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Wharton Professor Concludes Stable Value Is the Fixed Income Solution in 401(k) Plans

By Randy Myers

Stable value funds may be even more valuable than investors realize.

Long a favorite of retirement plan investors, stable value funds have nonetheless acquired a reputation as the financial equivalent of the button-down oxford shirt: sensible, pragmatic, and dependable, whatever the investment climate.

Now, research from David Babbel, a professor of finance and risk management and insurance at the University of Pennsylvania's Wharton School and a vice president and senior advisor at CRA International, an investment consulting firm in Boston, and Miguel Hence, a principal with CRA, suggests that steering investors away from stable value might be doing them a disservice. Using a variety of methodologies, including mean-variance analysis, stochastic dominance analysis, and multi-period analysis, Babbel and Hence compared the performance of stable value funds over the past 18 years with basic alternatives such as large and small stocks, long-term govern-

continued on page 2

IN THIS ISSUE

Redefining the Successful 401(k) Plan

By Randy Myers

Until recently, most employers gauged the success of their 401(k) plans on the basis of participation levels. If most of their employees participated, the plan was okay. Increasingly, though, they're deciding that's not enough.

"More and more, employers are asking how their plans are doing in terms of making sure employees have enough money to retire and whether or not employees are valuing their plan," says Pamela Hess, director of retirement research for Hewitt Associates, a global consulting and benefits outsourcing firm based in Lincolnshire, Illinois. Those metrics are important, she says, because 401(k) plans are now the primary retirement vehicle offered by 65 percent of employers. And while an average of 78 percent of eligible employees participate in those plans, that's fairly flat over the last 10 years. Meanwhile, the average pre-tax contribution rate to those plans has been flat at 6.9 percent for the past decade, and 20 percent of participants aren't contributing enough to capture the full amount their employers are willing to match. Also, while the average 401(k) account balance has risen nicely of late—to $82,310 this year from $49,160 in 2003—the median balance is still just $27,690. All these figures reflect the experience of participants in plans offered by more than 300 mid-to-large employers that participated in Hewitt's latest Trends & Experiences Survey.

continued on page 2

QDIA Rules Give Special Status to Stable Value Funds

By Randy Myers

On October 24, 2007, the U.S. Department of Labor (DOL) issued new rules for selecting default investment options in retirement savings plans: 29 CFR Part 2550: Default Investment Alternatives Under Participant Directed Individual Account Plans, Final Rule. On October 29, the Stable Value Investment Association hosted a conference call for members in which SVIA counsel Donald Myers, a partner with the law firm of Reed Smith LLP, reviewed the details of the new regulation, its history, and its implications for the retirement plan marketplace.

While much attention has been focused on the three primary safe harbor default investment options established in the regulation, the new rules for selecting default investment options in retirement savings plans actually give special and favorable status to stable value funds. As attorney Donald Myers points out, the new rules make it clear that plan sponsors can still use stable value funds as a default investment if they wish, as long as they adhere to long-standing guidelines for prudent investment selection. In addition, the rules offer a fiduciary safe harbor to plan sponsors that use stable value funds as default investments under limited circumstances.

To understand how the new rules will impact the retirement plan marketplace, it helps to understand the issues that led to their development. As Myers explained in his October 29 conference call with more than 50 SVIA members, the new rules were

continued on page 3

Redefining the Successful 401(k) Plan

continued from page 1

To meet their new definitions of success, employers are beginning to revamp the design of their plans by automatically enrolling new employees, defaulting their contributions into more aggressive diversified investment options when employees don't choose their own, and, in some cases, automatically increasing at regular intervals the percentage of salary that participants defer into their accounts.

Speaking at the Stable Value Investment Association's 2007 National Forum in Washington, D.C., Hess said that 10 years ago, only 4 percent of employers in the Hewitt universe automatically enrolled new employees in their plans. Today, she said, 34 percent do, a move that has doubled participation rates among their lower-paid and lower-tenured employees. By next year, Hess said, she expects half of all employers will have adopted an automatic enrollment feature.

Meanwhile, a third of plans that have already embraced automatic enrollment also set their plan's default contribution level at 4 percent of the participant's salary or higher, up from just 17 percent who did so as recently as 2005. Also, 28 percent of the auto-enroll employers have coupled that feature with periodic, automatic increases in participants' default contribution levels, so that participants end up saving more of their pay for retirement. Unfortunately, Hess said, most of the employers raising deferral rates are automatically starting at a low level—perhaps 2 percent or 3 percent of salary—and raising it over time to only 6 percent. "We'd like to see it go from 6 percent to 10 percent or 15 percent," she said. Right now, half of employers ratchet contribution rates up to 6 percent, while 15 percent default up to 10 percent of salary and 20 percent default up to 15 percent of salary.

Higher contribution rates can make a big difference in how much money workers save for retirement. Hess showed one illustration in which an employee deferring a flat 6 percent of salary from age 25 to retirement could amass a nest egg of $910,000 by the time they stopped working. Assuming no change in their income, investment returns, or years of employment, the illustration showed that same person could amass $1.3 million by start-

continued on page 3

Wharton Professor Conclusions

continued from page 1

ment and corporate bonds, intermediate-term government bonds, and money market funds. They concluded that although stocks generated the highest returns over the past 18 years, no asset class dominated stable value funds when factoring in the varying degrees to which different investors tolerate risk. By contrast, they found that stable value funds dominated both money market and intermediate-term bond funds across multiple risk-aversion levels. When combined with stocks and long-term government bonds, they concluded, stable value funds can play a prominent and often dominant role in constructing optimally efficient investment portfolios.

The Babbel and Hence study, "A Closer Look at Stable Value Funds Performance," an SVIA-sponsored independent academic study, is posted as a working paper on Wharton's website (http://fic.wharton.upenn.edu/fic/papers/07/0721.pdf). Babbel says he was surprised by its findings. "We're pretty jaded economists; we've seen a lot," he told participants at the SVIA's 2007 National Forum in Washington, D.C., in October. "The stochastic dominance model is now used by lots of economists, and if something exhibits stochastic dominance, it's like nirvana—you hardly ever find a financial asset that dominates any other."

The study demonstrates that volatile investment returns can be a particularly egregious enemy of people making regular withdrawals from their retirement savings accounts, a strategy that Babbel and Hence call "reverse cost averaging." If financial markets turn south early in the spend-down phase, Babbel told SVIA Forum participants, the amount of money available to them in retirement can be dramatically lower if they're invested in a portfolio of either stocks or bonds than it would be with a portfolio of stable value investments.

The point isn't that investors should shun equities entirely, Babbel said, but rather that if they are combining them with other assets to build a diversified portfolio, those other assets should be stable value funds. "They provide investors with a whole different way of planning for the future," he concluded.

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Redefining the Successful 401(k) Plan

continued from page 2

ing with a deferral rate of 3 percent and gradually increasing it to 10 percent over a period of seven years. By starting at 6 percent and climbing to a 15 percent deferral rate, Hess said, he or she could amass a nest egg of just under $2 million.

Contrary to what some plan sponsors have feared, Hess said reasonable deferral increases don't appear to scare employees out of their retirement plans. One Hewitt client bumped deferral rates from an average of 6 percent to 8 percent, she noted, with no complaints from plan participants. She said automatically increasing deferral rates can be especially important for automatically enrolled plan participants because people defaulted into a plan save, on average, 1.2 percentage points less of their salary than do people who enroll on their own. "It's a great way for employees to promise to save more in the future," Hess said. "Most acknowledge they want to and can, they just don't want to do it today."

In a bid to encourage plan participants to invest in diversified portfolios, Hess said half the employers in the Hewitt universe now steer default investors into target-date retirement funds that include substantial allocations to equities. "Target-date funds are being viewed as broadly superior to managed accounts," she said, "although managed accounts can make sense for people who have more complicated financial situations."

For participants who do want to make their own investment decisions, Hess said plan sponsors are streamlining their investment menus to simplify the process. Many have constructed what amounts to an investment pyramid that begins with target-date or target-risk funds at the base, aimed at the bulk of plan participants who want to minimize the time they have to spend managing their account. Halfway up the pyramid are perhaps half a dozen "core" funds covering the major asset classes, including stable value funds. At the top is a brokerage window for the 2 percent or so of participants who want the freedom to invest in any of the thousands of stocks, bonds, and mutual funds available from Wall Street.

More than 75 percent of employers offer some type of target funds, Hess said. They are primarily attracting younger participants with smaller account balances. While a whopping 45 percent of participants use them, the funds have attracted only about 13 percent of plan assets thus far.

Looking ahead, Hess said the retirement industry is keen to introduce retirement income solutions to 401(k) plans—annuities or annuity-like products that would allow participants to convert some portion of their nest egg into a guaranteed stream of income for life. Plan sponsors also are weighing whether or not to begin offering Roth accounts within their 401(k) plans.

To date, Hess said, few employers are offering income solutions, and few plan participants are using them when they are available. Many balk, she said, at the idea of cashing in a big sum today for small sums that will trickle out to them over a long period of years. "It's hard to be a millionaire today," she quipped, "and get $50,000 a year tomorrow."

While she expects many employers to begin offering Roth 401(k) accounts in the years ahead, they too remain largely a novelty for the moment. Unlike a traditional 401(k), which is funded with pre-tax dollars that are then taxed upon withdrawal, a Roth 401(k) is funded with after-tax dollars that can then be withdrawn tax free. Of six Hewitt clients that have been offering Roth 401(k) accounts for a full year, Hess said, five are financial services firms. Collectively, about 12 percent of their plan participants have opted to use the accounts.

QDIA Rules

continued from page 1

created largely in response to the growing trend by employers to automatically enroll employees in their 401(k) retirement savings plans. Those plans are governed by the Employee Retirement Income Security Act of 1974, better known as ERISA. Under section 404(c) of ERISA, as interpreted by the DOL, a company that sponsors a 401(k) plan cannot be held liable for the investment losses of plan participants exercising control of their accounts, assuming plan sponsors have prudently selected and monitored the investment choices and have complied with all the disclosure and other requirements of the section 404(c) regulation.

Plan sponsors have relied heavily on this regulation, and most have designed their plans to satisfy the requirements of Section 404(c). Compliance became a problem, though, as increasing numbers of plan sponsors introduced automatic enrollment features to their plans in a bid to boost participation. By doing that, they also boosted the number of participants who weren't bothering to choose their own investments and therefore weren't exercising control over their accounts, instead allowing their employers to do it for them. Where this happened, the employers forfeited 404(c) protection.

Because it wanted to encourage increased enrollment in retirement savings plans, Congress addressed this problem in the Pension Protection Act of 2006 (PPA) by creating a new section of ERISA, 404(c)(5). It directed the Department of Labor to establish rules for selecting default investment options for retirement plan participants who do not choose their own. If plan sponsors follow those rules, it said, plan participants would be treated as if they were exercising control over the assets in their account, and plan sponsors or other plan fiduciaries would not forfeit the fiduciary relief provided by ERISA Section 404(c).

On October 24, 2007, the DOL issued the new rules Congress wanted. They take effect on December 24, 2007. As mandated by the PPA, they provide guidance to plan sponsors on choosing default investments that include a mix of asset classes "consistent with capital preservation or long-term capital appreciation, or a blend of both." The regulations designate three principal types of default investment products—

continued on page 4

QDIA Rules

continued from page 3

what the DOL calls Qualified Default Investment Alternatives, or QDIAs—that will provide plan sponsors with a fiduciary safe harbor:

- **Lifecycle or "target-retirement-date" funds.** As defined by the DOL, these funds follow generally accepted investment theories to produce diversified stock and bond portfolios. Their asset allocation mix is based on the participant's age, target retirement date, or life expectancy. Along with the associated risk level, this asset allocation mix changes over time with the goal of becoming more conservative as investors age.

- **Balanced stock and bond funds.** These funds mix equities and fixed income investments in an asset allocation mix consistent with a target level of risk appropriate, the DOL said, for participants of the plan as a whole.

- **Managed accounts.** With this product, an investment manager, using generally accepted investment principles, designs a diversified stock and bond portfolio from the investment alternatives in the participant's plan. The asset allocation mix is consistent with the participant's age, retirement date, or life expectancy.

In addition to describing these three broadly applicable QDIAs, the DOL also outlined conditions under which investments geared toward capital preservation would provide fiduciary relief. Specifically, it said:

- **Principal preservation funds** or products, such as money market funds or stable value funds, will qualify as QDIAs for a maximum of 120 days after the date of the participant's first elective contribution to the plan. This provision, Myers noted, reflects the DOL's desire to make it easier for plan sponsors to return contributions to automatically enrolled participants who opt out of their plan soon after enrollment without having to worry about losing any of their principal.

- **Guaranteed principal and rate-of-return funds** or products (i.e., stable value funds) will qualify as QDIAs, but only in cases where the investments in those funds were made prior to December 24, 2007. Stable value funds will not qualify as a QDIA for investments made on or after that date, except for the initial 120-day period under the preceding paragraph.

Two caveats apply to all QDIAs. First, they must be managed by an investment manager, plan trustee, or plan sponsor who is a named fiduciary of the plan, or by an investment company registered under the Investment Company Act of 1940. Also, a QDIA generally may not invest participant contributions in employer securities.

"The inclusion of a plan sponsor (as an allowable investment manager) was added in the final regulations in response to comments that some employers serve as named fiduciaries and manage their investments in-house," Myers observed. "This, according to the Department of Labor and its analysis of the comments, results in reduced administrative and investment management fees, and the DOL thought this was good."

This represents another plus for the stable value industry, Myers said, since it would allow an employer to create a QDIA by pulling together some of the investment options it already offers. For example, the sponsor could create a target-retirement-date fund of funds that include a stable value fund as one of its components.

More special acknowledgement for stable value funds

The special considerations made for stable value funds had not been included in the proposed QDIA regulation the DOL promulgated last year, Myers noted. The DOL added them to the final rules following comments from numerous investment professionals about the important role that stable value funds play in many retirement plan portfolios.

Beyond carving out two special uses for stable value, the DOL in its final rules also acknowledged an important ongoing role for stable value funds in retirement savings plans. "Such investments can, and in many instances will, play an important role as a component of a diversified portfolio that constitutes a qualified default investment alternative," the DOL wrote. It also wrote that in the case of QDIAs that are funds of funds, "it is likely that money market, stable value, and similarly performing capital preservation vehicles will play a role in comprising the mix of equity and fixed income exposures for this alternative."

"This was the DOL's way of saying that while it's not offering stable value as a QDIA, it did see stable value playing an important role in the portfolios of pension plans," Myers commented. "As far as I'm aware, this is the first time the DOL has publicly acknowledged that stable value can play an important role in a portfolio. That's a very positive sign."

Myers added that beyond confirming the legitimacy of stable value funds as a component of a QDIA, the DOL also made it clear that plan sponsors may still designate a stable value fund as the default investment option for their plan—something, he said, that most press reports about the QDIA regulations have overlooked. Specifically, the DOL wrote:

> "*. . . As indicated in the regulation itself, the standards applicable to Qualified Default Investment Alternatives set forth in the regulation are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under (ERISA) with respect to the investment of assets in the individual account of a participant or beneficiary. Accordingly, fiduciaries may, without regard to this regulation, conclude that a stable value product or fund is an appropriate default investment for their employees and use such product or fund for contributions on behalf of defaulted employees after the effective date of this regulation.*"

Asked how a plan sponsor might demonstrate prudence in

continued on page 5

QDIA Rules

continued from page 4

selecting a stable value fund as a default investment option, Myers replied that while it is difficult to generalize, the employer might identify unique characteristics about its work force—a preponderance of older employees, for example, or a demonstrable aversion to risk—and conclude that it makes sense to use a stable value fund for its attractive risk-reward attributes. "Once an employer makes that decision," Myers said, "the next stage in the investment process would be to select an appropriate stable value product based on such factors as manager expertise and experience and investment performance. The whole process should be well documented and periodically revisited to make sure those decisions continue to be appropriate to that particular plan."

Myers said the DOL considered arguments the stable value industry made for including stable value funds as a stand-alone QDIA, including a warning that steering default participants into more volatile investments could cause them to opt out of their retirement plans, jeopardizing retirement security for more Americans. The DOL also considered the argument that by specifying that QDIAs should include "a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both," Congress intended to have capital preservation products such as stable value funds included in the QDIA lineup. Nonetheless, he said, the DOL concluded that allowing stable value or money market funds as QDIAs would not, over the long term, produce rates of return as favorable as those expected from the investment options that were designated as primary QDIAs.

Additional safe-harbor requirements

For plan sponsors to qualify for the fiduciary safe harbor afforded by the new regulations, Myers noted, six conditions must be met:

1. Default investments must go into a QDIA.

2. Participants and beneficiaries must have had an opportunity to direct their investments on their own but failed to do so.

3. Participants must be informed about the investments made on their behalf, both initially—around the time of their initial investment—and annually thereafter. The regulations spell out in detail the specific timing requirements for such notices and exactly what information they must include.

4. The plan must pass along to participants certain material provided to the plan relating to the participants' or beneficiaries' investment in a QDIA, such as account statements and investment prospectuses.

5. Participants must have the opportunity to direct investments out of a QDIA as frequently as from other plan investments, but at least quarterly, and there must be limits on charges that can be imposed on them for opting out of their plan or directing their investments out of a QDIA. During the first 90 days of a participant's defaulted investment into a QDIA, Myers noted, plans may impose no restrictions, fees, or expenses on withdrawals or transfers initiated by the participant, other than investment management fees and similar fees and expenses. After the first 90 days, defaulted participants must be treated like any other participant in the plan in terms of the surrender charges, redemption fees, market-value adjustments, or other charges imposed on withdrawals or transfers.

6. The plan must offer a broad range of investment alternatives as defined in the regulation under Section 404(c) of ERISA.

Myers said plan sponsors and other plan fiduciaries will enjoy the safe-harbor protection afforded by the new rules regardless of which QDIA they choose to adopt, provided, again, that they prudently select and monitor the QDIA. That means, he said, that fiduciaries must engage in an "effective, thorough, and analytical process that involves consideration of the quality of the competing providers of investment products, as well as any fees and expenses that would be incurred in connection with that investment."

That said, Myers noted that the DOL also warned that a plan sponsor or other fiduciary moving assets from an existing default investment option into one of the new QDIAs must do so in compliance with ERISA's prudence and exclusive purpose requirements. In other words, it must do so in the best interest of plan participants and not solely to take advantage of the limited liability protections offered by the new regulation.

Myers noted that the fiduciary relief provided by the new regulation applies to any participant-directed plan, regardless of whether its meets all the detailed requirements of ERISA Section 404(c). In addition, the relief will apply in circumstances outside of automatic enrollment. For example, it will apply if a QDIA is used when a plan participant does not provide investment direction following the elimination of an investment alternative, a change in service providers, or a rollover from another plan.

Finally, Myers noted that the new regulation makes clear that ERISA supercedes any state laws that might otherwise prevent employers from automatically enrolling employees into their plans and diverting some of their pay into the plan. Some states have laws that restrict the ability to withhold money from an employee's paycheck without the employee's specific approval, Myers said, and prior to the release of this new regulation, some plan sponsors worried about how such state laws might impact automatic enrollment and default investments. SVIA

Population Trends Challenge Europe and Developed Asia

By Randy Myers

For three decades, population growth has helped drive economic growth around the globe. Now, says Deutsche Asset Management chief economist Joshua Feinman, that demographic tail wind is dying out, with significant implications for the world's economies, the financial markets, and geopolitics.

At its peak in the late 1960s, Feinman told participants at the Stable Value Investment Association's 2007 National Forum in October, the world's population was growing at about a 2 percent annual rate, or doubling roughly every 35 years. Now it's growing only about 1 percent a year, and U.N. forecasters predict it will grow only about 0.5 percent annually by the middle of this century—the slowest rate since before the Industrial Revolution.

An unfortunate consequence, Feinman said, is that many of the world's economies find themselves slipping out of what he calls the demographic "sweet spot"—a phenomenon in which the percentage of working-age people is growing relative to the total population. With fewer people entering their workforce each year and their overall population aging, many countries will see GDP grow at a slower rate unless they can offset those negative demographic trends by boosting worker productivity. Those countries also will be challenged to provide for the financial security of their elderly citizens, straining government finances.

Among the countries facing the toughest demographic headwinds are Russia, Japan, and China. Russia's population is already declining, Feinman said, and by mid-century it is projected to be about 25 percent below its peak. Japan is flirting with outright population decline, and by the middle of this century its headcount is projected to be 20 percent smaller than it is today—an unprecedented development for a major country not decimated by war, famine, or epidemic. China, too, is expected to be in an outright population decline by mid-century, Feinman said, positioning it to become "the first country in history to get old before it gets rich." Based on current trends, it is poised to slip into second place behind India as the world's most populous country, complicating its rise as a world power.

In contrast to the outlook in China, Russia, and Japan, the United States is expected to see its population grow through mid-century, albeit at a slower pace than it is now—about 0.4 percent annually versus the current rate of 0.9 percent. Population trends in the European Union are expected to fall somewhere between those of the United States and Japan but turn negative by about 2025. As a result, Feinman said, the U.S. population will equal about 61 percent of the EU population by mid-century, up from about 40 percent today.

According to Feinman, these demographic trends should boost U.S. power around the world relative to Europe, Japan, and Russia, although he conceded that other factors will also weigh on those relationships.

Meanwhile, many of the poorest regions of the world, including sub-Saharan Africa and the Middle East, are on the cusp of positive demographic change. Their populations are aging more modestly, Feinman said, and their working-age populations are actually growing as a percentage of total population. But even as these regions seek to capitalize on these opportunities, he said, they also will face great challenges. "They will have to do what they can to integrate their growing working-age population into a productive workforce," Feinman said. "If they do, they should reap great economic benefits.. If they don't, they will have a disgruntled young population."

What all of this will mean for financial markets is uncertain. Conventional wisdom holds that as a country's population ages, its people will save less, putting upward pressure on interest rates and downward pressure on equity prices. Feinman isn't convinced that scenario will play out, though. He noted that there is limited empirical evidence of how aging populations save and spend. He also remarked that investors, being forward-looking, may have already factored demographic trends into securities prices. Besides, he said, global capital markets are increasingly integrated, so that it's quite easy to imagine people in emerging economies buying the securities those in aging economies want to sell, thus keeping markets on an even keel.

What is likely, Feinman said, is that there will be increased demand for annuities, long-term care insurance, reverse mortgages, and fixed income products, including stable value funds, in countries with aging populations.

SVIA Elects Five New Board Members

By Gina Mitchell, SVIA

This fall SVIA's members elected five people to the Association's Board of Directors for a three-year term starting in 2008. They are:

- Sharon Parkes, Halliburton, as a sponsor member;
- Doris Fritz, Fidelity, as a service firm member;
- Warren Howe, Metropolitan Life, as a service firm member;
- David Starr, Dwight Asset Management, as a service firm member; and
- Michael Wyatt, T. Rowe Price, as a service member.

SVIA members overturned last year's record high of 85 percent participation in the Board election by setting a new record of 95 percent participation in this competitive race.

Federal Reserve Employee Benefits System Optimizes Lifestyle Portfolios with High Stable Value Allocations

By Randy Myers

As chief investment officer for the $4.6 billion retirement savings plan that caters to employees of the Federal Reserve, Paul Lipson has strong and sometimes maverick opinions about what makes for smart investing. For example, while most plan sponsors today are tripping over themselves to offer plan participants access to target-date retirement funds—so-called "lifecycle" funds that grow more conservative as their investors age—Lipson doesn't much like them. He prefers target-risk or "lifestyle" funds with static risk profiles ranging from conservative to aggressive. And contrary to conventional practice, which precludes stocking them with stable value investments, which cannot be offered as mutual funds, he sees a clear benefit to substantial stable value allocations within lifestyle funds.

"Age is clearly important when selecting an investment allocation," Lipson told participants at the Stable Value Investment Association's 2007 National Forum in October, explaining his concerns about lifecycle funds. "But it is also just one in a long list of factors that must be taken into consideration." Another, he said, is the "glide path" that target-date funds follow as they segue from a high to low concentration of equities over an investor's lifetime. Most have a linear glide path, he observed, "while few things in nature are linear." To assert that all 30-year-olds need and can tolerate high equity exposure—and that all 50-year-olds need and can tolerate a high fixed income exposure—is, he said, problematic—and characteristic of the glide paths followed by most lifecycle funds.

This year, the Thrift Plan for Employees of the Federal Reserve Retirement System introduced five lifestyle funds to its investment lineup. Each is a fund of funds allocating its assets in varying degrees among four of the six core investment options offered by the retirement plan. The four underlying funds used are a broadly diversified U.S. stock fund, a small stock fund, an international stock fund, and a stable value fund. The most aggressive lifestyle fund has 14 percent of its assets in stable value, the most conservative 87 percent.

Most lifestyle and lifecycle funds offered by investment companies include no stable value allocations, largely because they are constructed using mutual funds, and there are no stable value mutual funds. That wasn't a problem for Lipson and his team, though, since the core investment options from which they built their lifestyle funds are privately managed separate accounts.

Lipson was adamant about including stable value in the plan's lifestyle funds, he said, because they deliver market-like bond returns at sharply lower levels of volatility than the typical bond fund. In fact, he noted, his plan's stable value fund posted higher annualized returns for the past 3-year, 5-year, 10-year and 15-year periods than the Lehman Brothers U.S. Aggregate Bond Index, the Lehman Brothers U.S. Intermediate Credit Index, and the Vanguard Total Bond Index Fund, the country's largest intermediate-term bond fund. The strategy of pairing equity funds solely with stable value, he said, has allowed for the construction of highly efficient investment portfolios.

Reflecting the confidence they have in their new stable-value-infused lifestyle funds, Lipson said he and his colleagues at the Thrift Plan for Employees of the Federal Reserve Retirement System have made the moderate-risk lifestyle fund, which has an allocation of 48 percent to stable value and 52 percent to equity, the default investment option for plan participants who do not choose one on their own. SVIA

Regulators Seeking Greater Fee Disclosure for 401(k) Plans

By Randy Myers

Participants in 401(k) plans could soon find themselves inundated with more detail about what those plans are costing them and where their money is going, but the retirement industry isn't sure it will do participants much good.

The push for greater fee disclosure is coming from federal legislators and regulators. In July, Rep. George Miller, D-Calif., introduced a bill that would require service providers to make detailed disclosures about the fees they charge retirement plans. U.S. Rep. Richard Neal, D-Mass., introduced similar legislation in October, and a third bill was expected out later in the month from Democratic Senators Herb Kohl of Wisconsin and Tom Harkin of Iowa.

In part because of its sweeping provisions and its first-mover status, as well as because Miller chairs the House Education and Labor Committee, which oversees pension and retirement security issues, Miller's legislation has attracted the most attention thus far. In addition to requiring greater fee disclosure, it would require that all plans include a low-cost index fund in their investment lineup.

Meanwhile, the U.S. Department of Labor (DOL) earlier this year began soliciting input from the retirement industry and other interested parties on fee and expense disclosures. It said it wanted to determine the extent to which rules should be adopted or modified to ensure that plan participants get the information they need to make informed investment decisions.

Nell Hennessy, president and CEO of Fiduciary Counselors, a registered investment advisor and independent fiduciary, doesn't give the Miller bill

continued on page 8

Regulators Seeking Greater Fee Disclosure

continued from page 7

high marks. "It's a very detailed piece of legislation," she said in an address to the Stable Value Investment Association's 2007 National Forum in October. "It requires a lot of disclosure about historical rates of return, fees and where those fees are going, and all this has to be disclosed by service providers to the plan and then by the plan to participants. If this were subject to review under the Paperwork Reduction Act, it would flunk."

Service providers argue that much of the information requested by the Miller bill would be difficult to calculate on a per-participant basis and would be confusing to many participants, perhaps discouraging some from joining plans. They concede that some plans could do a better job of telling participants what their investment expenses are but argue that detailing how those expenses are divvied up among various service providers makes no more sense than telling the person who buys a sweater how its cost was split among the clerk who rang up the sale, the fashion buyer who decided to receive the item, or the manufacturer who produced it.

The Department of Labor is still working through the responses it received from its formal Request for Information. Hennessy said the retirement plan industry is hoping that Congress will cool its heels and allow the DOL to take the first swipe at revamping disclosure laws on its own. "Everybody's mantra is let the DOL do something," Hennessy said. "They think the Department of Labor is more likely to listen to them and less likely to load on the kitchen sink. Because when you load on the kitchen sink, nobody gets meaningful information. You get more confusion."

If the DOL does act first, Hennessy said, she expects it to beef up disclosure requirements for the annual Form 5500 report that retirement savings plans must file with regulators. Plans will have to provide information on both direct and indirect payments going to service providers, she predicted. "The real question is when," she said. "Reading the tea leaves, I think it will probably be put off for at least another year." Hennessy also expects the DOL to issue guidance on what it considers reasonable compensation for service providers. Back in June 2005, it announced that it would be considering that issue in conjunction with the Securities & Exchange Commission (SEC). More recently—in April 2007—the SEC said it would cooperate with the DOL in reevaluating rules that allow mutual funds to charge so-called 12b-1 fees to financial advisors who sell their products. "There is a movement within the SEC, certainly among the staff, to eliminate 12b-1 fees altogether," Hennessy said.

Regulators and legislators aren't the only parties looking into the fees and costs incurred by retirement plan participants. The plaintiffs' bar has filed more than a dozen class action lawsuits against plan sponsors and service providers questioning whether they have exercised adequate due diligence on behalf of plan participants in choosing investment options, whether service provider compensation has been reasonable, and whether participants were adequately informed of the costs associated with their plans.

The courts have handed down only a few decisions in those cases, Hennessy said, but they have generally been favorable to plan sponsors and service providers. In a suit filed against Exelon Corp., for example, a federal judge in Chicago dismissed a claim of damages for investment losses. In a case against Deere & Co., a federal court in Wisconsin dismissed the complaint with prejudice. The court ruled that fees charged for mutual funds in a Deere retirement plan had been fully disclosed and that the mutual fund advisor was not required to disclose how amounts received from mutual funds were allocated to its affiliates.

Still, Hennessy said the lawsuits seem to have had some impact on industry behavior. "I'm seeing bundled recordkeepers come in and volunteer their fees unasked," she observed, "and that is probably good for plans." SVIA

DOL's Campbell Defends Logic Behind QDIA Regulations

By Randy Myers

Hopes that federal regulators might reverse position and designate stable value funds a Qualified Default Investment Alternative (QDIA) for 401(k) plans appeared to fade at the Stable Value Investment Association's 2007 National Forum on October 10, when Assistant Secretary of Labor Bradford Campbell defended a list of criteria that seemed to rule out stable value funds. In line with his comments, the Department of Labor (DOL) issued final regulations a week later that did not include stable value funds among the list of approved QDIAs.

On a more positive note, the final regulations, which become effective on December 24, 2006, did include a provision that 401(k) plans could still use stable value funds as default investment options if they wish, albeit without the fiduciary safe harbor that goes with using a QDIA. The DOL also included in its final rules grandfathered protections for assets that had been defaulted into stable value funds prior to the new regulations becoming effective before 2008. The DOL also emphasized that the final regulation does not absolve fiduciaries of the duty to prudently select and monitor QDIAs.

The Pension Protection Act of 2006 gave the DOL responsibility for developing a list of QDIAs, which are investments that plan sponsors will be able to use, without fear of fiduciary liability, for the accounts of retirement plan participants who don't choose their own investment options. In late 2006, the DOL proposed that three types of investments would qualify: target-retirement-date or "lifecycle" funds, balanced funds, and managed accounts. The final list handed down varied only by adding that plans could use "capital preservation" products, such

continued on page 9

DOL's Campbell Defends Logic Behind QDIA Regulations

continued from page 8

as money market funds, for the first 120 days of a worker's participation in their plan through default enrollment.

Stable value funds have, of course, long been one of the most popular default investment options for 401(k)s and similar defined contribution plans.

Speaking at the SVIA Forum, Campbell acknowledged that stable value funds represent about 20 percent of the $2 trillion in retirement plan assets overseen at a regulatory level by the DOL's Employee Benefits Security Administration (EBSA), which he heads. Nonetheless, he said the overriding factor in the EBSA's decision-making process was the idea that retirement savings plans are long-term rather than short-term savings vehicles, and that the agency wanted to choose investment options that would best meet the needs of the greatest number of people. Accordingly, he said, the agency looked for investment alternatives that would be appropriate regardless of the investor's age, allow for the reallocation of assets based on the investor's changing circumstances, and be available at a reasonable cost.

The SVIA had argued that stable value funds are well suited to serve as a default investment option based on their track record of consistent performance above inflation levels, preservation of capital, low volatility, and low cost. It also had warned that excluding stable value funds from the safe harbor afforded other QDIAs could unduly discourage plans from offering stable value investment options. And it sponsored research indicating that stable value funds can play a key role in building efficient, risk-optimized investment portfolios for retirement plan participants. (See "Wharton Professor Concludes Stable Value Is the Fixed Income Solution for 401(k) Plans" elsewhere in this issue of *Stable Times.*)

Responding to a question from a Forum participant, Campbell said the EBSA did take into consideration the possibility that someone investing in a diversified portfolio heavy with equities could see their retirement nest egg irreparably harmed if the stock market tumbled badly about the time they retired—a risk that a stable value portfolio would not present. "One of the concerns we had was: yes, there would be people who fall into time periods where that would result in losses," Campbell said. "So we tried to quantify that, and balance it against those who didn't fall into such a time period. And we recognized that regardless of how this comes out, there are going to be people who lose, but the bulk of the people are going to win, meaning they will be better off, in terms of retirement security, over time."

Campbell noted that developing the QDIA regulations was just one of several regulatory initiatives it was required to undertake in the past year under the Pension Protection Act. On October 24, two weeks after Campbell spoke at the SVIA Forum, the DOL issued final rules for automatically enrolling workers in 401(k) and other defined contribution plans. Meanwhile, the EBSA is in the process of developing regulations for dispensing investment advice to participants in retirement savings plans, completing the annual Form 5500 report that plan sponsors must file with the Department of Labor, and selecting annuity providers for retirement savings plans such as 401(k)s. The latter regulation, Campbell said, "should be helpful in making annuities more common in employee benefit plans."

The EBSA also is seeking comments on proposed new regulations that will likely increase the amount of detail service providers must give to plan fiduciaries about the fees those providers charge for their services. Although Congress is contemplating legislation that would govern such disclosures, Campbell said it is the view of the DOL that such legislation is not required. (See "Regulators Seeking Greater Fee Disclosure for 401(k) Plans" elsewhere in this issue of *Stable Times*.) SVIA

Simplifying the Roth 401(k) Decision

By Randy Myers

The debut of the Roth 401(k) account last year added a new layer of complexity to the retirement plan marketplace. Plan sponsors were left wondering whether adding Roth accounts to their traditional 401(k) plans would increase administrative costs or the cost of matching their participants' contributions to their plan. Plan participants puzzled over whether the tax advantages of the Roth outweighed those of the traditional 401(k) account. John Ameriks, a principal in the Investment Counseling & Research division of plan provider Vanguard, says the differences between Roth and traditional 401(k) accounts aren't as dramatic as they might seem. Plan sponsors should offer them, he says, and many plan participants should use them.

With a traditional 401(k) account, participants make contributions with pre-tax dollars; that is, they don't have to pay federal income taxes on any income they funnel into their account in the year they make the contribution. However, all their withdrawals of both contributions and earnings are taxed as ordinary income. By contrast, participants fund a Roth 401(k) with after-tax dollars. That robs them of a tax deduction in the year they make a contribution. In exchange, they get to make withdrawals tax free.

Most plan participants have tried to decide which type of account is more attractive by trying to guess whether they will be in a higher or lower tax bracket when they begin to make withdrawals in retirement. If they expect to be in a higher tax bracket, the Roth account looks more attractive. If they expect to be in a lower tax bracket, the traditional account holds more appeal.

Unfortunately, it is almost impossible for most people to know whether they will be in a higher or lower tax bracket in retirement. Even if they could make a good estimate of their future income levels, they would have no way of predicting whether Congress will raise or lower income tax rates between now and then. Accordingly, Ameriks

continued on page 10

Simplifying the Roth 401(k) Decision

continued from page 9

said at the Stable Value Investment Association's 2007 National Forum in October, most plan participants would do well to fund both types of accounts. That would give them the flexibility to decide which to draw down first in the early years of retirement, depending upon which yielded the most favorable tax consequences. That strategy makes all the more sense, Ameriks said, given that the cost of funding a Roth and a traditional account is identical if one assumes that income tax rates do not change. In such an environment, he says, the upfront tax break associated with a traditional 401(k) account exactly equals the back-end tax break associated with a Roth account.

There are some cases, Ameriks conceded, in which investors might want to bet on using only one type of 401(k) account. Those who have saved a lot of money for retirement and therefore do not expect their income to decline in retirement might prefer a Roth account; the odds of their tax bracket staying the same or going up are great. Similarly, workers in a very low tax bracket today might prefer a Roth account; the odds of their tax bracket going much lower in retirement also are low, but a change in tax policy could push them into a higher tax bracket.

Conversely, investors with little savings, those with temporarily high income levels, or those in low-income families eligible for various tax credits, such as earned income and additional child credits, may prefer a traditional account. In the latter case, diverting retirement plan contributions from a traditional to a Roth account could boost their taxable income today, possibly making them ineligible for those tax credits.

From the plan sponsor's perspective, Ameriks said, matching participant contributions to a 401(k) plan carries the exact same cost whether those contributions are funding a traditional or Roth account. That's because employer contributions are always made on a pre-tax basis. "We recommend that sponsors match contributions to both types of accounts," he said.

Ameriks said that by the end of 2006, approximately 14 percent of Vanguard's recordkeeping clients were offering Roth 401(k) accounts, a figure he expects to increase to about 33 percent by the end of 2007. Small plans, he said, were proving about twice as likely to adopt them as large plans.

Where the Roth accounts are available, he said, about 5 percent of plan participants are using them, with a slight majority putting all of their contributions into the Roth accounts. Many others are splitting their contributions evenly between a Roth and a traditional account. About 8 percent of those who were contributing to a Roth account at the end of 2006, he added, had switched back to a traditional account as of August 2007. SVIA

Grim Story: Rudman Says Medicare, Social Security in Dire Need of Reform

By Randy Myers

Former New Hampshire Sen. Warren Rudman could only describe the funding crises confronting the nation's Social Security and Medicare programs as grim at the Stable Value Investment Association's 2007 National Forum in October. Rudman said data compiled by the Concord Coalition, a nonpartisan organization that he co-chairs, indicates that both Social Security and Medicare are on a fiscally unsustainable track. And, he said, Congress needs to make hard choices if it is going to have any chance of rescuing them.

To put the problems into perspective, Rudman said data compiled by the Concord Coalition indicates that Social Security, Medicare, and other federal entitlement programs account for about 53 percent of the federal budget this year. Interest on the federal debt soaks up 9 percent and defense spending another 20 percent, leaving only 18 percent for discretionary spending—everything from highway construction to space exploration. By 2025, the Concord Coalition projects, Social Security, Medicare, Medicaid, and interest expense will consume all federal government revenues.

While Social Security gets far more media attention, Rudman said, Medicare is the greater problem. This year, it will cost taxpayers $371 billion, or 14 percent of the federal budget. By 2017, he said, it is projected to cost $730 billion and generate an annual cash deficit of $67 billion.

By the middle of this century, Rudman said, Social Security, Medicare, and Medicaid together could consume all federal revenue, leaving none for servicing the federal debt or running any other government operations. The public debt could equal 300 percent of the country's gross domestic product. "These are grim facts," he said. "And yet any effort for substantial reform comes a cropper. And why is that? Because whoever came up with the phrase that Social Security is the third rail of American politics was not exaggerating. I happen to think that one of the few good things President Bush has done is attempt to reform Social Security and give some privatization options to the American people. Yet Democrats and some Republicans ran from that like it was the plague, and it had no chance of getting through Congress. Essentially, it was dead upon arrival."

The way for the government to solve the Social Security funding crisis, Rudman said, is by issuing long-term bonds that would be repaid from tax revenue over a 30-year or 40-year period, with the proceeds being put into the Social Security system. Congress has debated such a plan in the past, he said, but never passed it. What will prompt Congress to take action, he said, is Medicare. "In about three or four years, the drain on the budget from Medicare is going to make it impossible for us to continue our current practice of taking money

continued on page 11

Accounting Skeptic: Alex Pollock Questions New Fair-Value Accounting Rules

By Randy Myers

Beginning on November 15, 2007, most U.S. companies will be required to report the value of their assets under a new accounting definition of "fair value" aimed at making accounting statements more consistent and transparent. Alex Pollock, a research fellow with the American Enterprise Institute, a conservative think tank, doubts that either objective will be achieved. In fact, he warns, the new accounting rules could have just the opposite effect.

"Financial reporting attempts to measure inherently abstract and debatable concepts such as income and net assets," Pollock told participants at the Stable Value Investment Association's 2007 National Forum in October. "It has features that make it to some extent inevitably subjective and even arbitrary. If you took four accounting firms and locked them in separate rooms with the same companies, they would provide four different sets of financial statements. It seems to me that fair-value accounting will exacerbate this and lead to even more second guessing of accounting results."

The Financial Accounting Standards Board approved the new fair-value accounting standard, FAS 157, in 2006. It requires that companies measure fair value based on the exit price of an asset and the price at which a hypothetical third party or market participant might value it. Companies complain that this will force them to value an asset based on multiple possible uses for it, even if it never sells the asset and an actual exit price is never realized.

Part of the problem, Pollock said, is that accounting theorists who pushed for the new rules seemed to think of all companies as mutual funds, which hold marketable securities, rather than as operating entities for which real value rests in hard-to-quantify assets such as institutional knowledge, proprietary products, customer relationships, and managerial expertise.

Calculating fair value under the new accounting rules could be particularly difficult in the midst of a financial panic, Pollock warned. "The very essence of a panic is that prices seem to lose any meaning. Does that mean everybody should mark their financial statements to fire sale prices? If not, does fair value mean some intrinsic long-term value? This is a highly theoretical exercise, and in my view there is no simple way to think about fair value in a panic."

The growing complexity of the nation's accounting rules, Pollock argued, has led to the production of financial statements that, as a former FASB member and former chief accountant for the Securities & Exchange Commission complained as far back as 2002, "nobody understands." Accordingly, Pollock said, politicians and regulators should worry less about "restoring" investor confidence in accounting and more about promoting investor skepticism.

Rather than try to force a single accounting perspective on all companies, Pollock said regulators should encourage multiple perspectives and multiple approaches. "The more we have, in my view, the better financial disclosure will be," he said. "Companies could explain how they actually conceptualize the business enterprise and its risks, manage them, and produce as many additional financial statements reflecting non-GAAP perspectives as seem reasonable in order to approximate the underlying economic truth as they believe it to be. I think that is the best we can do. And any dogmatic insistence on single theories should be ruled out."

Rudman on Medicare and Social Security

continued from page 10

out of the current Social Security surplus to fund the rest of government," he said, "and that is when we'll start looking for ways to fix it."

Rudman guessed that Washington will begin to try to fix Medicare in 2010 at the earliest, through both an increase in Medicare taxes and a reduction in certain benefits. A good starting point, he said, would be to raise the thresholds at which wage earners stop paying Social Security and Medicare taxes on their income. The current thresholds, he said, have created a regressive tax structure that penalizes the middle class for the benefit of the wealthy.

Before real change can happen, though, Rudman said the public needs to demand it. "The time for change is now," he insisted, "but it will only happen if the American people say they want it."

Searching for a Standard: Valuing Wrap Contracts

By Randy Myers

Nearly a year after the debut of new stable value accounting standards, stable value funds continue to employ a wide variety of methodologies for calculating the fair value of their wrap contracts. While there is no regulatory requirement to adopt a standard approach, the industry has been trying to do so in the interest of creating a more consistent and manageable reporting environment.

The mandate to assign a fair value to wrap contracts was included in the formal guidance issued by the Financial Accounting Standards Board in December 2005; FSP AAG INV-a, Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide. It said that stable value funds could continue to rely on contract-value accounting as long as they met specified benefit-responsive requirements.

Stephen LeLaurin, senior account manager with INVESCO Institutional Management, told participants at the SVIA's 2007 National Forum in October that the stable value manager's approach often was dependent upon the preferences of their auditors. Laura Powers, managing director of BlackRock Investment Management, added that even different fund managers using the same national auditing firm were sometimes steered toward different valuation strategies, as the various regional offices of those auditing firms had not always settled on a standard valuation methodology themselves.

BlackRock manages pooled stable value funds, or collective trusts, on behalf of approximately 3,000 retirement savings plans. Reporting to all those plans, Powers said, meant that as many as 1,500 audit firms or audit firm offices could have been looking at BlackRock's financial statements in 2007. While some accepted the investment company's reports as provided, she said, others looked for more detail. "We spent endless hours working with the audit community answering questions about our processes and methodology," she said. "That took time, costing us more money and costing our clients more money in the form of higher audit fees."

From an insurer's perspective, Ken Quann, managing director at New York Life Investment Management, said the new accounting rules have proved fairly straightforward when valuing traditional GICs, synthetic wraps, and participating separate accounts. Where the accounting gets more complex, he said, is with the evergreen general account structures. "With a general account structure, the contract is the asset; there really aren't any assets that can be identified as being allocated to specific contracts. This complicates the process of determining fair value."

Quann and Powers noted that an SVIA task force is continuing to work both with the American Institute of Certified Public Accountants and major auditing firms to move toward an industry standard. SVIA

Editor's Corner

By Andrew Cohen, New York Life Investment Management LLC

The SVIA's Annual National Forum, appropriately themed "Planning for Change: How Today's Trends and Events Are Shaping Financial Security in Retirement," was recently held in Washington D.C.'s Fairmont Hotel. In this issue of *Stable Times,* Randy Myers provides a synopsis of the most significant presentations.

Why the theme of change? The answer rings through "loud and clear" as we delve into the content of the presentations.

Deutsche Asset Management's chief economist, Joshua Feinman, explained how changes in population demographics worldwide will affect the balance of power. John Ameriks of Vanguard described how the introduction of the Roth 401(k) has changed the construct of today's defined contribution plan. Former Senator Warren Rudman spoke passionately about changes that need to happen; he feels Medicare and Social Security will be in deep financial hardship unless lawmakers address their funding deficiencies.

Change in accounting standards was the topic of two presentations. Alex Pollard, a research fellow with the American Enterprise Institute, tackled the subject of fair-value accounting. Stephen LeLaurin (INVESCO), Laura Powers (BlackRock), and Ken Quann (New York Life Investment Management) addressed the implementation issues associated with the FASB's December 29, 2005 standard, which addressed stable value's book-value accounting.

Assistant Secretary of Labor's Bradford Campbell spoke about some of the work the Department has done to address the issues currently permeating the retirement landscape. Subsequently, the pending change that has captivated the world of stable value for over a year, Qualified Default Investment Alternative (QDIA) legislation, was released. Randy does a nice summary of the final regulation in this issue.

David Babbel, a professor of finance and risk at the University of Pennsylvania's Wharton School, presented the results of his study which may change some minds about stable value. It shows the power of stable value both as a stand-alone option and as part of an overall asset allocation strategy. He extended his talk to address the importance of stable value to participants in the de-accumulation phase, an ever-growing segment of the market.

Paul Lipson, chief investment officer of the Federal Reserve Employee Benefits System, is someone who doesn't need to be convinced of the virtues of stable value. He spoke with conviction about his decision to include stable value in the Federal Reserve's newly introduced lifestyle portfolios in a big way.

These changes have produced a challenging, yet exciting, time for the SVIA. The final QDIA legislation presents challenges; the results of the Babbel study present opportunities. It is up to us, as an industry, to be innovative and collaborative in order to meet the challenges and seize the opportunities. It is truly important, as stable value provides a very real benefit to the monumental task we are all facing — providing enough income for retirement. SVIA