STABLE TIMES

The quarterly publication of the Stable Value Investment Association

Volume 6, Issue 1 • First Quarter 2002

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Reminder!

SVIA Sixth Annual Policy Survey

Due Date: March 1, 2002

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Assets in Stable Value Mutual Funds Pass $1 Billion Mark

By: Randy Myers

Stable value mutual funds are finally gaining traction. Roughly four years after Bankers Trust launched the first such fund there are now more than half a dozen, with total assets exceeding $1.3 billion. While that's a pittance compared to the $3.3 trillion in stock funds, $2.3 trillion in money market funds and nearly $1 trillion in bond funds, it's not pocket change, either. And with the stock market sluggish and money market returns at historic lows, stable value funds seem poised for continued growth.

"Product awareness is still a big issue, particularly with financial advisors in the IRA market," says John Axtell, managing director and head of the stable value group at Deutsche Asset Management, the asset management arm of Deutsche Bank, which acquired Bankers Trust in 1999. "But we've been doing a lot in terms of putting on seminars for both financial advisors and the press, and what we've seen is that once advisors are made aware of

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Loss in "Money" Fund Reminder that All "Safe" Funds Not Created Equal

By: Randy Myers

Even after suffering through the implosion of the tech-stock sector in 2000 and the broad market slump that's lingered since then, investors had reason to be disturbed by the December 14 article in *The Wall Street Journal*. A "money market fund," the newspaper reported under a bold headline, had lost 1.9% of its value, or $47.8 million, in a single day.

Investors have come to regard money market funds as safe havens, of course, since their first mandate is to avoid losing any of their shareholders' principal. The problem was that this Brinson fund—while positioned as a money market fund to participants in at least one company's 401(k) plan (BP PLC), according to the *Journal* —was actually a "cash management" fund. Also known as an ultrashort bond fund, these funds invest primarily in short-term debt securities that carry relatively little interest-rate risk.

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Investor Advice: Steering Clear of Another Enron

By: Randy Myers

While Congress scrambles to figure out how giant energy trader Enron Corp. could fail without advance warning from auditors, securities analysts or federal regulators, investors are left with a more immediate puzzle: How do I make sure I don't get burned by another Enron-like implosion?

It's not an idle question. Enron was just one of a record 143 publicly traded companies that filed for protection under Chapter 11 of the federal bankruptcy code last year, leaving behind a dismal $76 billion trail of debt, according to Moody's Investors Service. That was up from 119 bankruptcies affecting $30 billion of debt in 2000, and a mere 58 bankruptcies affecting $11.8 billion in debt in 1990. With the economy still slumping, there is, unfortunately, little to suggest that the trend will be reversed any time soon.

The problem, of course, is that no one knows exactly where the next Enron will come from or what form its financial woes will take. After all, there aren't many

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It's in the Message

An Outlook for 2002

By: Nick Caggia, SVIA

Eric Kirsch

Stable value has enjoyed increasing success and media attention over the past year. Many in the stable value community have wondered how to maintain this momentum and capitalize on it. SVIA's Chairman, Eric Kirsch, provides the answer, "It's all in the message!"

Kirsch recently expressed his opinion that 2002 will present good opportunities for stable value. As investors look to diversify their accounts, to protect themselves from volatility, they will seek stable value. To this end, investor education will be vital. SVIA and its membership must work to ensure that the name "stable value" is mainstreamed into the conservative investment lexicon, along side money markets and intermediate bonds. In order to accomplish this, SVIA will take its case to the media.

SVIA will target both mainstream newspapers and trade press across the country to reach out to a wide audience, including investors, plan sponsors, consultants, and financial advisors. In addition, SVIA also hopes to expand this media plan to television an online outlets to maximize its audience. To jump start this effort, the SVIA Board will work with press in cities they visit during quarterly meetings across the country, including San Francisco, New York, and New Orleans.

On a second front, SVIA will visit with policy makers to educate them on the positive attributes of stable value and the protections the product offers. Both the executive and legislative branches are exploring ways to avoid another Enron-type situation, offering a unique opportunity to spread the word. Members of the SVIA Government Relations Committee will travel to Washington, DC, to meet with Senators, Representatives, and staff at the Department of Labor.

In addition to traditional stable value markets, Kirsch thinks that 2002 should offer growth in newer areas. Stable value mutual funds will offer great opportunities in the coming year. There is good growth potential in this burgeoning area as existing funds garner greater respect and notoriety, enticing new players into the market. In addition to these domestic prospects, Kirsch believes that European and Asian markets are on the horizon for stable value.

SVIA is working to make 2002 a benchmark year for stable value. Kirsch has the winning formula to make this happen, "Strong investor appetite, combined with an active public awareness program, will lead to a robust year for stable value."

Stable Value in the Spotlight

By: Nick Caggia, SVIA

Industry insiders have long recognized the worth of stable value products in diversifying investments. Why has the general public been slow to catch on? The press, like the investing public, has not focused on stable value. Instead, they have been enticed by the sexy ups and downs of the stock market. When the markets are consistently down, the press tends to focus on conservative investments like stable value.

In the past few months, however, stable value has enjoyed press attention. Stable value's characteristics of stability and liquidity have made it more popular now that equity returns have decreased and volatility has increased. As plan participants have seen their balances drop, they have discovered stable value. The reason is obvious, steady but certain returns are far better than negative returns.

SVIA has been tracking stable value in the news and is proud to note the following articles among the positive press that stable value has received.

October 19, 2001, *The Wall Street Journal*, "Bond and Other 'Stodgy' Funds Come Back."
Besides the classification of Stable Value Funds as "stodgy," this was a positive piece that compared several different types of financial instruments including: Bond Funds, Gold Funds, Closed-End Muni Bond Funds, and Fixed Annuities.

November 26, 2001, *Pensions and Investments*, "Participants Get Reacquainted with Old Friend– Stable Value."
The story highlighted the $45 billion that has moved into stable value funds during the first three quarters of 2001.

January 6, 2002, *The New York Times*, "Satisfying 2 Cravings: Yield and Safety."
The article centered wholly on the stable value IRA community. This piece was unique in that it featured perspectives from real investors who are taking advantage of stable value.

February 1, 2002, *Employee Benefit News*, "Stock Volatility has Investors Seeking Happier Returns."
Details the transfer of 401(k) contributions from equities into more conservative options, led by stable value.

SVIA will continue to work on delivering the stable value message. Stay tuned for updates and progress reports. Also, if you notice press reports dealing with stable value, please let us know.

2002 SVIA National Forum

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Congress Takes Aim at Employer Stock in 401(k) Plans; Business Remains Leery

By: Randy Myers

Pressure continues to build in Washington for legislation that would protect US workers from future Enron-like meltdowns in their 401(k) plans. While Democratic lawmakers have proposed the most drastic changes to current law, Republicans are making their voices heard, too, with President Bush himself floating a proposal that would make it easier for workers to diversify out of employer stock held in those plans.

When energy trader Enron Corp. filed for protection from creditors under Chapter 11 of the U.S. Bankruptcy Code in December, it not only left many of its workers out of a job, it also left them with tattered retirement accounts. On average, those workers were reported to have held about 60% of their 401(k) assets in Enron stock, which last year fell from $83 to less than $1. Their retirement account losses alone exceeded $800 million.

On January 29, Bush proposed that participants in retirement savings plans be allowed to diversify out of company stock contributed to those plans by their employers after a maximum of three years. Bush would also preclude senior executives from selling company stock during times when rank-and-file workers can't trade in their 401(k) accounts, and assign fiduciary responsibility for plan assets to employers during plan lockdowns. Bush also called for the Senate to pass the Retirement Security Advice Act, which has already been approved by the House and would make it easier for financial advisors to provide investment advice to plan participants.

That same day, Rep. George Miller (D-CA) floated the "Employee Pension Freedom Act" which would, among other things, allow participants to diversify out of employer-stock matching contributions once they are vested in their plan, limit vesting schedules to one year, require advance notice of plan "lockdowns" that prevent participants from trading in their accounts, and impose other new legal protections for plan participants.

Other proposals have gone even further. On December 18, Sen. Barbara Boxer (D-CA) and Sen. John Corzine (D-NJ) introduced the "Pension Protection and Diversification Act of 2001," which would limit workers to maintaining a maximum of 20% of their dc plan in their employer's stock and also give them freedom to diversify out of company stock that had been contributed to their plan by their employer after just 90 days. The Boxer-Corzine bill also would limit to 50%, instead of the current 100%, the tax deductibility of employer contributions to retirement plans when those contributions are made in the form of employer stock. Additionally, the bill would allow employees to diversify out of company stock in an Employee Stock Ownership Plan once they have reached the age of 35 and have at least five years of participation in that plan. Currently, companies can prevent workers from diversifying their ESOP holdings until they reach age 55 and have 10 years of plan participation. Rep. Peter Deutsch (D-FL) and Rep. Gene Green (D-TX) had earlier introduced similar legislation that would limit employer stock holdings to 10% of retirement account assets, but would not restrict employers' use of company stock in matching contributions.

The business community has not responded warmly to these proposals. "They think it's a terri-

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Congress Takes Aim

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ble idea," says Janice Gregory, vice president of the ERISA Industry Committee, an organization of companies that sponsor retirement plans, when asked about the Boxer legislation. And, she adds, "Chances are their employees will agree." Gregory says US workers were "outraged" in 1997 when Boxer was pushing similar legislation, which Gregory characterized as an attempt to prevent workers from participating in the prosperity of their employers. Although Boxer succeeded in having a bill passed at that time, the final product was considerably weaker than what she had first proposed. It merely barred companies from forcing employees to invest their voluntary contributions to a 401(k) plan in employer stock or employer real estate (with some exceptions).

In the wake of the Enron debacle, however, Boxer may find herself in a stronger negotiating position. While Gregory insists that Enron was an isolated incident that shouldn't trigger wholesale changes in the way other companies run their retirement plans, the sheer size of Enron—it was the seventh largest company in the country prior to its downfall—has riveted Washington's attention like few other corporate failures before it. By late January, no fewer than 10 Senate and House committees had announced inquiries into the blowup. Even President Bush had ordered his economic team to review pension rules that could put other workers at risk.

"We know there are very powerful forces arrayed against this legislation, and that they are making their voices heard loud and clear," Boxer spokesman David Sandretti said in late January. "But we feel we have a compelling case and can make a compelling argument, given the huge amount of interest in this situation, given the really terrible losses that the Enron employees had to take, and given the fact that we've got a number of companies that have similarly exposed their workers to this kind of risk."

In fact, while Enron's implosion hopefully will be an isolated event, it is hardly the only major company that has crafted a retirement savings plans stuffed to the gills with its own stock. According to a recent report in the *Washington Times,* for example, workers at paint-store chain Sherwin-Williams have about 92% of their 401(k) assets in company stock, workers at Coca-Cola have about 81%, workers at pharmaceutical giant Pfizer Inc. have about 86%, and workers at McDonald's have about 74%.

Those are, to be sure, the extremes. A recent study by the Investment Company Institute and the Employee Benefit Research Institute, which examined the 401(k) accounts of 11.8 million workers in 35,367 plans (about 11% of the nation's total), showed that at year-end 2000 participants in those plans had about 19% of their assets invested in employer stock. In cases where employees do hold more than that, it's often because they have elected to do so, enthused by their employer's prospects. That was also the case at Enron, however, and it helps to explain why the environment for legislative action appears to have changed.

So does the current economic climate. "The difference between 1997 and 2002, says Karen Friedman, Director of Policy Strategies for the worker advocacy group the Pension Rights Center, "is that in 1997 we still had a bull market." When most companies' stocks were going up in value, few people were stopping to worry about what would happen when the party was over. The case that triggered Boxer's 1997 legislation—the failure of flooring retailer Color Tile—really did seem like an isolated incident. (At the time that Color Tile filed for bankruptcy protection, most of its employees' 401(k) assets were invested in real estate rented by Color Tile stores. The employees suffered huge losses in their retirement accounts.)

To some critics of the current rules governing 401(k) plans, the federal government has an obligation to step in and protect workers who are shouldering more and more of the responsibility for their own retirement security.

"We have a tax subsidized system and we're using it to help people commit financial suicide instead of financial security," argues plaintiff's attorney Marc Machiz, a partner and ERISA specialist in the Washington, DC, office of Cohen Milstein Hausfeld & Toll. "If we're going to pay for this system with our tax dollars, we ought to get what we paid for, and that requires a reasonable amount of diversification in these retirement plans. Letting people put 90% to 100% of their retirement assets into employer stock is a recipe for disaster."

Friedman agrees, pointing out that the law already prohibits employer-sponsored defined benefit plans from holding more than 10% of their assets in employer stock. "In those plans, where all of the risk is on the employers and where we have a federal agency in place to insure those plans if they fail, we limit the exposure to company stock to 10% because of the need for diversification," says Friedman. "Yet in 401(k) plans, where all of the risk is on the employees' shoulders, and where there is no insurance, we're saying, 'Oh, let them do what they want.' I think legislators will see the need to implement some legislative protections."

The challenge for supporters in that camp, of course, will be to overcome what will inevitably be intense lobbying from the business community and those legislators most sympathetic to their interests. Proponents of change will also need to balance their desire to protect workers from their own risky choices with the desire to give them as much freedom as possibility for directing their own retirement accounts. Whatever the outcome, it will be a lively, and important, debate.

All "Safe" Funds Not Created Equal

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Although the Brinson fund was far less volatile than stock funds or general bond funds—this was its first significant loss in its 20-year history—it wasn't a true money market mutual fund of the sort that most investors think of when they see the words "money" and "fund" in the same name. That's because it didn't adhere to the same investment restrictions aimed at minimizing risk. British Petroleum told the Journal that its investment Web site for employees explained that the fund didn't enjoy the same investment protections as a money market mutual fund, but that didn't stop some BP employees from being surprised when their accounts showed paper losses in the fund. Nor did it appease some segments of the money market fund industry.

"Equating this fund and a money market fund is like equating apples and oranges," steams Mike Sheridan, senior portfolio manager and director of investments for Reserve Funds, a New York investment firm credited with launching the first real money market fund and today a specialist in managing such funds. "It's inappropriate, and hence investors got burned. It highlights the need for better disclosure."

True money market mutual funds comply with Rule 2a-7 of the 1940 Investment Company Act, which sets strict limits on the types of securities the funds can hold. For example, they can invest only in debt obligations that mature in 13 months or less and must maintain an average weighted maturity for their entire portfolio of no more than 90 days. The funds also must invest at least 95% of their assets in debt obligations with the highest possible credit rating.

Cash-management or ultra-short bond funds also invest in high-grade, short-term fixed income securities, but will sometimes invest deeper on the credit-quality scale or farther out on the yield curve in search of slightly higher returns. The cash-management account profiled in *The Wall Street Journal* article is formally known as the Brinson Trust Co. U.S. Cash Management Fund. It is managed by Brinson Partners, a unit of UBS AG, which markets its funds to corporate clients but does not market directly to participants in the 401(k) plans of those clients. That marketing is done either by the plan sponsor or its plan administrator.

Included in the Brinson fund's portfolio in December was commercial paper (short-term debt) of Enron Corp., the Houston-based energy trading company which that month filed for protection from its creditors under Chapter 11 of the U.S. Bankruptcy Code. That filing triggered an inevitable decline in the value of Enron's commercial paper, which in turn triggered a decline in the market value of the Brinson fund.

True money market funds are allowed to buy commercial paper, provided it is highly rated by credit-rating agencies. However, they may invest only 5% of their assets in the paper of a single issuer, and then only if that issuer has a "tier-1" rating (the highest rating possible). They may invest up to 1% of their assets in the securities of a single "tier-2" issuer. Enron was a tier-2 issuer, says Sheridan. Brinson told the Wall Street Journal that the Enron paper accounted for about 2% of the $2.5 billion of assets in its fund.

For investors seeking preservation of principal in their retirement accounts or elsewhere, the Brinson incident reinforces the need for selecting carefully among the many types of investment options—from true money market funds to stable value funds to ultrashort bond funds—that tout safe returns.

"It's always good to read the fund's prospectus," says David Wray, president of the Profit Sharing/401(K) Council of America. "In the case of money funds, you're not looking for the highest possible returns, you're just looking for a place that's safe, and you want to make sure that's what you've got." Wray added that most funds advertised as money market funds in 401(k) retirement accounts and managed by well-known investment companies are just that. Again, however, it is incumbent upon investors to know what they're buying.

There is, of course, one type of fund that allows investors to enjoy the stability of a money market fund and the generally higher returns of an intermediate-term bond fund, and that is a stable value fund. Like intermediate-term bond funds, stable value funds routinely invest in high-grade shorter-term debt securities. Unlike intermediate-term bond funds, however, they wrap those securities in an insurance company guarantee, or "wrap contract," which assures investors that they will always be able to redeem their shares at book value, regardless of short-term fluctuations in the underlying portfolio. If the fund itself cannot pay full value on shareholder redemptions, the wrap issuer is obligated to step in and make up the difference. (Some stable value funds also invest in guaranteed investment contracts, which offer comparable protection for investors.)

John Kowalik, senior vice president, portfolio manager and head of investment-grade fixed income investments at Oppenheimer Funds, says it is telling to compare what would happen to a stable value fund if its underlying investment portfolio were to lose 2% of its value in a single day, as happened with the Brinson fund. Under such a scenario, he says, investors in the stable value fund would not realize that 2% loss, even if they withdrew their shares the next day. It would be possible, he conceded, that they would experience lower returns on their shares going forward, as that loss was amortized over a period of time (a process handled through reductions in the fund's crediting rate). However, the value of their shares would not have declined.

Stable Value Mutual Funds

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this product, they quickly see its benefits and are very receptive to it."Deustche manages the world's oldest stable value mutual fund, the Deutsche Preservation Plus Fund, which it markets exclusively to participant-directed retirement plans. It also manages the Deutsche Preservation Plus Income Portfolio, which is marketed to both retirement plans and IRA investors in two forms: as the Deutsche Preservation Plus Income Fund and the Security Capital Preservation Fund. Combined, these Deutsche-managed stable value mutual funds had assets of more than $580 million at year-end 2001. Other managers of stable value mutual funds include Dwight Asset Management (for the PBGH family of mutual funds); ICMA Retirement Corp.; Morley Financial Services, a unit of Nationwide Financial Services Inc.; Oppeneheimer Funds and Principal Life Insurance Co.

Growth Factors

Although stable value mutual funds attracted some attention from investors upon launch, interest accelerated in 2000 when the implosion of the tech-stock bubble was followed by a broad stock market downturn, bringing to a close the greatest bull market the US had ever seen. Investor interest intensified last year as the Federal Reserve Board drove down short-term interest rates in a bid to stimulate the economy.

"We started noticing it (increased interest by investors) in early-to-mid-2001, when the Fed started lowering short-term interest rates," says Axtell. "That made the yields on stable value funds much more attractive than the yields on money market funds and short-term bond funds." By the end of 2001, stable value mutual funds were still yielding about 6.0%. The average money market fund, by contrast, was yielding about 2.0%, while intermediate-term bond funds were yielding about 4.8%.

Soon, the older stable value mutual funds will have yet another marketing lever: a track record of sufficient length to merit a rating from Morningstar Inc., the influential mutual fund research firm headquartered in Chicago. Morningstar assigns mutual funds one of its risk-adjusted "star" ratings after they have been in operation for three years.

"We just received our Morningstar rating for the Deutsche Preservation Plus Income Fund and got the highest rating, five stars," says Axtell. "In fact, we have a five-star rating for both of our funds. We expect that kind of recognition to help us even more in our marketing efforts going forward. We expect things to only get better in terms of asset growth."

Other stable value mutual funds that will soon have three-year track records include the Nationwide Morley Capital Accumulation Fund managed by Morley Financial Services and the Oppenheimer Capital Preservation Fund managed by Oppenheimer Funds. The Nationwide fund was three years old in February, while the Oppenheimer fund will celebrate its third birthday in September.

Distinguishing Features

Not surprisingly, most stable value mutual funds launched to date are similar in structure, investing principally in high-grade short-term and intermediate-term fixed income securities. Most also charge a redemption fee to investors who sell their shares when yields on cash equivalents shoot above the yields on the funds themselves. It's a prudent measure aimed at discouraging investors from trying to arbitrage rates on those competing products to the detriment of long-term shareholders.

That said, there are some noteworthy differences in the way the funds invest their assets. On the credit-quality scale, for example, Deutsche Asset Management has taken the most aggressive approach with its PreservationPlus Income Portfolio. While the average credit quality of its portfolio is a healthy Double-A, the minimum credit rating at time of purchase for most securities in that portfolio is Triple-B. (Deutsche sets a higher minimum credit rating—Single A—for securities in its PreservationPlus Fund.)

ICMA also permits Triple-B investments in its stable value fund, but Deutsche goes a step further with the PreservationPlus Income Fund by retaining the right to invest up to 10% of the fund's assets in high-yield, or non-investment-grade bonds. Finally, Deutsche also allocates about 1% of the assets in that fund to a global asset allocation overlay strategy which takes tactical positions, both long and short, in various securities markets around the world. Those markets can include equity futures, fixed income and foreign currency markets. "It's a very risk-controlled strategy that has added value to the performance of the portfolio while still allowing the portfolio to be covered by the wrap contracts," Axtell says. (Wrap contracts are the book-value guarantees that insurance companies and other financial institutions sell to stable value managers to ensure that stable value investors won't lose any of their principal.)

At the other end of the credit-quality spectrum is the PBHG IRA Capital Preservation Fund run by Dwight Asset Management. This fund invests only in securities with a Triple-A rating.

Dwight has also gone against the trend by eschewing any interest-rate triggers for its redemption fee. Instead, it simply levies the charge on investors who hold their shares for less than 12 months. ICMA Retirement Corp., meanwhile, which serves government pension plans and IRA investors who participate in them, puts no restrictions on redemptions from its stable value mutual fund, which is marketed under the name Vantagepoint Income Preservation Fund.

"It's been difficult to construct this (redemption) fee because of the natural tension that exists between what the retail

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Stable Value Mutual Funds

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investor wants, which is no real restrictions, and the requirements of the wrap providers," says Laura Dagan, Dwight's chief operating officer and also a member of the team of portfolio managers running the fund. "The problem with the trigger is that it's complicated and hinders sales. So we've worked with our wrap providers to get them comfortable with how we're going to manage the fund to help protect their interests."

Dagan declined to discuss the details of how it will do that, but there are a number of ways to provide liquidity during times of rising interest rates, including holding a buffer of cash in the fund's portfolio. Dagan confirmed that the PBHG fund portfolio does include some cash, along with treasuries, agency bonds, mortgage-backed securities, asset-backed securities and Triple-A-rated corporate bonds.

Yet another approach to portfolio construction has been taken by Oppenheimer Funds, which has structured its stable value product as a fund of funds. According to John Kowalik, senior vice president, portfolio manager and head of investment grade fixed income investments for the firm, the Oppenheimer Capital Preservation Fund holds about 70% of its assets in an Oppenheimer Limited Term Government bond fund; 20% in the Oppenheimer Strategic Income bond fund (a diversified fixed-income offering), and approximately 5% each in an Oppenheimer money market fund and the Oppenheimer Bond fund (an intermediate-term fixed income fund).

Most managers are marketing their stable value mutual funds to IRA investors through established distribution channels, such as broker/dealers, financial advisors, banks, or, in the case of Nationwide and Principal, their own distribution networks. Most are marketing to the defined contribution retirement plan market as well. Oppenheimer, though, has proceeded cautiously in the IRA arena, and only plans to begin marketing there later this year.

THE OUTLOOK

Though still occupying a small niche in the mutual fund world, stable value mutual funds are poised for substantial growth, their managers agree.

"Stable value funds have been available to qualified plans and plan sponsors for a long time, and we simply need to get the word out that this asset class, which many Americans have already invested in through their defined contribution plans, is now available to them in a different way," says Steve Ferber, senior vice president of sales and marketing at Morley Financial. He says he expects his firm's fund to approximately quadruple in size this year, to about $200 million, now that Morley has beefed up its sales and marketing effort and signed on a number of new distribution partners.

"We need to build on the exposure and familiarity of DC plan participants," agrees Terry Hotchkiss, a product specialist with Principal Capital Income Investors. "Once those people investing in stable value funds in their retirement plans see they have the opportunity to roll their money into a stable value fund in their IRA, you'll see it become a popular option there, just like it is right now in DC plans. We also need to build an historical track record showing that our long-term performance is similar to that of an intermediate-term bond fund and over most time periods will consistently outperform money market funds."

The effort is well underway.

Stable Value Mutual Funds at a Glance

Fund Name	Available to IRA Investors?	Manager	Inception Date	Assets 12/31/01 (millions)	Assets in IRA Accounts (millions)	Portfolio Duration (years)	Total Return 2001
Deutsche Preservation Plus	No	Deutsche	Dec. 1997	$264.0	0	3.24	5.60%
Deutsche Preservation Plus Income	Yes	Deutsche	Dec. 1998	$25.8	$25.8	3.48	6.14%
Security Capital Preservation	Yes	Deutsche	May 1999	$291.3	$262.2	3.48	6.02%^
PBHG IRA Capital Preservation*	Yes	Dwight	Jan. 2002	$190.3	$190.3	2.93	6.05%
Vantagepoint Income Preservation	Yes	ICMA	Dec. 2000	$415.0	$21.0	3.11	5.45%
Nationwide Morley Capital Accumulation	Yes	Morley	Feb. 1999	$46.5	$3.0	2.9	6.27%**
Oppenheimer Capital Preservation	Pending	Oppenheimer	Sept. 1999	$76.3	0	2.0	5.94%
Principal Investors Fund: Capital Preservation	Yes	Principal	June 2001	$11.5	$1.2^^	2.58	N/A

* This is a successor fund to the UAM:IRA Capital Preservation Portfolio. The total return for 2001 is for predecessor fund, which on January 14, 2002, was rolled into the PBHG IRA Capital Preservation Fund with no changes to its portfolio.

** Total return is for institutional class shares. Total return for IRA class shares was 5.84%.

^ Total return is for Class A shares.

^ ^ All non-IRA assets represent seed money.

Investor Advice

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hyper-growth Fortune 100 energy-trading companies doing business with off-balance sheet partnerships run by one of their own senior financial executives, which is what Enron did. Nor is it likely that the next fallen corporate icon will exactly replicate the downfall of other prominent companies in recent years.

In such an environment, the only real solution for investors is to avoid situations which overweight the opportunity to be blindsided by corporate fraud, hubris or mismanagement. Investment guru Warren Buffet recognized the wisdom of this course decades ago when he concluded that he wouldn't invest in any business he didn't understand. He wound up sitting out the tech-stock boom that closed out the 20th century, yet still managed to generate fantastic investment returns.

Lynn Turner, director of the Center for Quality Financial Reporting at Colorado State University and, until recently, the chief accountant of the Securities & Exchange Commission, has a similar message for investors. "You need to read those financial statements and footnotes, and if there's something in there you don't understand, you need to ask about it," Turner says.

Of course, it's always possible to invest in a business you believe you understand without recognizing that you really don't. Accordingly, Turner warns investors to be wary of the following in a company's financial statements, SEC filings or press reports:

- Related-party transactions. Enron used related-party transactions between itself and partnerships controlled by its chief financial officer to keep hundreds of millions of dollars in debt off its balance sheet, thereby masking its true financial condition and the risks the company was facing. "Related-party transactions just provide too many opportunities for management to engage in self-dealing, and that won't work for outside investors," Turner says.
- Excessive reliance on pro forma financial results. Pro forma financial statements typically exclude many of the charges companies are required to take under generally accepted accounting principles, which can make companies look more profitable than they really are. "If you have a management team putting out pro forma numbers all the time and telling you not to worry about their restructuring charges or one-time write-offs, that would be a real red flag," Turner says. "It indicates that the management team is not being above-board with you. What they should be telling investors is what happened in the business that brought those charges and write-offs about. Quite often, those charges are indicative of a company that hasn't kept up with technology or its cost structure, and may not have a management team capable of steering the ship through the rough times."
- Declining cash flow despite rising sales. "Investors really need to hone in on companies' cash flow statements," Turner says. "In my opinion, cash is king. If a company is booking increases in sales and receivables but the amount of cash being generated is declining, it raises serious concerns about whether those are legitimate sales the company is going to collect. It might reflect the company giving extended payment terms to get those sales, which would indicate other underlying problems, or increased levels of vendor financing. Or it could suggest that they're dealing with a lower class of customers who may not have the wherewithal to pay." By way of example, Turner cites Motorola Inc., which has taken more than $3 billion in special charges since 1998. At one point, Turner says, the company was not only providing vendor financing to some of its customers but also guaranteeing the debt those companies took on to buy products from Motorola—and then booking revenue on those sales. "These were not very financially strong or stable customers, and when they didn't make it Motorola had to take a big charge," Turner says.

Accounting and investing experts cite these additional developments as potential warning signs of a company in distress:

- Poor return on total capital. One New York investment boutique calculated as far back as late 2000 that Enron, despite reporting ever higher profits, was earning only about 6% on its total capital, before interest and taxes, or not much more than much less risky government bonds. That's not the kind of spread that justifies a high-flying stock price. Analyzing metrics that link a company's income statement to its balance sheet—such as return on capital or return on equity—can be useful in comparing the company's performance to those of its peers.
- Insider stock sales. Yes, insiders can have many reasons for selling shares of the companies that employ them. It's still not something to be ignored. If insiders are making substantial sales at the same time they're talking up their company's great prospects, as Enron's management was, investors should be wary.
- Violating loan covenants. Most banks require that companies meet various financial criteria, such as staying under a specified debt-to-equity ceiling or maintaining a specified credit rating, or risk having their loans called. If a company violates a loan covenant or appears headed in that direction, investors should be cautious. In worst-case scenarios, it could leave a company facing a debt it can't pay, thereby forcing it into bankruptcy court.

One thing investors shouldn't do, Turner says, is rely on a company's outside auditors

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Investment Advice

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to alert them to potentially troublesome situations.

"Given the magnitude of the restated financial results we've seen in the last half dozen years and the resulting losses to investors, which are now approaching $200 billion, I really don't think the (auditing) system today is working," Turner says. "Absent some very significant changes to the regulatory system as it relates to the accounting profession, I think the credibility of the numbers (being reported by public companies) is going to be significantly questioned."

Turner suggests that Congress set up an independent oversight board for the accounting profession that includes representatives from the investing public and other public interests, including pension boards, banks and other entities that rely on corporate financial statements. That board, he says, should have the authority to oversee the establishment of disciplinary actions against accounting firms that fail in their duties, to investigate accounting firms, and to establish auditing standards—all anathema to an accounting industry that is currently self-regulating and self-policing.

Like many other critics of the current system, Turner adds that auditor independence must be strengthened by prohibiting auditing firms from also doing lucrative consulting work for their clients, or, if they are allowed to do it, by making them subject to joint and several liability when their clients are found guilty of fraud. Under the common law rule of joint and several liability, every defendant in a lawsuit is liable for the entire amount of the plaintiff's damages, regardless of the defendant's proportion of fault. The Private Securities Litigation Reform Act of 1995 made it harder for plaintiffs to hold accounting firms to that standard in securities fraud cases.

Turner's proposals are stronger than those suggested on January 18 by SEC Chairman Harvey Pitt, who has proposed creating a new entity "dominated by public members" that would have disciplinary and quality control power over accounting firms, but not to set auditing standards.

Although it has long been opposed to outside oversight of its industry, the American Institute of Certified Public Accountants pledged days after Enron's bankruptcy filing to draft new audit standards for detecting and handling fraud and for reviewing quarterly financial statements.

Whatever the outcome of any push to strengthen the nation's accounting system, it won't be resolved overnight. Until it is, investors will have to let their investment activities be guided by one overriding principle: caveat emptor.

What Parents Want:

Parental Views on College Savings Good News for Stable Value

By: Lynn Allen, AEGON Institutional Markets

Once little-known and little-noticed, 529 plans are fast becoming as indispensable to college savings as 401(k) plans are to retirement savings. 529 plan assets have mushroomed over the last couple of years to nearly $11 billion—a 70% increase since Spring 2000—and all signs point to continued explosive growth:

- New tax incentives, such as tax-free qualified withdrawals and enhanced tax-free rollover provisions, kicked in on January 1, 2002.
- All 50 states, plus Washington DC, have passed legislation enabling a 529 plan; 47 states currently have in place a savings plan, a prepaid tuition plan, or both.
- Tax law now allows private institutions to sponsor 529 prepaid tuition plans.
- The majority of states have partnered with major investment companies who have the resources and capability to market and distribute state plans nationwide.

The future is indeed bright for college savings plans. And that means there's a great opportunity for stable value to grow right along with them, as an integral component of the 529 investment mix. Those of us who work with stable value every day know that its growth and safety characteristics fit well within the asset/liability profile of 529 plans. And states that have already integrated stable value into their plans, such as the Commonwealth of Virginia, have seen the excellent results it can provide. Diana Cantor, Executive Director of the Virginia College Savings Plan recently stated, "Since the stock market's downturn, our portfolios have outperformed those of most other state college savings plans due in large part to the fact that we have stable value in our plans."

But if the stable value industry is to take full advantage of the growth opportunity the 529 market provides, states, program managers and participants must all be better educated about stable value and its benefits.

Survey Says

As part of that education effort, AEGON Institutional Markets commissioned Yankelovich Partners/Harris

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What Parents Want

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Interactive to conduct extensive interviews with 510 parents of children under age 18 in order to discover their specific attitudes and behavior toward saving for their children's college education expenses.

The survey found that nearly 9 in 10 parents—87%—believe that it is "extremely" or "very" important for their children to go to college. Eighty-six percent of respondents say they are wary of doing something to risk their accumulated principal. Clearly, the vast majority of parents view college savings as a serious responsibility—a promise they make to their kids that they don't want to risk breaking.

Given the seriousness with which they view college savings and the shorter investment horizon compared to retirement savings, it's not surprising that parents tend to have a low risk tolerance:

- Three in five parents—over 60%—describe themselves as "conservative" investors.
- Eighty-five percent of respondents believed that some investments are too risky for their children's education fund regardless of the potential returns.
- Eighty-seven percent wish they could have a safe investment for college costs that they would not need to worry about.
- Fifty-seven percent worry about the effect of stock market fluctuations on their college savings; however, an identical percentage agreed that a more "aggressive" investment strategy is fine if college is well into the future.

Other key findings:

- Most parents wish they were more knowledgeable investors. Seventy-seven percent wish they knew more about how to invest for college. A similar number, 74%, say they know only some or very few of the things necessary to make good investment decisions. And just five percent say they know "everything" they need to know to make good investment decisions.
- Most parents have already started saving. Two-thirds already save for college expenses; however, just two in five save on a regular basis. Not surprisingly, a significantly greater number of respondents with household incomes above $50,000 are saving for college—78% versus 52% of those earning less than $50,000.
- Parents use a variety of savings vehicles. Slightly more than half use bank savings accounts, while just under half use mutual funds and nearly two in five use savings bonds. Interestingly, only eight percent of respondents had heard of 529 plans and only one percent actually use them.
- Once started, most parents do not change their investment strategy. Seventy-two percent have stayed with the same investments for their children's college funds, regardless of performance. And, given a devaluation in their college portfolio's value, four in five parents say they would either leave the money alone or move it into a more conservative investment.
- Parents are worried about tuition inflation and underestimate college costs. Nine in ten believe tuition costs will be "astronomical" by the time their children reach college age. Yet, most also believe they will need to save an average of only $45,500 for each child. Two in five parents assume they will never be able to save enough to send their children to college.

In sum, parents understand the importance of saving for college; however, they lack accurate knowledge about college costs and how to invest to meet their goals. They are conservative, but they also need growth. Many of the investments within their risk tolerance, however, fail to generate adequate returns, while more aggressive strategies subject savings to unwanted volatility.

These findings suggest that 529 plan state sponsors and program managers have significant challenges ahead in better educating parents about 529 plans and providing an optimal range of investment options that meet their needs.

The findings also confirm that the 529 market represents an excellent new growth opportunity for the stable value industry. Many of the parental needs and concerns identified by the survey can be effectively addressed by incorporating stable value into the 529 investment line-up.

Of course, that means the stable value community has its own significant challenge ahead: educating states and program managers alike about that very fact. SVIA

Advice Providers Get a Grip on Stable Value

By: Randy Myers

The debate over how to handle stable value funds in asset allocation models appears to be winding down now that Financial Engines, one of the advice industry's biggest players, has modified its approach to simulating the risk and reward characteristics of the funds.

"I'm relatively pleased with how the (major) providers are handling stable value now," says Wayne Gates, a general director with John Hancock Financial Services in Boston and chair of the SVIA's Asset Allocation Task Force. "I'm not sure everyone on the committee would agree with that, but we certainly have made a lot of progress."

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Financial Engines and mPower, along with a handful of other firms, provide investment advice over the Internet to participants in defined-contribution retirement plans. They start by creating an asset allocation model for the investor based on his or her investment goals and tolerance for risk. They then recommend how the investor should divide their retirement money among the investment choices in their plan.

Stable value managers had long fretted that Financial Engines' asset allocation model didn't capture the true nature of stable value funds by failing to give them credit for the book-value guarantees that dampen their volatility. While the underlying assets in a stable value fund are comparable to the assets in an intermediate-term bond fund, the book-value guarantee results in decreased short-term volatility of the stable value fund's returns to a level comparable to money market funds. Yet stable value investors still enjoy superior bond-like performance.

Chris Jones, executive vice president of financial research and strategy for Financial Engines, says his firm spent much of last year refining its stable value methodology and began rolling it out to clients in December. The undertaking, he says, "basically addressed appropriately modeling the serial correlation in a stable value fund's crediting rate" and represented an "incremental enhancement" to the company's asset allocation model.

A stable value fund's crediting rate is the rate of return credited to its investors. The rate is periodically adjusted to reflect the actual performance of the fund's underlying assets, plus the impact of contributions and withdrawals that take place when the market value of the underlying assets differs from their book value. In essence, any differences between the credited rate and the actual rate earned on the fund's assets, as well as any gains or losses in the fund triggered by participant withdrawals, are amortized over ensuing months or years.

"If you want to show people a range of outcomes consistent with the crediting rate calculation, you need to be able to address the fact that when the value of the assets underlying the stable value fund changes, it is not fully reflected in the crediting rate for that period but is spread out over multiple periods in the future, maybe over a period of months or years," Jones says. "One way to accurately capture the volatility characteristics of these funds is to model that smoothing effect. Our model didn't do that before. It does now."

For purposes of projecting the long-term returns of a stable value fund, Jones says, his firm models the expected returns of the fund's underlying investment portfolio. Over longer time periods, he says, the returns of a stable value fund and a comparably configured bond fund, assuming they had the same expenses, would be identical.

For purposes of projecting risk characteristics, however, Financial Engines does recognize the lower volatility inherent in stable value funds over short time horizons. As a result, Financial Engines would almost never forecast a loss for a stable value fund over a one-year time horizon, although it could project a loss for longer time periods—albeit with a low probability. Unfortunately, these models do not offer a true forecast for stable value funds, which will never post negative returns.

In generating asset allocation advice for investors, Jones adds, Financial Engines' does not consider the gap between the stable value fund's crediting rate and the rates available on any competing money market funds. That way, it avoids giving advice that could trigger short-term trading in and out of the stable value fund. Such short-term arbitrage could have a detrimental effect on long-term investors in the stable value fund and on the insurers that provide the fund's book-value guarantees, or "wrap" contracts.

Although it might seem that Financial Engine's advice model wouldn't favor stable value funds over intermediate-term bond funds in making investment recommendations—since their long-term performance characteristics are comparable—Jones says that in practice, it would. "Even if the two funds had the same underlying assets, other things that would influence our choice would be the expense ratio of the funds," Jones says. "Generally speaking, the average stable value fund is less expensive than the average market-value fixed income fund. Because of that, we usually show a preference for the stable value fund."

mPower doesn't follow the exact same methodology used by Financial Engines to model stable value funds, but the outcomes it delivers are similar. And like Financial Engines, mPower tends to recommend stable value funds, when they are available, over money market funds and intermediate-term bond funds, according to Hal Ratner, mPower's vice president of investments. He says the company's advice service would have a "very low" probability of predicting a negative return for a stable value fund over any time period, and investors would have to "do a lot of work" on its Web site to even see that possibility.

For purposes of arriving at an asset allocation recommendation for a particular investor, Ratner says, mPower's model tends to treat stable value as if it were a blend of cash and short-term bonds, with the proportions dependent upon the diversity of the fund's portfolio and its other characteristics, such as the credit quality of its fixed-income assets.

Although stable value managers have found little to fault in the way mPower models their products, Ratner says the firm did make one minor change to its methodology recently. Where it used to make adjustments for changes in the composition of a fund's underlying portfolio on a

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FIRSTSource Data for 3rd Quarter 2001

Stable Value Cash Flow at a Glance

FIRST Source Market Data:	3rd Qtr. 2001	2nd Qtr. 2001	1st Qtr. 2001	4th Qtr. 2000	3rd Qtr. 2000	2nd Qtr. 2000	1st Qtr. 2000	4th Qtr. 1999	3rd Qtr. 1999
95%	9.62%	3.46%	10.08%	6.63%	5.48%	3.63%	1.82%	10.25%	2.56%
75%	4.65%	0.41%	5.15%	0.91%	0.64%	-0.55%	-3.85%	3.97%	0.42%
Average	2.80%	-0.81%	2.67%	-0.73%	-0.97%	-2.03%	-7.58%	1.75%	-1.46%
25%	0.66%	-2.51%	0.28%	-2.58%	-2.55%	-3.72	-10.33%	-1.18%	-2.96%
5%	-2.17	-4.92%	-4.93%	-8.07%	-6.15%	-7.46%	-19.06%	-5.32%	-7.88%

By: Kathleen Schillo, Hueler Companies

Hueler's FIRSTSource Market data reveals that third quarter 2001 cash flows once again showed strong positive cash inflows similar to the level seen in first quarter 2001. While second quarter 2001 cash flows were more in line with past trends, it appears that first quarter 2001 and third quarter 2001 showed the strongest positive cash inflows into stable value in years. The data reveals that the average plan experienced inflows of 2.67% in first quarter 2001 and 2.80% in third quarter 2001. With the declining stock market and tragic events of September 11th, this comes as no surprise. FIRSTSource Market data encompasses approximately 400 plans with $446 billion in total plan assets and $114 billion in stable value assets.

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quarterly basis, he says, the company now does so on an annual basis, having concluded that stable value managers don't typically change their portfolio strategy from quarter to quarter.

Morningstar Associates LLC, a subsidiary of Morningstar Inc., also markets an online investment advice service, which it calls ClearFuture. It, too, models stable value as a blend of cash and bonds, and like Financial Engines and mPower has a very low probability of forecasting a negative return for stable value funds. "One is more likely to be struck by a meteor," says Paul Kaplan, vice president of research for Morningstar Associates and director of research for Morningstar Inc.

Kaplan says ClearFuture doesn't factor the serial correlation of stable value crediting rates into its model because over the long-term time periods that are its focus, serial correlation has no material impact on performance. "Some would argue that you have to model every short-term feature, but we don't believe that's necessary," he says.

Like its peers, ClearFuture tends to favor stable value over money market funds and intermediate bond funds when all three are represented among the investment options of a retirement savings plan, Kaplan says. In part, that's because ClearFuture always assigns the highest quality score—a risk measure—to stable value funds.

As is the case at Financial Engines, both mPower and Morningstar say their advice models, by focusing on the long-term performance expectations for stable value in making investment recommendations, could not be used by investors to support a strategy of arbitraging differences between money market yields and stable value yields during periods of rising short-term interest rates.

"The wrap issuers don't want to see any volatility caused by these advice models, and I think they (the advice providers) have gone out of their way to assist in that," observes Gates.

While advice providers may not be able to provide a perfect model of stable value behavior, the consensus seems to be that they have come remarkably close.

"Hopefully, we've reached the conclusion of the debate," says Jones. "While we will certainly continue to evaluate possible enhancements, we are, at the moment, very comfortable with our model."