

SVIA STABLE TIMES

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Marching into the New Millennium

by Randy Myers

The stable value industry approaches the new millennium at a crossroads. In just four years, from year-end 1993 to year-end 1997, its share of defined-contribution plan assets shrank from 27 percent to 13.6 percent, according to the William M. Mercer Inc. Survey on Employee Savings Plans. Among only those plans that offered stable value funds, its share dwindled from 54 percent to 27 percent. These declines mirror America's transformation from a nation of savers into a nation of investors, almost all of them, it seems, entranced by a seemingly invincible stock market, and increasingly immune to the charms of a product whose foremost attribute is capital preservation.

Yet many leaders in the stable value industry remain surprisingly upbeat heading into the 21st century. "I'm very, very confident that stable value has a future in defined contribution plans," asserts SVIA board member Robert Krebs, director of pension services at NISA Investment Advisors in St. Louis. Adds Bill Gardner, SVIA chair-elect and senior vice president of Dwight Asset Management in Burlington, Vermont, "The next few years will offer us a very exciting growth opportunity."

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EDITOR'S CORNER

by Victoria M. Paradis, CFA PIMCO

Continued success of our industry is simply inevitable because we offer a fundamentally good product: attractive, understandable returns to plan participants. That's what it's all about, and that has not changed since the 1970s. We're just doing it better now, and applying the concept to new markets.

This issue of Stable Times is all about change – new products, new markets, and improving upon what we already do. That's not something you would automatically expect from our “established” industry.

Not only do we have a firm footing in the U.S. defined contribution market as the fixed income option of choice, we are forging ahead. Continued success of our industry is simply inevitable because we offer a fundamentally good product: attractive, understandable returns to plan participants. That's what it's all about, and that has not changed since the 1970s. We're just doing it better now, and applying the concept to new markets.

This issue is hefty, so look closely at the table of contents. I assure you that you will find invaluable information. Our new President, Gina Mitchell, rounded up three exceptional pieces. These include two market surveys by a professional journalist, Randy Myers: a highly-informative introduction to the new IRA mutual funds, and an informal “futurist” piece that explores the trends that most excite a dozen industry leaders. Gina also recruited an excellent update on Social Security Reform by Ann Combs at Mercer, who also serves as one of the trustees of the Social Security system. Continuing with the new products and markets theme, Brian Carosielli and Jennifer Williams from Fitch/IBCA submitted a piece on Funding Agreements that will teach even the seasoned FA veteran something useful.

In the category of “improving what we do,” fall two pieces on the industry's performance measurement endeavor. Allan Fen introduces the pending task force report on performance measurement, and then Dan Libby from IBM walks us through implementing some of the key recommendations. Janet Jasin Quarberg from the Hueler Companies presents a very effective and concise plea to the SVIA membership to help ensure that the budding investment advice industry gives stable value the attention it deserves. Last, Karl Tourville from Galliard Capital Management has created the first installment of side by side spread trends of our industry's unique fixed income universe, as it compares traditional fixed income security and GIC yields.

We call to you, the SVIA membership, to continue to keep this publication fresh. We encourage new voices to contribute by writing articles or suggesting topics that you would like us to cover. Please also let us know what you like or do not like; and especially what you do not agree with and what we may be overlooking. We welcome feedback! ♦

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FROM THE PRESIDENT

It's in the Numbers

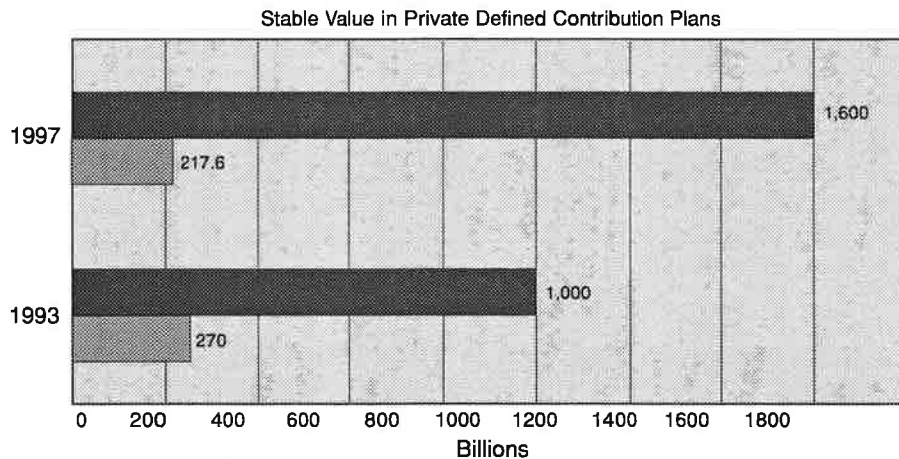
By Gina Mitchell

It seems like a very simple, straightforward question: What is the asset size for stable value investments? However, if you are the one trying to answer it, you may find yourself hedging and eventually digging for information.

Common sources for data such as the Federal Flow of Funds do not appear to track it as a stand-alone category. The Department of Labor's 5500 forms always run more than a few years behind.

This issue's "Marching into the New Millennium," illustrates the need for information. The article starts off by painting a rather dire picture for stable value: assets falling in a four-year period from 27% to 13.6%. What these numbers reflect is a decline in market share and a tremendous growth in defined contribution assets. The growing denominator for 401(k) assets can be attributed to some degree to investment performance and the power of compounding interest. Most of the growth has come from the sheer number of dollars going into these tax-deferred retirement plans.

The graph below provides another way to look at the same four years (1993 compared to 1997) and shows the impact of the growth of defined contribution plan assets.



SVIA has tried to provide stable value asset information in two ways. We have tracked the size of the stable value industry through the joint SVIA-LIMRA survey and the Annual Stable Value Investment Portfolio Survey. However, our answers in both surveys also have limitations: participation. We need to broaden our stable value base. We need your participation.

Having the results of SVIA's 1997 Annual Stable Value Investment Portfolio Survey at your fingertips shows the wealth of information that the survey collects. This information can be used to benchmark yourself against fellow SVIA members. The survey also puts SVIA on the map in Washington where opinions are plenty and supporting data is limited.

You can help as we begin the 1998 Investment Portfolio Survey by taking a minute to provide the contact information, which directs the survey to the individuals in your firm responsible for compiling the data.

As our visibility increases SVIA will continue to be asked this very basic question-how big is stable value? With your help, we can be the voice for the stable value industry by answering the question accurately and in a timely fashion. ❖

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"Stable value is getting mainstreamed," says Klaus Shigley, chair of the SVIA's data research committee and vice president of risk management for the guaranteed and stable value products division of John Hancock Mutual Life Insurance Co. in Boston. "It's beginning to look more like a generic fixed-income option."

Pollyannas peering through rose-colored glasses? Perhaps not. In an informal survey conducted by *Stable Times*, Krebs, Gardner and 10 other SVIA members cite good reason to be optimistic. Over the next several years, they argue, the stable value industry gradually will be transformed and strengthened by shifting demographics at home, new opportunities abroad, a recently launched foray into the individual retirement market, and an ever-broadening definition of stable value investing.

"Stable value is getting mainstreamed," says Klaus Shigley, chair of the SVIA's data research committee and vice president of risk management for the guaranteed and stable value products division of John Hancock Mutual Life Insurance Co. in Boston. "It's beginning to look more like a generic fixed-income option."

Domestic Growth: Tapping into the Boomer Generation

But the SVIA members also see plenty of challenges: in promoting stable value products, in embracing new investment strategies without sacrificing product stability, and in attracting a new generation of investors who've never seen the stock market go down for more than a few months. Here's what those members think the stable value industry might encounter, and how it might respond, in the years ahead:

This year, the first of 76 million baby boomers born between 1946 and 1964 turns 53 years of age. As this wave of aging Americans closes in on retirement, we can look for them to rethink their asset allocation policies, putting a greater emphasis on protecting their principal and less emphasis on earning outsized returns. When that happens, the stable value industry should be able to capitalize on their newfound conservatism.

"Stable value will be very popular with people who want to diversify out of equities," predicts David Wray, president of the Profit-Sharing Council of America. "Bonds are every bit as volatile as stocks, and bond funds especially have a great deal of volatility, so they're not the solution for investors who want to preserve principal. I think stable value funds will take more and more market share away from bonds funds and money market funds."

The industry is already preparing for this shift by making its first tentative forays into the IRA arena. (See "Breaking into the IRA Market, pg. 10)

"The vast majority of the money in IRAs comes from rollovers from other plans, not from people contributing \$2,000 a year to their account," observes Wray. "That's why the IRA market is so critical, and that's why I think you'll see many more stable value funds introduced for that market in the years ahead."

Take that trend to its logical conclusion, and we'll eventually see stable value funds migrating into the retail market at large.

To date, of course, nobody has been audacious enough to come out with such a product. That's because nobody knows how frequently retail investors might trade in and out of such funds into money market funds, particularly as interest rates fluctuate. But some industry insiders think the progression is inevitable.

"It's going to be some time before it happens, because of concerns about disintermediation (interest-rate arbitrage)," says Ken Walker, president of T. Rowe Price Stable Asset Management Inc. in Richmond, Virginia. "Funds developed to date for the IRA market have early redemption or surrender fees that apply in certain market conditions to offset withdrawal risk. In the retail market, that's not customary. We've just got to find a way to meet halfway between those two extremes. Once that nut is cracked, the game changes."

While the industry is excited about new products, it doesn't see them as the only future engine of growth.

"Last year, the stock market gave us the first real test in some time of how extreme volatility in the capital markets might impact the way DC-plan participants allocate their assets," observes Patrick Boyle, senior vice president in the

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Stable Value Group at New York Life. "And what we saw during the third quarter was a tremendous upsurge in demand for stable value products—about three times the norm, based on the amount of business we were asked to quote on. This shows us how it's going to be different going forward. It won't be just a bear market that sends dollars flying into stable value. High volatility may be enough to get people to reassess their asset-allocation decisions. Even a market that goes sideways for five or six quarters may be enough to create significant reallocation momentum into stable value products."

International Markets: Into the Vast Unknown

And what about stable value outside the U.S.? After all, this is a product born and bred on U.S. soil. Will it work overseas?

"One of the inevitabilities is that stable value is going to go international," says David Fallow, an executive vice president with Principal Capital Management, a unit of the Principal Financial Group. "There are several factors that will allow it to grow in overseas markets, including the aging population, particularly in developed countries, where birth rates have gone down. Another driver will be the movement away from defined-benefit plans outside the U.S. in favor of defined contribution plans, a trend that is just starting to gather momentum."

"Certainly there will be some marketing hurdles," adds Michael Wyatt, portfolio manager, savings plans, for the Dupont Pension Fund. "Each country has different regulatory and legal issues, and, in many cases, an investor population with different perspectives about what's appropriate to include in an employee savings plan. But I foresee that in the years ahead, international markets will be a potential growth area for stable value as an asset class."

Just don't expect foreign financial heavyweights to stay out of the fray. "Today, we already have foreign banks with branches in the U.S. issuing (stable value) products here," says attorney Al Turco, a partner with Turco & Mercier in Manchester, Connecticut, just outside Hartford. "Even as U.S. banks and insurers seek to establish a beachhead outside the U.S., the day may come when we have foreign banks issuing products here directly. It may require some breaking down of legal and other barriers, but we're going to end up with much more global interaction between buyers and sellers of stable value products."

Going Mainstream: Pushing the Boundaries of Stable Value Investing

As interesting as where stable value is going is what it will look like when it gets there. The range of investments underlying stable value products has broadened dramatically over the past decade with the introduction of synthetic GICs, and industry insiders look for that range to be stretched even further in the decade ahead.

"Ultimately, stable value will view itself as a fixed-income (investment) option, and all the investments in the conservative fixed-income world will be available for stable value funds," predicts Vicky Paradis, a vice president in the stable value group at Pacific Investment Management Co. in Newport Beach, California. "In addition, all the investment techniques we're familiar with in the pension world will be available. The result will be better diversification, improved returns, less risk, and more flexibility."

To date, managers of synthetic GICs have invested predominantly in high-quality securities, but some have already begun to add high-yield bonds and non-dollar debt to their portfolios in an effort to enhance yields while diversifying credit risk. A number of industry leaders warn against becoming too yield-hungry.

"One of the challenges for this very traditional industry," says Rudy Gernert, president of Diversified Financial Products, a division of AEGON USA, in Louisville, Kentucky, "is to continue to refine and create products, to innovate where we can, but also not to do things which take a very simple, straightforward, and, I think, healthy product, and stretch it in ways that it wasn't intended to be stretched. Buyers of stable value products are looking for preservation of capital and a consistent, reasonable rate of return over time. This product, by definition, is not intended to be overly sexy."

But the innovation train is hard to stop when it's built up a head of steam.

"Over time, we may see more stable value funds hold equities. Right now, only a handful do," says Dupont's Wyatt. "Remember, safety is a relative term. At one time, traditional GICs were considered ultra safe, but after a few insurance

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"If you're a participant in a 401(k) plan, you can look in the newspaper to see how your mutual funds are doing. But how is your stable value fund doing?" says John Milberg. "Most participants don't have a clue. That's one of the challenges for the industry and the association, and it's one of the reasons why this whole issue of performance measurement is a key challenge."

company failures, that perception was changed. I'm not saying I see equities becoming a significant portion of stable value, but that there may be a place for them."

"A small percentage of equities as a kind of kicker to stable value yields? I could see that evolve in a retail environment," agrees T. Rowe Price's Walker. "It is no different from some of the retail fixed income asset allocation funds which include equity income funds to provide the "kicker."

As stable value managers begin to invest synthetics portfolios more aggressively, industry leaders suggest buyers and underwriters take a balanced and long-term perspective.

"I'm cautious about including highly volatile securities in stable value products, from a buyer's perspective," says Gernert. "We can't forget the long-term history of the financial markets, and extrapolate based on the last five years of tremendous results. I'm more excited about the application of the stable value concept and opportunity in new markets than I am about trying to alter the core tenets of stable value investments."

Count on tomorrow's broader investment guidelines to further the push for a standardized performance measure for stable value products.

"Today, if a plan sponsor wants to evaluate a GIC manager, it's very difficult," says John Hancock's Shigley. "It's impossible to do it based on the book value returns that the participant sees. To really measure performance of a stable value fund, we have no choice but to adopt a total return framework similar to what is used in any other asset class."

When Might That Happen?

"The SVIA Task Force has drafted a report advocating fair value performance measurement methodology which was recently distributed to the membership," Shigley reports. "But I would guess it will be another year or two until we have a methodology that secures the board's full endorsement."

Resolving the performance measurement dilemma is important to expanding stable value's base in employer-sponsored pension programs and equally important to the millions of individual plan participants in those plans.

"If you're a participant in a 401(k) plan, you can look in the newspaper to see how your mutual funds are doing," says SVIA Chair John Milberg, senior vice president, institutional products, for Pacific Life Insurance Co. in Newport Beach, California. "But how is your stable value fund doing? Most participants don't have a clue. That's one of the challenges for the industry and the association, and it's one of the reasons why this whole issue of performance measurement is a key challenge."

Poised for Takeoff?

With expectations of growing domestic demand for its goods, increased flexibility in developing new products and investment strategies, the potential for expansion overseas, and work already begun on solving the performance measurement dilemma, is the stable value industry truly poised for takeoff as it approaches the new millennium? Not totally.

"We still have a long way to go in terms of getting people to think about stable value as an investment option," says Milberg. "It's not as well known as it needs to be, and the challenge for the industry is to promote it and get people to understand its very beneficial characteristics.

"Nobody really knows what the future is going to hold," Milberg concludes. "But I find it hard to believe that there won't be a continuation of existing trends, particularly the trend toward giving people more responsibility for investing for retirement. They will have tools at hand that are very simple to use. They can already move funds around at a moment's notice, and check their investment returns every night. It's going to be up to our industry to make sure that stable value products are incorporated into that picture." ♦

New Investment Advice Models Exclude Stable Value

By Janet Jasin Quarberg, Hueler Companies

With the shift in assets from defined benefit to defined contribution plans over the past years, today more and more plan sponsors are looking for ways to give plan participants better investment guidance. Three firms, Trust Company of the West, State Street Global Advisors partnering with Financial Engines, and 401(k) Forum are entering the "investment advice" business. Only the Trust Company of the West product required and received a DOL exemption. Many others such as Paine Webber and Merrill Lynch are soon to follow. While there is a real need for sound investment advice, none of the organizations mentioned above include stable value in their asset allocation model, and yet interestingly, money market and bonds are included.

According to a 1998 BARRA Rogers Casey/IOMA DC Survey of 455 plans, approximately 65% of plans currently offer a Stable Value Fund, with an average asset allocation of 22%, making Stable Value the third largest fund option for most plans. Money markets represent 1.2% and bonds represent 1.8% of assets. Disregarding a large asset class like stable value seriously diminishes the value of the entire investment advice service.

To exclude stable value funds from the advice model is a serious disservice to plan participants. Stable value can offer participants 1.5%-2% higher annualized return than money market funds and over a five year period ending 12/31/98, has offered comparable returns of an intermediate bond fund with 45 times less volatility.

Returns as of 12/31/98	<i>Hueler Stable Value Index</i>	<i>Lipper Money Market Average</i>	<i>Lehman Int. Gov/Corp</i>	<i>S&P 500 Index</i>
1 Year Return	6.41%	4.85%	8.44%	28.65%
3 Year Return	6.40%	4.85%	6.77%	28.25%
5 Year Return	6.38%	4.71%	6.60%	24.08%
5 Year Standard Deviation	0.14%	0.63%	6.33%	14.20%

The stable value community needs to challenge these organizations' position using proven statistics in a united effort to have stable value accurately represented in these models. SVIA has formed a task force led by Stephen LeLaurin from PRIMCO to address these issues. The task force is finalizing a white paper, which will be used to present stable value to as many asset allocation organizations as possible. The task force is also in the process of compiling a comprehensive list of asset allocation vendors.

You can help accelerate SVIA's efforts by contributing investment advice model contacts, the status of the model and whether it includes stable value. Please email information to STEVEL@PRIMCO.COM to help move this critical initiative forward. ♦

Implementation of a Framework for Performance Calculations of GICs

By K. Daniel Libby, CFA
Investment Manager, IBM Retirement Fund

With the Stable Value Task Force's draft recommendation on Performance Measurement for Stable Value Assets under consideration by the SVIA membership, attention will shift toward implementation of these standards. The intent of this article is to point out some of the issues that are outside the scope of the Task Force's document but I believe will still need to be addressed by the "participants" in this market, specifically Stable Value Managers and Plan Sponsors. This article will also look at some of the alternative calculations that are possible by various types of "participants" to achieve the same performance measurements. In addition, it will comment on the inputs required to provide these measurements in a consistent manner.

The Task Force concludes that the fundamental framework for this performance standard should coincide with AIMR - PPS. That is to say that it is an "economic" valuation approach and should seek to remove the effect of cash flow on performance. Of tantamount importance in considering the implementation of such a standard is that it be "Fair", "Robust" and "Consistent". This article will discuss each in some detail as it relates to implementation of this framework for performance calculations for GICs.

Fair - Who "owns" the performance of the benefit responsive insurance: Stable Value Managers or Policy Makers (Plan Sponsors) of the Fund?

The "fly in the ointment" in applying such a framework to stable value assets has long been the embedded benefit responsive insurance or "puts". Why should this be so when puttable corporate bonds are handled in a straightforward fashion under AIMR - PPS? The reason, ostensibly, has been that valuing these benefit responsive options is not a straightforward matter. I believe, rather, that the difficulty lies in defining who "owns" the performance of the benefit responsive insurance. Although I've made this point in some of my previous articles for *Stable Times*, it is worthwhile restating it somewhat differently for the purposes of this discussion on implementation.

The analogy to buying puttable corporate paper and GICs is a good one to bring out this point. Puttable corporate bonds are purchased as an economic decision that the investment manager has authority over to exercise or not. His decision to do so will be based on the relationship between interest rates and the coupon rate on the puttable corporate bond. Therefore the economic performance of the value of that embedded put is very relevant to evaluating the manager's performance.

A GIC is analogous to a puttable corporate bond with the exception that the manager does not have the authority to exercise the put embedded in the GIC. It is the participants that will determine if and when to exercise the puts based on a host of external factors such as demographics, plan structure, competing investment returns and plan communications.

For this reason, I have long advocated that the performance standard should not only be corrected for cash flow activity but also "grossed-up" for the benefit responsive costs as well, at least for the purposes of external publication and comparisons. This will have the added benefit of allowing performance composites to be aggregated across various plans and allowing performance comparisons among managers both within the stable value community and outside it.

What are the practical implications of such a position in this framework? As we know GICs are bond-like instruments that provide cash flows after charges for benefit responsive insurance. Likewise, GIC rates are net of these risk charges as well. Therefore, unfortunately, performance using a discounted cash flow method for a GIC will reflect returns net of these risk costs. Yet in today's market it is easy to obtain an indication of the "global" wrap cost attributable to a plan and use this to gross-up a performance return composite for traditional GICs that can then be used for external publication and comparisons. As for synthetic GICs, such as actively managed bond portfolios, performance net and gross of benefit responsive costs are commonplace. Therefore, combining these return

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composites, traditional and synthetic GICs, is straightforward and can be displayed on a gross or net of benefit insurance charges basis depending on the intended audience.

The larger implication of this conclusion is that it separates the strategic (i.e. policy) decision involved in setting up the benefit responsive insurance structure of a Stable Value Fund from the investment actions taken in managing its assets. Whether the Plan Sponsor is involved in setting this policy or delegates it to the Stable Value Manager does not change the appropriateness of separating these two functions for the purposes of performance measurement. The benefit responsive insurance structure lends itself better to consideration as a policy decision not only because the investment manager has little control over the exercise of those "puts", but also because the insurance structure of the Fund overall typically cannot be rebalanced except over very long horizons.

Robust - How should calculations be carried out for (daily priced) Mutual Funds vs. (monthly priced) Stable Value Managers in an environment where there are cash flows occurring into and out of the Fund?

Assuming that the portfolio manager does not "own" the performance of the benefit responsive insurance, the calculation of performance for GICs reduces to a discounted cash flow calculation. All that is necessary to know is the cash thrown off by a GIC and the appropriate discount rate to use (see "Consistent" below). No reference to the book value or the book-to-market ratio is required. The AIMR Performance Presentation Standards Handbook 1997 ed. (Chapter 2, pp. 43-51) provides all of the machinery necessary for performing these calculations.

The AIMR-PPS discusses the Daily Priced, Modified Dietz and Modified BAI methodologies. While daily priced is preferred, it may be impractical for most participants other than mutual fund families that are organized to provide daily pricing on its assets. For most stable value managers monthly valuations are standard practice and in those cases Modified Dietz would be more appropriate. In a situation where the cash flowing into or out of a GIC is significant due to a partial maturity or a deposit of a contract, the asset should be re-priced just prior and just after the cash flow and the resulting returns time-linked. This will remove the effect of the cash flow on performance.

As for a "non-participating" GIC, specifically where a deposit or withdrawal occurs in mid-period, the effect of the above or below market contribution to the payment made by the benefit responsive insurance provider is removed because it is priced into the basis of the asset both just prior and just after the payment is made. An issue could be raised that the relative importance of the GIC in question has shifted in overall market weight as a percentage of the portfolio and therefore the effect of the cash flow would impact the portfolio until the end of the period. However, typically, this cash flow will be an insignificant proportion of the overall portfolio. Therefore its impact in changing the market value weighting of the GIC in question will also be insignificant. If it were not a technique described in the Handbook on page 49 as the Asset-Weighted and Cash Flow Weighted Return could be used to mitigate its impact.

Consistent - How do you choose the correct spreads, adjusting for differences in quote conventions, credit risk and optionality? This is important for results to be consistent to other markets and across market cycles? While there is much that can be written to explain the "correctness" of various methodologies, perhaps the most important consideration is that the practice be carried out in a plausible and consistent fashion over time. In other words, the way GIC spreads are chosen should be market-based and yet derived in a similar fashion each reporting period throughout the maturity period of the GIC asset. This will ensure that the performance effect of the asset is properly represented in its composite.

Each of the requirements that I have discussed as they relate to implementation of a performance standard for GICs needs to be addressed by the participants of this marketplace if they are to be successful in their efforts. Other conclusions from the ones that I have discussed here are possible, however each will have certain ramifications associated with them. My attempt has been on providing a performance measure that is most analogous to existing performance measures commonly in use by investors and their advisors and therefore allow them to make the broadest use of their measure. I believe this is in the best interests of this asset class and the participants in the long run. ♦

Breaking into the IRA Market

By Randy Myers

"We feel our stable value fund for the IRA market will be a source of growth in the future," adds Karl Tourville, managing partner at Galliard Capital Management in Minneapolis, which is developing a stable value fund for an undisclosed no-load mutual fund company. "It allows us to broaden the target market for stable value funds." Galliard expects its fund to be introduced within the next three to six months.

For more than a year now, investors have been able to do something never before possible: open up the financial section of their daily newspaper and get a quote on a stable value mutual fund.

It wasn't the newspaper industry that changed, of course, but the stable value industry itself. Leading the charge: Bankers Trust, which introduced its BT PreservationPlus stable value mutual fund for institutional investors in October 1997.

At the end of last year, Bankers Trust scored another coup when it launched BT PreservationPlus Income Fund, a no-load, stable value mutual fund for the Individual Retirement Account market. Though just a niche right now, this market promises to become crowded quickly. Morley Financial Services launched the Morley Capital Accumulation Fund for IRA and institutional investors on February 1, and at least two more stable value mutual funds are due out for the IRA market in the next several months, including one from Dreyfus.

The executives behind these ground-breaking funds say their decision to enter the IRA arena was a logical response to changes taking place in both the retirement marketplace and the stable value industry itself.

"We recognized some time ago that the retirement plan market was moving more and more toward a retail orientation," says Morley vice president Taylor Drake, who serves as co-portfolio manager for the Morley Capital Accumulation Fund. "Fidelity and other big fund companies have convinced investors that mutual funds are the key to retirement investing. This on-going advertising has increased awareness of mutual funds, and the Morley Capital Accumulation Fund gives us a product (type) that every investor on the street is familiar with."

"We feel our stable value fund for the IRA market will be a source of growth in the future," adds Karl Tourville, managing partner at Galliard Capital Management in Minneapolis, which is developing a stable value fund for an undisclosed no-load mutual fund company. "It allows us to broaden the target market for stable value funds." Galliard expects its fund to be introduced within the next three to six months.

Stable value products were shut out of the IRA market in the past, of course, because the Securities & Exchange Commission requires that mutual funds hold no more than 15% of their assets in illiquid securities. And traditional GICs, virtually the only type of security held in stable value products until 1990, aren't liquid.

That hurdle was cleared over the past decade as innovative firms pioneered and refined the synthetic GIC. Today, a synthetic can consist entirely of highly liquid, intermediate-term fixed-income securities, all backed by a "wrapper" which guarantees the book value of those securities.

Even with synthetic GICs, though, the stable value industry faced a daunting problem in developing funds for the IRA market. How would such a fund handle the risk of disintermediation, meaning the inevitable flood of redemption requests that would be triggered if interest rates suddenly spiked upward? Under such a scenario, the yields on money market funds would track the changing rate environment very quickly, prompting many IRA investors to swap assets out of stable value funds and into money market funds or other higher-yielding securities.

Bankers Trust hit on this solution for the IRA market: it will charge a 3% redemption fee on withdrawals that take place whenever the interest rate environment is such that it would favor disintermediation. The only exceptions will be when the redemption is made due to the investor's death, retirement, or disability—the same three reasons which qualify for exemption from early redemption penalties levied by the Internal Revenue Service. Whenever the redemption fee is imposed, the proceeds will be funneled back into the fund, not to Bankers Trust.

"Breaking Into" continued on next page

"Breaking Into" continued from previous page

According to the terms of the PreservationPlus Income Fund's prospectus, the redemption fee will be triggered whenever the current yield on the fund, plus 225 basis points, is less than the yield of the Lehman Intermediate Treasury Index. Investors can call a toll-free Bankers Trust telephone number at any time to find out if this "Interest Rate Trigger" is in effect. In practice, it shouldn't be often.

"If you look back over time, you'll see that the trigger doesn't come on very frequently," says Bankers Trust's managing director, Eric Kirsch. "It really comes on only when rates spike up, or when we have an inverted yield curve. In the early 1980s, when the Federal Reserve Board was raising interest rates and inflation was high, the trigger would have been on. But the only other time it would have been on since then was in 1984, when the yield curve was inverted. It would never have been on during the 1990s."

The trigger goes off once the yield on the BT PreservationPlus Income Fund, plus 200 basis points, rises above the yield of the Lehman Intermediate Treasury Index. The 25-basis-point difference in the trigger's on and off calculations is designed to keep it from tripping frequently when rates are hovering near the trigger mark.

To further avoid liquidity problems, Bankers Trust is keeping about 10% of its fund's assets in cash equivalents. The rest of the portfolio is invested in synthetic GICs backed by an intermediate-term bond portfolio that will maintain an average duration between 2.5 and 4.5 years.

"It's a diversified portfolio," Kirsch says. "We'll invest in such sectors as U.S. Treasuries, asset-backed securities, mortgage-backed securities and corporate securities. From a credit-quality perspective, we can invest up to 10 percent of the fund in single and double B bonds, but the rest must be investment-grade securities with a rating of Triple-B or higher." (By contrast, the credit floor for its institutional stable value fund is Single-A.)

Bankers Trust is purchasing the fund's wrappers only from institutions with claims-paying ratings of Double A Minus or better, and is using mostly hybrid and non-par wrappers. The expense ratio for the fund is pegged at 1.25 percent; Bankers Trust is absorbing some of the fund's costs while it is small (\$5 million in assets so far) to keep that figure down. (Its institutional fund to date has garnered \$290 million in assets.)

Morley's no-load IRA fund, which carries an expense ratio of 95 basis points, is structured much like the BT fund, although the details of its redemption fee are slightly different. For starters, the fee is 2%, not 3%. Also, it's triggered when the gross yield of its fund is less than the Dealer Commercial Paper 90-Day Index, and applies to all withdrawals, regardless of the purpose. The trigger is reversed once the gross yield of the fund exceeds that index by at least 25 basis points.

"We have not applied any waivers (to the interest-rate trigger) for our IRA class of shares," says Drake. "One of the reasons is that if you have somebody who's over age 65 and sitting on a huge IRA balance, they'd have an opportunity to arbitrage the Fund if those waivers are in place. In certain interest rate environments they would have a strong incentive to react to short-term movements in interest rates. Because the trigger is activated only under unusual market circumstances, we don't foresee our position putting us at a disadvantage in the marketplace."

Morley is investing its fund's assets in fixed-income securities with a credit rating of Triple-B or higher, and has targeted an average portfolio quality of at least Double-A. Its target duration for its portfolio is 2 to 3.5 years. It will purchase wrappers from issuers with at least a Double-A claims-paying rating.

Certus Asset Advisors, a San Francisco firm, which has used synthetic GIC products since their inception in 1990, will be managing Dreyfus' no load, stable-value mutual fund once it clears the SEC. In yet another approach to dealing with the risks associated with operating a stable value mutual fund for the IRA market, Certus and Dreyfus plan to use a dual interest rate trigger, one tied to short-term interest rates and the other to intermediate-term bond rates. Either one could activate the trigger independent of the other.

"We think we have a valid reason for using two indices as triggers," says Certus Vice President Helen Napoli. "Yes, we're worried about people transferring assets to money market funds during an unfavorable rate environment, but we're also worried about those times when the portfolio's market value could be significantly less than its book value."

"Breaking Into" continued on next page

"Breaking Into" continued from previous page

"Because the stock market has been going great guns for so long, this is a good time to capture some of those investors who are looking for a way to lock up their gains, rather than to keep rolling the dice and assuming they'll get 25 percent a year from the stock market," explains Morley Senior Vice President and Managing Director Greg Ellis, who heads up the firm's sales and marketing efforts. "Also, the sheer demographics of the country are working in our favor; baby boomers are getting older, and whether they've run up a lot of stock market gains or personal income gains, they're looking toward retirement, and they're going to need a bit more safety from their investments."

By using two indices, we cover both risks."

Certus will construct the Dreyfus fund's portfolio using a mixture of buy-and-hold synthetic GICs (that is, those that hold just one security to maturity) as well as synthetic GICs that incorporate a portfolio of actively managed fixed-income securities.

The firms that have entered the IRA arena are taking slightly different tacks in marketing their products. Dreyfus will handle the marketing of the Certus-managed fund through its existing distribution channels. Morley, which is owned by

Nationwide Financial Services, a national distributor of retirement

products, plans to work initially through existing Nationwide and Morley distribution channels. Bankers Trust's is targeting the wholesale and financial-planning communities.

"Lots of mutual fund companies don't have stable value capability," says Kirsch. "They'll ask, 'Should we build it or buy it?' We think they'll find it attractive to buy it from Bankers Trust on a wholesale level. In that vein, we're talking with banks, mutual fund companies and insurance companies."

Whatever the distribution channel, expect the marketing pitch to be similar.

"Because the stock market has been going great guns for so long, this is a good time to capture some of those investors who are looking for a way to lock up their gains, rather than to keep rolling the dice and assuming they'll get 25 percent a year from the stock market," explains Morley Senior Vice President and Managing Director Greg Ellis, who heads up the firm's sales and marketing efforts. "Also, the sheer demographics of the country are working in our favor; baby boomers are getting older, and whether they've run up a lot of stock market gains or personal income gains, they're looking toward retirement, and they're going to need a bit more safety from their investments."

"Mutual funds allow us to follow the investor wherever he or she wants to go," adds Drake. "Now we can capture rollovers from the 401(k) and 403b markets, as well as accommodate any type of IRA investment, whether it's in a traditional IRA, a Roth IRA, an Education IRA, or even a KEOGH account."

But is the IRA market destined to take off quickly? Probably not. As Certus President Robert McCormish explains, the yield curve is sufficiently flat right now that stable value funds are yielding only a bit more than money market funds, although historically the spread has averaged about 200 basis points. In mid February, for example, the BT PreservationPlus Income Fund was yielding about 5.2 percent, versus about 4.8 percent for money market funds. The yield on Bankers Trust's institutional fund, which was launched when overall interest rates were slightly higher, was about 5.85 percent.

"We need some steepening of the yield curve and a commensurate shift in what stable value funds are returning versus money market funds to really put the stable value products on the map," McCormish says. "From then on, we'll benefit from the exposure IRA investors will have had to them."

That being the case, it might appear that Bankers Trust, Morley, Dreyfus/Certus and Galliard are too early with their products. They don't think so.

"We've had experience with both prospects and clients who've said they only want mutual fund options in their defined contribution plans," says McCormish. "And we've seen that with products like synthetic GICs and more sophisticated underwriting techniques, this is something we can deliver to the retail market. My gut says there's something to be had here, and if we don't try to find out, opportunity could sail by us."

"The biggest risk in the long run," says Ellis, "is in not doing something like this." ♦

Social Security: Getting at the Issues of Underfunding & Options for Reform

By: Ann Combs, Principal, Washington Resource Group, William M. Mercer, Inc.

The Problem

The demographic trends are irrefutable. The population is aging. Life expectancies have increased and fertility rates have dropped. The number of people over the age of 65 is expected to double over the next 40 years, increasing from 13 to 20 percent of the total population. The number of active workers supporting each Social Security beneficiary was 5:1 in 1960, 3.3 today, and is projected to drop to 2.0 by 2030. These facts are driving the pending insolvency of Social Security.

Social Security is essentially a pay-as-you go, inter-generational transfer program that uses active workers' taxes to pay current retirees' benefits. To date, Social Security has largely accomplished the objective of providing a floor of financial support in retirement for millions of Americans. However, due to a steady expansion of benefits and an increasing number of beneficiaries, the cost of the system has increased substantially over the years. The program's long-term deficit is projected to be 2.19 percent of taxable payroll. The current unfunded liability for Social Security is estimated to be as much as \$9 trillion.

While the cost of the system has grown, real rates of return individuals receive on their "contributions" have dropped dramatically. Workers retiring in 1960, on average, received a 15 percent real rate of return on the taxes they and their employers paid. Those retiring in 1980 earned eight percent. The average return for workers turning age 65 today is approximately four percent. In the future, even without taking into account any changes necessary to bring the system into balance, retirees can expect to receive only a one to two percent return. If taxes are increased and benefits are adjusted to restore long-term balance, returns will fall below one percent. This drop has contributed to an erosion of confidence in the current system, particularly among younger Americans.

According to the most recent projections, in 2013 the Social Security system will begin paying out more in benefits each year than it collects in taxes. At that point, the federal government will have to begin making interest payments on the special issue Treasury bonds held by the trust funds. In 2021, interest payments will be insufficient to meet benefit obligations and the trust funds will have to begin cashing in the bonds themselves. Beginning in 2032, an unreformed Social Security system will be able to pay only 75 percent of currently promised benefits. The critical date from a fiscal perspective, however, is 2013, the year the federal government will have to increase taxes, cut spending and/or borrow in order to meet its obligations to pay the accumulated interest on the Treasury bonds and, ultimately, to pay the face value of the bonds themselves.

The Options for Reform

Social Security plays an important role in the lives of all Americans. But in order for it to continue, it must be reformed. Social Security must be redesigned to recognize the demographic, economic and social changes in our society since the program was put in place. A new, strengthened system could continue to provide essential retirement, survivors and disability benefits, but it also could contribute to capital formation, improve savings, and reinforce individuals' responsibility to plan for and contribute to their own retirement. The current system is simply not sustainable without harm to the economy and future generations of workers and retirees. It's not a question of whether to reform the system. It's a question of how and when to do it.

There are really only three ways to restore solvency to the Social Security system: increase revenues; adjust benefits; or improve the rate of return realized by the investment of accumulated assets. The magnitude of the problem effectively requires the adoption of some combination of at least two of the three options.

Revenue Enhancement

If the problem were to be addressed solely through increases in the payroll tax rate, an immediate 2.2 percentage point increase in the current 12.4 percent tax would be necessary to bring the system into long range actuarial balance. To keep the system balanced in perpetuity, however, would require an increase of nearly five percentage points. Seventy-five percent of the population already pays more in payroll taxes than it does in income taxes. Payroll taxes are regressive and have a negative impact on cash wages and jobs. Higher payroll taxes, whether in the form

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Task Force Issues Report on Performance Measurement Recommends Reporting "Fair Value" Total Returns in Addition to Book Value

By Allan Fen

In the fall of 1997, the Stable Value Investment Association created the Task Force on Performance Measurement. The Association's charge to the Task Force was to develop a practical framework for performance analysis of stable value funds. The Task Force's primary focus was on addressing the major deficiency in stable value performance reporting - consistent portfolio return calculations, which are comparable across portfolios and with benchmarks. Without this, performance analysis for stable value funds can never be as thorough, objective and useful as it is with other asset classes.

The task force issued an exposure draft in March of last year. A number of comments were received and this final report reflects changes made as a result of these comments. The report was recently distributed to the membership to begin the process of debate, discussion, testing and implementation throughout the industry.

Performance analysis for any asset class has many components, including returns, risk measures such as duration, credit quality, and volatility, and for stable value funds, additional factors such as par/non-par allocation and market/book ratios. But in the absence of consistent return numbers across portfolios, performance analysis is seriously deficient. Book value accounting is the foundation of stable value, but it poses serious obstacles to meaningful return comparisons between funds and with benchmarks.

In order to have consistent and comparable return information, the task force advocates the disclosure of returns based on "fair value," in addition to book value. Fair value return numbers overcome the comparability issues posed by book value, making possible consistent comparisons across stable value funds and with common benchmarks. Fair value is generally estimated using market value for publicly traded assets, and for non-marketable assets, some other reasonable and consistent estimation method is used. This approach is already used for "Managed Synthetics," where the total return based on market values is an essential part of any performance reporting. In general, the task force looked first at approaches already developed and accepted in other asset classes, particularly fixed income, and adapted them to stable value, rather than blazing a new trail. These approaches have withstood the test of time and are widely understood by investment professionals.

Not only is the ability to have consistent return calculations important in and of itself, it also opens up the stable value world to a host of other performance analysis tools - benchmarks, composites, attribution, risk measurement, etc. - which are meaningful only with consistent return numbers. With this problem resolved, plan sponsors, investment managers and consultants can evaluate performance of these funds with the same level of confidence that exists with other asset classes. Compliance with AIMR presentation standards would be a possibility. And most importantly, this will bring more accountability into the investment and oversight process, which will ultimately benefit stable value investors.

While the report focuses primarily on providing consistent performance comparisons between funds for use by plan fiduciaries, investment managers and consultants, other types of performance reporting should also be mentioned. The importance of performance reporting to participants needs no elaboration, and for this purpose, book value returns alone are the appropriate reporting basis. In addition, book value is also the appropriate format for measuring returns and return volatility when comparing risk/reward characteristics with other asset classes in an asset allocation analysis. In this type of presentation, book value is appropriate for the stable value asset class because, over the long time periods involved, typically 10-15 years or more, the limitations of using book value returns tend to diminish. But for comparisons between stable value funds and with benchmarks, this is much too long.

The report is about six pages including a one and a half page overview at the beginning. It discusses in detail the shortcoming of using only book value when comparing stable value funds and gives examples of the cash flow effects and the delayed gain loss recognition problems. It then discusses how fair value addresses these issues and how it might be calculated for illiquid assets such as GICs. There is a discussion on valuing the benefit responsive option and of how the ability to present consistent return numbers could lead to a comprehensive performance analysis framework, including the possibility of AIMR compliance. The appendices have some additional detail including performance simulations using both book and fair value, AIMR compliance issues, and addressing the concerns raised

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by the membership after the publication of the exposure draft.

Consistent, objective performance measurement is an integral part of investment management in almost all other asset classes. It provides essential information to plan fiduciaries, consultants, and fund managers needed to carry out their responsibilities. It brings real accountability to the investment process, which ultimately benefits participants. By addressing a major deficiency in stable value performance reporting with the disclosure of fair value return information, one can envision stable value performance analysis being as useful and thorough as it is with any other asset class, and the industry will benefit as a result. ❖

"Social Security" continued from page 13

of a higher rate or an increase in the amount of wages subject to tax, would reduce the rate of return individuals receive on their contributions and undermine support for the system.

Benefit Adjustments

To solve the problem solely through adjustments in benefit levels would require a 25 percent across-the-board reduction if current retirees were included. If those in or near retirement are held harmless, younger workers would face benefit reductions of 30 to 35 percent. Benefit cuts sufficient to restore solvency, without some mechanism to replace them such as individual accounts, would reduce rates of return individuals receive on their contributions and could erode support for the system. While there are appropriate adjustments that can be made to the benefit structure, it is probably not feasible, or desirable, to restore solvency to the current system solely through benefit reductions. Possible benefit adjustments include increases in the normal retirement age and possibly the earliest eligibility age, changes in the benefit formula, modifications to the Consumer Price Index so that it accurately reflects inflation, and means-testing of benefits.

Increases in life expectancy and improvements in health status have been quite dramatic since Social Security was put in place and may justify an increase in the normal retirement age. However, increases in the normal retirement age will have a negative impact on many employers due to increased costs for employer-provided retirement, health and disability plans that will flow from delayed retirement or delayed receipt of Social Security benefits.

The formula for determining Social Security benefits could be modified in a way that protects the most vulnerable members of society. This could be accomplished by reducing benefits and adopting a more generous minimum guaranteed benefit. Such changes to Social Security's benefit formula can be viewed as a form of "means testing" because middle- and higher-income individuals would have less of their pre-retirement income replaced by Social Security. This approach contrasts with proposals to means test Social Security benefits based on other assets held in retirement. Asset-based means testing is popular with the public but would be difficult to administer, could lead to sheltering of assets and income, create a disincentive to save, and could undermine support for the Social Security system among middle- and higher-income individuals.

Increasing The Rate of Return

Problems posed by proposals to increase revenue and/or reduce benefits have spurred interest in proposals to improve the rate of return on assets held by the Social Security trust funds. However, moving to a more funded system and investing Social Security assets in the private markets where they would earn a higher real rate of return than is credited to the special issue Treasury bonds held by the trust funds raises a host of complicated issues that must be thought through very carefully.

Centralized Investment

One approach would maintain the defined benefit plan nature of the current Social Security system and have the government invest the trust fund assets through a newly-created governmental agency. Supporters of this approach

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argue that sufficient firewalls can be constructed to minimize government influence over the investments. Critics of this approach, however, raise a number of concerns. Investments of large amounts of capital by a central fund could result in undue asset concentration in certain market segments, leading to share price distortion. The government would own substantial portions of private companies, raising significant corporate governance concerns. It would create the potential for social investing - basing investment decisions on criteria other than financial risk and return. This approach could improve the financial status of the trust funds but would not create new savings in the economy. In essence, it would swap current trust fund investments in debt for investments in equity. The markets would respond with shifts in the relative cost of debt and equity. Other investors would then increase the amount of debt they hold and decrease their equity holdings. Thus, in a macroeconomic sense, the overall economy would be no better off.

Individual Accounts

An alternative to investing the Social Security trust funds in the private capital markets is to redesign the Social Security system so that it is made up of two components: 1) a defined benefit plan that continues to provide a guaranteed annuity based on work history and which invests any assets it holds in special issue Treasury bonds; and 2) a defined contribution component that consists of individual accounts owned and invested by the individual participant.

Properly structured individual accounts have the potential to create new savings and improve the overall economy, raising standards of living for active workers and retirees. Individual accounts would give all Americans participating in the Social Security system the opportunity to accumulate wealth that could be passed on to their heirs. Individual accounts should not, however, be a substitute for employer-sponsored retirement plans, IRAs, or other forms of savings. Individuals will need to continue to supplement their Social Security benefits with personal savings.

The creation of individual accounts also raises many issues with respect to the funding, administration and governance of such accounts. Depending on how they are structured, individual accounts could have similar consequences for the capital markets, including the potential for undue market concentration, share price distortion, and non-economic factors influencing investment decisions. However, unlike the centralized investment approach, individual accounts can be designed in a manner that minimizes these concerns. Individual accounts also raise a host of administrative issues. Approximately 147 million Americans participate in Social Security, including young, seasonal, part-time, and itinerant workers. Many of these workers would have very small account balances. Who should be responsible for collecting, allocating, and investing the contributions? Who would administer the accounts? How should fees be structured? How much investment discretion should be allowed? What is the proper form of benefit payment; full or partial annuitization or lump sums? Much work remains to be done in designing effective individual accounts.

Individual accounts that are funded by reallocating a portion of the current payroll tax also create transition problems. Current payroll taxes are used to pay current retirees' benefits. Reallocating a portion of these taxes to create funded accounts for active workers makes it more difficult to meet our obligations to current retirees. Because those in or near retirement will continue to receive their promised benefits, younger workers will face larger reductions in the defined benefit component of their Social Security benefits than would otherwise be the case if a portion of their payroll taxes were not reallocated to individual accounts. By taking advantage of the higher rates of return available in private markets in the individual accounts, however, individuals should be able to more than offset the benefit reductions in the defined benefit component of the system.

The Outlook

There is a great deal of bipartisan interest in enacting Social Security reform legislation this year. The President, anxious to move forward on developing a legacy, made Social Security reform the centerpiece of his State of the Union address. Republicans want to show that they can govern effectively. The window of opportunity, however, is relatively brief. Most experts agree that once campaigning for the 2000 presidential election begins in earnest, the candidates' and the parties' positions will harden - making compromise difficult, if not impossible. Reform is possible, but the conditions are very fragile. It also is unclear how substantial any reforms will be. Will Congress adopt fundamental reform to put the system on solid footing for the next 75 years, or will more limited steps be taken to extend the solvency of the trust fund for a shorter period of time? Prospects are likely to rise and fall over the coming months. ❖

Funding Agreements in Money Market Funds

Brian R. Carosielli and Jennifer F. Williams, Fitch IBCA
Janet D. Olsen, of Bell, Boyd, & Lloyd assisted in the preparation of this report.

Summary

The pace of innovation in money market investments has increased in recent years, leading to a proliferation of products and a complex array of investment choices. At the leading edge of this innovation are funding agreements. Consequently, money market fund portfolio managers are increasingly offered funding agreements for potential investment.

Professionals in the mutual fund industry have debated the appropriateness of funding agreements as eligible money market investments under Rule 2a-7 since money funds first invested in funding agreements. Often, fund managers are apprehensive of investing in new products, since the instruments have not yet been tested during adverse market conditions. Some portfolio managers have approached funding agreements cautiously due to concerns regarding liquidity, credit exposure, and inconsistent regulation among states. Proponents of funding agreements argue that they are stable, liquid investments that offer attractive risk-adjusted returns. In this report, Fitch IBCA examines the suitability of funding agreements as money market fund investments within the context of Rule 2a-7 eligibility standards and Fitch IBCA money market fund ratings guidelines.

Background

Funding agreements are contracts issued by insurance companies (the issuers) that provide the policyholder with the right to receive a fixed or variable rate of interest and the full return of principal on the maturity date. The market for funding agreements consists primarily of nonqualified institutional investors, as defined under the Employee Retirement Income Security Act (ERISA) of 1974, that purchase the contracts directly from insurance companies or brokers. The National Association of Insurance Commissioners (NAIC), as well as many state guaranty funds, have classified funding agreements as insurance policies; therefore, the policies are regulated under state insurance laws. As with all insurance products, funding agreements do not have to be registered with the Securities and Exchange Commission (SEC) under the Securities Act of 1933.

Funding agreements were developed by insurance companies as a means to maximize their existing guaranteed investment contract (GIC) underwriting expertise and distribution capabilities. In a GIC market that has been characterized by increased competition and declining sales, funding agreements have provided insurance companies with an additional source of revenue.

A GIC can be defined as a benefit-responsive contract that is issued to a tax-qualified pension plan, as defined by ERISA, that guarantees an interest-crediting rate for a specified period. Funding agreements and GICs have similar characteristics, but funding agreements differ in two fundamental ways: 1) they are sold to nonqualified institutional investors; and 2) they include embedded demand features.

A majority of the funding agreements sold are highly customized to meet money market fund investor preferences. For example, an investor in a variable-rate funding agreement can choose from a myriad of appropriate money market indexes that are used to determine the interest-crediting rate, including: one-month, three-month, six-month, or 12-month London Interbank Offer Rate (LIBOR); Fed funds; and the one-year Constant Maturity Treasury Index (CMT). In addition, funding agreements that are purchased by money market funds typically include embedded demand features, which entitle the policyholder to receive principal in a defined number of days after giving notice to the issuer. Money market funds may choose from seven-, 30-, 90-, 180-, 365-, or 397-day demand features. Several money market funds also customize their extension agreements, day of interest rate reset, and policies regarding issuer downgrades.

According to the Investment Company Institute, money market fund assets increased from \$1,055.93 billion at Nov. 30, 1997 to \$1,357.22 billion at Nov. 30, 1998 (see chart on next page). Over a similar period, a Townsend & Schupp Co. survey of insurance companies estimated that there was \$16.25 billion of new funding agreement issuance for calendar year 1997 and \$21.93 billion of new issuance for the first nine months of 1998 (see chart on next page). An estimated 35.7%, or \$7.83 billion, of all new 1998 funding agreement sales was to money market funds (see Distribution of Funding Agreement Sales by Market Segment chart, page 19). This \$7.83 billion of new issuance in 1998 represents

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close to a 9% increase over 1997 sales to money market funds. Townsend & Schupp has also approximated that, as of the first nine months of 1998, the amount of funding agreements outstanding was \$44 billion. With rapid growth and increased competition in the money market fund industry, elevated demand for funding agreements should continue.

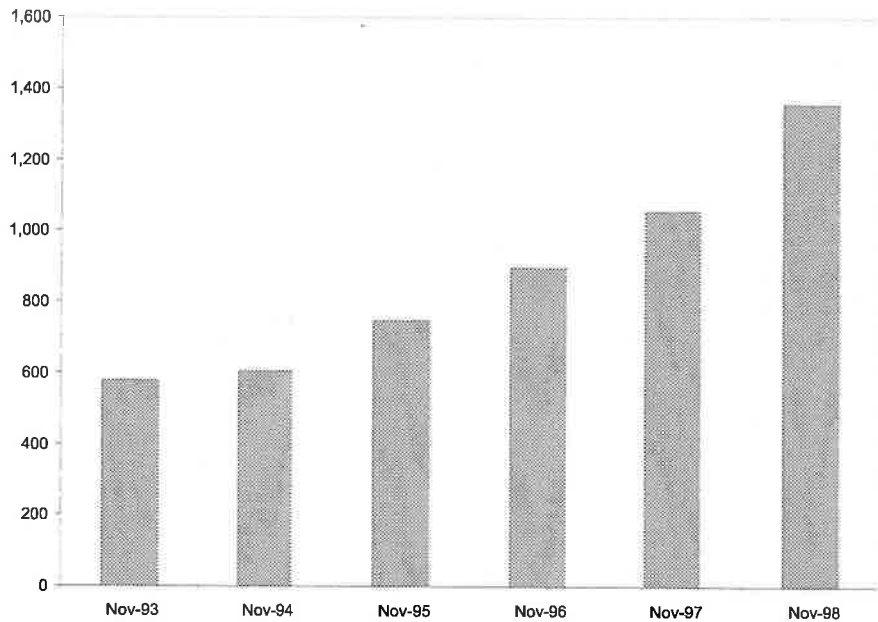
Reasons for Investment

Because of a flattening of the U.S. Treasury yield curve over the past two years, most money market fund managers have been actively seeking investments that will increase portfolio yield without adding supplementary risk. Funding agreements have become one of the fastest growing asset classes in several money market funds because of their attractive yields. Traditionally, funding agreements have offered yields that are, on average, 15 basis points higher than similarly rated commercial paper or other variable-rate instruments. Portfolio managers have also been enticed by the diversification benefits that funding agreements offer. Since most insurance companies do not issue commercial paper, funding agreements allow money market funds to receive credit exposure to the insurance industry (in particular, mutual insurance companies). In addition, funding agreements allow for a high degree of contract customization, which creates the opportunity for portfolio managers to build a security that meets their investment criteria and desired risk profile. Furthermore, due to seven-day demand features, funding agreements can offer more liquidity in volatile market conditions than some traditional money market investments.

Risks

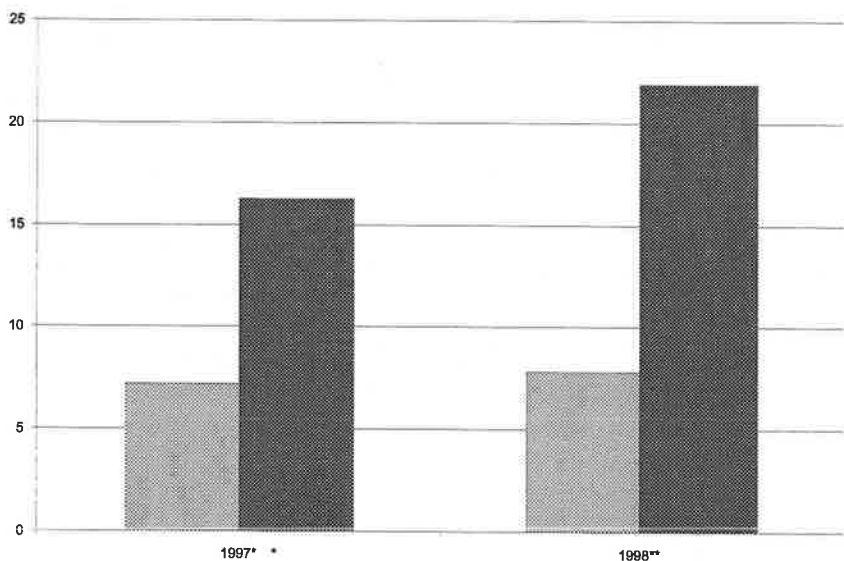
Even though investor demand for funding agreements has increased, many portfolio managers still oppose their use in money market funds. One of the most common arguments against

Growth in Money Market Fund Net Assets



Source: Investment Company Institute

Funding Agreement Sales



*Full calendar year. **Through first nine months. Note: All data provided by the Townsend & Schupp Co. survey are from reliable sources, but the company cannot guarantee accuracy. Source: Townsend & Schupp Co.

☒ Money Market Funds
 ☒ Total Sales

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funding agreements is that they should be considered "illiquid" securities. Because of the absence of a secondary market, accompanied with minimal contract standardization, many parties believe that funding agreements have no liquidity. No secondary market exists for funding agreements because they are insurance contracts and, therefore, cannot be traded. In addition, some argue that the demand features in funding agreements will actually decrease portfolio liquidity if a large percentage of the outstanding contracts is "put" back to the insurer over a short period of time and the insurer has difficulty fulfilling these large contractual obligations.

Funding Agreements: Rewards vs. Risks

Rewards

- Diversification.
- Contract customization.
- Liquidity from seven-day demand feature.
- High yields.

Risks

- No secondary market.
- Minimal contract standardization.
- Unclear state regulations.
- Credit and liquidity concerns about issuer.

Another concern of portfolio managers is the lack of clarity and continuity in state insurance regulations regarding the claims priority of funding agreements in the event of issuer insolvency. According to some state insurance laws, funding agreements are treated as obligations of the insurance company, giving the contracts senior claims status over all creditors and making them pari passu with all policyholders. However, some states have not clarified the claims status of funding agreements, which creates uncertainty as to how these agreements would be treated in the event of an insurance company's liquidation.

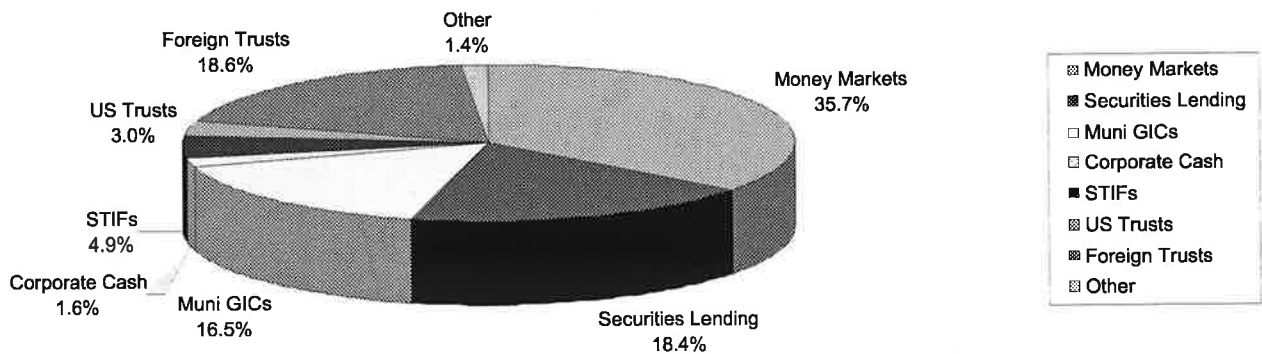
Because of the default in 1991 of two large insurance companies, Executive Life Insurance Co. and Mutual Benefit Life Insurance Co., some portfolio managers are worried about the claims priority of funding agreements. In the case of Mutual Benefit, GIC investors did

not suffer any loss of principal, while Executive Life GIC investors experienced minor losses of both principal and interest. More importantly, both groups of investors incurred a long delay in the return of their principal. In both cases, the state insurance regulators treated GICs as pari passu with all other policyholders.

As mentioned earlier, funding agreement investors are exposed to the inherent credit and liquidity risks of an insurance company. Therefore, a portfolio manager needs to thoroughly analyze the investment operations and financial strength of the funding agreement issuer. The portfolio manager should consider the asset/liability management techniques, capital position, investment policies, lines of business, and liquidity of an insurance company when determining the adequacy of its investment operations. When measuring the financial stability of an insurer, a portfolio manager can utilize the financial strength and claims-paying ability ratings provided by Fitch IBCA and other Nationally Recognized Statistical Rating Organizations (NRSROs).

"Funding" continued on next page

Percentage Distribution of Funding Agreement by Market Segment



GICs - Guaranteed investment contracts. STIFs - Short-term investment funds. Note: All data provided by the Townsend & Schupp Co. survey are from reliable sources, but the company cannot guarantee accuracy. Numbers may not add to 100% due to rounding. Source: Townsend & Schupp Co.

"Funding" continued from previous page

Rule 2a-7 Suitability

A funding agreement must meet several criteria to be classified as an "eligible security" under Rule 2a-7 of the Investment Company Act of 1940 (the 1940 Act). First, it must be a "security" as defined by the 1940 Act. Second, it must have a remaining maturity of no greater than 397 days. Third, it must satisfy certain credit quality criteria, including, in most cases, bearing a rating in one of the two highest short-term rating categories from at least two NRSROs.

Neither the SEC nor the courts have provided any guidance as to whether funding agreements are eligible securities. However, insurers offering these agreements, fortified, in some cases, by legal opinions issued by their counsel, have represented that such agreements meet the three criteria for an eligible security.

First, based on certain features of such agreements and various authorities relating to other types of financial instruments, these insurers have persuasively argued that such agreements meet the first test of an eligible security, namely that it is a security within the meaning of the 1940 Act.

Second, funding agreements targeted to money market fund investors typically meet the "remaining maturity" criteria for an eligible security by including demand features allowing the investor to put the agreement back to the insurer after the lapse of predetermined periods, each less than or equal to 397 days. Money market funds often invest in funding agreements with seven-day demand features. The variable rate of interest provided for in such agreements, coupled with the demand feature, allows the investor to treat the maturity of the funding agreement as the earlier of the period remaining until the next interest rate reset date or the date on which the holder, by exercising its demand right, can sell the security for its approximate amortized cost. This feature allows the fund to ascribe a seven-day maturity to such agreements in its determination of the fund's overall portfolio maturity under Rule 2a-7.

Finally, a majority of insurance companies offering funding agreements have satisfied the credit quality criteria for an eligible security by obtaining a rating in one of the two highest short-term rating categories from at least two NRSROs.

Fund managers should note that funding agreements that do not have seven-day demand features may be classified as illiquid securities for regulatory purposes and/or the fund's internal investment restrictions.

Rating Agency Perspective

As with any money market investment, funding agreements must meet a strict set of criteria before being eligible for purchase in a Fitch IBCA-rated money market fund.

First, all eligible variable-rate securities (i.e. funding agreements) should support a stable portfolio net asset value (NAV) by providing a market value that approximates par at the security's interest rate reset date. Moreover, the interest rate index that is chosen must be one that moves in tandem with short-term market rates, i.e. one-month LIBOR and Fed funds. Long-term interest rate indexes, such as the 10-year CMT, and indexes that lag market rates, such as the 11th District Cost of Funds Index, are not appropriate for money market funds. Also, Fitch IBCA will not permit investment in variable-rate securities with complex coupon formulas similar to those found in some structured notes.

In addition, since most funding agreements have demand features, it is important to evaluate the quality and liquidity of the feature. Fitch IBCA's Managed Funds group looks to the rating of the issuer when determining the issuer's ability and willingness to honor the demand feature, especially during periods of stress. When assigning a claims-paying ability rating for an insurance company, Fitch IBCA factors in the ability and willingness to honor all obligations, including funding agreements with their associated demand features. Second, the credit quality of the issuer, as well as the level of concentration with any single issuer, is also measured. Also, for all funding agreements that have demand features beyond seven days, Fitch IBCA will regard the put date, not the interest rate reset date, as the final maturity for the investment. Finally, Fitch IBCA defines any funding agreement that does not have a seven-day demand feature as an illiquid security, and such illiquid securities cannot comprise more than 10% of total money market fund assets.

Funding agreements are viable investment alternatives for money market funds if they are structured properly and entered into with creditworthy issuers. Through demand features, money market funds are able to obtain the liquidity they need to maintain a stable NAV. Furthermore, by performing a thorough company/investment analysis and utilizing NRSRO ratings, an investor can make an accurate assessment of the financial strength and claims-paying ability of an issuer. ♦

Highlights of Second Annual Stable Value Funds Investment Policy Survey

by Wayne Gates,

General Director, Guaranteed & Stable Value Products, John Hancock

The Stable Value Investment Association has completed its second, comprehensive, publicly available survey of stable value investment portfolios. The survey covers investment characteristics and placement activity of stable value portfolios for the calendar years ending 1996 and 1997. It included more than 60,000 plans with stable value assets of \$164 billion and placements of \$33 billion for 1997.

Data was collected from four distinct segments within the stable value market:

- external stable value managers for individually-managed plans;
- external managers of commingled stable value pools;
- in-house stable value managers; and
- single issuer managers of commingled funds (bundled full service life company providers).

Individually managed plans are much larger, on average, than are plans within stable value pools and commingled single issuer stable value funds. Whereas the average size of the 350 individually managed stable value funds contained within the survey was nearly \$400 million, the average size of the stable value plans assets of the nearly 60,000 plans investing in commingled funds (pools and single issuers) was only slightly more than \$0.75 million. The following table summarizes the survey results by segment.

Summary Statistics by Manager Segment For Year Ending December 31, 1997					
	Individual: Externally Managed	Individual: Internally Managed	Stable Value Pools	Single Issuer	All Funds
Assets Outstanding: Dec. 31, 1997	\$94,309 Million	\$23,546 Million	\$17,100 Million	\$28,816 Million	\$163,781 Million
Number of Plans Included	337	13	5,034	54,872	60,256
Average Size of Plan Stable Value Assets	\$279.8 Million	\$1,811 Million	\$3.4 Million	\$0.5 Million	\$2.7 Million
Blended Rate: Dec. 31, 1997	6.73%	7.17%	6.34%	6.67%	6.77%
Modified Duration	2.4 years	3.4 years	2.3 years	3.5 years	2.8 years
Average Credit Quality	AA+	AA+	AAA/AA+	A+ (a)	AA+/AA
Stable Value Placements CY 1997	\$18,186 million	\$1,973 million	\$4,273 million	\$8,848 million	\$33,386 million
Yield on 1997 Stable Value Placements	6.54%	6.68%	6.59%	7.40% (a)	6.84%
Modified Duration of 1997 Placements	3.8 years	5.0 years	3.5 years	4.1 years	3.9 years

(a) Account assets only. Excludes the quality of the issuer's guarantee.

The average portfolio blended rate ranged from 6.34% for the stable value pools to 7.17% for internally managed individual plans. The variation across segments is largely explained by average size, credit quality and portfolio duration. In addition, the relatively high average blended rate for the internally managed funds reflects the influence of several plans with quite long stable value portfolio durations that still maintain crediting rates well above 8 percent. Generally, the longer the portfolio duration and the lower the credit quality, the higher is the blended rate. In addition, with the exception of the single issuer segment, the blended rate appears to be positively correlated with the average size of the plan's stable value assets. For single issuers, this is not true, and may be related to several factors. First,

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the underlying quality of the assets backing the guarantee is single-A, on average. Second, these issuers manage the commingled funds to a longer investment duration. So, the quality and duration offset some of the effects of smaller size for the single issuers.

Multi-Issuer Stable Value Portfolios

Because single issuers manage their commingled stable value funds in a different fashion than individually managed stable value funds and pools, the portfolio mix for this segment is considered separately. The following table shows the mix of investments within individually managed stable value funds and stable value pooled funds.

The survey demonstrates that there are a number of different ways to manage stable value funds effectively. While some funds invest entirely in traditional GICs, others have virtually none, with a preference for synthetic GICs only. External stable value managers use more buy-and-hold synthetics, while internal managers use more evergreen synthetics and separate accounts.

Multi-Issuer Portfolio Mix: December 31, 1997			
Percent of Portfolio			
	Individual (Jumbo) Funds: Internally Managed	Individual Funds: Externally Managed	Stable Value Pools
Traditional GICs	45.1%	37.7%	31.4%
Separate Account GICs	23.3%	1.8%	2.4%
Buy and Hold Synthetic	2.1%	31.7%	35.0%
Managed Fixed Maturity Synthetic	6.7%	5.3%	12.0%
Managed Evergreen Synthetic	21.1%	16.2%	10.1%
Cash and Short Term Funds	1.5%	5.8%	5.6%
Other	.2%	1.6%	3.5%

From 1996 to 1997, traditional GICs continued to lose their share of the multi-issuer market, declining from about 47 percent to about 37 percent. This decline resulted from continuing increase in the use of synthetics, which grew from about 38 percent to 49.5 percent of multi-issuer portfolios. (Including the single-issuer segment, which is primarily GIC products. GICs had about 48 percent of the total market in 1997.)

Most likely a reflection of the decline in the share of traditional GICs, entirely non-participating and non-experience rated investments fell from roughly 56 percent to 45 percent from 1996 to 1997. On the other hand, the share of entirely participating and experience rated investments rose to 47 percent from 31 percent during that time. While all three segments of the multi-issuer group have increased this risk within their portfolios, the largest changes have occurred in the externally managed portfolios and pools. In-house managers have a lower portion of their portfolios in participating contracts, perhaps because of the longer durations of their portfolios.

Single Issuer Portfolio Mix

Within the single issuer segment, stable value funds have only one guarantee provider and often only one contract. SVIA surveyed the composition of the investment portfolio backing that contract. The following table provides the portfolio composition for that account.

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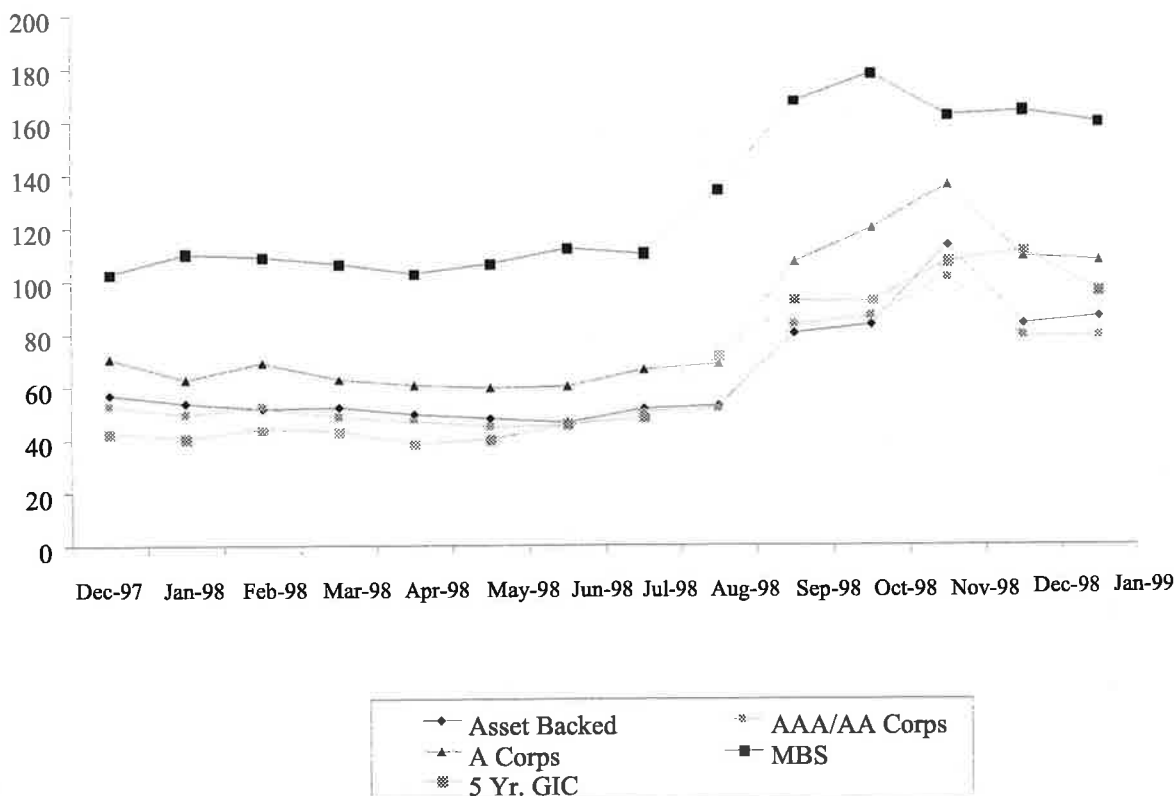
Single Issuer Portfolio Mix December 31, 1997	
	Share of Portfolio
Cash and Short Term Investments	1.5%
Bonds	48.8%
Collateralized Mortgage Obligations	11.3%
Commercial Mortgages	33.3%
Government Securities (excluding CMOs)	2.6%
Other	2.4%

This segment represented almost \$30 billion in stable value assets in 55,000 plans. One-third of these plans are class year plans, but such plans represent about three-quarters of the segment when weighted by assets. Almost one-third limit the volume of annual participant book value withdrawals from the stable value fund. Virtually all (99.5%) of the stable value assets are invested in general account contracts. Roughly one-half of stable value assets are both non-participating and non-experience rated, while the remaining one-half are entirely participating and experience rated. ♦

Tracking Stable Value Yield Spreads

by Karl Tourville,
Managing Partner, Galliard Capital Management, Inc.

Risk premiums on all non- U.S. Treasury securities recovered (tightened) in the December/January time period as the fixed income markets stabilized following the hedge fund /liquidity crisis last fall and evidence of continuing strength in the U.S. economy. At the same time, interest rate have backed up over 70 basis points in 1999 as market participants' concerns have mounted that a strong economy will cause inflation to rise and the Federal Reserve to tighten monetary policy. 5 year GIC spreads are now wider than comparable quality corporates after trading inside corporate spreads in the first half of 1998. ♦



NEW AT SVIA

Peter Bowles Wins 1999 Annual Forum Conference

Peter Bowles from Fiduciary Capital Management was the first person to call in using SVIA's 1-888-543-2788 number and correctly identify Hardball's Chris Matthews as the speaker in the postcard picture. As the contest winner, Peter has won himself a free registration to the 1999 Annual Forum on October 12-14.

Don't Forget October 12-14, 1999 SVIA National Forum

Don't forget to save October 12-14 (Tuesday to Thursday) for the SVIA National Forum at the Monarch Hotel in Washington, D.C.

Stable Value Glossary on the Internet

In response to your requests, the Association's stable value glossary of terms is now available on the Internet. The glossary can be obtained through SVIA's website at www.stablevalue.com.

1998 Market Predictions

In last year's first issue of Stable Times, you were asked to fax in your predictions for the 1998 financial market. Unfortunately, at this time, Stable Times is unable to locate your predictions and announce the winner of the contest.

Coming to Washington? Get SVIA Rate at the Jefferson

The Jefferson Hotel is offering SVIA members a special rate of \$210 exclusive of taxes. The Hotel's standard room rate is \$350. The Jefferson is located at 16th and M Streets, NW. To take advantage of this rate, just call the Jefferson at 202-342-2200 and tell them you are a member of the Association.

Scott Matirne Joins SVIA

As of January 25, SVIA's staff doubled in size with the addition of Scott Matirne. He is SVIA's Administrative Coordinator and in this crucial role, he will see the Association's work through its' various stages of production to completion.

Scott brings to the position, strong self-motivation, good judgment and the ability to integrate a number of diverse skills in accomplishing tactical and strategic objectives. He has successfully demonstrated these attributed in the short period of time since joining SVIA by helping us get to you the Report of the Performance Measurement Task Force, the 1997 Investment Policy Survey, and many surveys whose results will soon be shared with you.

His experience from the National Association of College and University Attorneys as a Membership and Staff Assistant will serve SVIA well as the Association continues to improve membership services and outreach. Scott also brings to the Association over eight years of military service from the U.S. Coast Guard and the Marine Corps. ♦

ANSWERS TO FOURTH QUARTER 1998 CROSSWORD PUZZLE

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