SVIA STABLE TIMES

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Stable Value and the Search for the Perfect Retirement-Income Product

By Andy Apostol and Jeff Norris, Dwight Asset Management

You know an idea has come of age when it gets its own trade industry association and its own conference. And so it is with retirement income. Never mind that in academia, chairs have been endowed and the research on the topic has been underway for a number of years. The leap to the mainstream has been made, and the issues surrounding retirement planning are now front and center.

So with the dismantling of the private pension system well underway, there is increased urgency around the question: What is the best way for baby boomers to convert defined contribution plan assets into a safe, steady, and predictable stream of income? The Search for the Perfect Retirement Income Product has begun, with investment managers, insurance companies, financial advisors, and others all prepared to tell John and Jane Boomer what to do with their 401(k) money.

If we were to design the Perfect Product, what would it look like? What attributes would be

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Stable Value Considerations within Retirement-Income Products

By Philip E. Connor, MassMutual Life Insurance Company

Over the last several years, product enhancements in the retirement-services industry have increasingly made it easier for 401(k) plan participants to diversify their investments according to their investment horizon and investor profile. It is typical that as participants near retirement age, they are encouraged to re-allocate their retirement savings in their 401(k) plan (their "nest egg") in a more conservative fashion. Going back ten or more years, the likely option for many plan participants was increased use of a stable value or other fixed income option offered within their plans.

Asset allocation strategies and education, of course, are an ongoing, vibrant part of the participant-communication landscape, and over the years, both lifestyle and lifestage (target-date) investment options have been introduced to make the management of the nest egg easier for participants through one-stop-shopping asset allocation solutions. Consistent with the trend of making decisions easier for participants, the retirement-services industry is currently paying increased attention to providing products that provide income streams to retired participants as a way to ensure the nest egg is sufficient through the retirement years. While participant education around asset allocation, as well as the asset allocation products that have been introduced over the

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A Closer Look at Stable Value Funds' Performance: A Quick Summary

Academic study sheds new light on the importance of stable value to defined contribution plan portfolios

By Dylan Tyson, CFA, Prudential Retirement. Written in collaboration with Andrew Cohen, Doris Fritz, Brian Murphy, and Victoria Paradis of the Stable Value Investment Association's Media Team.

Stable value has been a mainstay investment in qualified retirement plans since even before the introduction of 401(k) plans. Stable value continues to be a popular fixed income option within many defined contribution (DC) plans, even as regulators focus on the benefits of equity-focused asset allocation strategies such as target-date funds.

But what is the role of an investment that pairs the power of principal preservation with the return of intermediate-term bonds in a world focused on building a nest egg for retirement? Has stable value become somehow less important as the retirement industry adapts to the DC plan's newfound role as the primary pension plan for millions of Americans?

Today stable value accounts for $413 billion in retirement plan assets. Despite stable value's importance to investors, it remains an understudied asset class within the DC arena. Intuitively, many in the financial services industry have long been

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Stable Value Considerations within Retirement-Income Products

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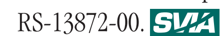
years, have reduced dependence of participants on stable value investments, the utilization of stable value within 401(k) plans raises important considerations for the new generation of retirement-income products.

The first is that stable value investments continue to account for a healthy portion of participant balances within 401(k) plans. A stable value option offers insulation from market volatility that can be an important factor for a conservative investor, as well as a reason for utilizing it as part of a broad asset allocation strategy. The low absolute levels of volatility offered by stable value, in combination with intermediate term fixed income returns, are attributes that have historically made these options attractive to many 401(k) participants in saving for retirement. It is logical to presume that many participants will also look to have similar attributes in new products that are designed to provide them with managed income at the time they are ready to begin taking payouts of the assets they have accumulated.

This will be an issue that the new managed-income products coming into the retirement-services industry will likely need to address. Granted, the trade-off to avoiding risk of market volatility by investing in stable value products exclusively, or in a high proportion, is the risk to retirement investors of not generating enough return to provide sufficient income during the retirement years. This is the dilemma that income products are attempting to address—i.e., how to balance the objectives of retirees to have both asset stability but also the ability to generate sufficient income to meet their needs. In constructing products to meet these competing objectives, the considerations are similar to those involved with construction of target-date or other asset allocation investment options. Thus, products focused on providing income over shorter periods of time, or those that are geared to target higher minimum amounts of income, are likely to be constructed on a more conservative basis and have greater amounts of fixed income assets over equities. Participants attracted to the shorter-term and higher-income products will therefore likely have lower expectations for future growth of their asset base, preferring a less volatile asset base and more certainty of the current income that can be generated.

The second consideration around developing retirement income products is evaluating if participants will be more sensitive to market volatility at the time payouts begin relative to their existing asset allocation profile. Once a participant is ready to begin accessing his nest egg and realize the level of annual income that can be generated from the balance he's accumulated, he may become more sensitized to how market fluctuations can alter payout or drawdown levels. A participant may develop minimum expectations of the annual payout amount to be supported and may have low tolerance if market volatility prevents this minimum from being realized. Such heightened sensitivity has already manifested itself in the variable annuity market, where recent industry innovations have centered around guaranteed lifetime income features.

Similar types of minimum-income products may increasingly find appeal among 401(k) participants, if comparable products are able to be adapted to this market. If this heightened sensitivity to minimum-income levels does manifest itself among 401(k) participants, stable value products are likely able to play a role – either on an individual basis or as part of an asset allocation strategy - given their low absolute volatility and stable return characteristics. It is already evident that stable value provides a mechanism for participants to minimize fears over equity market volatility, and it could very well contribute to the minimization of participant fears over volatility in payouts that are able to be supported by a participant's asset base during the drawdown phase. Thus, a retirement-income product constructed at least partially with an underlying stable value component may be an important consideration for the new generation of retirement income products coming into the industry.

Content represents the views of the author only and not of author's employer, MassMutual Life Insurance Company RS-13872-00. 

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A Closer Look at Stable Value Funds' Performance

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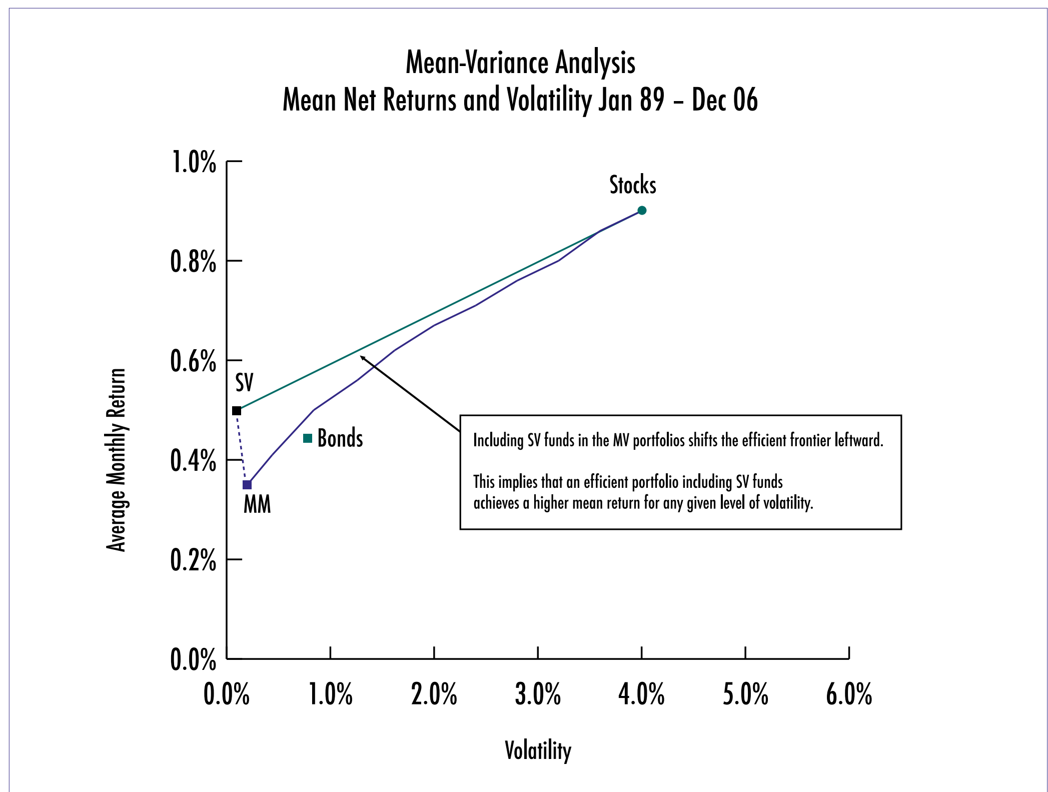

aware of the important role stable value can play in portfolio asset allocation. But until now, rigorous study of the appropriate role of this asset class has been light.

To address this academic knowledge gap, the Stable Value Investment Association sponsored an independent research study conducted by Professors David Babbel, PhD, and Miguel Herce, PhD. Dr. Babbel is a Professor of Insurance and Finance at the Wharton School at the University of Pennsylvania and a Vice President and Senior Advisor at Charles River Associates International (CRAI). Prior to joining CRAI, Dr. Herce served as a Professor of Econometrics at the University of North Carolina at Chapel Hill.

The study examines the risks and net returns of various assets. Stable value net returns were developed from data supplied by 12 stable value managers who manage commingled funds, separate accounts, and full-service funds representing $189 billion in assets. The study looked at stable value funds over the period of time beginning in January 1989 and ending in December 2006. The result of this work is the academic research paper "A Closer Look at Stable Value Funds' Performance"—the first rigorous analysis of stable value from an investor's point of view. The conclusions of this analysis are compelling—by enabling greater returns for a given level of risk, stable value greatly enhances the likelihood of DC plan participants meeting their retirement goals.

"The point isn't that investors should shun equities entirely 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," says Professor David Babbel.

Overview of the Analysis

Since the inception of the contemporary stable value fund almost 35 years ago, stable value funds have provided attractive fixed income returns with very low volatility. As a result, DC plan participants have come to rely upon stable value to protect assets from the risk of loss, diversify their portfolios, and blunt the risk of higher volatility investments like stock funds. But are these appropriate uses of stable value?

A Closer Look at Stable Value Funds' Performance closely evaluates stable value from an investor's point of view. It carefully compares stable value performance to other common investment alternatives such as U.S. large and small stocks, long-term government and corporate bonds, intermediate bonds, and money market investments.

Before the release of this study, plan providers debated the relative merits of offering stable value versus other fixed income options such as money market funds or intermediate bonds. Now, through state-of-the-art statistical techniques such as mean-variance analysis, stochastic dominance analysis, and multi-period utility analysis, the answer is clear. Offering stable value as the core fixed income option in a DC lineup provides a significant benefit to plan participants. By delivering investment performance characteristic of intermediate bonds with money market–like stability, stable value provides superior return per unit of risk. As illustrated in the diagram above, stable value shifts the efficient frontier leftward, outperforms money market funds over time and in nearly all market conditions, and provides a better risk-adjusted return than intermediate bonds over time and in nearly all market conditions.

As a result, stable value plays an important role in a portfolio context. It allows plan participants to increase the return on their portfolios for any given level of risk, or decrease the risk of their portfolio for any level of

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Four Economic Questions

Mickey D. Levy, Chief Economist, and Peter K. Kretzmer, Senior Economist, both with Bank of America, share their answers to four key questions at year-end.

The following is excerpted from "Critical Current Issues Facing the U.S. Economy in 2008," by Mickey D. Levy and Peter K. Kretzmer, published by Bank of America, January 2, 2008, and "Fed 'finishes' what it started with funds rate cut to 3 percent," by Peter K. Kretzmer, published by Bank of America, January 30, 2008.

1. What were the surprises in 2007?

While our year-ago macroeconomic forecasts for 2007 proved close to the mark—real GDP grew an estimated 2.6 percent Q4/Q4, with softer domestic demand offset by a healthy boost from the net-export sector, and core inflation declined in the second half of the year—the magnitude of the continued declines in housing activity and prices were larger than expected, and the jarring repricing of subprime mortgage debt, which triggered the unanticipated seizing up in the short-term funding markets and financial crisis, were the most glaring and unpleasant surprises of the year.

The major lesson of 2007 stems from trends in housing and mortgage finance: Beyond the valuable adage that "unsustainable trends will not continue," it is critically important to acknowledge that such trends would not have been carried to such extremes without the numerous government policies that subsidize and encourage homeownership and without the misguided incentives in the financial industry that fueled over-reliance on subprime mortgages and the distribution of their risks in the form of structured-credit products. All aspects of government economic and regulatory policies that influence housing and housing finance, as well as private-sector risk management, must be addressed. In the meantime, the reverberations resulting from the financial turmoil will provide yet another test of the resilience of the U.S. economic and financial systems and another challenge to the Federal Reserve, which must reconcile short-term crisis management with its long-run objective of maintaining low inflation as the best foundation for sustained healthy economic expansion.

2. Traditionally, our economic forecast is based on an assessment of long-term fundamentals and cyclical fluctuations around trendline, driven largely by monetary policy. Key variables, like profits and credit quality, tend to be directly linked to economic performance. What is atypical of the current situation?

Current conditions reflect some normal cyclical characteristics, but in many ways they are very atypical. Most glaringly, large credit losses and the sustained financial market turbulence have occurred amid healthy economic expansion and low unemployment; typically, credit deteriorates following an economic downturn and increase in unemployment. This credit deterioration, of course, stems from the collapse of the subprime mortgage market and structured-credit products based on it and the uncertainty about the true value of impaired assets. This atypical pattern raises the question of what may happen to overall credit quality if economic performance slumps and the unemployment rate rises materially.

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A Closer Look at Stable Value Funds' Performance

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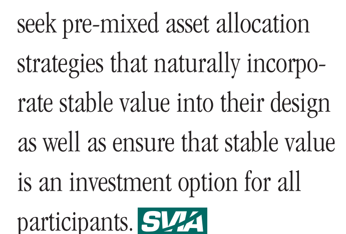
return. This finding has important implications for asset allocation strategies such as target date and target risk. The central reason for using a target-date or a target-risk fund is to effectively tailor participants' asset allocation to an appropriate measure of risk tolerance. The wisdom of such an approach is beyond question. Since stable value favorably shifts the efficient frontier, it naturally follows that it should serve as an important part of all targe-date and target-risk strategies that include a fixed income component.

Conclusion

As the study shows, stable value can greatly enhance the likelihood of DC plan participants meeting their retirement goals. Even as DC plan designs change to meet the needs of a shifting retirement landscape, one thing seems clear—stable value has an important role to play. Plan sponsors should consider investment line-ups that employ stable value as the core fixed income fund and seek pre-mixed asset allocation strategies that naturally incorporate stable value into their design as well as ensure that stable value is an investment option for all participants.



The study is available at www.stablevalue.org.

Using Stable Value in Retirement: The Power of Staying in a Qualified Plan

Stable value also serves as a powerful investment option in an individual's retirement years, providing steady, predictable income while insulating a portfolio from the shock of a market correction that could dramatically reduce a retiree's nest egg.

As such, stable value has an important role to play in meeting a retiree's need for steady income during retirement.

Participants that elect to roll out of their DC plan lose two important advantages: access to stable value funds and institutional pricing. The high fees often associated with retail investing are detrimental to participants who rollover their DC plan balances to IRAs. The availability and performance of stable value provides another compelling reason for participants to keep their money in a DC plan.

Editor's Corner
Stability in Uncertain Times

By Rick Garton, Pacific Life Insurance Company

The market volatility we have experienced since last August has affected many 401(k) plan-participant account values, increased the "uncertainty" factor, and continues to contribute to weaker market tone. We find ourselves in a world percolating with increased instability and associated uncertainty at the moment:

- Subprime exposure and the housing crisis,
- Credit and liquidity issues,
- Wall Street banking losses,
- Gasoline over $3 per gallon,
- Oil at $100 per barrel (Do I hear $120 per barrel?),
- The falling dollar,
- Worries about monoline downgrades,
- CDO and SIV exposure,
- An economy teetering on recession,
- Inflation fears (higher oil and higher CPI) and effect on future Fed action,
- Stagflation concerns,
- Flu pandemics,
- Geopolitical risks (terrorism; Iran, North Korea, and Pakistan; Venezuela and Nigeria threatening oil supplies…the list goes on.).

Having said this, stable value funds continue to perform as expected whether we are experiencing stable or volatile market conditions. Preservation of capital, a stable rate of return, and liquidity continue to anchor 401(k) plan-participant portfolios regardless of participant age, regardless of how close they are to retirement, and regardless of market conditions. During this recent period of market volatility, stable value has been the diamond in the rough and appreciated by millions of plan participants who have had the opportunity to invest a portion of their portfolio in their 401(k) plan's stable value fund.

This issue of *Stable Times* covers the following array of topics:

- The economy (economic outlook, risks, volatility, and uncertainties),
- The virtues of stable value investing based on independent, third-party research,
- Utilizing stable value technology to provide income during retirement,
- An update on accounting: FSP AAG INV-1 and SOP 94-4-1, and
- DOL-proposed service provider disclosure requirements under ERISA.

Stable Times provides a valuable service to the defined contribution–plan market place and keeps plan sponsors and their participants, stable value managers, and defined contribution service providers informed not only about stable value investing and the uses of stable value to provide income during retirement but also corollary employee benefit regulatory and legal issues that affect the defined contribution plan market. Hopefully, you will find that true with this issue as we continue to navigate through these stormy and turbulent markets.

Four Economic Questions

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As 2008 unfolds, many are forecasting recession, but in key respects, current conditions do not resemble typical expansion peaks. Most recessions are initiated when excessive monetary restrictiveness generates a slump in aggregate demand. Businesses continue to increase production, employment, and investment, not knowing whether the slowdown in demand is temporary or permanent. As a result, expansion peaks tend to be characterized by overhangs in inventories, too many employees, and excess capital stock relative to output. Accordingly, most of the decline in real GDP during recessions tends to be inventory liquidation (involving reduced production and employment) and large declines in capital investment. Currently, outside of the housing sector, business inventories are low (auto inventories are being reduced and should subtract from GDP in 2008Q1), employment has been modest, and business investment has been weak, so the capital stock net of depreciation has been declining relative to output. Perhaps most striking, the Fed's monetary policy, which was mildly restrictive in early 2007, has been eased and now is consistent with sustained growth in demand. We believe that the combined 125-basis-point Fed funds rate cut of the last two weeks reflects a clear change in the Committee's view of the degree of risk to the economy, informed in part by feedback from financial markets and in part by weaker economic releases for December. Nevertheless, despite the lack of large imbalances in much of the non-financial sector, and monetary policy, which is moving toward accommodative, the possibility of a "credit crunch" that inhibits the flow of capital to non-financial businesses certainly raises uncertainties—and places economic risks to the downside.

3. What is the economic outlook, and what are the largest risks and uncertainties?

Real GDP grew 0.6 percent in 2007Q4, down from 4.9 percent in the prior three months. GDP is

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expected to expand at a 1.5 percent pace in the first half of 2008 and then pick up in the second half. With a declining trade deficit boosting domestic production, this implies only slight growth in domestic demand in the first half of 2008 and recession-type conditions in some industries. Presently, uncertainties are larger than normal, and the risks facing the economy are to the downside, particularly through mid-2008. We see about a one-in-three risk of mild recession.

Residential investment is projected to decline and subtract from GDP throughout 2008 but at a lesser pace than in 2007 (-8.7 percent versus -17.8 percent, measured Q4/Q4), while a continuing decline in the trade deficit will provide a boost to domestic production. Consumption is projected to grow 1.9 percent annualized in the first half, a marked slowdown from recent years, but pick up to 2.7 percent in the second half. Business fixed investment is expected to grow very modestly, while businesses will keep inventories low.

The longer-term outlook is decidedly more favorable: The drag from declining residential construction eventually will run its course, and the Fed's monetary easing will stimulate growth, beginning in the second half of 2008. Accordingly, real GDP is projected to grow above 3 percent in 2009.

Uncertainties abound: a) how much will housing activity and home prices continue to fall? b) how does the current rocky financial environment affect non-financial business hiring, employment, and capital spending? c) how are the large capital losses and balance sheet constraints on large banks affecting overall bank lending to non-financial businesses? d) will the turmoil lead households to reduce consumption? and e) how will the unfolding slowdown in U.S. growth affect overseas economies?

These uncertainties suggest a wide range of possible economic and financial outcomes. In response to the downside risks, we have lowered our baseline forecast for 2008. However, because the Fed is easing monetary policy, and given the general lack of imbalances in business operations outside of housing, if any recession were to unfold, it likely would be shallow in terms of declines in output, employment, and personal income, and it would be followed by economic rebound.

4. Through what channels would the financial crisis affect the economy?

Financial markets affect economic performance primarily through the availability and costs of capital. Presently, the concern is that the financial crisis is driving up the costs of capital, tightening credit standards, and slowing the flow of credit to businesses and households. Indeed, a sharp deterioration in these factors would be sufficient to generate recession. Our assessment is that the impacts of the financial turmoil are fairly complex, and to date, while they certainly add downside risks to the economic outlook, they do not necessarily involve a severe "credit crunch" that points decidedly to recession. But the situation requires close scrutiny.

The Federal Reserve's Flow of Funds data confirm that total debt in the economy has risen dramatically, both in absolute terms and as a percent of GDP (debt has risen from 192 percent of GDP in 2000 to 233 percent in 2007Q3), but all of that increase has occurred in home mortgages and the heightened liabilities of financial institutions that have increased leverage to finance mortgage-related activities, while outstanding consumer credit card debt and debt in non-financial businesses have not increased materially relative to GDP. The deleveraging process has already started. At issue is whether the unwinding of the debt buildup—and the associated capital losses—occurs primarily in the mortgage-related "problem areas" or spills over materially to the rest of the economy.

The financial turmoil and sizeable capital losses have involved deleveraging of the earlier run-up in mortgage debt, large write-offs, and higher costs of capital for the housing and banking industries, but they have not materially affected the flow of capital to most non-financial businesses and most prime households. Lines of credit and leverage in hedge funds and venture capital funds have been pared, which has been associated with a contraction of short-term commercial paper outstanding. Similarly, write-offs of structured-credit products have been mirrored by a shrinkage of asset-backed commercial paper outstanding. Banks have reduced lines of credit to mortgage brokers, adding to their cutbacks and tighter credit standards they apply to building contractors and elsewhere in the housing sector. Losses incurred by the largest banks, largely in the form of write-offs of structured-credit products, have constrained their balance sheets and lowered their capital. So far, this has forced a significant adjustment in portfolios and a wave of capital raising.

A crucial issue is whether these trends have impaired bank lending to the wide array of non-financial businesses sufficiently to call for recession. So far, the answer is no. The largest banks seem to have "tightened lending standards" by applying more rigorously existing standards rather than cutting off lines of credit to their myriad non-financial business clients. Moreover, the vast majority of banks outside of the nation's largest banks have not been materially involved in the subprime mortgage-related mess, and they are still making loans. Bank commercial and industrial loans have not diminished, although to some extent outstanding C&I loans may capture the absorption onto the balance sheets of the largest banks some of the illiquid, impaired debt securities that are symptomatic of the financial turbulence. A survey conducted by the National Federation of Independent Business suggests that availability of credit is not a major concern.

The real costs of credit have increased, but the rise has not been material for most non-financial businesses. While corporate bond spreads have widened significantly to Treasury yields, a portion of that widening reflects declines in Treasury yields. New corporate bond issuance remains healthy, although costs have increased modestly in after-tax terms.

Similarly, borrowing costs for households have risen, but the

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Proposed Regulations Outline Fee and Conflict Disclosure Requirements for ERISA-Governed Service Providers

By Gina Mitchell, SVIA

The Department of Labor (DOL) has added its voice to the ongoing debate on the immediate and long-term corrosive effect that fees can have on retirement income and savings. The Department proposed regulations on December 13 that require service providers for all Employee Retirement Income Security Act (ERISA)-governed plans to disclose fees and potential conflicts of interest before a contract or agreement is entered, extended, or renewed with the plan fiduciary.

The proposed regulations are important because they provide transparency to what can be an opaque and arcane area. They focus on direct and indirect compensation and potential conflict-of-interest issues. The proposed regulations also closely follow the framework of Congressional legislation that requires more 401(k) fee disclosure and new reporting requirements for the Department's 5500 filings. The proposed regulations will likely become a de facto industry standard for disclosure for all fee information from service providers to ERISA plans and an influence on plan-participant fee disclosure.

Clearly, the proposed regulations are momentous for ERISA-governed service providers. Compliance responsibility falls squarely upon their shoulders. The Department strictly enforces the prohibited transaction rules and imposes penalties for fiduciary self-dealing and conflicts of interest. Plus, plan fiduciaries can always terminate service providers who fail to comply with the proposed regulations.

The General Accountability Office (GAO) estimates that a 1 percentage point increase in fees cuts retirement income by almost 20 percent over a 20-year period.

Service Providers

The proposed regulations apply to all contracts or arrangements between a plan and

- Fiduciary service providers under ERISA and the Investment Advisers Act of 1940;
- Providers of banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage, or third-party administration services; and
- Providers who receive indirect compensation in connection with accounting, actuarial, appraisal and auditing, legal, or valuation services.

Disclosure of Fees and Compensation

The proposed regulations impose a common business practice that, while generally followed, is not mandated in ERISA. The rules require that the terms of the contract must be in writing. This includes services to be performed and all compensation that will be received either directly from the plan or indirectly from parties other than the plan or plan sponsor, including how such compensation will be paid.

Compensation and fees include money or anything else of monetary value, including gifts, awards, finder's fees, commissions, 12b-1 fees, soft dollars, and float income, as well as indirect compensation received from a party other than the plan, the plan sponsor, or service provider. The Department will permit compensation to be disclosed as a specific dollar amount, formula, asset charge, or per capita charge so long as the description permits a plan fiduciary to evaluate the reasonableness of the compensation or fee. Additionally, the disclosure of fees includes fees paid to the service provider and affiliates, which include entities controlled by or under common control with the service provider as well as its officers, directors, agents, and employees.

Some Plan Investments Included

Entities that are not providing covered categories of services to plans as a result of plan investments under the plan assets rules are also covered by the proposed regulations. For example, the Department's plan asset rules extend the proposed regulations to bank collective investment funds and private funds that receive 25 percent or more of their investments from ERISA.

Rules for Bundled Services

For bundled arrangements, the bundled service provider must disclose all of the services and the aggregate compensation or fees received directly or indirectly by the service provider, its affiliate or subcontractor, or any other party. The new Form 5500 filing also has this requirement. However, the bundled service provider must break out fees that are a separate charge directly against the plan's investment reflected in the net value of the investment, such as management fees paid by mutual funds to their investment advisers, float revenue, other asset-based fees, and compensation that is set on a transaction basis such as finders fees, brokerage commissions, and soft dollars.

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Four Economic Questions

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increase in rates has been more selective than widespread. Reflecting bottlenecks in the secondary mortgage markets, mortgage rates have risen, and ARM resets will raise debt service costs materially for a relatively small subset of mortgagors. This dampens home purchases and presumably lowers house prices. However, while lending standards to prime customers for credit cards and other lines of credit may be tighter on the margin, the costs of credit have not risen materially. SVIA

Proposed Regulations Outline

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Conflict-of-Interest Disclosure

Service providers must disclose information about relationships or interest that may raise conflicts of interest for the service provider in performing plan services. They must describe

- Any participation or interest of the service provider in transactions to be entered into by the plan in connection with the contract;
- Any material financial, referral, or other relationship with a money manager, broker, other client of the service provider, other service provider to the plan, or any other entity that does or may create a conflict of interest for the service provider in performing its duties;
- Any direct or indirect compensation that it may receive without prior approval of an independent plan fiduciary in connection with the performance of the service and a description of the nature of the compensation; and
- Any policies or procedures designed to prevent the above compensation or fees, relationships, or conflicts from adversely affecting its services to the plans, such as procedures for offsetting fees received from third parties against amounts it would otherwise charge the plan.

General Compliance Requirements

Service providers are required to give these disclosures in writing and to the best of their knowledge. Additionally, this information must be made available with enough lead time before the contract is entered, renewed, or extended that the plan fiduciary can prudently make an informed decision. The Department does not prescribe a specific format for the required disclosures but does say the disclosures can be in an electronic format and may be in multiple documents from multiple sources.

The proposed regulations also require a service provider to notify a plan fiduciary within 30 days of acquiring knowledge of any material modification to the disclosures previously provided.

Material is defined by the DOL as any change that a reasonable plan fiduciary would view as significantly altering the total mix of information or significantly affecting a reasonable plan fiduciary's decision to hire or retain the service provider. Additionally, a service provider must provide all information necessary for a plan fiduciary to comply with the new 5500 form filing requirements.

Class Exemption for Plan Fiduciary

Because a failure by the service provider to comply with the proposed regulations will result in a prohibited transaction under ERISA affecting both the service provider and the plan fiduciary that entered the contract, the Department has proposed a prohibited transaction class exemption for plan fiduciaries that meet certain conditions. The Department will give relief to a fiduciary if three conditions were met:

- Based on the information available at the time, the plan fiduciary reasonably believed the service provider had complied with the regulations' requirements and did not know or have reason to know that the service provider failed to comply.
- Once aware of the failure, the fiduciary demanded in writing that the service provider comply with the disclosure obligations and then notified the Department if the service provider did not comply within 90 days.
- The plan fiduciary considered terminating the service provider or continued the contract by evaluating the failure and assessed the availability, qualifications, and costs of potential replacements and their responsiveness in furnishing the information that the service provider should have disclosed.

Prohibition against Termination Penalties

The proposed regulations continue to require that service providers permit termination of their contract on reasonably short notice without penalty. However, the Department asks if there are problems with the current regulatory framework and if interpretative guidance is needed.

Effective Date

The proposed regulations are scheduled to take effect 90 days after final regulations are published in the Federal Register.

SVIA Comments

Like many others, the Stable Value Investment Association (SVIA) has submitted comments to the DOL. While SVIA supports disclosure, it has asked for some changes and additional clarification on the proposed regulations. For example, the proposed rules require disclosure of all fees paid for all services performed for an ERISA-governed plan. This requirement may result in voluminous listing of services and their respective fees. SVIA suggests that the Department permit disclosure in major categories that are reflective of the services performed for the plan and that a standard of materiality be incorporated to guide this disclosure. SVIA asks the Department to provide illustrations of the types of conflicts that the Department wants service providers to disclose since ERISA prohibits service providers that have conflicts of interest and views such conflicts as a violation. Additionally, the SVIA requests that the Department extend the effective date to a year for new contracts and agreements, and up to three years for current contracts to minimize costs and permit an orderly update of contractual agreements. To learn more about SVIA's comments, please go to www.stablevalue.org.

SVIA's Third Spring Seminar
Creating Financial Security with Stable Value Funds
An Examination of Stable Value Opportunities in Tax Deferred Savings Plans
April 13-15, 2008
Ponte Vedra Beach, Florida
Please go to www.stablevalue.org for more information.

A Year in the Spotlight:

Implementing FASB's Accounting Standard One Year Later

By Gina Mitchell, SVIA

Last year will clearly be remembered as an important year for stable value funds. We saw the financial markets and 401(k) investments rocked by increased volatility. Stable value funds were a refuge in this storm. They performed as expected by delivering steady, predictable rates of return with principal stability.

It was also the first year that stable value fund financial statements had to use the Financial Accounting Standards Board's (FASB) stable value accounting standard, FSP AAG INV-1 and SOP 94-4-1. As you may recall, the standard was important to stable value because it reaffirmed the use of contract value, the accounting reference for stable value funds used by corporate defined contribution plans.

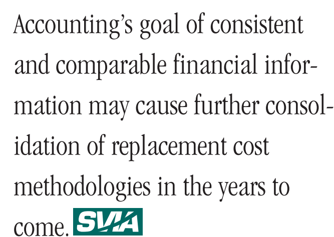
The FSP required a new presentation standard for stable value funds. Under the FSP's presentation, GICs and wraps must be part of the schedule of investments and reconciled to the corresponding line items in the financial statement. For the schedule of investments, the fair value of each investment contract must be shown along with the underlying investment held by the fund, the wrapped portfolio of assets. An adjustment from fair to contract value is required for each fully benefit-responsive contract. Lastly, the credit rating for the issue or wrap provider must be shown.

Since wrap contracts are non-transferrable, determining the fair market value is not as straightforward as with a bond or stock. SVIA surveyed stable value managers to determine what valuation methodologies were used and accepted in audited stable value fund financial statements. Nineteen stable value managers participated in the December 2007 survey. The survey found that three variations of replacement-cost methodology were used. Replacement-cost valuation is the cost of replacing the contract today, then present-valuing this cost over the duration of the contract or the termination notice period of the contract, if longer.

Seventy-nine percent of respondents compared replacement cost to the actual wrap fee at year-end. If they were the same, respondents reported the value of the wrap contract at zero. If there was a difference between the replacement cost and the actual wrap fee at year-end, the value of the wrap is worth the present value of the future cash flows of fee payment difference between the replacement cost and the actual fee.

Sixteen percent of respondents present-valued the future cash flows of fee payments using replacement cost at year-end. The remaining five percent present-valued the future cash flows of fee payments at the beginning of the year using actual wrap fees at the beginning of the year. Then they present-valued future cash flows of fee-payments using replacement cost wrap fees at end of year. The difference between the end-of-the-year present value and beginning-of-the-year present value is the value of the wrap contract. If negative, the difference was reported as a liability.

Stable value managers reported that plan sponsors and auditors had turned to them for advice on wrap-valuation methodologies. The majority (75 percent) also found inconsistent use of wrap-valuation methodology among and within the various audit firms. In fact, one manager commented, "We are investment managers, not accountants. It seems odd to provide advice to accountants."

In fact, only 25 percent of stable value managers reported that the wrap-valuation process went smoothly during the first year of the standard. Clearly, stable value managers and the accounting community are looking for improvement in future years. Now that the accounting community has embraced three variations for determining the replacement cost, this process should be smoother in the future. Accounting's goal of consistent and comparable financial information may cause further consolidation of replacement cost methodologies in the years to come. 

Search for the Perfect Retirement-Income Product

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essential? Here is an initial, but by no means exhaustive, list:

- First, it would be liquid and portable. Circumstances change, and these days, no one wants to be locked into a product or a provider indefinitely.
- Second, it would be predictable. While retirees are smart enough today to know that they should not park their money in a passbook savings account, most would sacrifice at least a bit of upside return for less volatility.
- Third, it would keep pace with inflation. Again, retirees have been well warned of the corrosive effects of inflation on purchasing power, and our Perfect Product would have to speak to this issue.
- Fourth, there would be little or no chance of outliving the product. Retirees have been well warned that they are likely to live longer, and as a result, their assets need to last longer.

No doubt, there are other attributes or combinations of attributes that we would look for, but for now we can focus on these: liquid/flexible/portable, predictable/non-volatile, inflation-fighting, and mortality-aware.

Next, let's examine a couple of products that are often mentioned in this search. Surprising to some but not to others, annuities are a product that have received renewed attention. On a straight-up basis, annuitization of defined

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contribution assets most clearly replaces the defined benefit check of the recent past, and there is nary an insurer who would not jump at the chance to annuitize a participant's 401(k) balance. The issues around annuities, however, have not changed. While it is indeed the most mortality-friendly product on the market, the standard fixed annuity comes up short on issues related to our other criteria, including its inflation-fighting abilities. To their credit, many insurers have altered their marketing approaches and now often promote a partial annuitization of assets. For at least some portion of an individual's retirement nest egg, the idea of locking in an income stream that cannot be outlived has merit and is one that we will return to.

Other retirement "decumulation" products are less products, per se, and more strategies, often involving manipulation of the individual's asset allocation. In the not-too-distant past, one approach was to execute a wholesale change of asset allocation at the exact point of retirement. Therefore, a 60 percent equity, 40 percent fixed income allocation (to use one example) on the day before retirement would switch to 100 percent fixed income on the day of retirement. In hindsight, this now looks a bit silly. At that time, however, the predominant driver was the notion that in retirement, predictable income instantaneously becomes the overriding concern. The realization that life expectancy in the United States was steadily increasing, coupled with studies of inflation, led to reassessment. We now know that the average person may live 20 years or more in retirement. (This is a far cry from the days when the average worker was dead before his Social Security benefits were set to commence!) Longer life expectancy leads naturally to a retirement asset allocation that may include a healthy percentage of equities. Of course, this reintroduces the notion of volatility and unpredictability, anathema to most retirees….just ask someone who is retired how he feels about the stock market swings of 2008-to-date.

Some prominent mutual fund families have developed probability-based asset allocation strategies for the retirement years. These strategies model expected outcomes using historical rates of returns across many broad and secondary asset classes. One phenomenon, in particular, that is of concern to these modelers is the dreaded "Year-One Bear Market Effect," which notes that a big equity market downturn in the first year of retirement is extremely difficult to recover from. An overriding objective in these approaches is to identify the optimal drawdown each year that would cover expenses, adjust for inflation, and maybe, or maybe not, leave an inheritance for the kids. Output from such an approach may then be worded along the following lines: Given this asset allocation, you can comfortably withdraw x percent of your assets each year with a y percent probability that your money will last to at least age z. The strategies allow for dynamic adjustment to preserve flexibility. Therefore, the amount of monthly drawdown and terminus date can be changed—and probabilities then recast—to accommodate individual changes.

So where does this lead us in our search? We see that annuities are not the perfect product. Neither is a portfolio of 100 percent fixed income investments. Other approaches involve more dynamic multi-class asset allocation married to personal preference around lifestyle and risk tolerance. These presumably can be actively managed/overseen by financial advisors or be (more or less) automated through a mutual fund family, but they do run the risk of becoming too complicated for the ultimate beneficiary, the retiree. Based upon our Perfect Product wish list, gauging life expectancy is the biggest challenge here.

We may then conclude that we should set a more modest goal for ourselves. Much as insurers today advocate for partial annuitization, we can look for a partial solution by identifying products that add value, address certain issues, and are best utilized in combination with an overall asset allocation strategy. Chances are John and Jane Boomer already have such a product within their 401(k) plan, namely their stable value fund. Continued access to and investment in the stable value fund in retirement, as allowed by the retiree's former employer, has many benefits.

How can stable value add value to the retiree? For the answer, we return to our Perfect Product wish list. First, stable value is a big winner on liquidity. Typically, there are no limitations on participant withdrawals or investment transfer/reallocation within a plan. If the needs of the retiree change, money can be allocated both into and out of stable value with relative ease. Second, stable value certainly qualifies as predictable. Through the crediting rate mechanism of stable value funds, intermediate bond market results—which taken alone can evidence a degree of volatility—are amortized into a relatively smooth pattern of returns over time. As market rates move both upward and downward, stable value follows accordingly but with much less volatility.

Next we will look at stable value's inflation-fighting credentials. For this, we'll turn to the accompanying graph (see Figure 1).

As is evident, stable value has historically proved to be a largely effective tool in protecting purchasing power against inflation. There were a few years during the hyper-inflationary period of the 1970s where it did not keep pace, and other fixed income investments would have been more effective. Nonetheless, stable value, at a minimum, has protected participant wealth against inflation over the last 26 consecutive years and over the aggregate time periods shown, broadly satisfying this requirement.

Finally, we should take a quick look at that most challenging of problems for retirement-income products: how to guarantee an income stream for life. Through our examination, we know that only an annuity (based upon the financial strength of the insurer) provides something close to a real guarantee. To take the extreme example, if you live to be 200 years old and your annuity provider remains solvent, you

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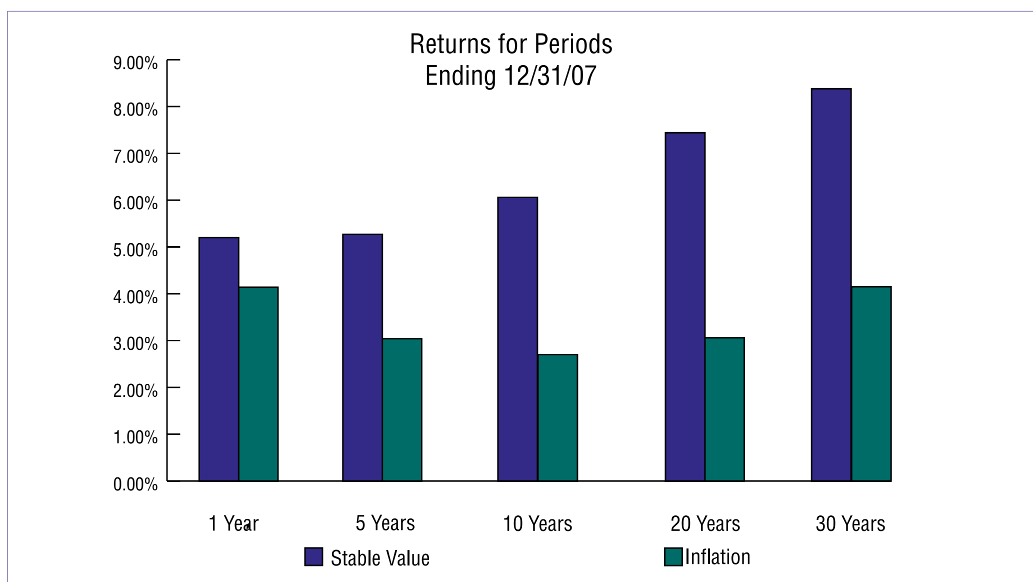

Figure 1

Note: Returns for stable value are hypothetical and were calculated using historical returns of an intermediate-duration, market-value bond index and applying to those returns a standard book-value, crediting rate methodology. Return information is based upon certain assumptions, including neutral cash flow over the periods presented. Once market-value returns were calculated, the crediting rate formula CR=(MV/BV)^(1/D)(1+YTM)-1 was applied to construct the stable value return series, pursuant to which CR = Crediting Rate, MV = Hypothetical Market Value, BV = Hypothetical Book Value, D = Duration of the bond indices and YTM = Yield to Worst of the bond indices. The year-over-year Consumer Price Index (CPI) headline number from the Bureau of Labor Statistics was used as our proxy for inflation.*

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continue to get paid. In the absence of such a guarantee, stable value (and the asset allocation–based strategies that we reviewed) relies upon the quality of the modeling performed to prove their ability to provide sustainable payments.

Let's examine a hypothetical scenario where John is primarily concerned with protecting his account value. Accordingly, he decides to take out the minimum amount required by the IRS under current regulations and takes this withdrawal from the stable value fund. Figure 2 shows the account value assuming a starting balance of $1 million at age 65, with a 5 percent growth rate for the stable value fund over time and a constant 2.5 percent level of inflation. Between the age of 70 1/2 and age 100, based on the current IRS minimum distribution requirements, John can withdraw an average annual distribution of $78,500. This scenario not only provides a predictable payment stream, it also preserves the account value for John's beneficiaries should he die early. By contrast, with a simple life annuity, the insurance company assumes the mortality risk but is paid handsomely if the annuitant dies early. In this scenario, the value preserved for beneficiaries is considerable, especially during the first 25 years of retirement.

Let's next assume that Jane needs more to live on than simply the IRS minimum distribution. Here, we assume the same starting balance and growth and inflation rates as in the previous scenario and that 10 percent of the balance is withdrawn each year from age 66 to age 100. As Figure 3 shows, at age 100, after collecting annual payments for 35 years, Jane has over 10 percent of her initial starting balance remaining. It is interesting to note that, because the distributions start earlier than our previous example and princi-

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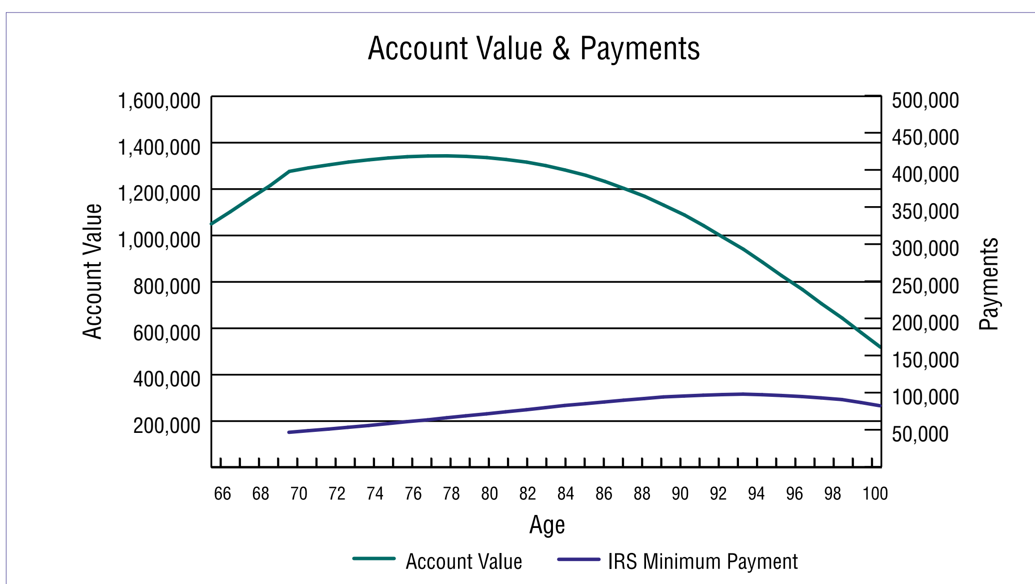

Figure 2

Note: The account value presented above was calculated assuming a $1 million investment at age 65 and an annual growth rate of 5 percent over the period of time presented. IRS minimum annual payments reflect current requirements and the impact of the 5 percent growth of the account. The payments have not been adjusted for inflation.

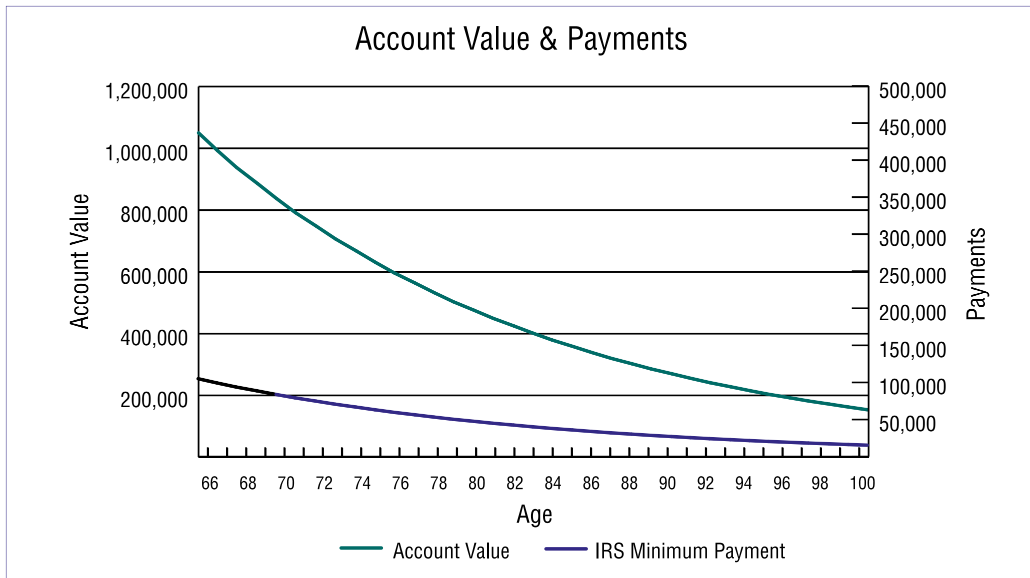

Figure 3

Notes: The account value presented above was calculated assuming a $1 million investment at age 65 and an annual growth rate of 5 percent over the period of time presented. Distributions were assumed to start at age 65. The 10 percent annual payments reflect the 5 percent growth rate on the underlying account. The payments have not been adjusted for inflation.

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pal is being withdrawn, the average annual distribution for this second scenario is only $47,000.

It is relatively simple for John and Jane to run different scenarios to evaluate how much money they can withdraw from the fund and how long their money will last. Using the same starting balance and growth and inflation assumptions as the previous scenarios, Figure 4 shows the account value under three withdrawal scenarios: IRS minimum, $75,000 per year, and $100,000 per year. The IRS minimum payment equates to an average annual payment of $78,500 from age 70 1/2 to 100. This is because the account grows from age 65 to 70 1/2. As you can see, it is relatively easy to project how various annual distributions will impact account balances under different scenarios. Based on historical experience, stable value also is not generally subject to, and can even help to buffer the impact on the retiree of, equity market downturns, including the Year-One Bear Market Effect discussed above. Of course, with the caveat that past performance is informative of, though not determinative of, future performance.

So, perhaps surprisingly, we can conclude that stable value has many attributes that make it (at least) an attractive product for use in retirement-income planning. It is flexible, provides the opportunity to run various scenarios intended to predict future needs, and, based on historical information, had done a good job of fighting inflation. We can even say good things about it when it comes to protecting against the risks of living longer.

A final point arguing for a place for stable value in retirement-income planning is simplicity. In the effort to create the Perfect Product, the notion of keeping it simple is sometimes unavoidably trampled upon. Practitioners would be wise to consider the desires of their audience for a readily understandable approach that, at the same time, includes a host of desirable characteristics. SVIA

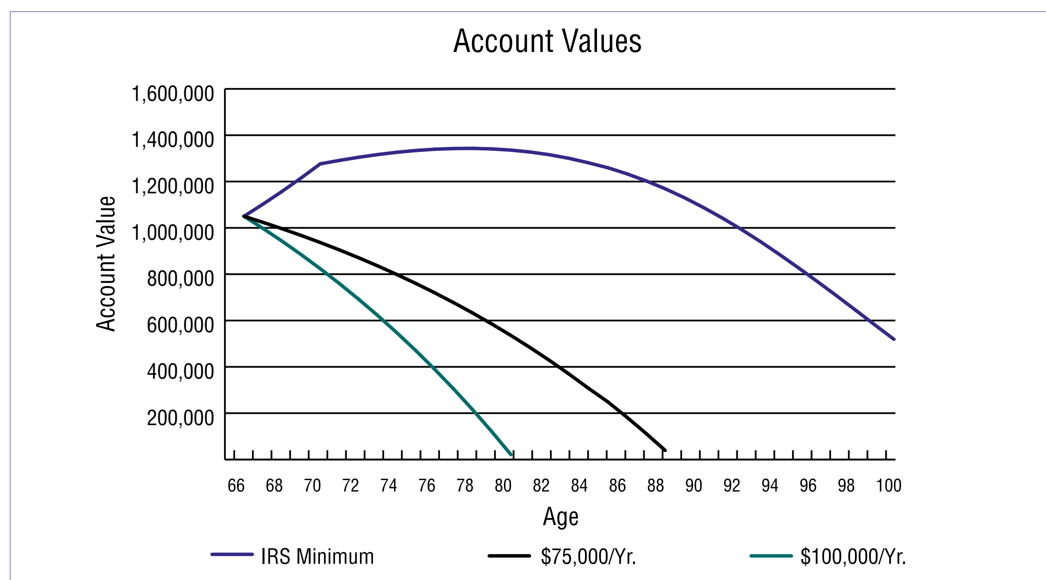

Figure 4

Notes: The account values presented above were calculated assuming a $1 million investment at age 65 and an annual growth rate of 5 percent over the period of time presented. Distributions were assumed to start at age 65, except under the IRS minimum scenario, where distributions started at age 70 1/2. The payments have not been adjusted for inflation.