is dependent upon the relevance of the material and the expertise and insights of our authors. You, as a reader and an industry participant and perhaps an expert in your field, can help *Stable Times* continue being relevant, topical, and insightful. Please don't hesitate to submit an article or to contact us with your ideas.

We wish you the best with your respective efforts to advance stable value through the first quarter and the course of the year, and we look forward to seeing everyone at the spring SVIA conference in April.

SVIA's Second Spring Seminar

Evaluating 401(k)s:
How Demographics, Savings, Plan Design, and Investment Choice Are Shaping Retirement Security

April 15-17, 2007
Charleston Place Hotel
Charleston, SC

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401(k) Investors Must Act

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the net return actually delivered to investors," in his article, "*The Relentless Rules of Humble Arithmetic,*" published last December in the *Financial Analysts Journal.* He explains that, "From 1983 to 2003, the average investor in mutual funds received only 24 percent of the return before taxes and inflation that was indicated by the S&P Index growth. In other words, 76 percent of the returns were eaten up by the costs of intermedia-tion."

While Bogle points to the erosive effect that fees can have on 401(k) balances, other gurus like Jeremy Siegel, the author of *Stocks for the Long Run, Third Edition*, believe that the equity premium, the return premium for taking on the increased risk of investing in stocks, is overstated and will not live up to historical averages. Siegel writes, "The implication of this finding, which many investors have not come to grips with, is that future returns on equities are going to be lower than in the past." He postulates, "The abnormally high equity premium since 1926 of 6.5 percent is not sustainable…As stocks and bonds become more correctly priced, the equity premium certainly will shrink."

Some of the leading financial theorists have presented strong evidence that challenges the conventional wisdom of asset allocation: the longer the investment horizon, the larger the allocation to higher risk and, thus, higher returning assets such as stocks. "These results compound the sobering evidence in recent work that the equity risk premium is lower than suggested by post-1926 data. We confirm analytically that parameter uncertainty, properly incorporated, produces optimal asset allocations, in stark contrast to conventional wisdom. Longer investment horizons require lower, not higher, allocations to risky assets," report Eric Jacquier, Alex Kane, and Alan Marcus in their article, "Optimal Estimation of the Risk Premium for the Long Run and Asset Allocation: A Case of Compounded Estimation Risk," in the *Journal of Financial Ecometrics.*

Putting It in Pictures

CRS's illustrations demonstrate the impact that 401(k) investors can make on retirement wealth by making a few fundamental decisions. Deciding when and how much to contribute to a 401(k) plan is the first step in tackling the very real complexities of investing.

These complexities are the reasons why investors find stable value funds valuable and why they consistently allocate 20 percent of their assets to stable value when it is offered as an investment. 401(k) investors intuitively 'get' stable value even if they do not understand how stable value addresses the complexities that are inherent in investing. They appreciate stable value's:

- Safety of principal;
- Bond-like returns without the volatility associated with bonds;
- Stability and steady growth of principal and earned income;
- Benefit-responsive liquidity, so that plan participants may transact at "book value" – that is, principal plus accumulated interest – at any time.
- Competitive net returns (stable value management and wrap fees average 41 basis points) with low risk;
- Diversified, high-credit, quality bond portfolio that is 'wrapped'

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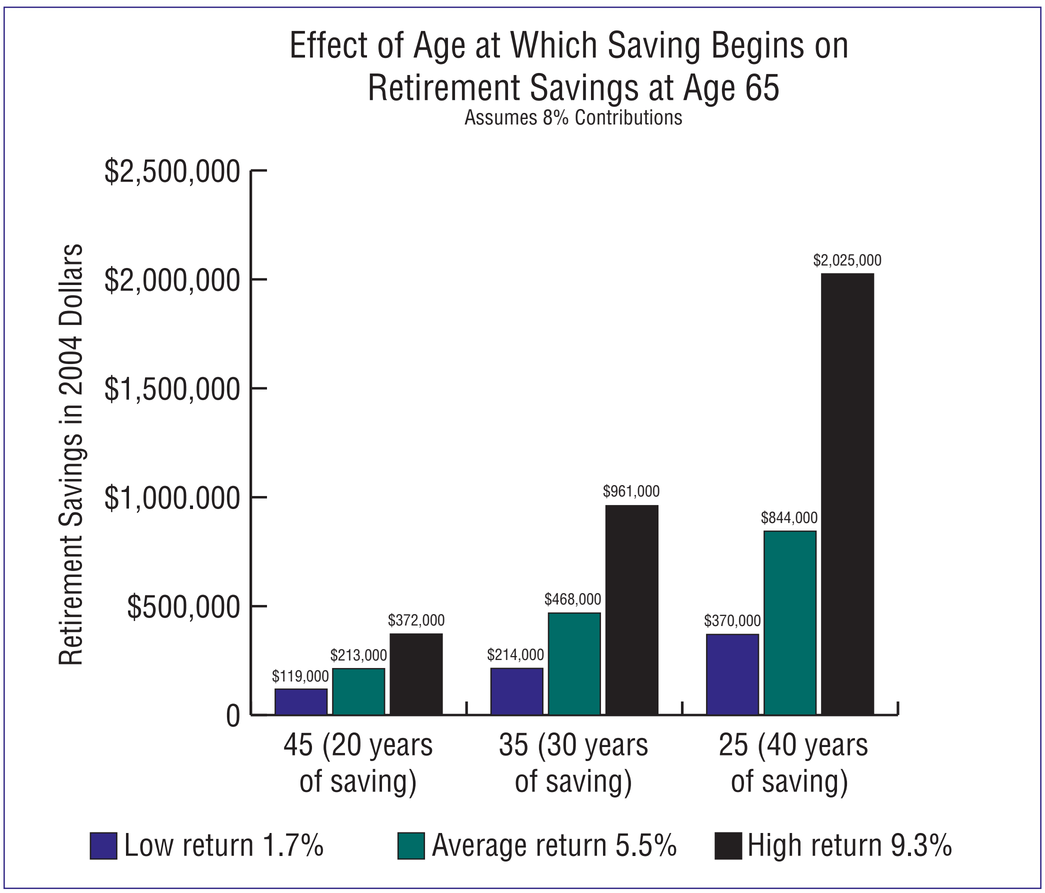
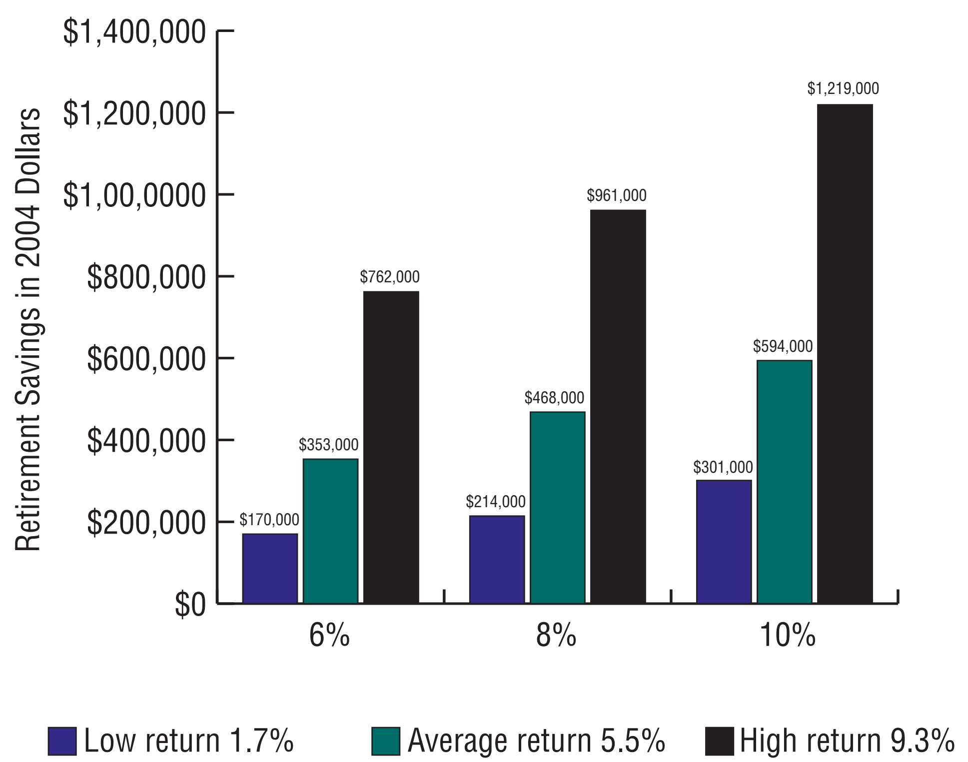


Effect of Annual Contribution Rate on Retirement Savings at Age 65



401(k) Investors Must Act

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to protect investors against interest rate volatility.

As Bogle's, Seigel's, Jacquier's, Kane's, and Marcus's assertions becomes more mainstream, stable value funds should discover new investors and solidify their use with the innovators who have relied upon their stable value fund for the more than the 30-plus years that stable value funds have been offered.

About the Report

The CRS January 29, 2007 report takes data from the 2004 Survey of Consumer Finances and looks at retirement savings patterns for households. Using this data as the baseline, CRS projects retirement savings based on two changing variables: individual contributions: 6 percent, 8 percent, and 10 percent; and time horizons: 20 years, 30 years, and 40 years. They assume an asset allocation of 65 percent to the Standard & Poor's 500 Index of Stocks from the ages of 25 to 34, 60 percent to stocks from 35 to 44, and 50 percent to stocks after age 55. The remainder of the portfolio was invested in AAA-rated bonds. Additionally, the accounts were rebalanced each year to reflect the chosen asset allocation for each age grouping. Lastly, rather than assume an average rate of return for the investment period, CRS used a Monte Carlo simulation process that selected the rate of return each year from a range of returns implied by the historical returns on stocks and bonds. Based on their simulation, they found a median real rate of return was 5.5 percent. They also found a 5 percent chance that the average annual real rate of return could be 1.7 percent or less, or conversely, that the average annual rate of return could be 9.3 percent or more.

Congressman Looks for More Transparency

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vide all participants with a summary plan description, account statements, and the summary annual report, but these documents are not required to disclose information on fees borne by individual participants. (The following GAO chart summarizes required disclosures.) Further, GAO criticized the piecemeal manner in which fee information is disclosed, which makes it hard for 401(k) investors to get a complete picture of their investments and difficult to compare investments among each other.

Where Does the Money Go?

GAO found that investment and record-keeping fees comprise nearly all of 401(k) plan fees. Further, they found that investment management fees account for the majority of 401(k) fees, regardless of plan size. They point out that investment management fees were 84.5 percent of total fees in plans with 25 participants, compared to 98.6 percent of total fees for plans with 2,000 participants.

Who Pays?

According to GAO's research, plan participants are shouldering more of 401(k) costs. GAO used the following chart from the Profit Sharing/401(k) Council to illustrate how costs are borne.

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Required Disclosures and Frequency

Disclosure document	Document Purpose	Information on Fees	Timing Rquirement
Summary plan description	To explain to participants how the plan operates.	May contain information on how various fees – such as investment, record-keeping, and loan fees are charged to participants – but not required by ERISA to do so.	Within 90 days of being covered by the plan, then every 5 or 10 years depending on changes.
Account statement	To show the account balance due to a participant.	Typically indentifies fees, such as for loans, that are directly attributable to an account during a specific period. Also may show investment and record-keeping fees, but not required by ERISA to do so.	Generally, within 30 days of a written request. Quarterly statements are required beginning in 2007.
Summary Annual Report	To disclose the financial condition of the plan to participants	Contains total plan costs incurred by plan participants during the year.	Annually.
Prospectus of fund profile	To provide investment option information		Immediately following initial investment.*

Source: GAO analysis
*Required only for 404 (c) plans and for securities regulated by the SEC.

Congressman Looks for More Transparency

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Impact of Fees over Time

Congressman Miller points out that fees are important not only because plan participants are shouldering more of these expenses but also because they can have a tremendous and even detrimental impact on retirement savings over time. As the following chart illustrates, with a $10,000 annual contribution, a 1 percent difference in returns can reduce savings by $8,610 over 10 years, $74,942 over 20 years, and $355,395 over 30 years.

What Are the Fees?

While the hearing was full of hyperbole about hidden and excessive fees, it was a little thin on actual fee information. A 2006 study by the Investment Company Institute found that in 2005 the average asset-weighted expense ratio for 401(k) plan investing in stock mutual funds was .76 percent, compared to a .91 percent for all stock mutual funds. Data from "Plans in Transition: IOMA's Defined Contribution Survey, 2004," found that investment fees averaged

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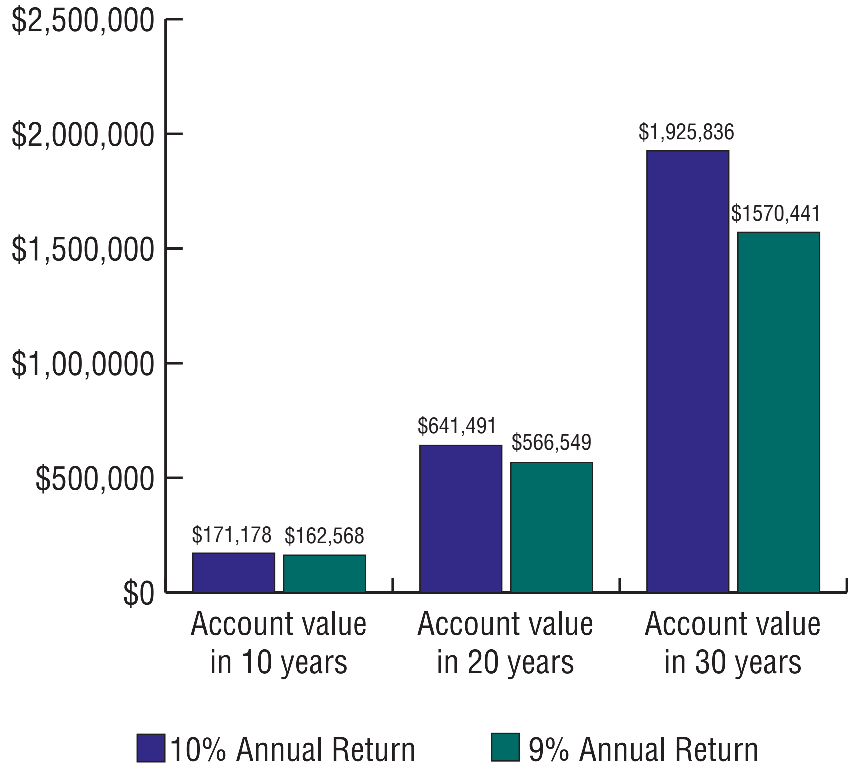
Who Pays for Major 401(k) Plan Fees

	Plans with Fewer than 5,000 Participants			Plans with More than 5,000 Participants		
	Participants (percent)	Sponsors (percent)	Participants and Sponsors (percent)	Participants (percent)	Sponsors (percent)	Participants and Sponsors (percent)
Investment fees	61.8	27.5	10.6	71.5	16.2	12.3
Plan record keeping	32.5	58.3	9.2	50.4	34.6	15.0
Audit fees	16.0	82.5	1.5	33.3	62.2	4.4
Communication to employees	20.0	70.5	9.5	34.3	49.6	16.1
Investment consulting fees	33.0	60.0	7.0	39.0	52.8	8.1
Legal fees	10.3	84.7	5.0	20.7	66.7	12.6
Trustee fees	29.4	66.6	4.0	47.2	43.2	9.6

Source: Profit Sharing/401(k) Council of America

Illustration of Impact of Fees on 401(k) Assets Over Time



Source: March 6, 2007 Testimony of Stephen J. Butler before the Committee on Education and Labor, U.S. House of Representatives

Congressman Looks for More Transparency

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.81 percent in 2004 for 401(k) plans for all investment options.

What about Stable Value?

IOMA reported in the same survey that stable value investment management fees of .42 percent compared favorably to the .81 percent average. IOMA found stable value fees averaged .56 percent for plans with less than $50 million in assets and .37 percent for plans with more than $50 million in assets.

Stable value funds may also have a leg up on other investment options when it comes to transparency and disclosure. SVIA's Fee and Disclosure Template has been used by many stable value managers as a framework to provide information on stable value investment management and wrap fees to 401(k) sponsors and participants. More information about the template and the break down of stable value fees can be found on the Association's website, www.stablevalue.org.

Bundled and Proprietary Products Take the Brunt of Fee Focus

An estimated 70 percent of all 401(k) plans are "bundled," according to Stephen Butler, President of Pension Dynamics Corporation, a practice that combines 401(k) investment services with administration. Butler charges this 'packaging,' used by some insurance and mutual fund companies, obscures fees for 401(k) plans. This packaging is typically used by smaller and less sophisticated plans. Butler charges that insurance companies' bundled offerings get by with minimal disclosure since they are regulated by state insurance commissions, an oversight which he feels Congressman Miller must address by providing federal oversight of insurance company products offered to 401(k) investors.

Butler also viewed the mutual fund practice of requiring a core percentage of a 401(k) plan's investment options to consist of the same fund family providing a 401(k)'s administration as problematic. This is because most mutual funds do not provide superior returns across all their investment offerings, and, of course, investment fees vary.

More to Come

Congressman Miller put the hearing into perspective. He notes, "Social Security is the sole source of retirement income for half of all retirees and the primary source of income for two-thirds of all retirees. Still, Social Security was not intended to be a primary source of retirement income for workers; it was meant to supplement workers' pensions and other retirement savings. Here's the rub: 401(k)-style plans were never intended to be a primary source of retirement income either. They, too, were designed to give workers a way to supplement their retirement income. Today, the average 401(k) account balance among private sector workers is just $28,000…that's why we have to make sure that workers with 401(k)s are getting the best bang for their buck. Improving 401(k) transparency is just the beginning of our efforts to ensure that all Americans have access to a secure retirement…"

Non-Traditional Assets in Stable Value Funds

By John Axtell, Deutsche Asset Management

In today's environment, money market funds are often out-yielding stable value funds, DC plans are more frequently replacing DB plans as an employee's primary retirement savings vehicle, and tight yield spreads are limiting managers' ability to generate excess returns. These factors and others are all driving an increased appetite for safely and prudently enhancing stable value fund returns. The most common approach is to turn to non-traditional asset classes, which raises an important question: Is enhancing stable value returns through non-traditional asset classes a prudent move for plan sponsors and investors in stable value funds?

Deutsche Asset Management believes the answer to this question is yes, with a caveat. The caveat is that not all non-traditional asset classes or investment strategies are appropriate for a stable value fund. Many non-traditional assets require a substantial trade-off of lower credit quality or reduced liquidity in order to enhance returns. While those trade-offs may be acceptable in limited amounts, they often don't provide the most efficient way to achieve the desired return enhancements. How, then, can non-traditional assets be deployed

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A Word about Alternative Investments

This issue of *Stable Times* provides several stable value managers' views on alternative investment strategies. These managers define and explain their views on the specific strategies that they have adopted in their investment guidelines. According to the latest SVIA Annual Stable Value Fund Investment and Policy Survey covering $397 billion in stable value assets at the end of 2005, 9 percent of assets fell into the 'other' category, which includes alternative investments. We also hear from a manager who does not use alternative investments in their stable value fund. While the array of articles highlights a few of the many investment strategies that stable value managers can use, the articles do not represent an industry or association position on any or all of the investment strategies profiled. The articles do show that stable value managers may use different investment strategies, but all are striving to ensure that stable value funds continue to provide principal stability with competitive, conservative returns that 401(k) participants and plan sponsors have come to expect.

Private Mortgages – A Compelling Stable Value investment

By Victoria May Paradis, CFA, Managing Director, JPMorgan Asset Management

When designing a conservative fixed income investment strategy, the correct way to reduce risk is to incorporate many imperfectly correlated asset classes in order to reduce overall portfolio volatility. The powerful, timeless concept is "many tools in moderation."

An example of a tool to enhance stable value portfolios is private mortgages. This is a unique fixed income sector that is

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Strategic Allocations to High Yield Corporate Debt in Stable Value Funds

By Greg Wilensky, AllianceBernstein

Portfolio managers typically strive to maximize risk-adjusted returns. For a portfolio that is being used to fund a specific liability (e.g., a college tuition payment in five years), risk is typically measured relative to the liability. For portfolios without clearly defined liabilities, maximizing risk-adjusted total returns would typically be the objective. A client's risk tolerance can be directly incorporated

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The Relative Value of GICs: "Show Me the Spread"

By David J. Molin CFA, Fiduciary Capital Management

Throughout our 20-year history, FCM has maintained above-average allocations to traditional guaranteed investment contracts (GICs) issued by major life insurance companies within our stable value portfolios. We have found several advantages in using GICs over other stable value products, including the following: policyholder/senior claims status, built-in benefit responsiveness, individually tailored cash flows, no embedded options, no broker commissions, and an inefficient marketplace resulting in advantageous risk/return opportunities. Nonetheless, when it comes to the investment decision-making process one has to focus on what we consider to be one of the most important advantages of GICs: relative value. The term "relative value" can be loosely defined as the ranking of fixed income investments by sectors, structures, issuers, and issues in terms of their expected performance during some future time horizon.

During the investment decision-making process, FCM evaluates various segments of the high-investment-grade bond market on a nominal and option-adjusted-spread (OAS) basis in order to identify relative value opportuni-

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Non-Traditional Assets

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to most efficiently and prudently enhance stable value returns?

To answer this question, stable value managers and plan sponsors have historically looked to trends in defined benefit investing. A big trend over the last five years has been the separation of alpha and beta and increased acceptance of using alpha overlay strategies to enhance returns. While alpha overlay strategies differ significantly in implementation, Deutsche Asset Management believes that a prudent and risk-controlled portable alpha overlay can be an excellent source of return enhancement for a stable value fund.

An alpha overlay is an investment strategy that is combined with an existing evergreen fixed income portfolio and covered by the wrapper agreement to create a prudent and effective way to enhance stable value fund returns with little incremental volatility. A prudent alpha overlay strategy for a stable value fund should have the following characteristics: (i) the source of the return enhancement shouldn't come from lowering credit quality, (ii) it should not sacrifice liquidity, (iii) it should be governed by a stringent value-at-risk budgeting approach so risk is always quantified and understood, (iv) it should demonstrate a successful track record of generating positive alpha, and (v) it should add little volatility to the fixed income returns of the fund by having a low correlation to traditional stable value strategies. The question becomes what type of non-traditional assets can be utilized to achieve all of these objectives for the alpha overlay strategy? Government bond and currency markets in developed and creditworthy countries around the globe offer an excellent solution. These markets are typically extremely liquid and require very little credit risk to make an investment. By taking relative value views on these markets that combine long and short positions, a well-managed portable alpha overlay strategy adds very little volatility but can add significant return enhancement.

A good alpha overlay strategy is additive to the underlying fixed income portfolio where you want it to be, in the returns, but not additive where you don't want it to be, in the volatility. This is achieved only when the returns from the alpha overlay have a very low correlation with the underlying fixed income portfolio. Investing in very liquid and high quality government and currency markets is an effective way to achieve these low correlation returns, because these markets respond more to the ebbs and flows of foreign market economies as opposed to the U.S. market economy. This fundamental difference in driver-of-market returns naturally generates alpha returns with low correlation to domestic fixed income markets.

Deutsche Asset Management has taken a leadership role in using alpha overlay strategies to enhance stable value fund returns for over seven years, with very compelling results. Seven different wrapper issuer institutions (both banks and insurance companies) have done extensive due diligence on the strategy and concluded that they are comfortable issuing a wrapper contract that puts their balance sheet at risk to provide book-value coverage for the strategy. This is a testament to the confidence that these institutions have in the risk management of the strategy and its appropriateness for a stable value fund. Prudent and well-managed portable alpha strategies in non-traditional markets can and do provide an effective way of enhancing stable value fund returns in a risk-controlled framework with minimal incremental volatility, credit risk, or liquidity risk. SVIA

"Show Me the Spread"

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ties. When evaluating the appropriateness of investments for stable value portfolios, a manager should consider several factors, including credit quality, cash flow volatility, liquidity, and benefit responsiveness. Based on these factors, the characteristics of the GIC market can be best compared to AA-rated corporate bonds that are wrapped to provide for benefit responsiveness. Exhibit 1 illustrates the excess yield or spread over similar duration Treasuries for the average five-year GIC contract, the high five-year GIC contract, and five-year AA corporate bonds net-of-wrap fees based on a FCM study looking back to early 2002, a period in which spreads have become increasingly tight by historic standards. As illustrated, GICs have historically provided solid spreads over comparable AA bonds with the average five-year GIC contract typically offering around 10 to 20 bps yield advantage, while the high five-year GIC has offered close to 40 basis points on average over the time period of the study. Moreover, although we are sometimes able to buy the high GICs, FCM's actual GIC purchases, after taking into account diversification needs, have historically been at yields somewhere between the average GIC offering and the high GIC offering. Based on that fact, we have calculated the FCM five-year GIC/AA spread as the average of the excess spreads over AA corporates for the high GIC offering and the average GIC offering. Over the period of the study, the FCM five-year GIC/AA spread has averaged 26 bps, a value opportunity that has consistently enhanced the relative performance of FCM's stable value portfolios. Moreover, we feel that this spread more than compensates for a lack of liquidity in GICs given their private placement

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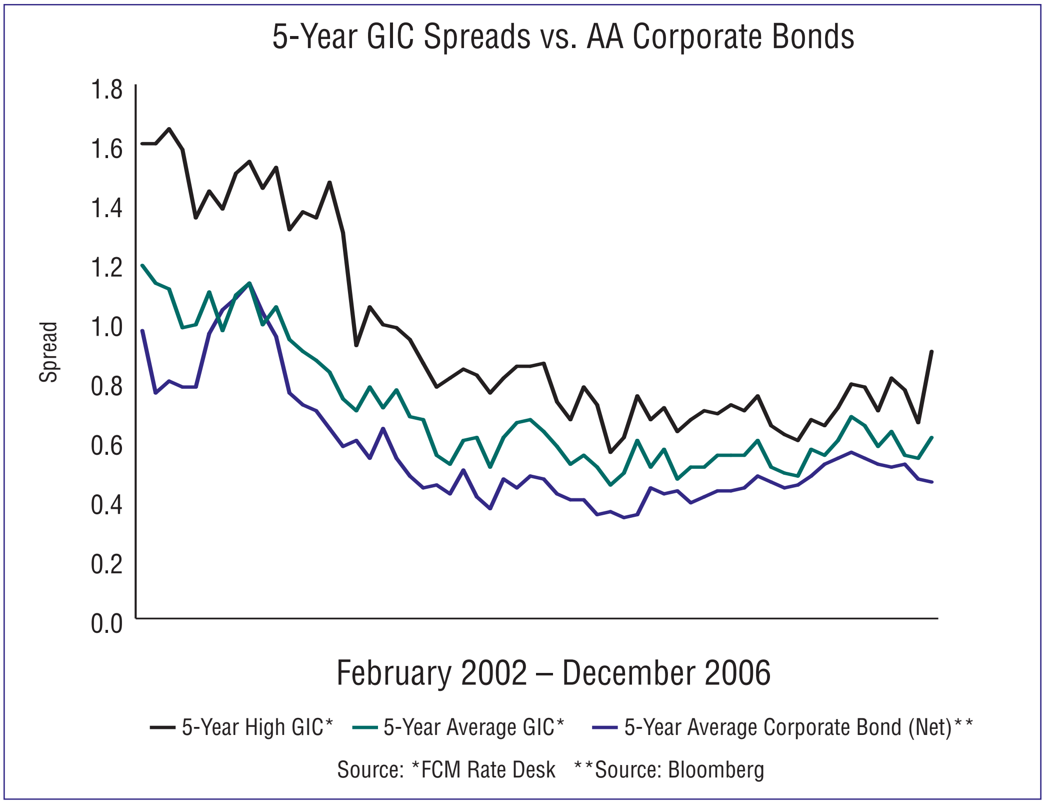
Exhibit 1



"Show Me the Spread"

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nature compared to publicly traded corporate bonds.

Over the last year, the excess spread of GICs over AA bonds has narrowed to well below the longer-term averages, with the FCM five-year GIC/AA spread averaging "only" 18 bps over the last six months. This can best be explained by current conditions within the fixed income markets that have resulted in historically tight spreads across the credit spectrum. From the insurance company perspective, the GIC business is a spread business with profitability tied to the difference between yields on invested assets and interest credited to the GIC holder. Moreover, companies issue GICs based on their financial strength ratings (typically AA or better) and invest these proceeds into segments of their general accounts comprised of lower-rated investments, including BBB-rated public and privately issued corporate bonds and to a lesser degree commercial mortgages. As shown in Exhibit 2, the spread between AA and BBB bonds has declined over the past few years to historically low levels. This has resulted from the very favorable credit cycle with historically low levels of defaults and increased investor appetite for risk in the

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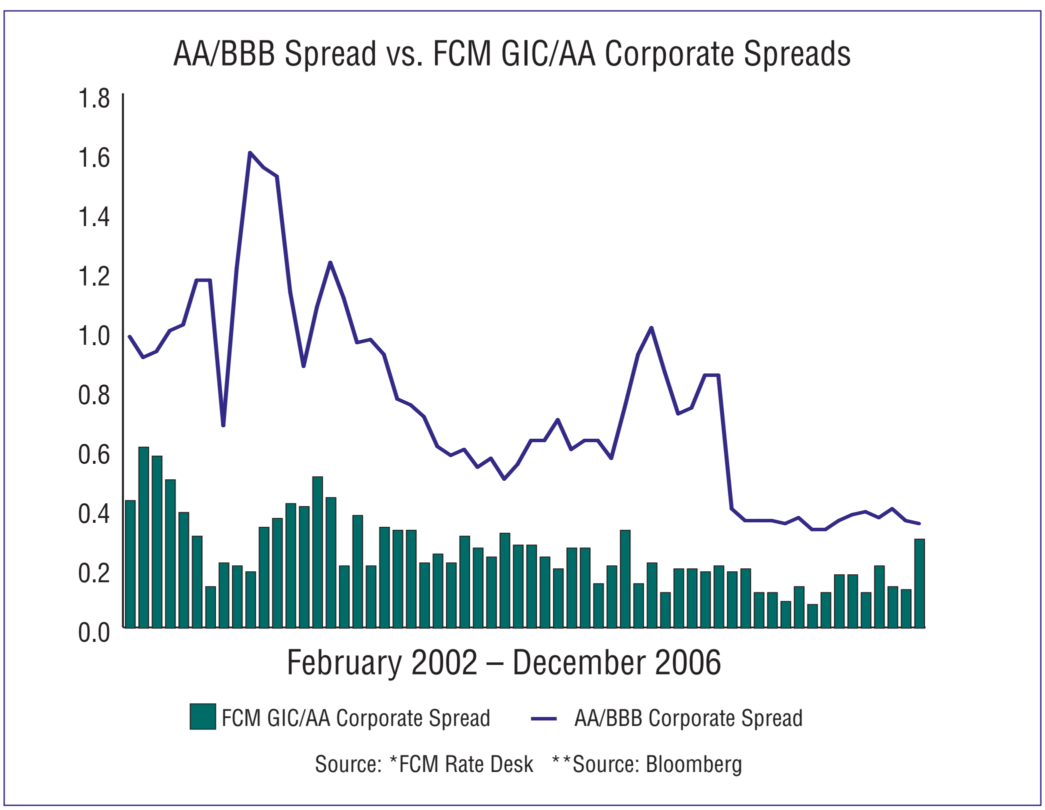
Exhibit 2



Private Mortgages – A Compelling Stable Value Investment

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characterized by commercial real estate whole loans collateralized by first mortgages, generally on office properties, retail centers, multifamily, and industrial properties. The loan terms can be fixed or floating, with terms generally between 2 and 15 years. These directly originated loans are written with strong call protection, including significant prepayment premiums (penalties). By directly placing the loans, the portfolio benefits from a yield advantage. This sector behaves most similarly to commercial mortgage-backed securities (CMBS), which is a common stable value sector.

The risk reduction power of private mortgages is illustrated by its low correlation with other fixed income sectors, including two common sectors that have "mortgage" in their name: CMBS and Agency pass-through mortgage-backed securities (MBS).

It follows that correlations are also low with other fixed income sectors, including Corporate (0.45), ABS (0.55), and Agency debt (0.47).

The investment considerations for this sector are multi-faceted. First and foremost, this asset class must be delivered through a commingled fund structure. Directly placed loans are not appropriate for holding within any portfolio with liquidity demands. With a commingled vehicle, the manager can build a portfolio of hundreds of loans over many years. This level of diversification is particularly compelling to wrap issuers. To enhance the natural liquidity from principal and interest payments, an allocation can be made to liquid sectors such as MBS to produce a liquidity profile appropriate for a DC investment option.

This investment type is commonly found within life insurance company general accounts and is less common as a sector within wrapped fixed income stable value portfolios. JPMorgan Asset Management has been managing a mortgage private placement fund for pension and ERISA clients for over 45 years and frequently offers this sector as a modest allocation (15-20 percent) within our stable value portfolios. The portfolio holds over 600 investments, placed with 10 unique market sectors, and covering over 30 states. Underwriting such loans requires significant infrastructure, as it demands extensive real estate, structuring, legal, and credit resources. Capacity constraints must be managed carefully.

From a fundamental perspective, despite the current softening residential real estate market, commercial real estate fundamentals are strengthening and multi-family properties are benefiting from stronger rents. Historically, the commercial real estate sector tends to improve when the economy is strong, so this fund tends to perform well even when interest rates are rising (and stable value funds are more vulnerable). Of course, high quality underwriting standards are critical to ensuring a timeless, long-term investment strategy.

All too frequently, stable value funds seek to lower risk by significantly limiting investments. While such an approach is concerned about valid risks, such as concentrated credit risk or derivatives, a highly constrained portfolio approach is flawed because it confuses individual sources of risk with total portfolio volatility. The alternative is to build a portfolio of many investment sectors coming from many sources. Along these lines, private mortgages are a compelling sector for the ability to deliver high quality, outstanding issuer diversification, favorable prepayment characteristics, and portfolio diversification benefits. SVIA

Correlation of Excess Returns (Ten Years Ending 12/31/06)

	MBS	CMBS
CMBS	0.66	—
Private Mortgages	0.54	0.72

Source: Duration Neutral Excess Return Correlation of JPMorgan Mortgage Private Placement Fund Versus Respective Lehman Brothers Indices. January 1996-December 2006. CMBS data from April 1997-December 2006. Source: JPMorgan, Lehman Live

SAVE THE DATE!

SVIA's National Forum and Membership Meeting
October 9 - 11, 2007
Fairmont Hotel
Washington, D.C.

"Show Me the Spread"

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search of higher yields. Tighter credit spreads have translated into lower returns on new GIC business for insurance companies, which has resulted in lower capital allocations to the business and less aggressive pricing. As a result, the FCM five-year GIC/AA spread has also contracted to historically low levels, as illustrated in Exhibit 2, albeit with a spike in January 2007. That said, GIC spreads have held up very well compared to AA bonds even in the current relatively difficult environment and are expected to improve once market conditions normalize.

In conclusion, compared to the other investment vehicles available to FCM, GICs have offered significant relative value. SVIA

Strategic Allocations

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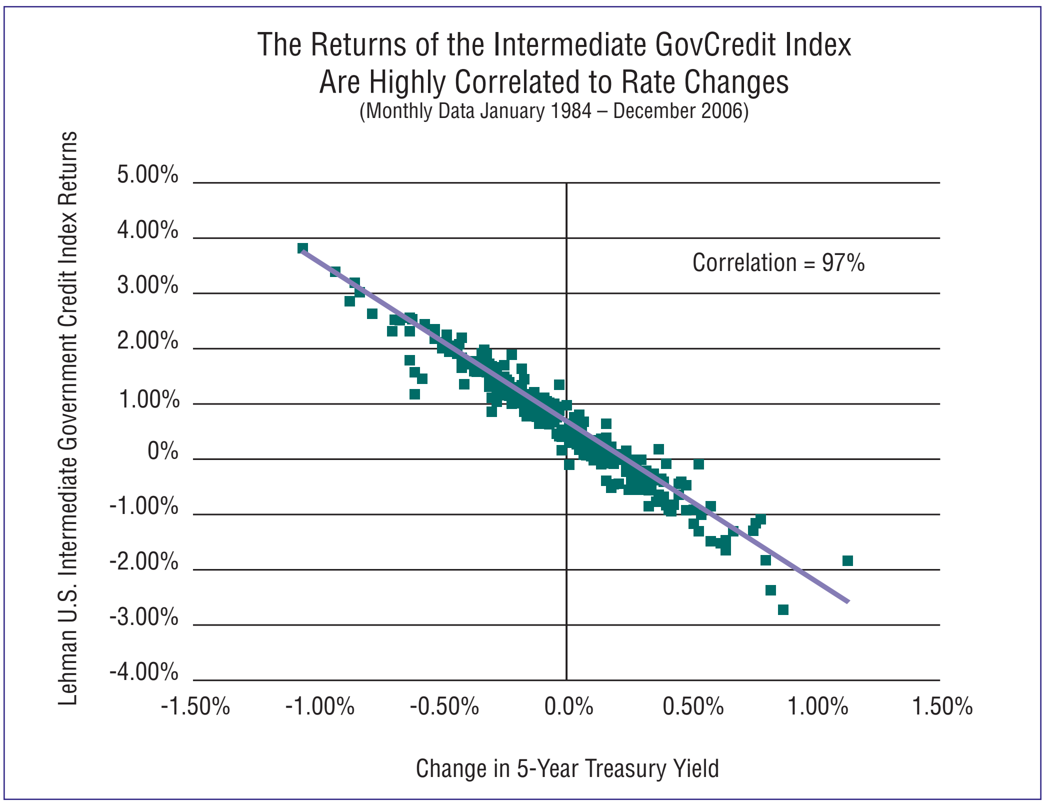
by adjusting the risk penalty scaling factor used in the analysis.[1]

Portfolio Theory 101 states that combining investments (even assets that look risky in isolation) whose returns have low correlations reduces the overall risk level. While we often think that fixed income benchmarks like the Intermediate Government Credit Index are highly diversified (and it is if you are thinking about the number of different issuers or securities), it turns out that a single risk factor (five-year Treasury rates) can explain over 95 percent of its return variability (see Exhibit 1). Therefore, if our goal is to maximize risk-adjusted total returns, adding a prudent amount of high-yield corporate and emerging-market debt (even on a purely passive basis) can increase the portfolio's expected returns without increasing total volatility. In addition, diversifying the portfolio with some hedged non-U.S. dollar bonds, while not increasing expected returns (if done passively), will actually reduce the total volatility of the portfolio. Therefore, investors with all risk preferences should applaud such a change. This happens because these sectors exhibit much lower correlations to Treasury rate changes.

While AllianceBernstein has included all of these sectors in our fixed income portfolios (including our stable value portfolios) for at least a decade, the balance of this article will specifically focus on the case for high-yield corporate debt. We will first examine the risk and return implications from a market-value perspective before closing with an examination of any nuances created by the presence of book-value wrappers. We will update and expand upon the analysis we presented on this topic at the spring 2005 stable value conference.

Exhibit 1



Market-Value Analysis

Over the last 23 years, high-yield corporate debt has returned just under 10 percent annualized and has outperfomed five-year Treasury bonds by over 200 basis points per year. While the long run performance has been stellar, focusing on this average outperformance would obscure the highly volatile nature of these returns. The standard deviation of the calendar-year returns is over 12 percent (see Exhibit 2). It is the fear of this volatility that has caused many investors to forgo the strong excess returns that this sector has historically generated.

When looked at in isolation, high-yield corporate debt is certainly risky. However, unlike the Intermediate Government Credit Index, the returns of the High Yield Index display a very low correlation (<20 percent) to Treasury rates changes (see Exhibit 3). This extremely low correlation with the dominant risk factor affecting traditional fixed income benchmarks means that the addition of a modest amount of high-yield corporate debt will not materially increase total portfolio risk.

For this analysis (see Exhibit 4), we compare the historical returns of the Lehman Intermediate Government Credit Index to a strategy that overlays a

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[1]Note: investment managers whose performance will be measured relative to a market benchmark typically strive to maximize risk-adjusted returns relative to such benchmarks.

Strategic Allocations

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set percentage of the Lehman High Yield Index hedged with five-year Treasuries. At a 5 percent overlay level, the portfolio outperforms the Intermediate Government Credit Index by 13 basis points per year (consistent with the 200-basis-point-plus outperformance of the sector). The Intermediate Government Credit Index generated relatively low (or negative) returns.

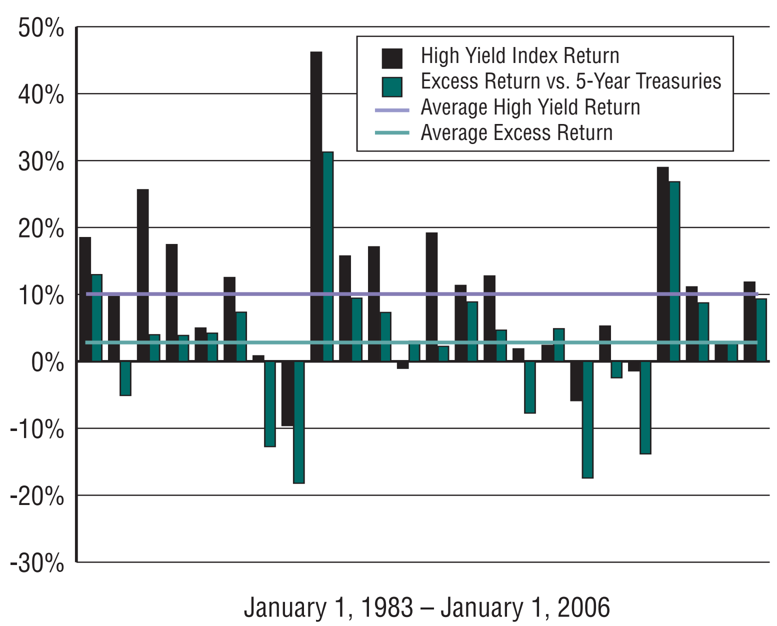
The impact on average credit quality is also small. With 5 percent allocated to high yield, the average credit quality of the portfolio can still be comfortably maintained in the AA category (if desired). Finally, while high-yield securities are typically less liquid than the other investment grade components of the bond market, given the modest allocations that we are talking about, only fund level cash flows greater than 10 percent would force a need to rebalance the position.

The overlay percentage can be increased to 15 percent before the risk matches the Intermediate Government Index. At this level, the overlay strategy outperformed by 37 basis points. Please keep in mind that this performance advantage occurs even if we assume that the allocations are purely passive (i.e., the portfolio manager does not add value through adjusting the sector weight through time or via security selection). Manager skill can amplify the results.

The conclusions of this historical risk analysis are also corroborated by ex-ante risk analysis performed using the Lehman Point risk model as well as AllianceBernstein's Wealth Forecasting System. Therefore, at modest allocation levels, the addition of a diversified, high-yield, corporate debt position to a traditional core fixed income portfolio should be unambiguously favored by investors who want to maximize risk-adjusted total returns, regardless of risk tolerance levels.

Before moving on to address issues pertaining specifically to stable value portfolios, we would like to briefly comment on the relative risk implications of such an overlay strategy. The amount of the relative risk being generated from a 5 percent overlay (about 12 basis points per month, according to Lehman Point) is less than the risk generated from a +/- .5 year duration bet (14 basis points per month) that almost all clients/managers are comfortable with. Furthermore, the probability of winning with a passive high-yield overlay strategy each month is almost 60 percent (70 percent for calendar-year periods). Most portfolio managers could not make the same statement about their duration betting strategies.

Exhibit 2



standard deviation of calendar-year returns actually is slightly lower for the 5 percent overlay strategy than the straight index (5.09 percent vs. 5.17 percent). Furthermore, because high yield has historically outperformed during periods of rising interest rates, the overlay strategy outperforms the straight index in every calendar-year period when the

Implications for Stable Value Portfolios

The stable value investment option is often the recipient of large allocations from risk-averse investors. Therefore, some clients or managers believe the inclusion of any "risky" high-yield securities would be inappropriate. However, the decision to include one or more securities in a portfolio is made by considering their impact on the entire fixed income portfolio and, even more broadly, the investor's overall asset allocation. Are 10-year Treasury bonds too "risky?" They have similar price volatility as the high-yield

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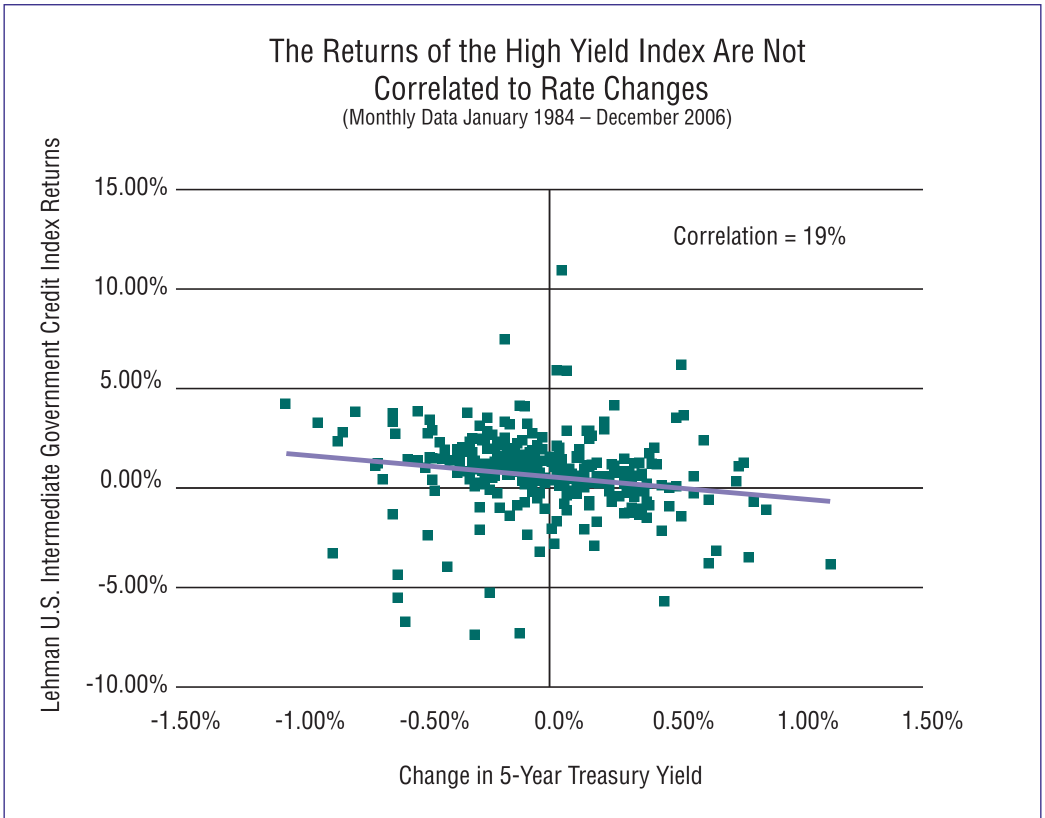
Exhibit 3



Strategic Allocation

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index (30-year Treasuries are a lot more volatile than the high-yield index). We have never seen a mandate that precludes 10-year Treasuries from a stable value portfolio, but prudent guidelines would undoubtedly prevent a portfolio that was invested only in these long-duration securities. The same tenet holds for the inclusion of high-yield securities.

In many ways, it should be much easier to hold a modest high-yield allocation in a stable value portfolio versus an unwrapped fixed income allocation. The period-to-period volatility is actually less of an issue for stable value funds because of wrapper smoothing. Wrappers allow stable value participants to focus on the correct long-run decision without being caught up in the short-run volatility. This is what allows an individual participant who would otherwise give up the 150 basis points excess returns that intermediate bonds typically earn over money market funds in order to get the day-to-day stability on money that typically won't be used for years.

If high-yield corporate debt generates excess returns over the long run, the crediting rate that stable value participants earn will be higher if a portfolio invests in these securities. If this investment is maintained at an appropriate level, there will be no noticeable impact on crediting rate volatility (see Exhibit 5).

On an opportunistic basis, adding high yield to a stable value fund is going to be less risky than lengthening a portfolio's duration. If the manager lengthens duration, rising interest rates would hurt in two ways. The manager's poor relative returns will detract from the fund's return at the same time that the stable value returns will already be lagging changes in interest rate levels. High-yield underperformance has typically occurred during periods of falling interest rates. Therefore, any performance impact will be muted by the fact that crediting rates naturally outperform falling interest rates. Another diversification benefit may exist with respect to stable value fund cash flow impacts. High-yield performance is positively correlated with stock performance. Therefore, underperformance in the high-yield allocation is likely to occur when stocks are falling. Typically, money has moved into stable value funds

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Exhibit 4

	Intermediate Government Credit Index	5% High Yield Overlay Strategy (hedged with with 5-year Treasuries)	Difference	15% High Yield Overlay Strategy (hedged with 5-year Treasuries)
Annualized Returns	7.90%	8.03%	0.12%	8.27%
Standard Deviation (calendar year returns)	5.17%	5.09%	-0.08%	5.15%
Maximum Return	18.1%	18.3%	0.19%	19.0%
Minimum Return	-1.9%	-1.8%	0.15%	-1.5%

Spread Lending Strategies

By Tim Murphy, NYLIM; Andrew Cohen, NYLIM; and Richard Taube, Pacific Life

The stable value industry grew up around Guaranteed Investment Contracts (GICs): a low risk, benefit-responsive instrument that fits the needs of both participants and sponsors looking for a conservative investment option in defined contribution plans. Capitalizing on that expertise, providers developed other stable value products to meet the needs of an evolving marketplace. Today, stable value options are the largest conservative investment in defined contribution retirement plans, with over $396 billion in assets.

Insurance companies that have grown and maintained GIC operations share several characteristics. A strong balance sheet and solid marks from major rating agencies are the backbone of a GIC capability. Over the years, leading issuers have also developed keen asset-liability management, underwriting, and pricing expertise. A natural outgrowth of these endeavors was the development of sales and marketing efforts that forged solid relationships with institutional fixed income investors. As the GIC market matured, issuers expanded these capabilities into alternatives creating what is now a flourishing stable value market with products that include GICs, Synthetic GICs, Guaranteed Separate Accounts, etc.

While the stable value option remains a mainstay of 401(k) plans, insurance companies continue to seek ways to expand this capability into other markets. Seeking further growth and the utilization of an established skill set, insurance companies turned to "spread lending," a concept rooted in stable value competency, as a viable growth opportunity. By leveraging their general account to back the guarantees and taking advantage of asset management capabilities, insurers have crafted a variety of products that share stable value characteristics. Success stories include the development of Funding Agreement, Municipal GIC, FHLB participa-

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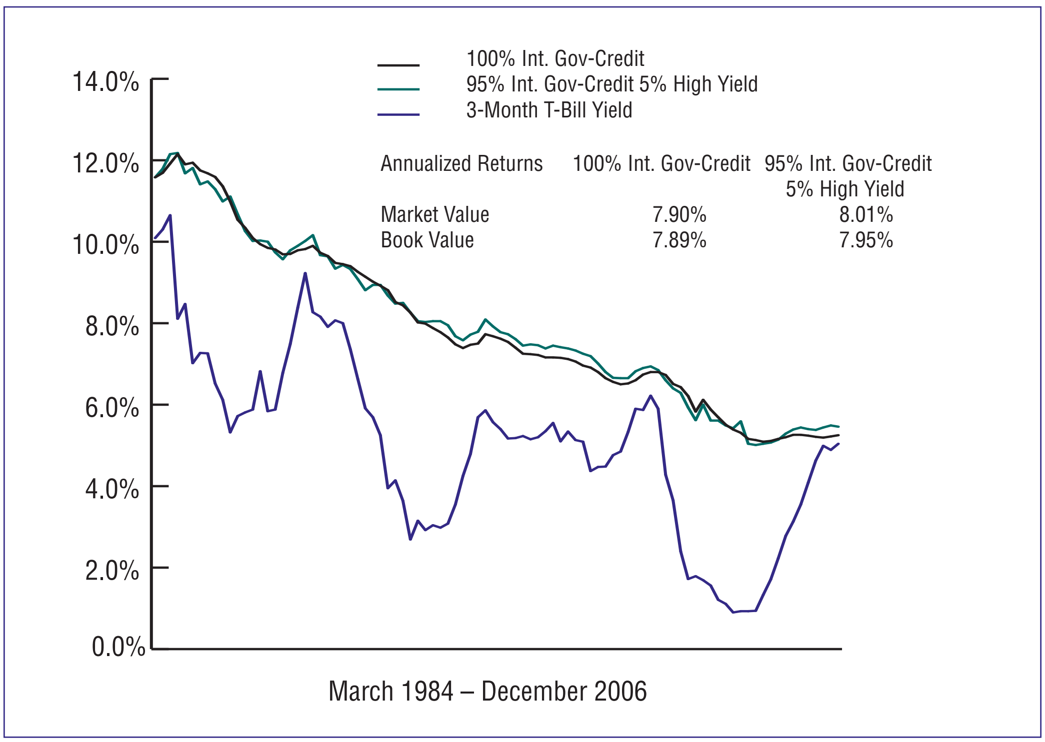
Exhibit 5



Strategic Allocation

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when stock prices fall. This would help dilute the impact on crediting rates from the underperformance of high-yield bonds.

Again, the analysis shown above assumes no manager skill at the sector or security level. Obviously, any such skill would improve the results further. While we believe that we have presented a very convincing argument for the inclusion of a modest allocation to this sector for stable value portfolios over the long run, we would close by noting that spreads are currently very tight. We believe, in the short run, that expected excess returns will be well below historical levels. As such, we have reduced our high-yield holdings below the levels we expect to hold in the long run and have been substituting bank loans over traditional high-yield securities.

Auto Enrollment and Auto Deferral Are Effective, But to What Degree?

By Gina Mitchell, SVIA

Behavioral finance research has identified many of the reasons why plan participants follow the path of least resistance when planning for retirement. These human traits are highlighted in the January 2007 Employee Benefit Research Institute (EBRI) Issue Brief entitled "Behavioral Finance and Retirement Plan Contributions: How Participants Behave and Prescriptive Solutions" by Jodi DiCenzo, Behavioral Research Associates.

The common human tendencies described in the issue brief ring so true that they are almost painful to read, especially when you recognize one or more of these shortcomings in yourself. For example, many of us lack the ability to overcome inertia and procrastination, even when it is in our financial best interest. For those of us who do take action, we are prone to making poor investment decisions for a variety of reasons. Fortunately, behavioral economists offer a prescription to plan sponsors to help ease individual retirement plan investors deal with their inability to modify our natural inclinations.

Behaviorists explain that procrastination may result from a bias toward the status quo and that short-term decisions often conflict with long-term desires and goals. A related behavioral bias called *hyperbolic discounting* is the human tendency, when faced with uncertainty, to sharply reduce the importance of the future in the decision-making process. No matter whether the future consequences are good or bad, the further off they are in the future, the less importance we attach to current choices. This theory is certainly applicable when faced with making contribution and investment decisions today for your future retirement. In addition, the behavioral model known as the *Prospect Theory* suggests that individuals are more sensitive to losses than to gains of the same magnitude. This loss-aversion results in our reluctance to lose income today even if it is for a future gain.

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Spread Lending Strategies

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tion, and Medium Term Note (MTN) programs.

The concept of spread lending is very simple: invest money at a higher rate than the guaranteed rate and "pocket the spread" to cover expense, risk, and profit margins. Of course, like the golden rule of investing, "buy low, sell high," there is some art to doing it successfully. Asset-liability management expertise, as well as a demonstrated ability to effectively invest in multiple asset classes (i.e. public bonds, private placements, commercial real estate) is paramount. Among the other issues insurance companies consider in pursuing spread lending are the current spread environment, return on investment, the effect of the business on reserving requirements, and the view rating agencies take of the programs.

Rating agencies always cast a "weather eye" concerning the impact of new strategies on the financial health of issuers. Although they have been generally approving of spread lending, Moody's has specified guidelines regarding the appropriate allocation of general account capacity (20 to 30 percent of total liabilities) required to maintain the AA-or-better rating most spread lenders enjoy.

Overall, the infrastructure used to successfully develop and grow a strong stable value business is sufficient to move into spread lending. Issuers can leverage existing resources (i.e. credit, asset-liability management) to contribute a greater amount to the company's bottom line. They can participate in a number of markets when internal return hurdles are met and rating-agency constraints are satisfied. This allows providers to issue opportunistically across a broader spectrum while maintaining a focus on optimizing profitability as well as the impact of the asset/liability mix on capitalization ratios and other financial measures.

Some providers create a broad product set that fits their goals and constraints and maintain a presence in multiple markets. However, their footprint may vary in those markets. For example, a company may have only a foothold in Muni-GICs while being a major player in the MTN market. The goal is to be able to tap opportunities when they present themselves, while drawing on a well-diversified liability base by both product and investor on an ongoing basis.

Others take a single product focus. They establish a strong presence in one market and channel their resources into that effort. This enables them to further streamline their commitment of resources and refine their competency.

While there is some difference among issuers regarding tactics, they share similar philosophies, goals, and concerns. Having demonstrated a long term commitment to stable value, they see spread lending as a logical extension of that commitment. SVIA

Auto Enrollment and Auto Deferral

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Whereas traditional economic theories assume that humans will always act logically, behavioral economists understand our limits as humans. They realize that our ability to make rational decisions may be limited by our lack of information, time, costs, and intelligence. Behaviorists also acknowledge that calculating an optimal savings rate is complex and involves making assumptions about future employment, earnings, longevity, health care, retirement age, inflation, and capital markets, to name a few.

Complexity and "choice overload" come into play in the plan-enrollment process and is influenced by the effectiveness of the retirement plan communications provided to plan participants. As the presentation of investment information, as well as the method by which participants enroll, becomes more convoluted, the less likely it is participants will take any action whatsoever. Empirical findings suggest, for example, that for every 10 additional investment options added to an average plan, which currently has between 10 and 20 investment options, participation will drop by approximately 2 percent due to "choice overload" associated with the additional ten investment options.

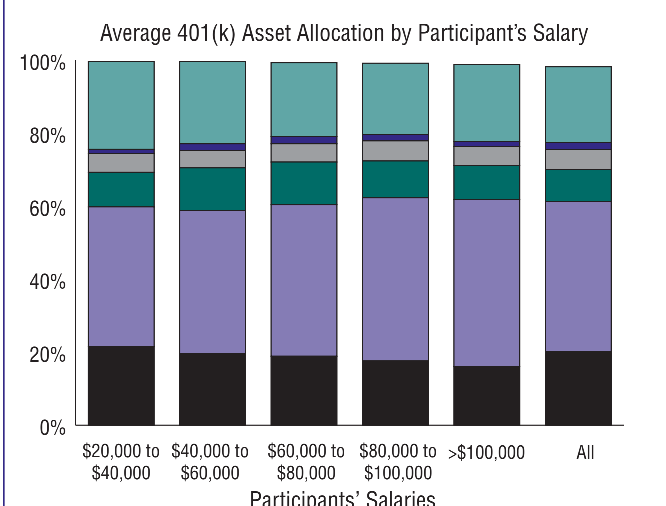
Not only are we inert and loss adverse, but many of us also suffer from overconfidence in our investment decisions. Coupled with this is the false belief that investments with which investors are most familiar are less risky. This is most evident in the case where individuals maintain a high percentage of their retirement assets invested in employer stock. Chasing the performance of top well-known funds, particularly those that are heavily advertised, is another one of our flaws.

To top it all off, behaviorists tell us that investment education and targeted communication programs alone will unlikely be effective in changing our behavior. Our lawmakers, however, have been listening to the findings of the behavioral economists. The enactment of the Pension Protection Act of 2006 (PPA) illustrates the implicit endorsement of Congress by providing plan sponsors a fiduciary safe harbor for automatic enrollment, default contributions, and automatic deferral increase plan provisions. Armed with new safe harbor incentives, many more plan sponsors are expected to add automatic enrollment to 401(k) plans. A question is whether the default contribution rate will be sufficient for individuals to save an adequate amount for retirement, assuming there are no other employer savings programs to count on, such as a defined benefit pension.

In the Issue Brief, Jodi DiCenzo highlights a study in 2006 by behavioral economists Craig McKenzie, Michael Liersch, and Stacey Finkelstein entitled "Recommendations Implicit in Policy Defaults." This study suggests that when automatic enrollment is included, many automatically enrolled participants remain at the default contribution rate after several years, even when the matching percentage exceeds the default percentage. In addition to being anchored to the default savings rate, automatically enrolled participants are also predisposed to remain wholly invested in the default investment fund. One reason for this may be due to a perception by these participants that the default percentage and default investment fund are considered implicit investment advice by the plan sponsor.

If plan sponsors raise the default rate to achieve higher savings, some are concerned that participation in the plan will fall. The Issue Brief notes, however, that in one study, participation remained high after the default rate was increased from 3 to 6 percent. Another study reflects that the plan with the highest default rate also had the highest participation rate.

Since plan sponsors can influence participants' security in retirement, the Issue Brief stresses that plan sponsors should carefully consider the contribution percentage that is set as the default. The choice of default options and the manner in which the defaults are conveyed are important because they may signal a recommendation of action, or inaction, to plan participants, which will impact the level of participation and savings overall. SVIA



Source: Investment Company Institute, Appendix, August 2006, Volume 12, Number 1A, Perspective