

# SVIA STABLE TIMES

The quarterly publication of the Stable Value Investment Association

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## Gwen Collick joins SVIA



Gwen Collick

SVIA has a new addition: Gwen Collick as an Administrative Assistant. Gwen joined the Association on September 11. She has quickly entrenched herself in National Forum preparations and all

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## What Employers Should Know About Investment Education and Advice

By Leslie B. Kramerich, Acting Assistant Secretary, Pension and Welfare Benefits Administration, U.S. Department of Labor



Leslie B. Kramerich

One of the most significant trends in employment-based benefits has been the

increasing responsibility placed on American workers for their own retirement security. Most 401(k) plans today require workers to make their own investment decisions. Every year, participants direct an estimated \$70 to 80 billion in contributions to 401(k) plans.

It is also becoming increasingly clear that many workers may not be adequately equipped to evaluate, develop and implement investment strategies necessary for a secure retirement. Many need

tools and education to make investment decisions, while others want more—want in fact very specific advice as to what the decisions should be.

Someone who undertakes that responsibility will most likely be an ERISA fiduciary and owe pension participants a special duty of care and loyalty. One of ERISA's most fundamental principles is that a fiduciary cannot deal with plan assets in its own interest. Mutual fund vendors providing

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## Close the Investment Advice Gap

By Congressman John Boehner (R-OH), Chairman, Employer-Employee Relations Subcommittee

Workers today have more control than ever over their retirement savings. They are shortchanged, however, by outdated federal laws that deny them access to employer-provided professional investment advice that can help them make the most of their savings. We owe it to America's workers to modernize these laws and prevent this unintended consequence.

Earlier this year, I introduced a bill to accomplish that goal — the Retirement Security Advice Act (H.R. 4747). This bipartisan legislation, which passed the Employer-Employee Relations Subcommittee (EER) on a voice vote in July, would help to close the growing "advice gap" many

workers face in investing their retirement savings by allowing employers to provide workers with access to professional investment advice. Currently, outdated federal restrictions written before 401(k) plans had even been invented deny millions of workers access to top-quality investment advice.

Under current law, it is easier for employers to offer pet insurance and emergency babysitting services than it is for them to offer their workers a qualified investment advisor who can walk them through some of the most important decisions of their lives. This is clearly not what the authors of the law intended.

The Retirement Security Advice



Congressman John Boehner

Act is the product of months of bipartisan retirement security hearings in the EER Subcommittee aimed at updating the 1974 Employee Retirement Income Security Act (ERISA), the principal federal law governing employee pensions and

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## Investment Advice

*continued from page 1*

other benefits, to reflect the opportunities of America's new economy.

When ERISA was enacted 25 years ago, defined benefit plans, which do not allow workers themselves to invest their retirement dollars, were by far the predominant form of employee pension.

But since then, the number of workers covered by defined contribution plans, which allow workers to invest their savings and hold onto any gains from those investments, has increased 250 percent, from 12 to 42 million. The explosive growth of defined contribution plans has led to new opportunities for workers but also created a growing advice gap, leaving employees with the responsibility

for investment decisions that many are ill-equipped to make on their own.

Wealthier Americans can contend with the advice gap by hiring an investment advisor. But few middle-income families can afford such a luxury on their own. As a result, most employees have little choice but to sort through today's maze of investment information without the benefit of professional advice.

Employees and employers agree there is an obvious solution to this problem: allow employers to provide their employees with access to quality investment advice. The Retirement Security Advice Act would clarify existing federal law to give employers the green light to provide their employees with

access to high-quality investment advice. Employers would be permitted to provide their employees with access to investment advice from registered investment advisors, provided there is full disclosure concerning any potential conflicts. Safeguards would remain that would shield employees against abuse, and advice would have to be provided by a "fiduciary-adviser" who would be personally liable for any failure to act solely in the interest of the worker.

The more educated investors are, the better they will be able to deal with investment risks, make the choices that best serve their long term needs, and maximize the gain from their hard-earned retirement dollars. **STV**

## The Race is On! Candidates for SVIA Elections

The primaries are over for SVIA. This year 52 members made nominations to fill the six open seats on the Board (two plan sponsor positions and four service firm positions). The nominations produced 19 potential plan sponsor and 47 service firm candidates.

To be a candidate, an individual must be:

- A member in good standing in the Association,
- The voting member for his/her firm,
- Committed to taking an active leadership role in Association activities.

The four plan sponsor candidates are:

Nathaniel Duffield, Halliburton  
Nathan Sax, Lucent  
Robert Toomey, South Carolina Retirement System  
David VanBenschoten, General Mills

Service Firm candidates had an additional requirement. They must receive the greater of three nominations or ten percent (rounded to the next higher value) of the total number of voting members who submit nominations to stand for election to the Board. This year, a service firm

member needed to receive six nominations. Seven individuals received six or more nominations. The seven service firm members running for the four open seats are:

Peter Brigando, New York Life Investment Management LLC  
Richard Cook, GE Financial Assurance

Jo Anne Davis, State Street Global Advisors

Aruna Hobbs, AEGON  
Jeff Norris, Metropolitan Life Insurance Company  
Vicky Paradis, J.P. Morgan  
Steven Schaefer, Allstate Life Insurance Company

Thanks to everyone for taking the time to nominate a great group of individuals. A very accomplished slate of candidates has been created. They will make a fabulous contribution to the Association and a most difficult choice for all you in SVIA's election, which will occur shortly after the Forum.

Many thanks to our retiring Board members for their numerous contributions and years of service: Vic Gallo, Dan Libby, Tom Obsitnik, Tami Pearse and Rudy Gernert! **STV**

## SVIA STABLE TIMES

Third Quarter 2000

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### Co-Editors:

Victoria Paradis	J.P. Morgan paradis_vicky@jpmorgan.com
Wendy Cupps	PIMCO cupps@pimco.com

### Editorial Board:

Gary Bacchiocchi	MassMutual Life Insurance Co. bacchiocchi@massmutual.com
Jo Anne Davis	State Street Global Advisors jo_anne_davis@ssga.com
Allan Fen	Telekomnet Telekomnetallan@telekomnet.com
Aruna Hobbs	AEGON Institutional Markets ahobbs@aegonusa.com
Janet Jasin Quarberg	Hueler Companies janetj@hueler.com
Steve LeLaurin	PRIMCO Capital Management stevell@primco.com
Dan Libby	IBM Retirement Fund dlibby@us.ibm.com
Barbara MacLean	ING Institutional Markets barbara.maclea@ing-im.com
Robert Whiteford	Bank of America robert.whiteford@bankofamerica.com
Greg Wilensky	Sanford C. Bernstein & Co. Inc. wilensky@bernstein.com



**EDITOR'S CORNER***By Wendy Cupps*

Wendy Cupps

Some of the most popular topics in the media recently have focused on the pursuit of goals and thrive on the stories surrounding the difficult journey toward achieving them. The TV show "Survivor" certainly mesmerized viewers who tuned in every week to see who would have the strength and smarts to survive the obstacles in their quest to become a millionaire. And the presidential race is certainly getting a lot of coverage and attention with a 'gazillion' opportunities to hear about the candidates' campaign efforts and debate on the issues. But probably the most classic example of media interest in the struggles and hard work involved in reaching a goal has been evident in the worldwide coverage of the Olympic Games where so much time and work goes into being "the best you can be".

The SVIA also has specific goals it is trying to achieve and the media, in particular this publication, is an excellent vehicle for presenting the progress in the journey to achieve those goals. Of course the goals of the SVIA and the Stable Value Times are not as shiny as Olympic gold, or as lofty

as running the country, but the journey to achieve our goals is fortunately much less dramatic and doesn't require eating rats to survive. The goals are much more altruistic, as they are centered on raising awareness, understanding and respect for stable value in the marketplace and educating plan sponsors and their participants on significant developments in the broader defined contribution industry. I think you will find that there are several interesting articles in this issue which will update you on the progress that is being made in the journey to reach our goals.

One of the hot topics in the DC industry today is a push to make better information available to participants for their investment decisions. We have two feature articles which offer interesting commentary on developments toward this goal. First, Republican John Boehner (R-OH) discusses the bill he introduced – the Retirement Security Advice Act (H.R. 4747), which would help to "Close the Investment Advice Gap." This bipartisan legislation passed the Employer Relations Subcommittee (EER) on a voice vote in July and we are honored to have his passionate plea for investment advice as part of our collection of articles on this important issue. An article provided by Leslie Kramerich marks a first for the SV Times – an Administration perspective on the issue of offering investment advice. Leslie is the Acting Assistant Secretary for DOL's Pension and Welfare Benefits Administration (PWBA) and author of the article entitled "What Employers Should Know

About Investment Education and Advice". Leslie highlights the increasing need for investment education and advice and describes that the PWBA continues to provide suggestions for changes that would allow vendors to render advice if safeguards are in place to deal with conflicts of interest. She wants employers to know that if appropriate standards are met, employers can offer investment education and advice without significant risk of liability. Special thanks to our SVIA president, Gina Mitchell, for inspiring Leslie to contribute this article to SV Times.

Not only did Gina recruit others but she also wrote an article on behalf of SVIA on another important and timely topic: "Asset Allocation Models- Finding the Way". Gina describes the SVIA's recent efforts to get asset allocation modelers to accurately reflect stable value in their models. She explains that this requires that they not only understand the unique features of this asset class, but importantly also understand that for some investors "it is the journey and not just the destination that matters". Sounds a lot like NBC's philosophy in covering the summer Olympics.

We are also provided with an important roadmap for the path toward deriving market value performance measurement for stable value funds in Vicky Paradis' article "the ABC's of Measuring Stable Value Performance". Vicky explains the importance of having access to market value performance measurements in addition to book value returns in order to evaluate the success of stable value management. She effective-

ly shows us how the SVIA Task Force has proposed that the fair value of traditional GICs can be calculated, and effectively shows how it is consistent with the AIMR Performance Presentation Standards. We look forward to continuing to move forward along this path with discussion on the presentation of performance in future publications.

Our professional journalist Randy Myers is back with another very interesting article about a new twist in retirement plan offerings. Randy describes Bank of America's recent offering for participants to move their 401k assets to the company's cash balance pension plan. Randy provides an interesting collection of views on the subject and as always provides for interesting and comprehensive reading on the topic. We also have an update on the progress being made in the area of funding agreements. While the effort to attract interest in the sale of funding agreements recently met with some unexpected challenges, the market has experienced a modest recovery in 2000. The article takes us through what happened with a focus on the progress that has been made since.

And finally, good news to report on the state of cashflows in the stable value market. Heuler reports that the negative cashflow trends we saw earlier in the year stabilized in the second quarter of this year.

No doubt we will continue to highlight these journeys in future editions. We welcome your input and participation toward reaching our desired goals.

## Investment Education

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advice about their own funds where, for example, different funds have different fees could present a conflict of interest if the vendor is a fiduciary.

PWBA has worked to craft a number of individual exemptions permitting vendors to render investment advice regarding products in which they have an interest which contain safeguards to deal with conflicts of interest. PWBA has announced that it remains open to additional ways of structuring safeguards through exemptive relief.

The need to maintain safeguards is greater than ever. The financial markets and transactions have grown so complex that in many cases only the professionals who developed the particular product or service are able to effectively understand and evaluate the accompanying risks. The resulting gap in experience and sophistication between persons who act on behalf of a plan, such as plan sponsors, and service providers to a plan is probably greater today than it was at the time ERISA was enacted. Further, the consolidation in the financial services industry has increased the complexity involved in understanding products, providers and their different relationships. Although PWBA has often relied on disclosures as an effective and efficient safeguard, this complexity in the financial services industry — and the vulnerability of 401(k) participants most in need of advice — makes it particularly important that we not lower important safeguards and place unreasonable expectations on the very participants we need to help.

There are a number of other

factors that merit close attention as we go forward on this issue. For example, obtaining affordable advice is perhaps not the obstacle some suggest. A number of advice providers have said publicly they don't anticipate charging employers or employees for their advice. They feel a competitive pressure to get into this market, and want to offer the service for a variety of reasons.

It is also interesting that vendors are looking for multiple relationships with advice providers in order to offer sponsors and participants flexibility and choice. That sounds like a solid, common sense approach but we must recognize that both sponsors and participants must be able to trust the advice offered or offering the advice will not achieve the results desired. Without basic trust in the integrity of what is offered, sponsors won't be perceived as offering a valuable employee benefit, participants won't feel they were presented with the ability to effectively use a benefit that relies so heavily on their own ability, and vendors won't be valued and entrusted with non-plan assets with which they can offer overall financial planning.

There are, nevertheless, steps we can take now. PWBA has offered a number of suggestions for both legislative and other change and we look forward to continuing that important discussion. There are also some things we want employers to know:

Many workers need investment assistance. Most workers are not schooled in investment management, risk/return strategies, asset allocation, and diversification principles, yet they are given responsibility for making investment decisions in their 401(k) plans that ultimately will determine the extent of their retire-

ment benefits.

Investment education is an important tool. In an effort to both encourage and facilitate the provision of investment education by plan sponsors to employees, the Department of Labor issued Interpretive Bulletin 96-1 distinguishing a variety of investment-related education activities from the fiduciary act of investment advice. The Department also made clear that the designation of a person to provide investment education to participants would not, in itself, give rise to liability for losses resulting from participant investment decisions.

Investment education may not be enough for some workers. Many workers may not wish to assume responsibility for making investment decisions. This may occur because of a perceived or real lack of sophistication about investing, because of a lack of interest in pursuing investment education, and because of an overwhelming number of investment choices. These workers may need professional investment advice. A plan may pay reasonable expenses necessary to the provision of investment advice to plan participants.

Employers not liable for acts of investment advisor. In Interpretive Bulletin 96-1, the Department indicated that, in the context of an ERISA section 404(c) plan, the designation of a person to provide investment advice to participants would not, in itself, give rise to fiduciary liability for loss, or with respect to any fiduciary breach, that is the direct and necessary result of a participant's exercise of control. As with the selection of any service provider, however, the responsible plan fiduciary is responsible for the prudent selection and periodic monitoring of the designated

advisor.

Prudent selection of an investment advisor limits liability of employer. The rules applicable to the prudent selection of one or more investment advisors for plan participants are similar to those applicable to the selection of any plan service provider. With regard to the selection of a service provider under ERISA, the Department has indicated that the responsible plan fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of the services offered, and the reasonableness of the fees charged in light of the service provided. In addition, such process should be designed to avoid self-dealing, conflicts of interest or other improper influence.

In applying these standards to the selection of investment advisors to plan participants, the Department would anticipate that the responsible fiduciary would take into account: the experience and qualifications of an investment advisor, including registration in accordance with applicable federal and/or state securities laws; the extent to which the advisor acknowledges its fiduciary status and responsibility under ERISA to participants; and the extent to which the advisor can provide informed, unbiased, and appropriate investment advice to the plans' participants.

Monitoring of investment advisor. Plan fiduciaries are expected to periodically monitor service providers to determine whether retention of the provider continues to be prudent. Generally, such monitoring will involve a determination as to whether there have been any changes in the information, which served as the basis for


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## Investment Education


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the initial selection. In general, it is anticipated that the responsible fiduciary would periodically review: the performance of the investment advisor; whether the investment advisor continues to meet applicable state and Federal securities law requirements; compliance with contractual provisions of the engagement; utilization of investment advice services by participants in relation to the cost of the services to the plan; and comments and complaints about the services.

In conclusion, we believe that employers can be responsive to the investment education and investment advice needs of their employees, without significant burdens or risk of liability. The selection of providers that offer informed, unbiased and appropriate investment education or investment advice will, in our view, not only serve to increase the likelihood of employees achieving retirement security, but also significantly reduce the potential for employee dissatisfaction and possible litigation. 

## Gwen Collick

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things SVIA. Gwen has extensive association experience and has worked with me (Gina) on two separate occasions: the Coalition of Northeastern Governors and the National Conference of State Legislatures. As her resume states, Gwen is "an excellent organizer, coordinator, and troubleshooter. She is also a delight to work with. I hope that you enjoy working with her and the contributions she makes as much as Scott and I." 

## Asset Allocation Models: Finding the Way

By Gina Mitchell, SVIA President



Gina Mitchell

Questions like "Does asset allocation really matter if equity markets only go up?" may send shudders up the spines of many investment professional but they also serve as a healthy reminder that the majority of today's investors have not been in the markets long enough to experience a prolonged decline in stocks.

Defined contribution plan educational campaigns have an altruistic goal of creating an educated individual investor that is fully equipped to take his/her retirement future into his/her own hands. However, they are about as prepared and empowered as a tourist trying to navigate the Washington beltway during rush

hour without a map. Not that materials and maps are unavailable, investors may have not yet taken the time to plot their course.

*On the road without a map*

Most studies confirm this "on the road without a map mentality." In fact, they go further. John Hancock Financial Services' Sixth Defined Contribution Plan Survey found familiarity with virtually all investment options is declining. John Hancock found this trend was most pronounced with stable value funds. They reported that familiarity with stable value had consistently fallen since 1993, when it ranked second to equities in familiarity.

*Uniqueness creates complexity*

So, is it any wonder to find sophisticated investment professionals like asset allocation model makers struggling with stable value while they are trying to provide a road map to defined contribution plan participants? Simply put: yes. Like the individual investors they are trying to help, most model makers are not taking advantage of the information and resources available to them. Plus, the very qualities that make stable

value unique create some complexity when translating stable value's low risk and moderate return characteristics into models. *First the product, then the regulation*

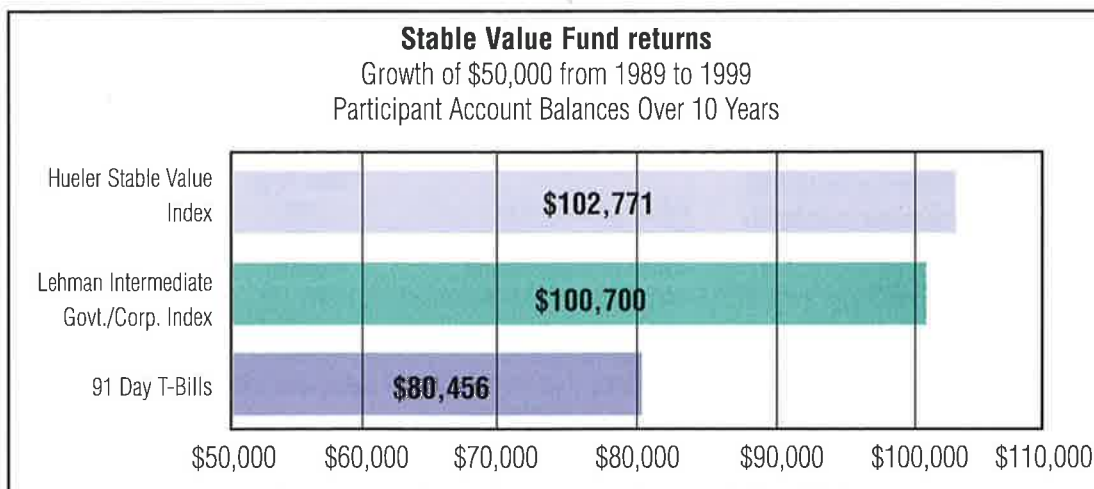
When SVIA first started looking at asset allocation models, there were rumblings from modelers that stable value was just an accounting gimmick. Somehow FAS 94-4's reaffirmation of book value treatment was viewed as the equivalent of a financial sleight of hand by the SEC sanctioned Financial Accounting Standards Board (FASB).

Stable value like passbook savings accounts was created long before 94-4 and ERISA. First came the product, and then came the regulation. The SEC and FASB do not permit or encourage financial sleight of hands. That's what they are designed to detect, prohibit and stop dead in its tracks.

*She's my sister. No, she's my daughter*

Now, as SVIA has dug in deeper, the classic and confusing line from the movie, "The Two Jakes" well applies, "She's my sister. No,

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### Benefits to plan participants from Stable Value

- Returns of intermediate bonds
- Principal safety, return volatility, and liquidity of money market funds
- Returns that are less related to equities than other fixed income investments
- Unique product—available in retirement saving vehicles

## Asset Allocation

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she's my daughter." When it comes to stable value and asset allocation models, it goes, "Stable value is a money market. No, stable value is a bond fund." In fact, like in the movie, it is a little of both. It gets back to the unique characteristics of stable value: money market liquidity and returns similar to intermediate bonds minus the volatility. *It is the journey, not the destination*

Not wanting to sound too much like Deepak Chopra, but it is the journey, not just the destination when it comes to retirement savings and investment. Once model makers recognize the characteristics of stable value, they have a second stumbling block focusing on the end point: retirement income. The end-point or destination focus causes modelers to put the round stable value peg back into a square money market or intermediate bond hole.

This type of destination planning ignores the human condition. Individuals care how they get there. They focus on the

short-term experience. The journey matters. It is not just the destination!

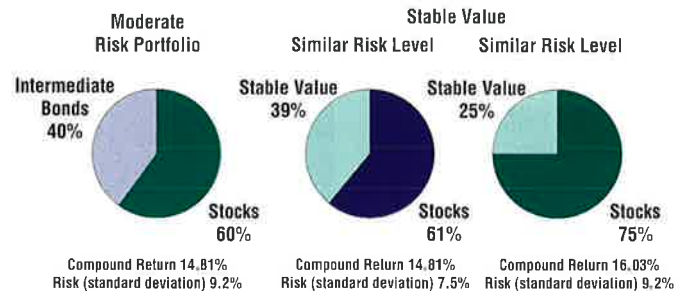
*More risk or lower returns?*

Models that force stable value into a money market or intermediate bond fund format do harm to the party that they are trying most to help: plan participants. A destination or outcome mentality results in under-estimating Stable Value's return or over-estimating Stable Value's risk. A defined contribution plan participant ends up in one of two undesirable and preventable positions: taking on more portfolio risk or having lower returns. More risk or lower returns is not a choice that stable value fund investors have to make, if models recognize the unique qualities of stable value. *Efforts to set Stable Value right*

That's why SVIA as an organization and our members individually are involved in a dialogue directly with modelers, plan spon-

### Historical Portfolio Return and Risk Comparison: "Moderate Risk DC Asset Mix"

1983-1999



Sources: Ibbotson Associates, Deutsche Asset Management, John Hancock

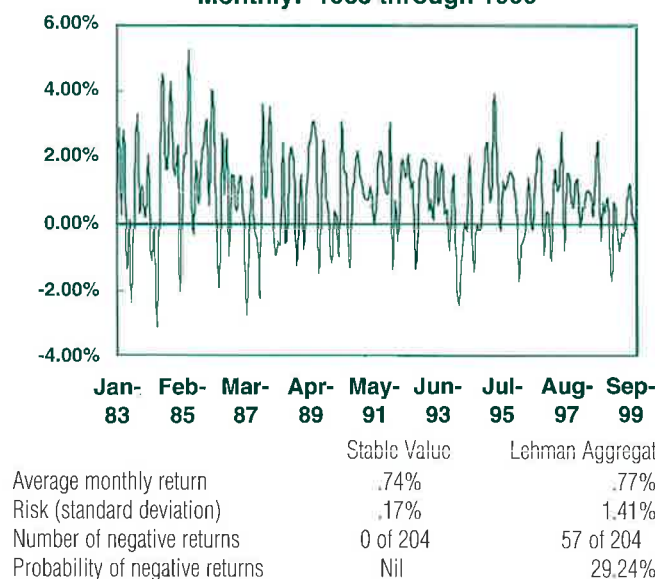
sors and policymakers to educate them as to how to best capture Stable Value's unique characteristics: the marriage of minimal risk with strong, dependable returns. SVIA's Task Force on Asset Allocation Models is tasked with addressing this important issue. The Task Force is chaired by John Hancock's **Wayne Gates** and comprised of the following mem-

**Michael Curran**, UBS AG  
**Chris Cutler**, Deutsche Bank  
**Paul Donahue**, PRIMCO  
**Vic Gallo**, Jackson National Life  
**Steve LeLaurin**, PRIMCO  
**Paul Lipson**, Federal Reserve Employee Benefits System  
**Melanie Mabe**, AEGON  
**Jim McDevitt**, State Street Bank & Trust  
**Ken Quann**, New York Life Investment Management  
**Klaus Shigley**, John Hancock  
**Bruce Vane**, Certus

The Task Force is drafting a paper that provides guidance as to how to appropriately represent the unique characteristics of stable value. Wayne Gates provided a framework to address this daunting task that served as the straw man for the Task Force's review. Deutsche Bank's Chris Cutler is refining the draft's guidance on how to model stable value with able assistance from State Street's Jim McDevitt and the Federal Reserve System's Paul Lipson. In addition to the dialogue and draft, SVIA's Retirement Security in the New Millennium National Forum has dedicated Tuesday, October 10 to explore the challenges that asset allocation models pose. **SVIA**

### Volatility of returns and Stable Value

Monthly: 1983 through 1999



Compounded return is 9.27% for Stable Value and 9.5% for Lehman Aggregate. Risk (standard deviation) is 2.3% for Stable Value and 6.72% for the Lehman Aggregate for 1983 to 1999.

Sources: Ibbotson Associates, Bankers Trust, John Hancock

## Bank of America Swap Offer to 401(k) Participants Has Implications for Defined Contribution Plans and Stable Value

By Randy Myers

For two decades, corporate America has had a love affair with the 401(k) plan. Now, Bank of America Corp. is rethinking that relationship—with potentially significant implications for the stable value industry and the pension industry at large.

On July 1, Bank of America gave participants in its \$6.7 billion 401(k) plan a one-time, two-month window of opportunity to roll their assets out of that plan and into the company's \$8 billion cash-balance pension plan. The potential benefit to the company is obvious: if Bank of America can earn more on the transferred assets than it ultimately pays out in benefits, it will enhance its bottom line, either by foregoing contributions to the pension plan that it otherwise would have been required to make, or by actually booking some of its excess investment gains as income. This is a luxury the company has already tasted; last year, pension income added \$149 million to Bank of America's total pretax income of \$12.2 billion.

Plan participants who elect to make the swap will be able to allocate their transferred assets among "virtual" mutual funds designed to track the performance of the in-house funds currently available in the bank's 401(k) plan. But that's largely a record-keeping exercise that will allow Bank of America to compute employees' investment returns. The managers of its cash balance plan will actually be able to invest the assets in whatever manner they choose. Their goal, of course, will be to match or better the virtual returns of the employees who have swapped 401(k) assets into

their plan.

Investment experts say that shouldn't be too hard for Bank of America to do, at least over the long-term. "The company is taking the assets of individuals with a 10-to-20-year investment horizon and transferring them to an institutional plan with an investment horizon of 40 to 75 years," says a retirement attorney at a large benefits consulting firm. "The plan can be much more aggressive with those assets than could an individual."

Still, the offer is not without risk, especially since Bank of America has agreed to lock in the value of any assets transferred to the cash balance plan. That means a participant who swaps in \$100,000 would be assured of getting that \$100,000 out upon retirement, even if his or her account loses money in the interim. Over the short term, that's always a possibility.

"Promising an employee a specific return (i.e., one based on their asset allocation choices) with no downside risk doesn't sound like the sort of business I'd like to be in," remarks a pension executive at one Fortune 500 company. "Yes, it can work. But it can also boomerang big time."

### Implications for Stable Value in Defined Contribution Plans

Were it to become widespread, Bank of America's maneuver could lead to reduced use of traditional defined contribution investment vehicles, including mutual funds and stable value products. While 401(k) participants as a group make sizeable allocations to stable value funds, managers of defined benefit plans, including

the cash-balance variety, almost never do. (The book-value accounting that makes stable value products appealing to investors in defined contribution plans isn't allowed in defined benefit plans.) A Bank of America spokeswoman confirms that while its 401(k) participants had 13% of their assets in stable value investments as of August 9, the company's cash balance plan had none. (Interestingly, both plans had high allocations to equity; 84% in the case of the 401(k) plan, and 68% in the case of the pension plan.)

"From a stable value industry perspective, you need to be alarmed, clearly," remarks Ted Benna, creator of the first 401(k) plan and now president of the 401(k) Association, a third-party plan administrator in Bellefonte, Pennsylvania.

Still, there are reasons to believe that corporate America will not embrace the Bank of America model en masse. For one thing, the model depends upon the availability of a cash balance pension plan, which allows for the maintenance of individual participant "accounts" with a unique asset allocation mix in each one. Although cash balance plans have become increasingly popular in the past few years, they still represent a minority of all defined benefit plans. "Cash balance plans, due to their regulatory constraints and complexity, are going to be limited to a certain number of companies," says one industry observer. "You're not going to have a universal move to this approach."

"I don't think it's going to become commonplace," agrees

William Quinn, president of AMR Investment Services, the \$14 billion pension arm of AMR Corp. "The overall trend is in the opposite direction; companies are trying to get people off their defined benefit rolls and onto the defined contribution rolls." AMR operates a traditional defined benefit pension plan as well as two 401(k) plans, one for its pilots and the other for its other employees.

David Wray, president of the Profit Sharing/401(k) Council of America, also points out that Bank of America can't count on its employees to remain as conservative with their investment allocation decisions, once they're in the cash balance plan, as they were when their assets were housed in the 401(k) plan.

"If I'm a rational employee, I'm going to put 100% of my money into equities because the bank is now guaranteeing me all of the underlying protection of a cash balance plan plus a floor on my return," Wray says. "In that situation, the bank probably wouldn't be able to outperform the investment allocation by employees. The success or failure of their program may depend upon whether employees figure out that they can have their cake and eat it, too."

Some outside observers also fret that the Bank of America model could face regulatory hurdles. Even though the company received a favorable determination letter from the Internal Revenue Service on its cash balance plan a few years ago, when the company was still called NationsBank, the Wall Street Journal reported in June that reg

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## Bank of America

*continued from page 7*

ulators have since become concerned about the plan's design, especially its definition of normal retirement age as either 65 years of age or five years of service. The five-years-of-service definition, if adopted elsewhere, could allow some companies to circumvent the accrual rules set down by both the IRS and the Employee Retirement Income Security Act. Those rules are designed to prevent employers from backloading benefits in favor of highly compensated employees.

Absent the accrual rules, a company could make an unusually large contribution to an employees' pension benefit after that employee logged many years of service. The fear is that highly paid employees are much more likely to stay with one employer than are low-paid employees, and that the latter group would therefore be discriminated against. Since accrual rules expire at normal retirement age, though, an employee who met that require-

ment through five years of service could legally receive a large back-loaded pension benefit.

That's not an issue with Bank of America's cash balance plan as its currently structured. The plan calls for the company to make contributions ranging from 2% of pay for the shortest-tenured employees to 8% of pay for the longest-tenured employees. However, the formula also takes an employee's age into account, so an older, short-tenured employee could get a higher percentage than a younger but longer-tenured employee.

Bank of America notes simply that it hasn't run afoul of the IRS. "In view of not having received any comments from the IRS on the current plan, it would be speculation on our part to assume they have any concerns," a Bank of America spokeswoman says.

Meanwhile, Benna notes that assets in a pension plan are insured by the Pension Benefit Guaranty Corp., but those in a 401(k) plan are not. Because the premiums paid by plan sponsors


to the PBGC are based on the number of participants in their plans, rather than their assets, "this is kind of a back-door way of getting PBGC protection around a large block of 401(k) assets without paying an increased premium," Benna says. "I don't know how policy makers will react to that."

Whatever the implications for the pension industry, Bank of America's plan seems to offer a win-win outcome for employees. In addition to getting PBGC protection for their accounts and a principal guarantee, Bank of America is allowing them to take up to two loans from their vested pension plan account at any time. (The company has, however, eliminated the loan feature from its defined contribution plan.)

Bank of America says that despite its swap offer, it has no plans to discontinue its 401(k) plan. Participants who elect to transfer assets into the cash balance plan may continue to participate in the 401(k) thereafter, but will have to begin building their

account balances from scratch.

The company says its swap offer was part of a restructuring of its 401(k) and cash balance plans that included simplifying and changing the contribution formula for the cash balance plan and improving the company's 401(k) contribution schedule (the company now matches employee contributions dollar-for-dollar up to 5% of pay). It says those changes will increase the company's retirement plan costs over time.

While no data was available at press time on the number of Bank of America 401(k) plan participants who took advantage of the company's swap offer, historical precedent suggests that it was probably high. Bank of America made a similar offer to its 401(k) participants in 1998 when it was named NationsBank Corp. (Later that year, it acquired Bank of America and took the latter's name.) In that first offer, 74% of the participants in the company's 401(k) plan transferred \$1.4 billion of their money into the cash balance plan. 

## Cash Flow 2000 - 2nd Quarter Update

*By Janet Jasin Quarberg*

As a follow up to last quarter's cash flow report, Hueler's 2nd Quarter FIRSTSource Market Data, which encompasses 400 plans, \$100 billion in stable value assets and \$508 billion in plan assets, shows improved cash flows as anticipated. As discussed in the


last issue, January and February resulted in heavy outflows with total withdrawals as a percent of stable value assets averaging

-4.42% in January and -2.83% in February. Additionally at the extreme end, outflows for those months were -11.2% and -7.6%

respectively.

As seen in the table below, the negative trend broke during the month of March showing that average flows were only slightly negative -.09%. Second quarter 2000 results looked much more like third quarter 1999 with average flows being close to neutral and the extreme ends ranging from -2% to -4%.

Stable value is actually well positioned to receive inflows, with

average stable value one-year returns hovering around 6.35% as compared to the Lehman Intermediate Government/Corporate's 4.23% and even the S&P's 7.25%. We'll see what happens! Hueler Companies will continue to monitor cash flow statistics from the FIRSTSource Market Data and report out new trends that appear in future issues. 

Percentile	Jun-99	Jul-99	Aug-99	Sep-99	Oct-99	Nov-99	Dec-99	Jan-00	Feb-00	Mar-00	Apr-00	May-00	Jun-00
5%	-2.45%	-4.84%	-2.55%	-3.70%	-3.38%	-3.44%	-2.88%	-11.27%	-7.63%	-3.96%	-4.68%	-2.63%	-4.57%
25%	-0.77%	-1.79%	-0.89%	-1.05%	-0.61%	-1.13%	-0.41%	-5.88%	-4.30%	-1.68%	-2.09%	-1.07%	-1.76%
Average	0.13%	-1.06%	-0.04%	-0.53%	0.70%	-0.18%	1.38%	-4.42%	-2.83%	-0.09%	-1.06%	-0.31%	-0.96%
75%	0.69%	-0.02%	0.59%	0.20%	1.23%	0.66%	2.59%	-2.16%	-0.98%	-0.87%	-0.11%	0.35%	-0.11%
95%	3.37%	2.10%	2.79%	1.59%	3.44%	3.18%	6.25%	0.29%	0.93%	4.21%	2.67%	2.50%	1.53%



## Funding Agreement Update

By Frank Cataldo, *Travelers*

(Editor's note: Funding agreements are principal protected products issued in alternative markets outside of the retirement plan market. In this first of a two part series, the author discusses recent events in one such alternative market—the short-term institutional market. The second part of this series will address the importance of funding agreements to institutional investors and how issuers manage the liquidity risk inherent in the product.)

The sale of funding agreements to money market funds and other short-term institutional investors dates back into the 1980s, but in the 1990s this became a high profile business. After a period of rapid growth in the late 1990s, the demand by money market funds and other short-term institutional investors was shaken by the demise of two major issuers, General American Life and ARM Financial, in the summer of 1999.

The typical funding agreement sold to short-term investors offers an indexed rate reset periodically, with a choice of various money market indices (including one month and three month LIBOR). Short-term investors are attracted to funding agreements because of competitive spreads, liquidity demand features that allow redemption of principal within a specified time period, industry diversification and customization to the buyer's specifications.

GIC issuers found a significant

growth opportunity in the sale of funding agreements to money market funds and other short-term institutional investors. Taxable money market funds alone are a \$1.5 trillion market. The stagnant conditions in the market for GICs among qualified retirement savings plans, and the opportunity to diversify funding sources, combined to draw numerous GIC issuers to this market.

According to Townsend & Schupp, the sale of funding agreements to money market funds, securities lending pools and other short-term investment funds grew to \$18.2 billion in 1998 from \$10.9 billion in 1997. Account balances grew to \$36.9 billion from \$30.1 billion over the same period.

The market for funding agreement sales to short-term investors hit a snag in 1999 when two major issuers, ARM Financial (ARM) and General American Life, encountered financial difficulties. Since 1995, ARM and General American had an agreement whereby ARM would sell funding agreements issued by General American. Although General American reinsured 50% of the business back to ARM, it retained risk as the issuer of the contracts.

In July, 1999, ARM terminated its arrangement with General American and transferred its funding agreement assets and liabilities back to General American. After ARM's withdrawal, General American had \$6.8 billion of short-term funding agreement

obligations, of which \$5 billion could be recalled by investors with seven days notice. The availability of this short notice period, at these volumes, was unique to General American and contributed significantly to its downfall.

Following ratings downgrades by several rating agencies, General American experienced a high level of redemptions by clients, which it was unable to meet. On August 10, General American sought protection from the Missouri Insurance Department.

Despite the fact that General American's exposure to short-dated puts was unique for the industry, the confidence of investors was shaken. While the majority of short-term funding agreement issuers reported modest levels of surrenders, sales momentum slowed dramatically. According to a Townsend & Schupp survey, funding agreement account balances dropped during 1999 by 7% for money market funds, 44% for securities lending pools and 9% for other short-term investment funds.

Since July, 1999, the number of buyers and issuers has dropped. Some buyers reduced holdings while others discontinued new purchases and allowed existing contracts to mature and pay out. Most of the issuers have discontinued shorter dated puts, particularly seven-day and thirty-day puts, in favor of longer dated puts or contracts with no advance liquidity. At least one issuer has withdrawn from the business entirely.

Rating agencies have cautioned insurers against offering shorter dated put contracts, and have encouraged restraining "institutional spread-based" business (GICs and funding agreements) to certain percentages of general account liabilities. However, it is recognized by rating agencies that properly managed growth of funding agreement business helps diversify insurers' funding sources and is appropriate for experienced issuers.

So far, the market for short-term funding agreements has seen a modest recovery in 2000. Although the landscape has changed, with reduced availability of more liquid contracts, the appeal of competitive spreads with strong credit still exists.

It is difficult to demonstrate that the demand for funding agreements by short-term funds is recovering from the events of last year but our own experience indicates that buyer interest is growing modestly. Further, issuers have been able to turn to their European Medium Term Note conduits to sell floating rate notes backed by funding agreements. LIMRA/SVIA survey results showed \$5.8 billion of funding agreement sales to short-term investment funds through June, 2000 - by comparison, the survey results for 1999 indicate sales were \$11.4 billion for the full year, the vast majority of which were undoubtedly in the first six months of the year. While a recovery may be underway, sales data do not show it to be a strong recovery. 

## The ABC's of Measuring Stable Value Performance

Victoria M. Paradis, CFA, J.P. Morgan Investment Management



Victoria M. Paradis

- A good investment policy
- A good investment manager, or
- Favorable interest rate levels when participants made deposits and withdrawals from the fund?

In fact, each of these facets has a material, independent effect on stable value fund returns. These are key distinctions to draw and answers to find. However, a quick assessment of a Fund's book value returns alone cannot decipher these distinctions.

To evaluate any investment strategy, including stable value, plan sponsors should question two components:

- 1) Is my **investment policy** appropriate to meet the objectives

of the fund?  
2) Is my **manager** best suited for the assignment?

Let's address these topics in more detail.

- 1) Is my **investment policy** appropriate to meet the objectives for the fund?

An investment policy determines the objectives and investment guidelines of the fund, by defining permitted fund investments based on:

- **Duration** What duration (average maturity) range is most appropriate to meet the fund's return versus responsiveness objectives? What duration will best match the fund's liquidity profile?
- **Credit quality** What average quality and minimum quality requirements are most appropriate to meet the fund objectives? What diversification limits by issuer and industry make sense?
- **Sector** What investment sectors will best suit the fund's role within the DC line-up? To what degree should the fund invest in GICs, government, corporate, mortgage-backed, and asset-backed securities? Should the fund exclude or include below investment grade or international securities? Who decides the investment policy? Usually the plan sponsor, not the investment manager. Stable value investment managers may help design an investment policy, but they do not usually make broad policy decisions.

After the plan sponsor decides

investment policy and guidelines, then a discretionary investment manager can meaningfully be held accountable for their decision-making ability within those parameters.

- 2) Is my **manager** best suited for the assignment?

After adjusting for policy differences *between funds*, book value returns still mask distinctions *between managers*.

Understandably, many plan sponsors historically have been comfortable without transparency of investment performance because stable value funds often invest in low risk, low turnover portfolios. They are perceived as passive investments. Yet, true passive investments mimic an index and require no manager decisions. The insert box gives some examples of active stable value investment decisions.

How can a plan sponsor evaluate whether their manager has actually made good decisions? One effective approach is to compare the manager's returns with those of a strategy that could have been passively produced. Many plans have already established passive book value benchmarks, such as blended GIC index or Treasury yields. However, because of the embedded "lag effect" and "cash flow effect" of book value returns, the results of book value return comparisons will always be murky. This topic has been thoroughly addressed in previous issues of *Stable Times*. Book value results do not enable a plan sponsor to differentiate one man

*continued on page 11*

What's the best way for a **plan sponsor** to evaluate the success of their stable value fund?

Specifically, if a fund offers attractive book value returns, to what degree can the plan sponsor attribute the results to:

### Book Value is the Foundation of Stable Value

Stable value investment vehicles insulate defined contribution plan participant account balances from declines due to changes in market conditions. Stable Value investments qualify for stabilized, "book value" accounting treatment when they meet the requirements of The American Institute of Certified Public Accountants Statement of Position 94-4.

Participants receive book value returns. All reporting to participants should be made based on book value results. Book value return series are appropriate for helping participants make asset allocation decisions. The volatility of stable value returns, measured on a book value basis, is the appropriate measure of the risk that should be disclosed to participants for purposes of asset allocation. Third-party providers of asset allocation models should use book value returns in constructing their models.

The assets underlying book value contracts held by stable value funds have separately-determined market values and total return performance results. Market value data can be a useful tool for plan sponsors and their consultant advisors to evaluate the investment decision-making ability of stable value managers. Market value return series are not appropriate representations of stable value returns for reporting to individual participants or for representing stable value vehicles alongside other defined contribution investment vehicles.



### Active Investment Decisions

- 3 year versus 5 year
- AA versus AAA
- GIC versus bond
- Cash versus invest
- Hold versus trade
- Asset backed versus Mortgage backed

## Measuring Stable Value Performance

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ager's ability from another, to ensure the best choice for managing the investments.

A market value-based approach is the solution that works. The time-weighted total return methodology prescribed in the Performance Presentation Standards sponsored by the Association for Investment Management and Research (AIMR-PPS) is designed to get at the answers that plan sponsors should be seeking.

### Total Return

The calculation of total return is based on the formula

$$R_{TR} = (MVE - MVB) / MVB,$$

where  $R_{TR}$  is the total return, MVE is the market value of the portfolio at the end of the period, including all income accrued up to the end of the period, and MVB is the portfolio's market value at the beginning of the period, including all income accrued up to the end of the previous period.

This well-known formula represents growth (or decline) in the value of a portfolio, including

both capital appreciation and income, as a proportion of the starting market value. This formula does not incorporate cash flows during the measurement period (see section below).

### How to handle Traditional GICs

GICs are not readily marketable; so true market value returns are not possible. Yet, it is feasible to calculate the fair value of GICs by discounting cash flows using three simple steps outlined below. See Table A at the end of this paper for a mathematical example.

The fair value calculation for GICs is clearly an approximation. Specifically,

- The discounting formula includes estimates of current spreads. This will create variations in results between managers. However, there exist analogous situations for other asset classes that invest in privately negotiated or infrequently traded securities.
- The SVIA Task Force approach allows for the exclusion of bid-ask pricing differences when determining GIC values. The intent is to calculate fair value, not liquidation value. Liquidation value is the objective when valuing most other asset classes, but is not necessarily appropriate for GICs which cannot be readily valued for liquidation.

### Measuring the effect of interim cash flows

The Standards seek to isolate the investment results that managers can control, while adjusting for those things that managers cannot control, such as partici-

AIMR-PPS allows flexibility in methodology, as long as the calculation method chosen represents performance fairly, is not misleading, and is applied consistently to all portfolios and time periods.

pant cash flows.

The total rate of return calculation outlined above is a reasonable way of presenting the performance of a portfolio with no cash flows over a period. However, the condition of no cash flows is clearly not applicable in a stable value environment with unpredictable, daily participant cash flows.

When cash flows occur, theoretically, they must be used to "buy" additional units of the portfolio at the market price on the day they are received. Thus, the most accurate method of calculating return is to calculate the market value of the portfolio on the date of each cash flow, calculate an interim rate of return for the sub-period according to the preceding formula, and then link the subpe-

riod returns to get the return for the month or quarter. This approach removes the effect of each cash flow. Methods that use this approach, or an approximation of it, are called time-weighted rate-of-return methods.

### Time-Weighted Rate of Return

The AIMR-PPS standards require calculation of a time-weighted rate of return using a minimum of quarterly valuations and geometric linking of these interim returns. Approximation methods are acceptable.

There are three methods to compute time-weighted rate of return. The first is the daily valuation method (or valuation whenever cash flows occur), which is most precise and therefore considered the ideal. Two other methods - the modified Dietz method and the modified Bank Administration Institute (BAI) method - result in approximations of the daily valuation method. Only the daily valuation and modified Dietz method are included in this

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### Calculating the fair value of traditional GICs

Step 1: Project future contract interest and principal payments

Step 2: Track market yields and spreads as of key measurement dates\*

- Record yields of Treasuries with maturities that correspond to future contract payments
- Maintain GIC spread data; source is at manager discretion

Step 3: Discount cash flows from Step 1 using yields plus spreads from Step 2 to generate fair value as of each measurement date

- Use financial calculator or spreadsheet PV function

*See Table A at the end of the article for a numerical example.*

\*at least quarterly and upon material participant and contract cash flows

### Measuring Stable Value Performance

*continued from page 11*

article.

**Whichever method is chosen, being consistent is important.**

Daily valuation method. The daily valuation method uses the market value of the portfolio whenever cash flows occur. The chief advantage of this method is that it calculates the true time-weighted rate of return rather than an estimate. The major drawback is that it requires precise market valuation of the portfolio on the date of each cash flow, something that is not always feasible or practical.

The formula is

$$R_{DAILY} = (S_1 \times S_2 \times \dots \times S_n) - 1,$$

where  $S_1, S_2, \dots, S_n$  are the subperiod indexes for subperiods 1, 2, etc., through  $n$ . Subperiod 1 extends from the first day of the period up to and including the date of the first cash flow.

Subperiod 2 begins the next day and extends to the date of the second cash flow and so forth. The final subperiod extends from the

day after the final cash flow through the last day of the period.

Each of the subperiod indexes is calculated using the formula

$$S_i = \frac{MVE_i}{MVB_i},$$

where  $MVE_i$  is the market value of the portfolio at the end of subperiod  $i$ , before any cash flows in period  $i$  but including accrued income for the period, and  $MVB_i$  is the market value at the end of the previous subperiod (i.e., the beginning of this subperiod), including any cash flows at the end of the previous subperiod and including accrued income up to the end of the previous period. See Table A for a simplified mathematical example.

**Modified Dietz method.** The Dietz method overcomes the need to know the market valuation of the portfolio on the date of each cash flow by assuming a constant rate of return on the portfolio during the period. The chief advantage of the modified Dietz method

is that it does not require portfolio market valuation for the date of each cash flow. Its chief disadvantage is that it provides a less accurate estimate of the true time-weighted rate of return.

The original Dietz method assumed that all cash flows occurred at the midpoint of the period. The modified Dietz method weights each cash flow by the amount of time it is held in the portfolio. The formula for estimating the time-weighted rate of return using the modified Dietz method is:

$$R_{DIETZ} = \frac{MVE - MVB - F}{MVB + FW},$$


where  $MVE$  and  $MVB$  are as defined previously,  $F$  is the sum of the cash flows within the period (contributions to the portfolio are positive flows, and withdrawals or distributions are negative flows), and  $FW$  is the sum of each cash flow,  $F$ , multiplied by its weight,  $W_i$ .

Weight  $W_i$  is the proportion of the total number of days in the period that cash flow  $F_i$  has been in (or out of) the portfolio. The formula for  $W_i$  is:

$$W_i = \frac{CD - D_i}{CD},$$

where  $CD$  is the total number of days in the period and  $D_i$  is the number of days since the beginning of the period in which cash flow  $F_i$  occurred. The numerator is based on the assumption that the cash flows occur at the end of the day. If cash flows were assumed to occur at the beginning of the day, the numerator would be  $CD + 1 - D_i$ .

While this paper addressed measuring performance, the next installment will cover the ABC's of presenting stable value performance. It will include:

- Composite construction
- Presentation of results
- Disclosures 

Measurement Dates						
	12/31/99		6/30/00		12/31/00	
Market yields	Treasury GIC sprd		Treasury GIC sprd		Treasury GIC sprd	
6 month	5.75%	0.75%	6.00%	0.75%	6.00%	0.75%
1 year	6.00%	0.80%	6.25%	0.80%	6.25%	0.80%
2 year	6.25%	1.00%	6.30%	1.00%	6.30%	1.00%

Contract Cash Flows			
	Future Cash Flow		
	Jun 00	Dec 00	Dec 01
Contract A	\$15		
Contract B		\$15	
Contract C			\$15

Fair Value Calculations								
time	yield	Fair value	time	yield	Fair value	time	yield	Fair value
0.50	6.50%	\$15	-	-	\$15	-	-	\$15
1.00	6.80%	\$14	0.50	6.75%	\$15	-	-	\$15
2.00	7.25%	\$13	1.50	7.18%	\$14	1.00	7.05%	\$14
1H00 return		\$42			\$43	3.39%*		
2H00 return					\$28	\$29		
						3.51%**		
						12 month return		
						7.02%***		