

# SVIA STABLE TIMES

The quarterly publication of the Stable Value Investment Association

Volume 4, Issue 2 • Second Quarter 2000

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## Stable Value: Challenging the Reach of Asset Allocation Models

By Randy Myers

The latest and hottest innovation to hit the defined contribution plan market is proving to be a lukewarm event for the Stable Value industry.

The innovation is automated online investment advice for DC plan participants. By considering information about a participant's age, income, investment goals and appetite for risk, these Internet-based services can spit out a custom-tailored asset allocation plan for that person complete with fund-specific recom-

mendations about how to execute them. Nearly all of the major plan providers now make them available.

The problem, according to Stable Value experts, is that these advice services use widely divergent methodologies to model Stable Value Funds, often with less precision than would be ideal.

"Some treat Stable Value as a money market fund, others as a bond fund, others as a combination of the two," observes Wayne Gates, General Director of John Hancock Financial Services and chairman of a SVIA task force

looking into the issue. "But none of these approaches gives Stable Value full credit for its key attributes."

Gates says the root of the problem is the belief by many advice providers that standard deviation of participant returns—the risk measure commonly used in their computer models—does not capture the full risk of Stable Value Funds. By virtue of their book-value guarantee, of course, Stable Value Funds generate returns that are much less volatile than those of the typical short-term bond

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## What Asset Classes and Funds Should Plan Sponsors Be Adding in 2001?

Excerpts reprinted with permission from IOMA's DC Plan Investing Spring 2000 IOMARATE.

High tech and Asian markets were clearly some of the best sectors to be in during the past twelve months and, as a result, were most often on last year's list of new fund areas for DC plan managers. But with valuations at such lofty levels in high tech and Japan still in mired in recession, what should plan sponsors be looking to add next year? Another small cap growth fund? Biotech? Stable Value? Will value prove to be the common sense area once again? To get some answers to these questions, DC Plan Investing takes a look at the latest trends from its analysis of the leading stable value pooled

funds, the performance of company stock, and more than 4,000 funds with five-year performance records in its IOMARATE database.

### Review safest asset classes first.

If, as Alan Greenspan speculates, we are in a market bubble, the first order of duty is to make sure participants have a safe haven for their gains. In this regard, stable value funds stand head and shoulders above the crowd. Any captain worth his or her salt, looks to the safety of the passengers first. Make sure participants have an option should they see storm clouds on the horizon.

The time to make such a move though is well before the weather changes. Enormous drops in markets occur so quickly that most participants make these moves after the market has completed its correction. Today's Web-based plans, however, make it easy for participants to switch quickly out of high risk equity funds into the safety of stable value with a few keystrokes. And, while timing the market is bad advice generally for 401(k) plan participants, many sponsors are now taking heed and building cautionary advice and common sense strategies into their education programs. IOMA's

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## EDITOR'S CORNER

By Vicky Paradis

If the objective of *STABLE TIMES* is to plug readers into the pulse of the stable value industry, then this issue should certainly meet its goals.

We once again asked Randy Myers, a professional journalist, to cull together the insights of various industry members on two key issues that we face today: liquidity management and investment advice models. Both topics are on our radar screen because they are symptomatic of a new defined contribution investment paradigm – we now exist in an environment that is, and will continue to be, driven by daily internet access and equity returns.

Randy's first article is on cash flow volatility, which is something of great interest to virtually all parties in the stable value industry, whether plan sponsor, investment manager, or book value contract provider. Randy polled a good sample of voices on cash flow trends and various techniques to meet what have been surprising levels of liquidity demands for many plans. His conclusion was favorable – that all stable value strategies held up well. Yet, we still have room to maneuver and refine our techniques. This issue of *STABLE TIMES* also includes statistics from Hueler Companies that quantifies the cash flow trends.

Randy's second contribution covered the new online advice models, and the modeling and interpretation challenges posed for stable value funds. It's

important both to participants and members of the stable value industry, that these models accurately reflect the risk-return profile of stable value investments.

On the topic of asset allocation, we have included excerpts from a recent IOMA DC Plan Investing article that suggests some of the most attractive investment options that plan sponsors should consider adding in 2001. It wisely suggests that offering a good stable value fund as a safe haven is particularly important in today's marketplace.

Yet another important topic in our industry is presenting performance results for stable value investments. We have summarized a useful speech on this very topic by a performance presentation expert at this past April Institute for International Research conference.

Judy Markland once again has shared the insights gained from the Third Annual Stable Value Fund Investment and Policy Survey. This time she focuses on the life company full service funds by presenting some interesting statistics and comparisons with other investment approaches.

Last, Gina Mitchell and the SVIA's Committee on Communications and Education has had a successful start at garnering favorable press for stable value funds. Jennifer Hudson's short piece highlights some of their success.

We think these topics will be of great interest to you. We hope to hear your opinions. We welcome letters, emails, or phone calls in response to these articles and we're always looking for new topics to include in upcoming issues.

Enjoy the summer!

## Announcing Four New *STABLE TIMES* Editorial Board Members

The *STABLE TIMES* Editorial Board is happy to announce the addition of four new members this quarter:

**Jo Anne Davis**, Principal, State Street Global Advisors

**Aruna Hobbs**, Director of Institutional Products and Head of Stable Value Business at AEGON Institutional Markets

**Barbara MacLean**, Director of Marketing at ING Institutional Markets

**Bob Whiteford**, Principal, Bank of America

Please join SVIA in welcoming them aboard and thanking them in advance for dedicating their time and talents to *STABLE TIMES*.

## SVIA *STABLE TIMES*

Second Quarter 2000

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## Adding in 2001

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recommendation: If you don't have a stable value option in your plan—add it now. A guaranteed 6% gain looks spectacular next to a potential 25% decline.

### Next, look at company stock— If you are so lucky.

The use of company stock in 401(k) plans is expanding rapidly. It is commonly found in many Fortune 1,000 plans and more generally in about 14% of all 401(k) plans nationwide. Company stock is a great way to build participants' sense of "ownership" and is a relatively inexpensive match for the corporation. Moreover, studies have shown, that when company stock is used in conjunction with stable value, the combination actually allows the participant to hold higher percentages of company stock in their portfolio without out increasing risk as much as they would with out stable value.

### Growth funds—Too late to add in 2000?

Clearly the place to be in 1999—mid cap growth funds were up a whopping 53% on average while small cap funds were up only slightly less with a 51.6% gain. The longer term trends however, favor large-cap growth funds—which posted a 31.8% over the last three years (versus 21.8% and 28.7% for mid and small cap respectively) and 30.0% for the last five years (versus 24.2% and 27.3%). IOMA's recommendation: Add a large cap growth category and fund if you don't have one in your plan. Not only are the valuations of most of the larger companies in these funds likely to be more realistic

than in their smaller cap peers, but these funds also tend to incorporate some of the large cap high tech growth companies so they tend to track the high tech areas ups and downs but with somewhat overall slower growth. It is also abundantly clear that despite Greenspan's best efforts, the economy's growth and these funds are likely to remain on the fast track at least for the rest of 2000.

### Value funds—Still out of favor?

Once the bedrock foundation of many wise investment strategists ranging from Warren Buffet to Michael Price, the market's tilt towards growth and high tech has

left most value funds in their wake in the last two years. Indeed. Value large-cap funds gained just 7.5% in 1999 and 13.8% in 1998. Mid cap value gains were similar. Small cap value however had a good 1999 — with a gain of 27.3%. Small cap value fund performance is likely to continue beating out their larger value peers this year since the market is still having a hard time placing a value on underperforming "old economy" large cap stocks. IOMA's recommendation: If your plan doesn't have a small cap value category or fund — add it in 2000.

### European or Asian?

Was 1999 a fluke for Asian funds? After waiting for nearly

eight years, most Asian funds with a significant Japanese exposure jumped any-where from 80% to 113%. Was it worth the wait after significant declines in both 1997 and 1998? Not many plan participants have this time horizon or risk tolerance. Besides, now that Japan has slipped back into recession, has this market gone into a holding pattern? European market funds, on the other hand, lead by the region's growth engine Germany, have climbed steadily up 22.5% over the last five years, 23% over three years and 25% last year. IOMA's recommendation: If you don't have a European category or fund in your plan, add one this year. 

## Where Are They Now?

*An update from STABLE TIMES founder Allan Fen.*

Things were just a little too, uh, stable. With over fifteen years in the business, I craved uncertainty, chaos, and yes, instability. I certainly found it at a dotcom startup, Telekomnet.com. After taking a year off - highly recommended if your marriage has a solid foundation - to reflect upon this midlife crisis, I took the plunge at the beginning of this year. Since I was a founder and first editor of *STABLE TIMES* and my career took an unusual turn, Gina thought a brief piece about all this might be of interest. Hah!

My experience editing not only *STABLE TIMES* but also a Fidelity client newsletter and another for investment actuaries got me thinking about publishing as a possibility, web publishing in particular. Unless you are techie, the smaller companies are looking more for a track record in

managing projects, managing people and running a business unit, and are not so hung up on specific expertise. With the tight job market, I somehow was able to overcome all of these shortcomings.

Telekomnet is an online networking and telecommunications destination. Our site has industry news, articles, white papers, audio interviews with industry professionals as well as an e-commerce component, reselling networking gear such as routers, switches and bandwidth. I serve as editor for the ISP (Internet Service Provider) Community at [www.telekomnet.com/community\\_isp/index.asp](http://www.telekomnet.com/community_isp/index.asp); our discussion forums ([www.telekomnet.com/scripts/webx.cgi](http://www.telekomnet.com/scripts/webx.cgi)); and the bandwidth marketplace, [www.telcosearch.com](http://www.telcosearch.com). I write some pieces but mostly recruit contributors from around the industry as well as work with free-

lancers. One of my more interesting responsibilities is doing taped phone interviews with industry executives, which are put up on our site as streaming audio files. The first round of venture capital funding was received in November; a second round will hopefully come through by the end of the year and an IPO, fame, glory and riches in 2001. This is all very uncertain. With industry and market shakeouts occurring almost monthly, stable it's not. But it is an interesting fast-paced environment with a lot of incredibly talented people — a sure cure for complacency.

We added a 401(k) plan a few months ago with about ten mutual fund options from various companies ranging from aggressive equity and international to bond and money market. There is no stable value option, and the consultant told me it's really not even on the radar screen. A good future topic would be why this is so for startups and the consultants who advise them. 

## Asset Allocation Models

*continued from page 1*

fund, even though they invest in similar securities. But many advice providers discount the value of the wrap contracts used to provide the book-value guarantee. As a consequence, they tweak their models to assign greater risk to Stable Value investing than its returns would warrant.

"The end result is two things," Gates says. "One, investors who use these models often get lower allocations to Stable Value than they would if it was modeled correctly. Two, they probably end up with lower equity exposure than they should have, and more fixed income exposure, because neither cash nor bonds are as good a diversifier relative to equities as Stable Value is."

Paul Lipson, chief investment officer for the Federal Reserve Employee Benefits System, says he's thus far declined to make any of the commercial advice services available to participants in his organization's \$2.6 billion defined contribution plan because of his concerns about how they would model its Stable Value Fund.

"What these consultants will tell you is that in their view, Stable Value is the equivalent of a money market fund, and they have the capability for modeling that," Lipson says. "In fact, I do not think Stable Value investing is the equivalent of money market investing, and I think the inputs have to be unique."

The numbers tell the story. According to Lipson, a portfolio of 90-day Treasury bills held for 10 years ended June 30, 1999, would have produced a compounded

annual return of 5.5% with a standard deviation of 0.5. During the same period of time, the Lehman Brothers Government/Corporate index of intermediate-term bonds would have earned 8.1% with a standard deviation of 4.4. Meanwhile, the Stable Value Fund in Lipson's defined contribution plan earned 8.9% with a standard deviation of 2.2.

"What we've just done is define Stable Value," Lipson says. "Stable Value over 10 years gives you an intermediate-bond return with much less risk."

Lipson sees another problem with the current crop of advice engines in that the mean-variance modeling methodologies on which they are built were originally developed for use by traditional pension plans, and so employ mathematics that assume very long investment horizons, a single investment objective and a completely tax-free environment. But individual investors who participate in defined contribution plans have complex and multiple financial goals with varying time horizons, and must pay taxes on their withdrawals from those plans.

Gates says the advice providers are making progress toward better modeling of Stable Value Funds, even if they haven't overcome all of the hurdles. "They're getting a lot closer," he says. "For example, the people who run mPower (one of the leading advice providers) have learned a lot about Stable Value in the past few years, and recommend it quite frequently."

Lipson, though, is waiting for still more progress. In the meantime, he has developed an asset allocation modeling program for

his own DC plan participants that suggests how the commercial advice providers might want to approach the task.

Like most of the mean-variance models that are at the core of the commercial advice engines, Lipson's asset allocation program is built on three inputs: projected returns for each asset class, a projected risk level for each asset class, and the correlation between the returns of the various asset classes. To come up with projected returns for his Stable Value Fund, Lipson looks at its actual returns for the past 10 years and then determines the spread between that number and the 10-year return for 90-day Treasury bills. He then layers that spread over the current T-bill rate and uses that as the return going forward.

Lipson's model uses the historical standard deviation of his fund as its risk measure, not so much because he considers that ideal but because it remains the industry standard. In the future, he would prefer that such models use a measure that gives a higher weighting to downside volatility and a lesser weighting to upside

volatility.

Although most Stable Value managers argue that asset allocation models should use inputs for the specific Stable Value Fund available to each investor using that model—and Lipson is emphatic that this is necessary—Gates' task force is nonetheless working to develop a methodology that would allow for the modeling of a generic Stable Value Fund, too. Gates says the point of the generic isn't to use it as a substitute for actual fund data in those instances where it is available. Rather, it would be available for use in the generic asset allocation models that are found on many financial Web sites, most of which do not address Stable Value products at all.

"I think it's a reasonable thing to do," says Gates. "If someone is using one of those generic sources to get an idea about how to allocate money to their Stable Value Fund, and Stable Value doesn't show up on the menu, they're not going to know what to do with it."

The task force hopes to complete a white paper on the issue during the summer of 2000. **SVIA**

## SVIA PR Initiative Produces Articles

*By Jennifer Hudson*

**S**VIA hit the ground running this millennium, launching a public relations initiative that has generated news stories in respected industry publications, as well as in *Newsweek*, *The Wall Street Journal* and *Employee Benefit News*.

The idea for a public relations initiative was hatched in SVIA's

Committee on Communications and Education. In order to fill the void in complimentary coverage of Stable Value, the Committee set the following goals for their campaign:

1. Increase Stable Value's name recognition by generating favorable, informative stories on Stable Value

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## Stable Value Industry Weathers Liquidity Test

*Consider the Stable Value industry tested and certified.*

By Randy Myers

In the most extraordinary example of cash flow volatility that most professionals in the business have ever seen, investors stuffed money into Stable Value funds during the fourth quarter of 1999, then yanked it out at a fast rate in the first quarter of 2000. While the resulting liquidity squeeze caused many investment managers to scramble for cash just as the value of their assets was declining, all were able to make good on their promise to satisfy withdrawal requests at book value.

The rush to Stable Value late last year was prompted by fears that the Y2K computer bug could wreak havoc on the economy and the stock market. When the bug proved benign, and the stock market continued to post heady gains, investors flocked out of Stable Value and back into equity funds. According to data compiled by the Hueler Companies, Stable Value fund cash flows averaged between -0.9% and +1.6% during 1999, but grew to -7.1% in the first quarter of 2000. At the extreme, some funds experienced withdrawals in excess of 18.3%. Particularly hard hit were funds in defined contribution plans where the investment options included technology-oriented mutual funds, or company stock in which the company was a high-tech concern.

Despite the turmoil, many investment managers were able to weather the storm using routine liquidity strategies that performed

as expected, with no extraordinary impact on their funds. Most traditional managers simply worked through their standard hierarchy of liquidity mechanisms to meet withdrawal demand, for example, starting with tapping new deposits, then maturing contracts, then cash buffers, and finally with selling some of the securities inside their wrap contracts. Managers who no longer rely upon preset maturity schedules also fared well because their "evergreen" portfolios afforded them plenty of flexibility and liquidity.

In other cases, managers were able to get the liquidity they needed as the result of precautionary measures they took late last year, when it looked like the Y2K "crisis" could rock the financial markets. Dwight Asset Management Company, for example, put a number of windowed GICs onto its books late in 1999 to help it manage liquidity. (A windowed GIC is structured to have a targeted funding level and a finite period of time during which it will accept deposits. It will take deposits up to and above the targeted level. Then, if the total deposits exceed the target, the excess monies are returned to the fund, where they are available for reinvestment or to satisfy withdrawal requests.)

"We structured our windowed GICs to accept cash flows and provide liquidity from the fourth quarter of 1999 through the first quarter of 2000," said David Richardson, a managing director and portfolio manager for Dwight. "They worked as designed."

Another large investment manager relied on a heftier-than-normal cash position to help it weather the storm.

"We had built up a lot of cash heading toward year-end 1999 because we didn't know what to expect from investors, and that proved very helpful in meeting our liquidity needs, as did our laddered maturity portfolio structure," observed a portfolio manager at this firm. "As a consequence, we didn't have to restructure any of our portfolios. However, we did access our wrap contracts in one or two plans, which is something that from time to time will happen for us anyway."

Jo Anne Davis, a principal at State Street Global Advisors in charge of that firm's Stable Value investment group, says her firm weathered the liquidity crunch without taking any extraordinary measures, thanks to an investment strategy built on "well-laddered portfolios" that feature contracts maturing on a rolling monthly basis. Between December 31, 1999, and February 29, 2000, the total cash position declined 20%, before recovering to more normal, pre-December '99, levels in March. However, less than 1% of the firm's book of business was impacted. "Our strategy held up under the gun," Davis says.

To be sure, the industry sustained some minor bumps and bruises. For example, some investment managers were compelled to access their investment contracts for liquidity at levels that produced losses for the issuers. It was a rare and by most accounts

unprecedented event, but not a devastating one.

"We saw investment managers using a wide variety of strategies to meet their liquidity needs, from beefing up their cash positions to restructuring contracts to accessing those contracts," says Aruna Hobbs, director of institutional products and head of Stable Value business at AEGON Institutional Markets, a unit of Dutch insurer AEGON N.V. "But what we saw was that the liquidity management practices used by our clients were very closely aligned with what we anticipate in our risk models when we underwrite this business. The industry might have scrambled a bit during the first quarter — especially during January and February — but it wasn't the sort of thing that caused us to panic."

Steve Butters, managing director for wrap issuer CDC Capital Inc., takes a similar view. He says that just two Stable Value funds that do business with his firm accessed their wrap contracts in the first quarter.

"I've been in this business for 12 years, and this is the first time I've been involved in any contracts that were unexpectedly invaded for benefits," says Butters. But noting that his firm has about 350 contracts outstanding, he says the hits weren't dramatic "from a big-picture perspective." Rather, he says, they were newsworthy simply because "it never happened before."

There were persistent though unconfirmed reports during the first quarter that some investment managers took measures to avoid

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## Cash Flow 2000

By Janet Jasin Quarberg,  
Hueler Companies

According to Hueler Companies' FIRSTSource Market Data, the dawn of the new millennium brought on significant outflows from Stable Value Funds breaking the gradually improving cash flow trend exhibited over the past several years. As shown in the table, the calendar year-end 1997 showed average outflows of - 8.18%, 1998 showed - 1.19% and 1999 showed average outflows of -1.05% of total Stable Value assets.

Many speculate that the outflow occurred due to the exceptional returns in other markets and little residual Y2K concerns after the clock struck 12 and the world remained calm.

Looking deeper, the monthly cash flow trend prior to December of 1999 was consistent with the annual data showing relatively neutral flows. Yet, December brought an increase into Stable Value, which many people credit to conservative sentiment over Y2K concerns. In January many

	YEAR ENDING AS OF:									
	09/30/97	12/31/97	03/31/98	09/30/98	12/31/98	03/31/99	09/30/99	12/31/99	03/31/00	
5%	5%	-23.12%	-27.44%	-28.33%	-23.58%	-15.12%	-14.80%	-16.56%	-15.12%	-23.29%
10%	10%	-17.36%	-19.68%	-21.08%	-17.86%	-11.09%	-12.14%	-11.99%	-11.06%	-18.24%
25%	25%	-10.41%	-11.81%	-11.66%	-9.81%	-6.60%	-5.81%	-6.39%	-6.51%	-13.70%
Median	Median	-5.35%	-6.90%	-6.09%	-4.18%	-1.48%	-0.50%	-1.43%	-1.21%	-8.15%
Average	Average	-6.14%	-8.18%	-7.53%	-4.61%	-1.19%	-0.17%	-1.05%	-1.05%	-9.06%
75%	75%	-1.58%	-2.63%	-1.86%	0.93%	3.41%	4.16%	4.17%	4.18%	-3.91%
90%	90%	1.99%	0.23%	2.38%	7.24%	8.44%	10.00%	10.27%	10.58%	-4.00%
95%	95%	7.39%	3.88%	6.98%	11.92%	10.18%	15.53%	15.72%	13.86%	2.97%

Data is a percentile distribution of annual cash flow rates as a percent of Stable Value assets for the trailing 12-months as of the date specified.

investors received their year-end statements reporting some spectacular returns in other markets, prompting investors to make some significant asset allocation changes causing heavy outflows from Stable Value.

As noted in the table below, January outflows averaged - 4.42% and February's average was -2.83%. This is quite different from December's +1.38 or October's +.70%. During February, outflows continued to be

negative but not at the same magnitude. Fortunately, March numbers broke the cycle showing that the heavy outflows have subsided and cash flow has come back in line with earlier neutral trends. In addition, preliminary discussions with managers indicate that April numbers may prove to be even better as many other markets have been experiencing some significant volatility causing investors to retreat back to Stable Value.

The Stable Value industry in general has not experienced outflows in a single quarter to this magnitude in quite some time. Given the recent volatility of the equity markets, it is a reasonable prediction that outflows from Stable Value will fall back in line with the previous trends or even turn positive in the coming months. Stay tuned to the next issue of the *STABLE TIMES* for a follow up report on Second Quarter 2000 cash flows. **SVIA**

Dateline Wall Street... "Investors Look for Bright Spot in Havoc," *USA TODAY* JULY 17, 1996... "Most Mutual Fund Investors Buying...," *LOS ANGELES TIMES* APRIL 5, 1997... "Economy May Be Unruffled...," *USA TODAY* OCTOBER 28, 1997... "Relax, Stocks Rarely Steer the Economy," *NEW YORK TIMES* SEPTEMBER 3, 1998... "Dow Finishes Day Over 10,000 Mark for the First

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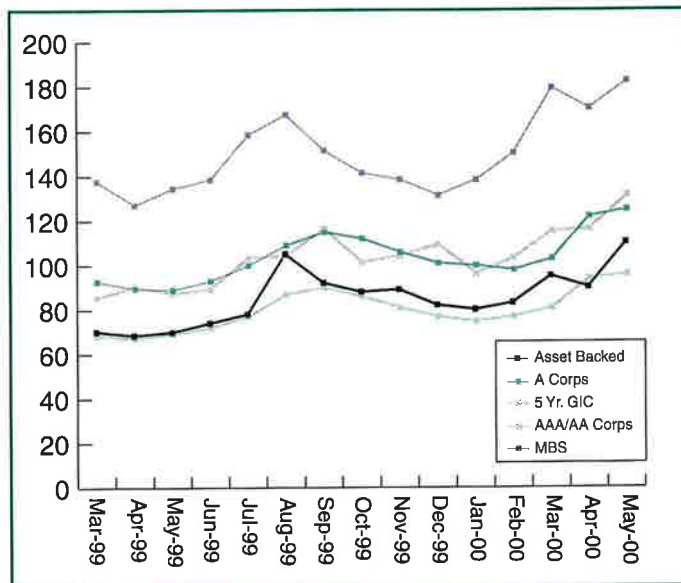
	Oct-99	Nov-99	Dec-99	Jan-00	Feb-00	Mar-00
5%	-3.38%	-3.44%	-2.88%	-11.27%	-7.63%	-3.96%
10%	-1.79%	-2.34%	-1.68%	-9.34%	-6.44%	-2.44%
25%	-0.61%	-1.13%	-0.41%	-5.88%	-4.30%	-1.68%
Median	0.28%	-0.16%	0.86%	-3.76%	-2.47%	-0.59%
Average	0.70%	-0.18%	1.38%	-4.42%	-2.83%	-0.09%
75%	1.23%	0.66%	2.59%	-2.16%	-0.98%	-0.87%
90%	2.30%	1.93%	4.89%	-0.67%	-0.27%	-2.72%
95%	3.44%	3.18%	6.25%	0.29%	0.93%	4.21%

# Tracking Stable Value Yield Spreads

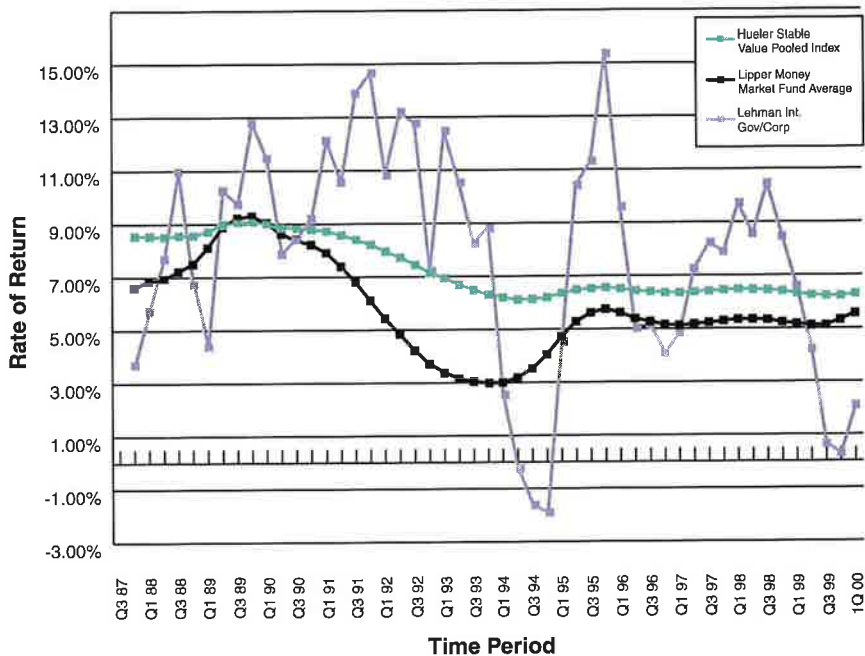
By Karl Tourville,  
Galliard Capital

Long term Treasury yields have continued to fall due to the buyback of US Treasury debt with the 30 Yr Treasury Bond yielding 6.01% as of 5/31. Conversely, tight monetary policy has resulted in upward pressure on short-term rates. The

Federal Reserve increased the federal funds rate in March by 25 basis points and again in May by 50 basis points attempting to cool off the economy and potential inflation pressures. Credit spreads have remained under upward pressure across all sectors. Five-year GIC spreads have widened 28 basis points since 2/29 to 130 basis points over Treasuries. **SVIA**



Fixed Income Index Comparisons



## SVIA wants to hear your opinions

The *STABLE TIMES* Editorial Board is now accepting submissions for future OPINION columns. The goal of OPINIONS is to focus on new issues that captivate the Stable Value industry and to stimulate an on-going dialogue among the membership. For more information, or to submit an article, please contact Jennifer Hudson at [jennifer@stablevalue.org](mailto:jennifer@stablevalue.org).

got ideas?

As of 3/31/00			
	Hueler Stable Value Pooled Fund Index	Lipper Money Market Average	Lehman Intermediate Gov/Corp
1 Year Return	6.29%	5.56%	2.08%
3 Year Return	6.36%	5.36%	6.06%
5 Year Return	6.38%	5.36%	6.50%
5 Yr Standard Deviation	0.09%	0.22%	3.24%

The Lipper MM returns have been grossed up by an average Lipper fee of 39 bpts.

*STABLE TIMES* needs your input. If you would like to contribute an article or just have suggestions, please let us know. Contact SVIA at 1-800-327-2270 or by e-mail at [jennifer@stablevalue.org](mailto:jennifer@stablevalue.org)

*Window on Stable Value*

## Highlights from the Third Annual Stable Value Fund Investment and Policy Survey

### Stable Value's Hidden Segment: Life Company Full Service Funds

by Judy Markland,  
Landmark Strategies

Life company full service guaranteed funds, the earliest DC Stable Value option, remain extremely popular with plan sponsors although they have remained virtually invisible to other providers within the industry. The Association's Third Annual Stable Value Fund Investment and Policy survey covers \$48.5 billion of such funds as of 12/31/98 representing over 93,000 defined contribution plans with total plan assets of \$183 billion (1998 year-end.)

#### The Full Service SV Fund

These funds are most typically

part of a bundled 401(k) or other defined contribution plan sold by the life company providing the Stable Value guarantee. The wrap guarantor is also the fund manager and the plan administrator. This complete vertical integration has helped keep the segment 'hidden' from other providers in the SV marketplace.

Full service Stable Value Funds are commingled funds and compete directly with Stable Value pools in the smaller plan market. The average full service Stable Value Fund averaged less than \$1 million compared to \$3 million for bank and investment company pools and \$227 million for non-commingled funds managed by Stable Value managers. The commingled funds offer smaller plans

economies of scale and diversification benefits that they would not be able to achieve on their own.

#### Full Service SV Investment Characteristics

We typically think of a Stable Value Fund as having a mix of GIC, synthetic GIC and separate account contracts from a variety of issuers. However, the full service fund generally consists of one or more investment contract(s) invested in assets in the life company's main general account — a wrapped portfolio of public and private bonds, commercial mortgages and CMO's. The chart below shows the dollar-weighted asset mix backing these funds as of 12/31/98.

Not surprisingly given this asset mix, the duration of these funds at 3.7 years is significantly longer than the 2.5-year duration of SV Funds in the third survey. Bank and investment company pools, the full service funds' primary SV competitors, had durations of 2.4 years and 8.4% in cash as of 12/31/98. Longer durations produce higher yields on average but increase the risk of having the crediting rate lag market rates in a rising rate market.

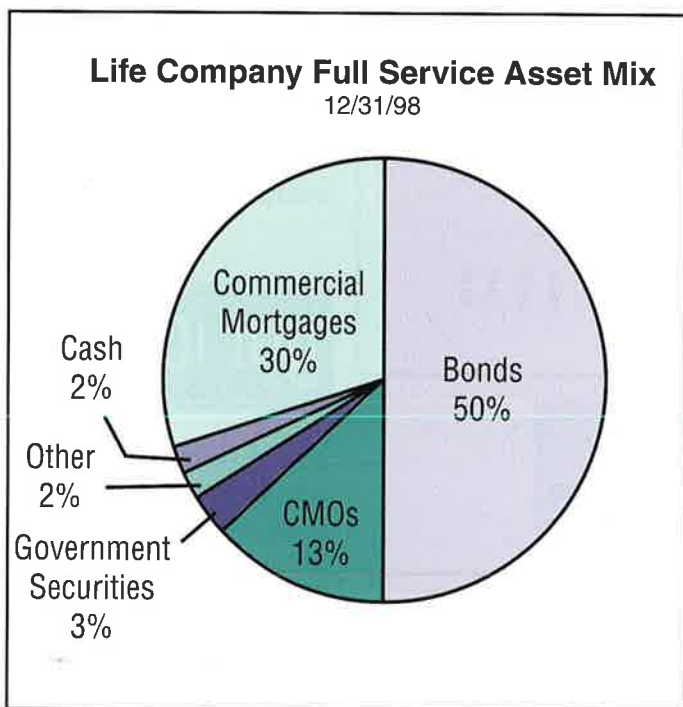
The longer durations work for full-service funds because of several unique product features. Because they are invested in the life company's general account,

these funds have access to other liquidity sources within the life company, including lines of credit, so need not maintain as large a short-term portfolio as many other types of SV Funds. The funds also have the ability to credit a different rate on new deposits than on the existing portfolio, which helps produce a competitive market rate for new sales in a rising rate market. Also, about half of the full-service funds in the survey (on a dollar-weighted basis) limit the volume of participant transfers at which can be made at book value. This reduces the risk of participant withdrawals further lowering the credited rate in a rising rate market.

#### Wrap Diversification Issues

Some question whether the single guarantor structure of full service funds provides adequate diversification of the wrap risk. The ERISA 404(c) regulations specifically note that a single guaranteed contract from a life company, like a single mutual fund investment, qualifies as a diversified investment under ERISA as a "look-through" instrument where one looks through to a diversified pool of assets underlying the investment. In addition, because the guarantor in these funds is also administering the participant's account, many states classify the full-service contracts as "allocated" contracts that are

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## Window on Stable Value

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eligible for state insurance guaranty fund coverage should the insurance guarantor have financial difficulty.

### Full Service Plans' Asset Allocation

It's somewhat ironic that the least visible segment of the industry to other Stable Value providers is the one with the highest overall Stable Value allocation in its 401(k) plans. According to the recent 401(k) provider guide in CFO magazine, participants in life company 401(k) plans allocated 18.4% to Stable Value assets, compared to 10.2% in mutual fund company plans and only 6.7% for banks. Presumably a higher proportion of the life company plans offer Stable Value Funds.

However, the SVIA survey indicates that the full service plans also have a higher allocation to Stable Value where the fund is offered than some other manager segments. This isn't surprising given the historic importance of Stable Value to the life industry, but it does indicate that this "hidden segment" of the business may have some useful information for the rest of the industry. **SVIA**

*"CFO Buyer's Guide: 401 (k) Providers", CFO April & May, 2000; data summarization by Landmark Strategies.*

### Commingled SV Fund Comparison by Type

#### Life company full service SV funds

- Single guarantor (likely insurance guarantee fund protection)
- Guaranteed group annuity contract
- Client-specific risk charges, fees, and experience
- Capability to have different rate for new deposits
- Liquidity from other GA business lines

Best competitive position in rising interest rate markets.

#### Bank & mutual fund SV pools

- Wrap issuer diversification
- Collective investment trust
- Unit value fund with single rate for all investors
- Shared experience across plans
- Capability for both bundled and non-bundled clients
- Book value surrender for contract holders

Best competitive position in declining interest rate markets.

### Liquidity Test

*continued from page 5*

accessing their wrap contracts where doing so would have inflicted losses on the issuers, even though their contracts would have permitted it. On the surface, such behavior would seem implausible — akin to a motorist declining to file a claim against his auto insurer after denting the family sedan. But just like the motorist trying to avoid a future increase in insurance premiums, managers who shied away from accessing their wrap contracts could argue that their investors would benefit over the long term.

"When you start exercising benefit responsive provisions of your contracts and cause the issuers to experience losses, it affects their view of the risk in that portfolio or that management style," observes a senior portfolio manager at one investment firm. "Subsequently, they may charge higher wrap fees or simply refuse to underwrite that business."

Indeed, Butters reports that the

two plans which accessed their wrap contracts with CDC and other issuers have effectively been forced back to the drawing board to create a new set of operating rules.

A key concern in determining whether or not to access an investment contract for liquidity, of course, is how it will affect investment results going forward. When managers who use conventional laddered portfolios restructure them to gain liquidity, they often change the duration of their portfolio unintentionally. They also sacrifice the opportunity to reinvest at current market interest rates.

"When managers restructure assets to meet unexpected liquidity needs, that tells us that those portfolios are operating inefficiently and may sacrifice results," says Vicky Paradis from J.P. Morgan Investment Management.

Whether the first quarter's extreme cash-flow volatility will prove a harbinger of trends to come or merely an isolated event remains to be seen, as will its impact on wrap pricing. Many

industry observers suspect that active trading by investors in defined contribution plans is a novelty that will eventually lose some of its popularity, and that cash flow volatility will trend back toward its historic levels.

In the meantime, the upward pressure on wrap pricing that one would expect in the wake of the first-quarter activity isn't in evidence. One wrap issuer noted that with money flowing out of Stable Value funds recently, there's been far less demand for wrap contracts recently than there was at this time a year ago. That lack of demand appears to be countering the pricing pressure caused by the liquidity crunch.

"My thought is that the cash flow volatility of the first quarter should have had an impact on prices," observes Butters. "But my observation is that it hasn't. In part that's because the volume of business being passed around today is a lot less than was being passed around last year at this time." **SVIA**

## Performance Presentation Standards...They May Not Be As Inflexible as You Think

Submitted by Victoria M. Paradis, CFA — J.P. Morgan Investment Management



Victoria M. Paradis

A recap of the April, 2000 speech at the IIR GICs 2000 conference, given by Iain McAra, Global Head of Performance at J.P. Morgan Investment Management and a leader in the global performance measurement industry

Iain McAra's talk at the recent industry conference in Palm Springs thoroughly covered many of the issues that the stable value industry faces in its performance measurement and presentation project. Given the scope and magnitude of the issues he covered, the Editorial Board of *STABLE TIMES* considered a recap of his talk to be of value to the readership. His talk covered the global framework for conceiving Standards for Performance Presentation, and how they might be relevant for the Stable Value industry.

### Timeline

In 1987, an initial Performance Presentation Standard (PPS)

report included the following quote: "By acting now, we have an opportunity to determine proper guidelines rather than let the regulatory authorities resolve the matter for us." To champion the project, the investment management industry chose its self-regulatory body, the Association for Investment Management and Research (AIMR). After several years in development, the first edition of AIMR-PPS was released in 1993 as a 70-page document for the North American marketplace. In the meantime, half a dozen other countries began developing their own standards. AIMR agreed to sponsor the compilation of a global set of standards and established a global subcommittee in 1995. In 1997, the second edition of AIMR-PPS was released; by then it had grown to 140 pages. In 1999, we saw the approval of the Global Investment Performance Standards (GIPS), which will eventually replace AIMR-PPS.

### Global Investment Performance Standards

Committee members were drawn from experts in the field, including investment managers, consultants, plan sponsors, banks and performance measurers. The membership included firms of all sizes and representatives from at least 28 countries.

The initial construction of GIPS was deliberately kept as straight forward as possible. The committee used the AIMR-PPS as a starting point to develop a standard that represents one hurdle level

that is achievable. GIPS present guidelines for equity and fixed income only. The standards are expected to be dynamic and developing. GIPS do not address all the other asset classes that AIMR-PPS includes, such as real estate or private placements. The idea is that GIPS will be the common denominator, and that a GIPS "plus" concept will develop to include other asset classes and unique country issues.

### Investment Performance Council

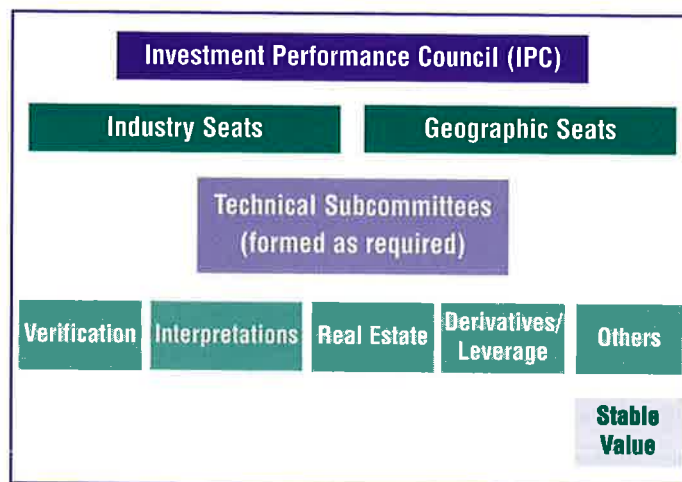
Just recently, on March 9, 2000, AIMR established the Investment Performance Council (IPC) to control PPS in all its forms. The IPC is primarily concerned with establishing GIPS as the Gold Standard, administering and promoting the investment PPS.

Stable Value to be incorporated appears to be high. The structure recognizes the need for Technical subcommittees and expansion beyond the current asset class coverage.

### Objectives of the Performance Standards

1. To create a worldwide standard with full disclosure
2. To ensure accurate and consistent presentation within a period and between periods
3. To promote fair competition globally without creating unnecessary (or unrealistic) barriers.

In other words, the objective is to create a standard that is full and fair but does not demand unattainable and unnecessary levels of information for some partic-



### How does Stable Value fit in?

There is clearly potential for Stable Value to be represented as an additional asset class within the framework. The ability for

participants as long as the other objectives can be met.

### Lessons Learned

1. The key is to educate the recipients as to what the standards

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## Performance Presentation Standards

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are and how they should be approached. They are not a cookbook to follow an exact recipe. A number of issues are 'add to taste' (and then disclose how much!). The standards would be unwieldy if every nuance was covered with an opinion. With respect to GIPS, AIMR has set aside a significant budget for education on the standards.

2. Guidance and interpretation will be needed however well structured your standards. There is always an interpretation or nuance you did not think to cover. Don't write them in but be ready with interpretation.
3. Be concise; it makes things easy to remember. Exact detail really does confuse and makes people think of the standards as an exact recipe rather than a set of guidelines to be used. The flip side is of course that where there is room for interpretation or manipulation, disclosures (footnotes) should be provided.
4. Standards are 'minimum requirements'.

Do "this" and you are okay.

But if it helps explain your circumstance, provide disclosures and / or present Supplemental Information.

There are 10 key characteristics in the standards, which we will

not reproduce here. Of most relevance are the following:

### Definition of Entity

Whether GIPS or AIMR-PPS, the concept of what entity is implementing and adhering to the Standards is important. What constitutes that 'Entity' must be disclosed and must follow some requirements in the standards. Having determined this, the ability to claim compliance with the Standards relates to the Entity in its entirety.

The concept of Entity drove the one small reference to stable value that excluded GICs in the 2nd version of AIMR-PPS. This is because at the time, there was controversy within the stable value industry regarding the proper measurement value for these contracts (book or market value). Since AIMR found our issues difficult to deal with, they, as a band-aid, said that investment management firms, as an entity, can comply with AIMR-PPS even if they didn't follow the prescribed approach for GICs that is required for all other asset classes (specifi-

From the AIMR-PPS: "Presenters have the responsibility to include disclosures that contain material information not covered in the Standards. No portion of the Standards should be interpreted as inhibiting managers from providing supplemental information that would clarify the firm's investment results."

cally marking GICs to market). If it weren't for this exclusion, managers of equity and fixed income strategies that also had a GIC management business could not claim that their firms were in compliance with AIMR-PPS

unless they marked their GIC portfolios to market all along.

### Effective Date

To roll out new concepts, the Standards typically start with a 'recommendation' that in time will become mandatory. This provides lead-time for firms to change their methods and systems.

#### GIPS Presentation and Reporting Requirements

- Five year minimum reporting period
- Number of portfolios
- Assets and % of total assets under mgmt. per composite
- Dispersion measure
- Composite creation date
- Relevant benchmark or explanation
- Recommended – relevant risk measure

### Different Target Audiences—a Useful Analogy

The early stable value measurement debate focused on market value versus book value reporting. After much debate, the task force concluded that the target audience for each was different, therefore different measures were appropriate for different audiences. Other industries target performance reporting to different audiences. For example, the SEC requires mutual fund performance data that is net of fees because they focus on the ultimate return for individual investors. Since AIMR is interested in presenting performance that assesses a manager's ability, AIMR requires returns that are gross of investment management fees. To be compliant with AIMR, investment managers report gross of fee results, and then to satisfy SEC

they also present the net of management fee returns; neither precludes the other, they complement each other. The different sets of data are relevant to different audiences. The same concept allows for Stable Value managers to present Book Value returns, which are relevant to the participant and Market Value returns, which indicate the abilities of the manager

with the underlying assets.

### Composite Construction

AIMR requires (mandatory) that all actual (no model or hypothetical), fee-paying, discretionary accounts must be

placed into Composites. What is a Composite? To quote from the AIMR-PPS handbook: "a Composite is an aggregation of a number of portfolios into a single group that is representative of a particular investment strategy, style or objective." This is an area that can be confusing as people think that a Composite has to be at a minimum an aggregation of 2 things if not more. In the case of AIMR, a Composite need only have one constituent in it; therefore a Composite 'of one' is perfectly valid.

In addition, a level of materiality should be exercised when determining the different Composite definitions and what constitutes a different style and objective from another. In exercising that flexibility all you have to do is define and maintain the Composites according to reasonable

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## Performance Presentation Standards

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guidelines (which you should document), and apply the discretion and the definitions consistently across all the portfolios and Composites and across time.

The full list of Composites that constitute the entity must be made available, so each Composite can be placed in relation to the other Composites. There are a number of other requirements relating to the number of portfolios in a composite, the percentage of assets the Composite represents, etc., to paint a full picture of the specific composite in relation to the rest of the Entities business.

## Public Relations Campaign

*continued from page 4*

2. Build relationships with key industry reporters
3. Educate plan sponsors and individual investors on the benefits of Stable Value.

To start the ball rolling, SVIA President Gina Mitchell worked with the Committee to develop a press kit. These materials provided reporters with a comprehensive overview of the recent stock market volatility that has many reminded investors of the downside volatility associated with equities. Distributed towards the end of March, the materials generated much interest, and resulted in several worthwhile exchanges between SVIA and members of the media; thereby taking SVIA one

## Effective Date

The presentation issues around effective date have caused concern for the Stable Value industry. The standards require several years of back data and the ability to mark to market, which may not necessarily have been captured by Stable Value managers. It would appear that the inability to comply with this precludes ability to claim compliance. However, since Stable Value would be being treated as an additional and new asset class to join the core Standards, there is potential for an effective date to accompany the incorporation of this class, i.e., a point in

**A Note from the SVIA Performance Measurement Task Force: January 1, 2000 is likely to be a suggested effective date for our industry to start measuring market value performance in order to comply with agreed-upon standards.**

step closer to establishing ongoing relationships with key press contacts.

The SVIA media push has already produced results. In April, educational stories about Stable Value appeared in the Wall Street Journal Sunday, a supplement published in ten regional newspapers whose circulation total more than five million readers. SVIA's efforts also produced favorable stories in Defined Contribution News and Employee Benefit News. These articles are available on SVIA's website ([www.stablevalue.org](http://www.stablevalue.org)) in the Members Only section under "SVIA In The News."

In addition to SVIA's direct efforts with the media, the association is undertaking extensive promotional campaign to recruit new members and increase attendance at the national forum. By

time from which all the necessary data is required. Prior to that date, a subset (with the appropriate disclosures) of the information will be sufficient if the totally compliant data is not available.

## Relevance?

So can the standards be of use for Stable Value? Certainly they are flexible, certainly they do not

preclude the inclusion of additional information. We may also be able to get the effective date we need to make the standards accessible for all managers.

Most importantly, the SVIA Task Force has done a significant amount of the 'spade-work' by

now, SVIA members and associates should have received the first in a series of postcards promoting this year's National Forum:

"Retirement Savings In The New Millennium," on October 10-12 at the Monarch Hotel in Washington, D.C. Through direct mail efforts and wide distribution of the newly redesigned *STABLE TIMES*, SVIA will continue to keep the facts about Stable Value before relevant industry and investment groups, as well as the media.

And we're not finished yet. SVIA intends to take advantage of ongoing market volatility to further educate investors and plan sponsors about the benefits of Stable Value. If you would like to make yourself available as a spokesperson for SVIA, please contact Gina Mitchell at 202-261-6530. **SVIA**

drafting a set of presentation guidelines for our industry that build upon an AIMR-PPS base.

## Benefits

There are a host of benefits that the Stable Value industry will gain by adopting PPS, including:

- A level playing field when presenting each manager's ability
- Incorporation of this significant asset class within the investment management industry
- Increased global awareness of asset class
- Better recognition by advice models
- Classes incorporated through the dynamic development of GIPS "plus" and the IPC
- Since the IPC council is very new, we have a chance to be involved from ground zero if we make contact and have a clear idea of our requirements and goals
- We understand that key contacts at the IPC welcome our initial contact. . . . So let's get going. . . .Volunteers?

We need to begin discussion between ourselves and the relevant Standards setting committee. Potentially a new Product group can join with those already incorporated in the AIMR-PPS; then take the journey potentially to GIPS "plus" and maybe into Core GIPS. **SVIA**

*Iain McAra industry leadership roles include: Member of AIMR-PPS Verification Subcommittee, Member of the GIPS Committee, Member of Advisory Board, Journal of Performance Measurement, AIMR-PPS Implementation Subcommittee as part of the IPC Structure.*

*For a comparison of the key differences between AIMR-PPS and GIPS, please contact Vicky Paradis at J.P. Morgan Investment Management at (212) 837-5272.*