SVIA STABLE TIMES

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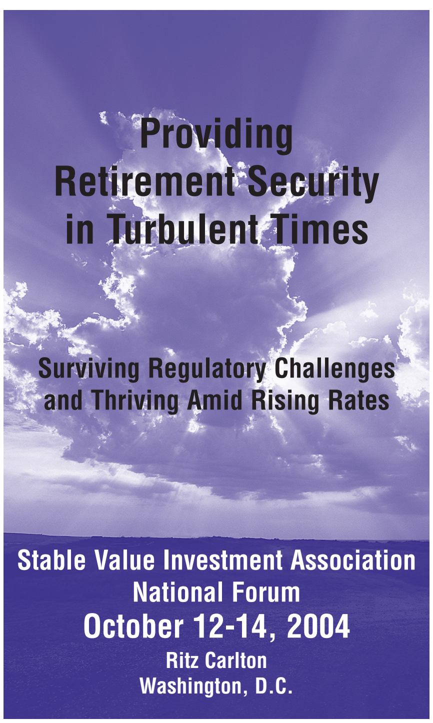

Consumer Groups Endorse Mutual Fund Reforms—But Want More

By Randy Myers

It is, not surprisingly, all about the money.

A year after New York State Attorney General Elliott Spritzer began exposing unfair trading practices at some of the nation's most prominent mutual fund companies, much has changed. Many fund companies have overhauled their trading policies and procedures. Some have pledged restitution to their shareholders. A few have agreed to lower their fees. And the Securities & Exchange Commission, which oversees the industry, has proposed a broad slate of reforms. Yet consumer advocates say more needs to be done to protect investors, particularly on the fee front. High on their complaint list: the industry's practice of allowing fund companies, rather than investors, to determine the compensation paid to the broker-dealers who sell their funds—through sales loads, 12b-1 fees and other sometimes obscure arrangements.

"When mutual funds set the brokers' compensation, brokers in too many cases end up recommending funds based on which offer them the most generous compensation, rather than on which are in their clients' best interests," says Barbara Roper,

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Stable Value in a Rising Interest Rate Environment

By Paul Curran, Bank of America

Rising interest rates negatively affect bond portfolio market values – a simple concept to understand. But how do rising interest rates affect stable value returns? It is difficult to answer this question because there are so many pieces to this puzzle. Depending on the specific characteristics of a stable value fund at the time of the rate move, rising rates will produce varying results.

The fixed income marketplace has been waiting for higher interest rates. It has been anticipating movement in the factors that could cause rates to rise: the economy, war and terror developments, inflation, and Fed moves. Since shortly after yields started their descent in mid 2000, some investment managers have been positioning their portfolios defensively in anticipation of rising rates. The reasoning is that investing short allows the manager to stay nimble and take advantage of higher yields when rates finally turn around. Over time, some managers lost patience with this strategy. They gave up yield as well as price appreciation as rates fell, and abandoned their defensive positions. These managers were hurt most as they shed relative performance both when rates fell as well as when they rebounded sharply. Other managers continued to remain short and recovered most of their relative performance.

Stable value crediting rates need to be responsive to rate movements and competitive with other investment returns or participants may move their cash elsewhere. The crediting rate reset formula (shown below)

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US Rates: A Cycle Like No Other

By Bernard Connolly, AIG Financial Products

Where are US rates going? The potential for mispricing in the curve is probably greater than at any time since the development of the Eurodollar market began, forty-odd years ago. Why? Because there is a chance that the prevailing economic orthodoxy -- which says we are in a "normal" US cycle -- is simply wrong. That orthodoxy says, in effect, that once a recovery clearly gets going, it continues until the central bank has to step in to slow things down. Because there are lags in the effect of monetary policy, then once a recovery is firmly established, the central bank will typically wish to get short to a "neutral" level perhaps a year or so before the expected return of the economy to full capacity-utilization – a zero output gap. However, this cycle is likely to be different, and, as a result, the Federal Reserve may not raise rates as much as the Eurodollar contracts are predicting. In fact, the Federal Reserve might be forced to stop tightening monetary policy after only a handful of rate hikes.

Until a few months ago the Fed was apparently not convinced that downside risks had been eliminated. But as soon as Greenspan said, in late April, that deflation was now definitely no longer a danger the market reacted violently. After the Greenspan comments, a high CPI number and a change in language in the FOMC statement, the market is now (late-May) pricing short rates for mid-2005 to reach 3 1/2 percent and those for

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Editor's Corner
Stable Value Cash Flow—What Really Matters?

By Greg Wilensky, Alliance Capital Management

Along with other interesting articles, this information packed issue of the *Stable Times* includes an article from Judy Markland subtitled "Macro influences on 401(k) contributions" and an article from Paul Curran entitled "Stable Value in a Rising Interest Rate Environment." Both articles touch upon future stable value cash flows, one from the perspective of macro outlook and the second from the perspective on return implications. Building upon these articles, I wanted to share some thoughts on the factors that drive stable value fund cash flows at the micro (i.e., individual plan) level.

Over time, the cash flows for a particular plan's stable value fund will be driven by the overall growth rate of the 401(k) plan as a whole. While plans with a stable work force and relatively small retiree populations can experience reasonable net contributions, an expanding work force (or other favorable demographics such as increasing participation rates) generates the fastest growth rate. It is worth noting that even if macro factors such as the ones Judy Markland discusses reduce the net contributions on an economy wide level, individual plan cash flows will be driven by plan specific (i.e., micro issues) and can still experience rapid growth.

While we should not completely ignore the short term cash flow trends for the stable value fund, plan level cash flows should carry more weight when trying to predict future stable value fund cash flows. Clearly, any planned changes to employee levels or drastic changes to the plan structure should also be considered. This long term expected cash flow trend should be a key input into determining the duration target for a stable value fund with growing plans managed to longer duration targets.

Deviation from the trend suggested by overall plan level cash flows are primarily driven, not by interest rate movements or the difference between stable value returns and money market yields, but by equity returns. I am skeptical that even a sharp increase in interest rates (keeping equity prices constant) would generate significant withdrawals from stable value funds. This statement assumes that we are talking about a separately managed stable value fund (i.e., not a pooled fund) and that intraplan transfers from the stable value option to a money market option/competing fund are not permitted, either because there is no money market fund or an equity wash requirement must be met. Interest rates do not drive stable value cash flows for the following reasons:

1. The vast majority of plan participants change their allocations (either the existing allocations or the allocations for new contributions) with the same frequency that Dick Grasso will be inviting Elliot Spitzer to stop by one of his houses for drinks. To paraphrase Bill Murray:

   > "Even if rates rise so far above our heads that our noses bleed for a week to 10 days; even if every man, woman and child joined hands together and prayed for rising rates, it just wouldn't matter because all the 401(k) participants would still rather watch 70's movies about summer camp on cable than change their 401(k) asset allocations. It just doesn't matter if interest rates go up or down. It just doesn't matter!"

2. For the small minority of participants who do seem to care, the absence of a money market fund or presence of an equity wash provision prevents a risk free arbitrage (Small exceptions to this rule may be possible e.g., sophisticated participant transfers money from stable value to domestic equities while the participant's spouse transfers from domestic equities to money markets; a larger exception would be non-active participants that could withdraw money from an old 401(k) and roll it into a money market fund in an IRA or new 401(k)). Transferring money to equities to capture the differential between the market value and book value in their stable value fund is a very risky strategy. Any potential benefit could be wiped out in a day let alone 90 days. Even the incremental risk of moving to a high quality fixed income alternatives such as an intermediate bond or TIPS funds, if offered, probably outweighs the benefits. The Lehman Aggregate index was down 2.6% in April (and 3.4% last July) and the Lehman TIPS index fell by 4.9% (so much for the competing fund argument). Furthermore, as noted in the 2004 John Hancock Survey of DC Participants, only 23% of participants know that the best time to invest in bonds is when rates are expected to fall. It just doesn't matter!

So, what does matter? For the majority of the minority of participants who actually modify their investment allocations, the key is equity prices. When equity prices go up, people sell stable value and buy equities (e.g., 1998 – 2000). When equity prices fall, they do the reverse (e.g., 2001 – 2002). This clearly demonstrates the ever successful buy high, sell low strategy. Maybe the participants who ignore their 401(k) allocations are on to something?

If it is not general equity prices driving cash flow, then my second choice is the price of the plan sponsor's stock (if offered as an investment option). While these flows are clearly driven by a very small number of plan participants, movements between company stock and stable value, at some companies, can explain a disproportionate share of the stable value fund transfers. The only good news on this front, based on my anecdotal evidence, is that these participants at least try to buy company stock on dips—unfortunately dips sometimes turn into long slides.

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What Really Matters?

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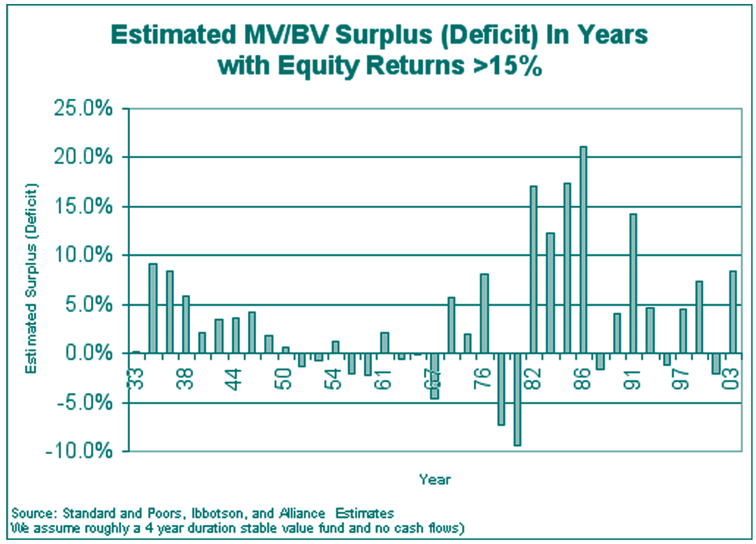
Even if you are now convinced that stable value cash flows are caused by the equity market that does not mean that cash flows are not negatively correlated with interest rates (i.e., stable value experiences negative cash flow when rates rise). Correlation does not prove causality. If interest rates and stock prices tend to rise at the same time, a negative correlation would likely result.

While the future may differ from the past and we needed to make a lot of simplifying assumptions to facilitate our analysis, we looked at the 37 calendar years since 1929 that had equity returns in excess of 15% (high enough to get the return chasers moving). For each of those years, we estimated the year-end market value to book value surplus (deficit) by comparing the estimated market value return on a 5-year Treasury over the prior 3-years to the estimated book value return over the same period assuming no cash flows. In other words, their will be a market value to book value surplus if interest rates had generally been falling over the prior 3-years. The results shown in the chart show that most of the time the market value would have been above book value at the end years when equity returns exceeded 15%.



If participants chased the equity market returns (transferring from stable value to equities) when MV>BV, they would leave behind this surplus for the remaining participants. This would increase the crediting rate for the remaining participants. In only 12 of the 37 "high equity return" years was there a market value to book value deficit, and, in most of these years the deficit was quite modest.

Anecdotally, most our accounts ended 2003 with market value to book value ratios around 102%. So the withdrawals that occurred in late 2003/early 2004 as investors chased the equity market rebound would have helped the remaining participants. Even after the worst calendar quarter (2Q2004) for the bond market in over a decade, the ratios were hovering around 100%, but, with the Federal Reserve in play and the equity markets struggling, cash now appears to be moving into stable value.

If a booming equity market causes rates to rise sharply from here, withdrawals would negatively impact stable value funds now that the MV/BV ratio are close to 100%. While it is not difficult to imagine (or forecast) higher interest rates, I doubt this will be accompanied by the kind of equity returns necessary to get the money moving. Furthermore, money market rates would still need to rise by at least another 300 basis points in (assuming no increase in stable value returns) in order to close the gap with stable value fund returns. Enjoy the rest of the summer. SVIA

Consumer Groups

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director of investor protection for the Consumer Federation of America. By allowing funds to compete for distribution by offering more generous compensation to brokers, she says, the industry drives costs to investors up, not down. "Right now," she says bluntly, "you basically have price fixing. I know it's counterintuitive to suggest we don't have a thriving competitive marketplace in the mutual fund industry when, in fact, we do. It's just not competition on terms that are beneficial to investors."

The SEC has taken some promising steps, Roper allows, such as proposing a ban on directed brokerage, in which fund companies send portfolio transactions to a particular brokerage firm to reward it for selling the company's funds. The SEC also has floated the idea of eliminating 12b-1 fees, or, at the least, changing the way they are assessed. "We would just like to see them push that farther," Roper says, "and do the kind of radical reform that, frankly, the commission staff has recommended on and off for years."

For now, however, most of the proposals set out by the SEC remain just that: proposals. Among the few that have been adopted are requirements that funds implement compliance policies and procedures and employ a chief compliance officer, disclose in their shareholder reports the fund expenses born by shareholders on a hypothetical $1,000 investment, report portfolio holdings on a quarterly basis to the SEC, and that of independent chairman of fund boards. They also must disclose their market-timing policies and procedures for shareholders who try to dart in and out of the market based on where they think prices are headed, and detail more prominently the breakpoint discounts on front-end sales loads that are available to investors as their account balances grow.

Still on the table are a slew of reforms that consumer groups generally consider to be more critical, including the proposed ban on directed brokerage, 12b-1 fee reform, and additional fee disclosures. On the latter point, the SEC has proposed that broker-dealers show customers the distribution-related costs of a fund purchase at the time of that purchase, either by referencing the value of the customer's actual transaction or a model investment of $10,000. Even more detailed disclosures would be required on the paperwork confirming a transaction, a proposal the fund industry is strenuously opposing on the argument that it would be costly and potentially confusing to investors.

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Consumer advocates disagree. "The most important proposal on the agenda is the proposal to require point-of-sale and confirmation disclosure of fund costs," argues Mercer Bullard, a securities law professor at the University of Mississippi School of Law and founder and chief executive officer of Fund Democracy, an advocacy group for fund shareholders. Roy Green, senior lobbyist for financial services for the American Association of Retired Persons, concurs. "We think this is an important change," Green says. "There needs to be an effort to make these costs comprehensible to the ordinary investor—and they need to receive the information in advance so they can do a bit of comparison shopping." Opponents saw their case weakened recently when MFS Investment Management—one of the fund companies implicated in the scandals—announced that it will begin to provide detailed fee disclosures with their trade confirmations on a voluntary basis.

While consumer advocates are eager to see the SEC maintain its reform momentum, they are not particularly eager to see every SEC proposal enacted. One of the most inflammatory transgressions to surface in the fund scandals was the accommodation that some funds were making to allow certain big institutional customers to buy and sell funds at the market's 4 p.m. Eastern time closing price—after 4 p.m. Spritzer likened it to betting on a horse race after the horses had crossed the finish line. The SEC's proposed remedy is a so-called "hard close" at 4 p.m. Eastern time for all mutual fund trading. Critics, including the 401(k) industry, argue that for participants in retirement savings plans to enjoy same-day pricing on their plan transactions under the hard-close rule, plan administrators would have to collect trade orders much earlier in the day so they could be processed and forwarded to the fund companies by 4 p.m. Individual investors in western time zones would face a similar time crunch. Opponents of the hard close are calling instead for a system that would allow orders from retirement plan participants and western investors to be processed after 4 p.m., provided there was adequate documentation that their orders were entered prior to that time.

"I am very skeptical about the need for a hard 4 p.m. close, at least before other equally effective alternatives are explored," says Bullard. "In fact, the worst thing your typical mutual fund investor could do is worry about whether he is going to get that day's price. But as a practical matter, the SEC can't ignore the appeal that getting the same day price has for investors, be it in their interest or otherwise. This is primarily a matter of perceived fairness more than actual disadvantage."

The conundrum highlights the need, says the AARP's Green, for better cooperation between the SEC, which regulates the fund industry, and the Department of Labor, which oversees employer-sponsored retirement plans. The SEC has already warned that it does not believe it has the authority to oversee certain intermediaries in the retirement plan market who process mutual fund transactions. That could hamstring efforts to develop alternatives to the hard-close proposal.

Although consumer advocates are convinced that much remains to be done before the mutual fund playing field is level for investors—Bullard has even called for creating a "Mutual Fund Oversight Board" to supplement the SEC's efforts—they do not suggest that investors should steer clear of all mutual funds until then. "As a general rule, we think the SEC has done a pretty good job of addressing the specific abuses of both the sales practices and the trading practices uncovered by Elliott Spritzer," says Roper. "We also think they've had a pretty aggressive enforcement program, with tough sanctions, and I think they've been doing a lot of work on upgrading their inspection and oversight program, so that they'll be quicker to identify problems in the future."

Nonetheless, Roper worries that the abusive behaviors uncovered last year were so pervasive that they may reflect a consumer-unfriendly attitude that could lead to other types of abuses at later dates, even after the current set of problems is resolved. "I don't think mutual fund investors can afford to be complacent," she warns. "I think they need to be aware that not all mutual fund companies are created equal, and that there are some that were a lot more willing to sell out their shareholders interests than others."

Bullard is similarly cautious, and even more adamant than some of his peers that Congress, where several legislative initiatives are languishing, should act more aggressively to reform the fund industry. "The SEC hasn't adopted much at all thus far," he says, "so I think the jury is still out on whether their actions will have material long-term benefits to fund shareholders."

Failure, he and other consumer advocates suggest, would carry a price higher than consumers should have to bear.

US Rates

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mid-2006 to reach 4 1/2 percent. Ten-year yields, which in late-March were about 3 3/4 percent, are now (late-July) around 4.8 percent.

It is striking to compare the current expectations for 3-month eurodollar rates with what actually happened in the hiking cycle that began in 1994. Then, 3-month rates doubled during the course of the year, going from 3.15 percent in January 1994 to 6.27 percent in December (month averages). That was a much faster increase than is currently priced in by the curve. But rates subsequently drifted down a bit, and by February 1997 3-month rates were at 5.63 percent, about 250 bp higher than before the cycle began. In contrast, the curve currently depicts 3-month rates rising monotonically for several years, reaching a level around 6 percent later in the decade.

Is this path of short rates plausible? It seem to imply that inflation gets – even if gradually – quite a way above current underlying levels (according to the Fed, the underlying

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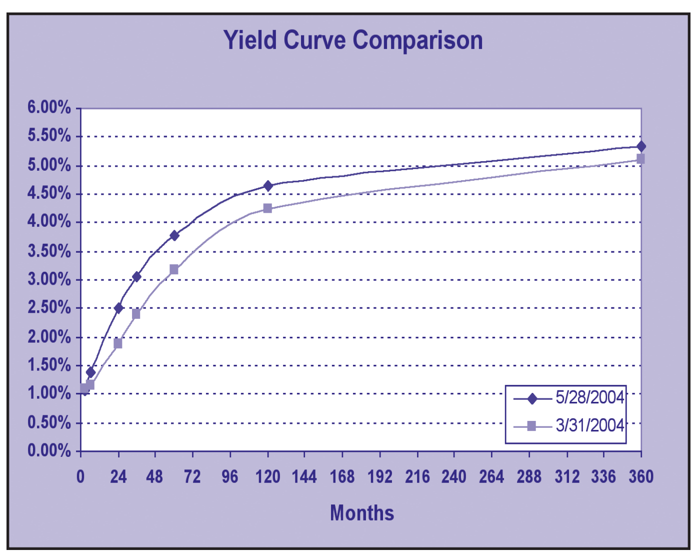

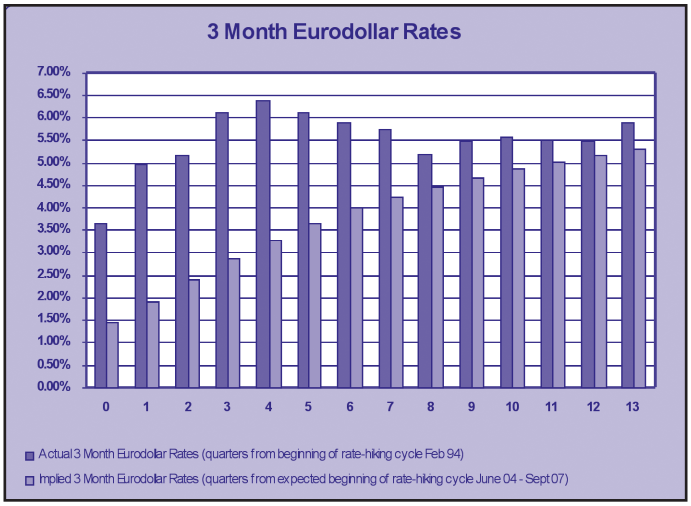

US Rates

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trend rate of inflation is currently about 1 1/2 percent). The market is apparently suggesting that the Fed is, and will remain, behind the curve and that it will not act vigorously enough, soon enough, to head off a significant rise in underlying inflation. (The breakeven inflation rate implied by longer-term TIPS yields also apparently suggests expectations of a trend inflation rate above the Fed's "comfort" range).

Does that mean that in order to avoid a rise in inflation the Fed should act in a way that pushes 3-month rates up as sharply as in 1994? If the Fed has been wrong about the size of the output gap or its relevance to inflation, then there is an argument for an upward jump, that is, more or less immediately, to a level of 4 1/2 percent or even a bit higher. But there are two reasons for thinking that would be very dangerous.

First, the currently-implied expected short rates several years out are just an interpolation from long rates – and violent swings in long rate are mainly the result of positioning panics and risk reduction in the market. If short rates now "jumped" upwards, then that would not produce a flattening in the curve and a reduction in apparent future inflation expectations but another lurch upwards in long rates. That would in turn indicate, to those who believed in the inflation-prediction power of the curve, even higher expectations of future inflation. But if the Fed responded with another upward "jump" in short rates, long rates could well go higher still. In short, it is almost certainly wrong to see the curve as a meaningful indicator of future inflation expectations.

Second, it is highly likely that even the current height of the curve will be too much for the US recovery to be sustained. That is, the current economic orthodoxy is wrong and the recovery is definitely not a "normal" one. Comparisons with the cycle of the early 1990s are very telling. That cycle was a "normal" one. Sharp increases in interest rates between the Spring of 1988 and the Spring of 1989 set the scene for falling household demand in 1990/91, a fall exacerbated by rising oil prices and reduced consumer confidence around the time of the Iraqi invasion of Kuwait. Residential construction and spending on consumer durables fell very sharply, and as growth slowed and profit margins dipped, accelerator mechanisms then depressed business investment, too. All these elements of spending fell below "normal" levels, and when the Fed took fright at the extent and persistence of recession, it needed very low levels of interest rates to begin stimulating spending again. When that process was sufficiently well-established, the momentum of pent-up big-ticket household spending was strong enough for the Fed to be able to begin, in February 1994, moving rates quite quickly back to "normal" levels without crushing growth.

What is remarkable about the current cycle, in contrast, is the extent to which the Fed has had to keep household spending unusually strong almost throughout the period since business confidence collapsed in the second half of 2000.

There is certainly now no "pent-up demand" for houses or consumer durables – indeed, spending in both areas is already showing signs of slowing quite sharply. Rising interest rates now, combined with the disappearance of the stimulus from tax refunds and with the appearance of a new "oil tax," are likely to exacerbate the slowdown in household big-ticket spending and turn it into a period of sharp absolute falls. And the unusually favourable conditions for business investment this year –bunching of delayed replacement investment held back from the financially-constrained 2001-2003 period; unusually high profit margins as productivity accelerated unexpectedly ahead of wages growth; the bringing-forward of investment from 2005 to take advantage of the temporary partial expensing tax provisions; unsustainably rapid growth in Chinese demand –will no longer obtain next year. So the removal of the very important prop represented by extremely low ex ante real long rates of interest is likely to mean that 2005 will be a weaker year for business investment, too. In all, 2005 is likely to be a "payback" year – one in which over-investment by households in houses and durables as a result of extremely low interest

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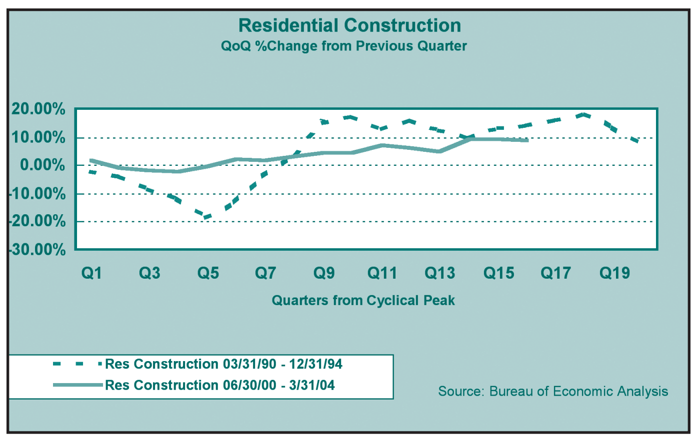

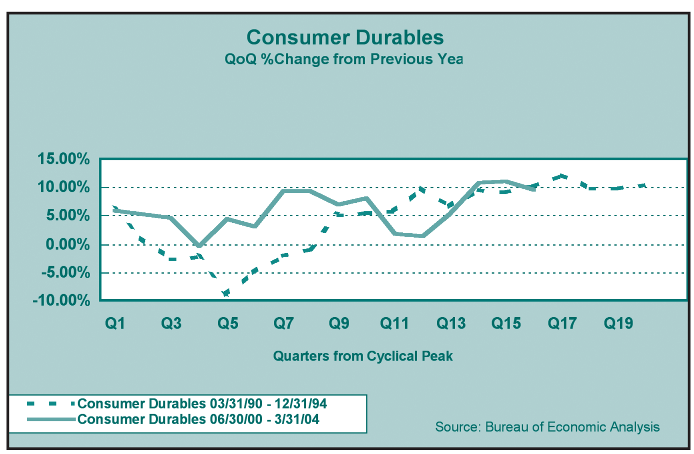

Rising Interest Rate Environment

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makes it clear that a number of factors will influence the magnitude and direction of crediting rate movements during rising interest rate environments.

Crediting Rate = (Market Value (MV) / Book Value (BV)) ^ (1/Duration of the portfolio)*(1 + Yield of the Portfolio)-1

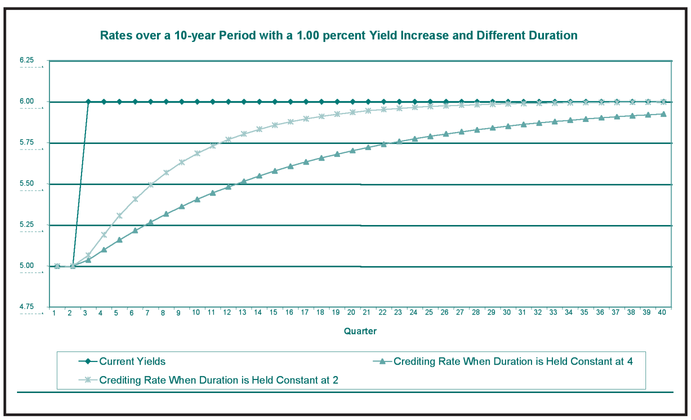
The interplay between the yield and the MV/BV ratio is interesting. When yields rise, both the market value and the MV/BV fall. However, the yield increase and the drop in the MV/BV ratio somewhat counterbalance each other in the crediting rate reset formula. This generally results in the crediting rate moving slowly in the direction of current yields. The outcome is that the crediting rate, and correspondingly book value, grow smoothly compared to market yields and market values of unwrapped portfolios.

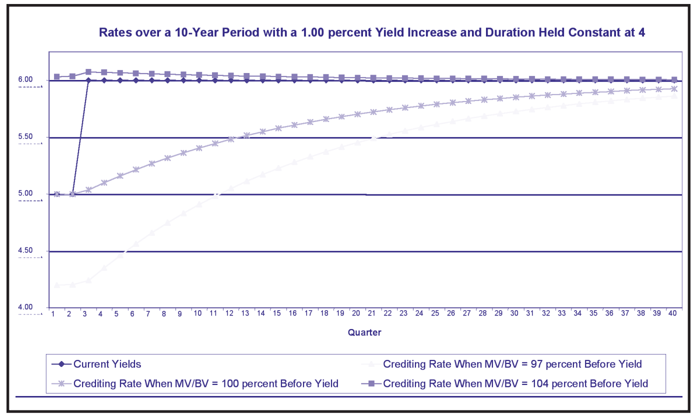
The biggest driver of the sensitivity in crediting rates to the changing yield level is the duration of the fund. The shorter the duration, the more responsive the crediting rate will be to rate changes. The chart below displays the crediting rate paths resulting from a one percent interest rate increase for two funds with different durations.

The MV/BV ratio that existed prior to the yield increase will also have a major influence on the behavior of the crediting rate. If market value is greater than book value before the yield movement, you will see a different result than the scenario where market value is less than book value when yields increase. The chart shows that the crediting rate is going to move in the direction of current interest rates. The larger the difference between the prior crediting rate and the new yield the greater the change will be (holding duration constant).

The shape of the yield curve before and after the rate increase will also affect the relative attractiveness of a stable value fund. If the short part of the yield curve rises sharply, money market funds are likely to become relatively more competitive versus stable value crediting rates. Furthermore, if a stable value fund was structured to take advantage of a particular curve reshaping, the relative loss resulting from higher rates might be reduced further, thereby improving the responsiveness of the crediting rate.

Participant cash flow can also have an effect on crediting rates. Positive cash flow into the fund will help the crediting rate keep pace with the rising rates. Positive cash flow causes the crediting rate to move in the direction of current rates more quickly, everything else being equal. This is achieved because positive cash flow, which comes in with a MV/BV ratio of one, always causes the overall





MV/BV ratio to converge to 100 percent. The greater cash inflow will help to attain a higher crediting rate and make stable value more competitive to alternative investment options when rates are rising. Conversely, cash outflow in a rising rate environment, when MV/BV ratio is below 100 percent, could have the opposite effect of lowering crediting rates.

The following factors influence plan specific participant cash flow:

- Access to other fixed income investment options;
- Company stock returns;
- Equity fund returns;
- Plan participant demographics; and
- Plan transfer rules.

The crediting rate's relative competitiveness versus other fixed income investment alternatives over the short run may influence the cash flow decisions of some participants. As mentioned previously, the smoothing mechanism that prevents negative returns to stable value investors will cause stable value crediting rates to lag short-term movements in rates. The crediting rate will rise more slowly than current yields in a rising rate environment and drop more slowly in a dropping rate environment. This lag makes stable value crediting rates especially attractive versus bond and money market fund yields when yields drop. Conversely, the lag may reduce this attractiveness or, in the event of sharply rising interest rates - especially in an inverted yield curve environment - cause crediting rates to be below bond or money market yields. Additionally, strong equity market or company stock returns will attract some stable value dollars regardless of interest rate movement.

The chart shows the instantaneous effect to the crediting rate after an increase in rates directly followed by a 10 percent cash outflow for several starting MV/BV ratio scenarios. All the scenarios assume a

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rates leads to a period of significant retrenchment, however robust household balance sheets might appear to be.

Give all that, unless the US economy is supported by massively higher net exports – and that would require a dollar depreciation far bigger than the rest of the world could absorb -- it seems simply inconceivable that short rates can go on rising through 2005. In fact, it will be very surprising if short rates get much above two percent before the Fed has to do a handbrake turn and start bringing rates down again.

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Will the Mutual Fund Scandal Make Equity Washes Easier to Swallow?

By Chris Tobe, AEGON Institutional Markets

The trading restrictions that have resulted from the mutual fund scandal are intended to prevent future abuses that harm a majority of shareholders. That's good news for investors. Indirectly, the new restrictions could also spell good news for stable value providers by making equity washes easier for some plan sponsors to swallow.

Historically, equity washes have been required by stable value providers on plans with competing funds. A competing fund is any fund, usually a money market or short-term bond fund, that subjects a stable value fund to the risk of disintermediation by presenting arbitrage opportunities. The equity wash mandates that any monies transferred out of the stable value fund and into a competing fund option must sit in an equity fund for a period of time, usually 90 days before the transfer is completed.

This rule protects the stable value provider, to be sure, but it also protects remaining stable value fund participants. How? First, it is arguably true that only reasonably sophisticated investors would actively engage in arbitrage to begin with. Second, it is also arguably true that a majority of plan participants would not consider themselves sophisticated investors. Since all (unless there is no cash buffer) stable value options are at least partly participating in nature, meaning all participants share in the gains and losses of the underlying portfolio. This means that arbitrageurs, the relatively sophisticated few would benefit at the expense of the remaining longer-term investors, the probably less sophisticated many, who stay in the stable value option.

Assume, for example, that an arbitrage trade occurs when the market value of the stable value fund is below its book value. The arbitrageur would collect this difference at the expense of the remaining investors, whose market value to book value deficit would further grow to their detriment, thus lowering their crediting rate.

Many plan sponsors offer stable value as their only low-risk option, since it has a proven record of significantly higher returns than nearly any other principal-protected option. For these plans, no equity wash provision is needed. There are still plans, however, that prefer to include, in addition to their stable value fund, options such as money market funds and short bond funds, even though they historically have inferior risk/return characteristics as compared to stable value. Most stable value providers either refuse to issue into such plans, or they require an equity wash or similar remedy that eliminates any arbitrage potential.

In some cases, stable value restrictions on competing funds are resisted by plan sponsors who are concerned about short-term operational strains on systems associated with monitoring these restrictions and/or the difficulties of explaining the restrictions to participants. These are legitimate concerns, of course. But the likely upshot of focusing on such concerns is that the stable value provider will simply refuse to issue into the plan, thus plan participants are deprived of stable value's superior risk/return characteristics.

This is where trading restrictions brought about by the mutual fund scandal may prove to be beneficial for stable value funds. One of the primary thrusts of the mutual fund scandal has evolved around late or illegal trading of international equity mutual funds. Since almost all major 401(k) plans have an international option, almost all plans must adapt their operating systems to comply with these new restrictions. In turn, these new restrictions have forced plan sponsors to educate participants about these new rules.

In other words, when plans come into compliance with the new international mutual fund trading restrictions, two of the primary objections to stable value competing fund restrictions will have been eliminated.

If the plans that have competing funds can be shown that the objective of equity washes is to protect the vast majority of the participants from adverse experience at the hands of a few arbitrageurs similar to how the new mutual fund restrictions protect buy-and-hold fund participants from trades that benefit a few at the expense of the many, then stable value wins. And, importantly so do the vast majority of plan participants. SVIA

Rising Interest Rate Environment

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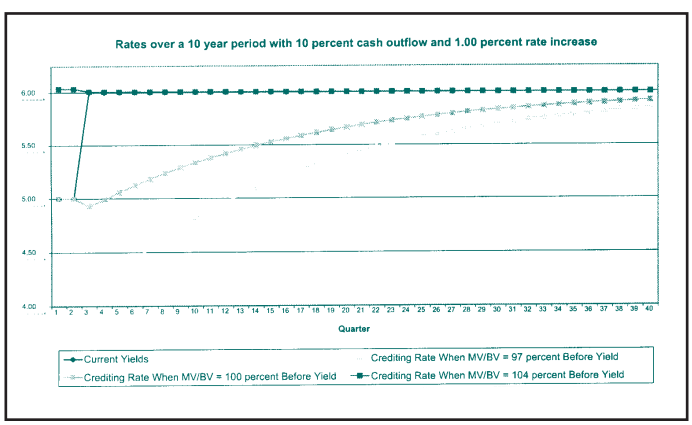
constant fund duration of four years. As can be clearly seen, there is a slight dip in the crediting rate due to the negative cash flow followed by a steady convergence to the current yield. The dip in the crediting rate is more pronounce for lower initial levels of the MV/BV ratio.

Stable value crediting rates may change only slightly following an instantaneous increase in yields. The relative smoothness of the crediting rate and competitive returns compared to fixed income investment options are exactly what the investment managers, insurance carriers and wrap providers that participate in the marketplace intend to provide. When rates move rapidly in either direction, participants feel confident that their crediting rate will remain relatively stable but still move in the direction of current yields. Over the decades, participants invested in stable value have been rewarded for their patience with competitive returns with low volatility during unstable yield environments. SVIA



Stable Value Survey Shows Consistent Performer With Consistent Results

By Marc Magnoli, JPMorgan Chase and Gina Mitchell, SVIA

SVIA's Eighth Annual Investment and Policy Survey reported on $355 billion in assets from 110,184 defined contribution plans as of December 31, 2003. Looking at consistent responses for both 2003 and 2002, stable value assets grew by 6.6 percent in 2003. While quite respectable, this reduction in the growth rate of stable value assets reflects the end of the equity bear market, which caused many participants to reduce equity allocations in favor of stable value during the prior two years.

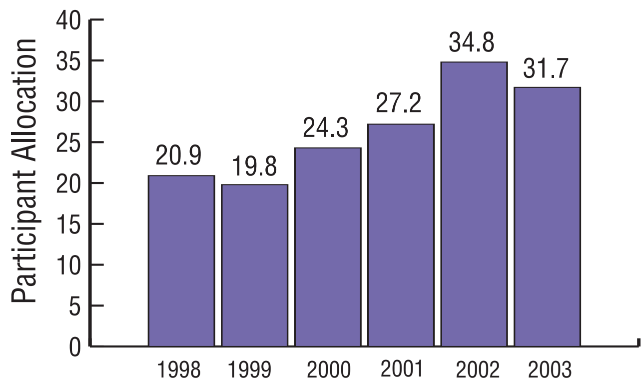
Stable value returns continued to significantly outperform money market returns, despite declining with interest rates. Returns on stable value funds were 4.93 percent in 2003 compared to 5.84 percent in the previous year. Participant allocations to stable value were strong, averaging 31.7 percent of 401(k) plan asset in 2003. Participant allocation was down slightly from 34.8 percent in 2002 on a consistent response basis.

Wrapped assets were 66 percent of stable value portfolios in 2003, compared to 59 percent in 2002. GICs declined from 34.6 percent in 2002 to 28 percent in 2003. The remaining assets included three percent cash and one percent other. The use of global wraps continued to expand in 2003, with 39 percent of respondents reporting using global wraps, which compares to 31 percent in 2002. As the Wrapped Assets Underlying Portfolio Graph demonstrates small adjustments were made in asset composition between 2003 and 2002.

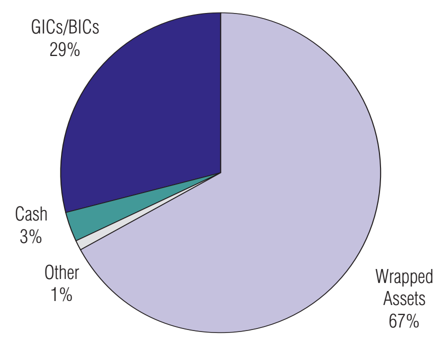
Interestingly, duration rose in 2003 to three years, compared to 2.8 years in 2002. Credit quality also increased in 2003 to 8.8 (AA/Aa and better) for both S&P and Moody's ratings, which compares to 8.7 and 8.4 respectively for 2002.

To learn more about SVIA's Eighth Annual Survey and individual market segments, please go to SVIA's website (www.stablevalue.org) and visit Members' Only for the full annual report. Otherwise, look forward to future articles in *Stable Times.*

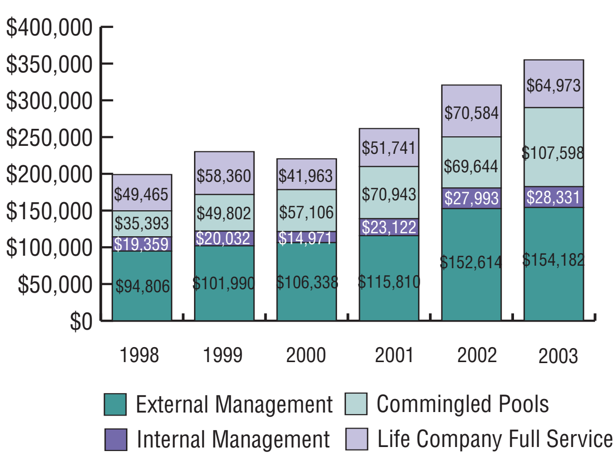
Stable Value Asset Allocation from 1998 to 2003



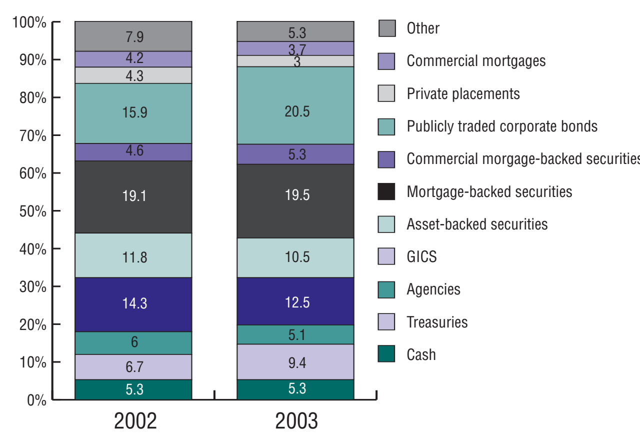
Stable Value Portfolio Allocation



Stable Value Assets from 1998 to 2003



Wrapped Assets Underlying Portfolio



401(k) Participant Investment Knowledge Remains Low Despite Educational Efforts

By Charlene Galt, MassMutual

The results of the 2004 John Hancock Survey of DC Participants have changed so little over the past 13 years that you may wonder if, perhaps, the same phone listing had been used each year to place phone calls to participants.

The 800 individuals contacted for the survey are, in fact, chosen randomly from participants age 25-65, who currently contribute to an employer sponsored retirement savings plan offering a choice of investment options. The demographics of the 2004 survey, compiled by Matthew Greenwald and Associates, are as follows:

- 52 percent female,
- Average Ann. Salary: $60,800,
- Average Age: 44,
- 49 percent have at least a college degree, and
- 58 percent covered only by a defined contribution savings plan.

After posing 60 questions about the participants' knowledge of investment, preparation for retirement, expectation for investment returns, and their desire for investment advice or assistance, the results are analyzed and interpreted by John Hancock Financial Services, the sponsor of the survey.

Wayne Gates, a general manager with John Hancock who has overseen the surveys since 1995, summarizes, "Each time we conduct this survey, I hope the results will improve, but they haven't. The results still show that the level of investment knowledge and skill remains low and people continue to make many of the same mistakes that they have made in the past." Gates provides the following observations to support his view:

- Since 1997, participants increasingly believe that they are not good investors. When asked to rank themselves as investors on a scale from 1 (little or no investment knowledge) to 5 (relatively knowledgeable about investments), those that scored themselves a "one" increased from 38 percent in 1997 to 44 percent in 2004.
- 2004 was the first time, since inception of the survey, that the respondents reported a decrease in the proportion investing in stocks.
- While respondents reported an increase in the use of fixed income investments in 2004, over the last two years, their familiarity with money market funds and domestic bond funds has remained fairly constant since 1995.
- When asked what types of investments are found in a money market fund (short-term securities, bonds, stocks, short-term securities only), only 9 percent responded short-term securities only. This percentage has remained virtually unchanged since 1997. Although, 48 percent responded that short-term securities were found in a money market fund, 47 percent thought that bonds were found in money market funds and 43 percent also thought that stocks were found in money market funds.
- Since 1991 from 28 percent to 34 percent of respondents think the best time to transfer money into a bond fund is when rates are expected to increase.
- Respondents continue to rank their employer stock fund as less risky than domestic stock funds.
- Since 1995, stable value is the fixed income option that respondents were most likely to know nothing about and this level of unfamiliarity has increased gradually from 27 percent in 1995 to 40 percent in 2004.

The results of the survey are likely to add to the growing frustration of 401(k) plan sponsors and those in the industry that have worked diligently to provide individuals with tools designed to assist them with their retirement planning. It has become increasingly apparent that the majority of plan participants do not utilize much of the education information, investment fund data, and do not access the investment planning and advice provided. This remains true despite the industry's efforts to motivate participants to access the tools, even when the tools are offered in a variety of methods and free of cost.

Although it was Gates' wish that the renewed interest in fixed income over stocks in 2001 and 2002 represented a desire by participants for a more diversified portfolio, he noted that the results are unclear and could reflect a tendency of investors to chase performance as the trends follow the higher performing asset class. "On paper, 401(k) plans provide the right incentives, the right investments, the right educational tools and in many cases investment assistance and advice. But in reality, human nature gets in the way," says Gates.

Until more 401(k) plans change their plan design to address issues identified by behavioral economists such as participant procrastination and inertia, participants cannot expect to meet their retirement investment goals. Fortunately, one program gaining popularity, the SmarT plan, is a prescription to cure procrastination. The plan automatically enrolls participants and automatically increases the participant's contributions over time by aligning it with an increase in the participant's annual income, such as a raise. Other programs providing automatic rebalancing and managed investment accounts are being adopted to address the difficulty participants have in changing their investment mix. To gain broad acceptance, strategies must also simplify as much of the process as possible by bringing account information, education and advice tools together in an easy to use platform.

For stable value, the challenge may be even greater. Even though participant familiarity of fixed income investments has increased over the past the 2004 John Hancock survey illustrates that participants are becoming increasingly unaware of stable value as an investment option.

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Second & Third Quarter 2004

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While We Weren't Looking… Macro Influences On 401(k) Contributions Exacerbate Stable Value Cash Flow Problems

By Judy Markland, Landmark Strategies

The stable value world has historically paid more attention to fund flows within the plan than those coming into the plan. That was especially true from early 2001 through much of 2003 when transfers out of equity funds and higher allocations of contributions to conservative investment options produced large stable value inflows. Recently, however, stable value cash flows have been negative for many funds. This is partly the result of contribution and transfer allocation shifts back towards equities. However, it's also due to some dramatic changes in the macro factors influencing contribution growth at the plan level. These forces changed several years ago, but their influence on stable value was masked by the strong participant allocation shifts.

During the 1980's and 1990's sustained growth of both 401(k) plans and the economy produced steady and predictable growth in plan contributions. Wage rates and employment rose comfortably. Plan sponsors worked to increase participation. Many increased their matches as they moved to emphasize defined contribution plans at the expense of traditional defined benefit plans. We all came to expect growth in plan inflows to be the norm, and it helped sustain stable value asset bases when equity funds found such strong favor with participants during the late 1990's.

All this changed with the recession and the turbulence in equity markets. Plan contributions, after all, are a percentage of payrolls on the participant side and depend on the ability to pay benefits on the plan sponsor side. Both payrolls and profitability have suffered over the last several years. The impact on the forces affecting the growth of plan contributions is summarized below. Charts illustrating many of these points are provided at the end of this article.

- **Employment** in the U.S. grew at a strong 1.9 percent a year rate from 1990 through then end of 2000. Over the last three years, it's declined at about one percent a year. That's a swing of almost 3 percent.
- For those working, **wage rates** rose steadily in the 3.5 to 4 percent range from 1997 through 2002. Since then, the rate of increase has fallen steadily to about 2.4 percent for the latest data. Since contributions are a percentage of earnings, this slowdown cuts directly into the growth of plan inflows.
- Even when workers are lucky enough to have a job, there's been a shift to employment at smaller firms with fewer benefits, including less **pension coverage.** After rising fairly steadily from about 50 percent in 1990 to almost 57 percent in 2000, the percentage of U.S. workers employed at a firm that offers any form of pension plan fell to 53.4 percent in 2002, a significant drop in the proportion of workers covered.
- Where workers are lucky enough to have a 401(k) plan, they're not participating at the same levels they did during the economy's and the markets' hey-days. **Participation rates** have dropped from 77.5 percent of those eligible in 2001 to 72.4 percent in 2003 according to a survey by Plan Sponsor. Analysts of this trend say that the drop is due to lower enrollment rates among new workers, a trend that augurs poorly for the future.
- And even when those eligible are participating, they're doing so at lower rates. Spectrum surveys

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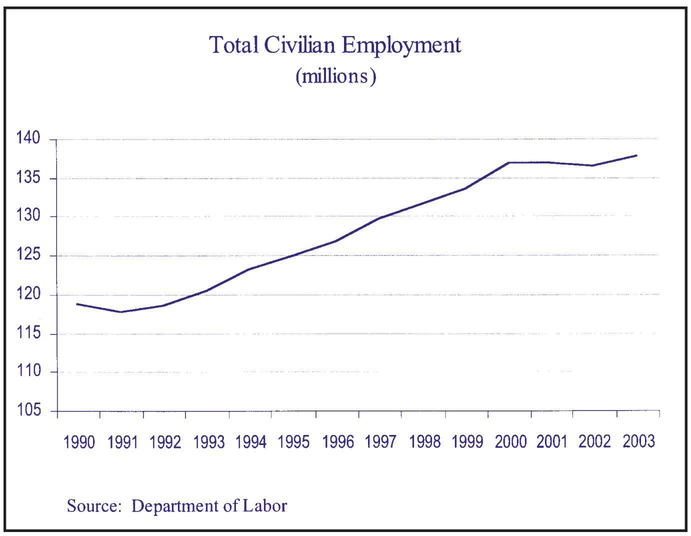

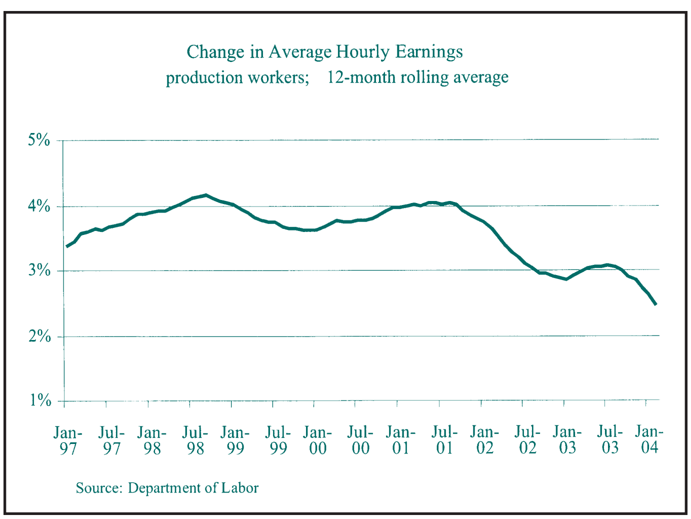

Investment Knowledge

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Part of stable value's problem is that many plans do not offer it. "This is because new plan formation has been at the smaller end of the market, and stable value has lower market penetration in these plans" explains Wayne Gates. This issue, in addition to the incorporation of stable value within life style, balanced funds and managed account programs will need to be addressed by the industry to ensure that all 401(k) investors have access to a stable value fund.

While We Weren't Looking

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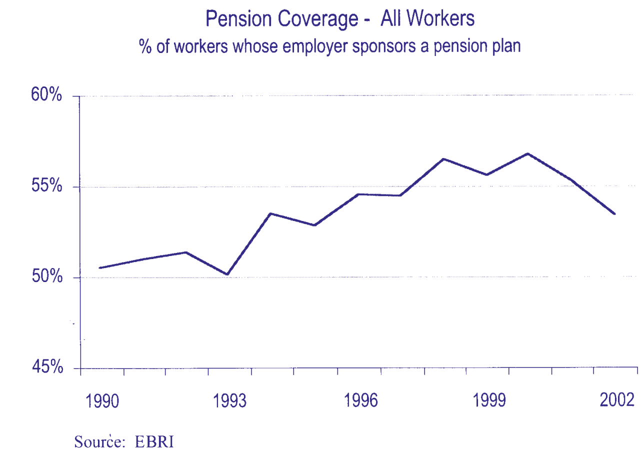
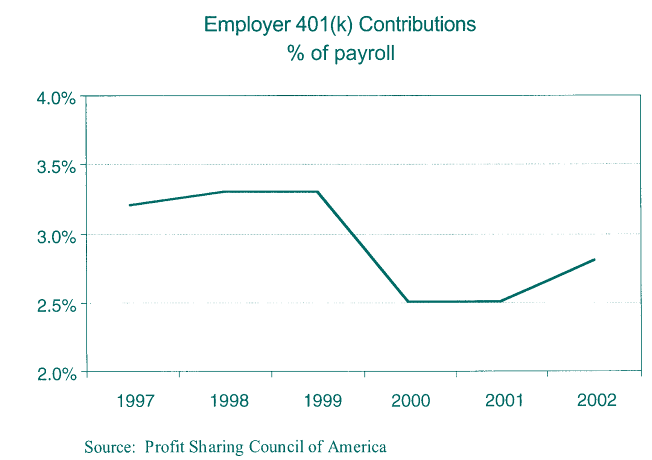


indicate that salary **deferral rates** have fallen from a peak of 8.6 percent in 1999 to only 7 percent in 2002.

- The falloff in contributions from employees is bad enough, but there have been declines on the plan sponsor side as well. **Employer contributions** to 401(k) plans averaged 3.3 percent of payrolls from 1997 through 1999, but only 2.6 percent over the last three years according to the Profit Sharing/401(k) Council. Contributions to profit sharing plans dropped much more steeply.
- Even worse, many firms **terminated or suspended the company match** altogether. Since many of these were large firms (see the chart, "Companies Suspending/Reducing 401(k) Match 2001-2003"), the number of participants affected is much greater than the number of firms would indicate. This is a major issue, since research shows that the company match is the biggest single factor influencing employee participation.
- With the slowdown in contribution activity, plan **withdrawals** become more of an issue. A Hewitt survey found that in 2002 only six percent of those changing jobs and taking lump sum distributions rolled their 401(k) balance over to the new employer's plan. In the over 60 group, 39 percent took the lump sum distribution in cash, as did 33 percent of those aged 50-59.

Stable value underwriting has tended to focus primarily on risks of interfund transfers and external rate arbitrage opportunities. Recent events make it clear that the exercise needs to be broadened to look at the factors influencing plan contribution and withdrawal levels, as well as those impacting the stable value fund itself.



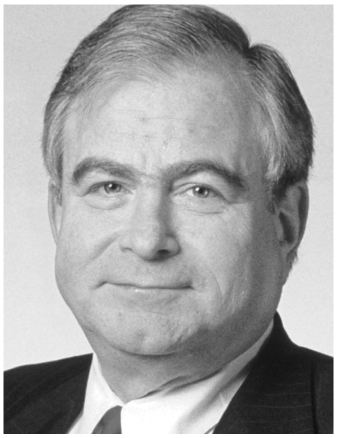
Companies Suspending/Reducing 401(k) Match 2001-2003

Firm	Participants Affected	Action
Textron	23,000	Suspended for 2003.
Prudential Securitiesa	13,560	Suspended for 2003.
Schwab	11,630	Suspended for 2003.
El Paso	3,700	Suspended .75 match; reinstated @ .5 as of 7/1/2003
Goodyear	33,000	Discontinued indefinitely.
CMS Energy	9,400	Suspended until 1/1/2005.
Tech Data	1500	Basic match suspended. Variable match effective in PY2003.
Ford	45,000	Suspended for 2002 and 2003.
Great Northern Paper	1130	Suspended 2002. Bankruptcy filing 2003.
MSX	6,000	Discontinued indefinitely.
Lear	5,900	Discontinued indefinitely.
Daimler/Chrysler	15,000	Suspended.
Visteon Corp.	2200	Suspended
Delphi Automotive Systems	17,000	Suspended in 2002. Reinstated 2003.
GM	50,000	Reduced match from .8 to .6 and .6 to .2. Increased to .5.
total	238,020	

Source: Munnell & Sunden, "Suspending the Employer 401(k) Match," Center for Retirement Research at Boston College Issue in Brief, June 2003, Number 12, page 4.

October 12-14 Forum Speakers

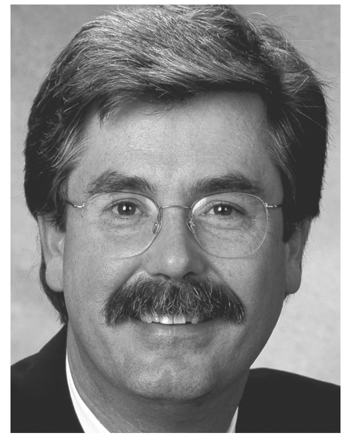
SVIA's October Forum, "Providing Retirement Security in Turbulent Times: Surviving Regulatory Challenges and Thriving Amid Rising Rates," will look at the trends that are causing this uncertainty and provide ideas to help you to survive and thrive. To date, SVIA has lined up four nationally recognized speakers listed below to give you their insights on the issues that are shaping our times. Check www.stablevalue.org for additions to this great line-up and remember to register before the close of August to take advantage of SVIA's early-bird registration.



Sandy Berger served as national security advisor to President Clinton. In that capacity, he was pivotal in shaping America's role in a new global era — from the fight against terrorism to dealing with Iraq, from directing the war in Kosovo to driving the peace process in the Middle East and building our relations with China. Mr. Berger has had a distinguished career in both the public and private sectors. Prior to his service in the Clinton Administration, Mr. Berger spent 16 years in the Washington law firm of Hogan & Hartson, where he headed the firm's international group. Earlier, Mr. Berger served as special assistant to former New York City Mayor John Lindsay, legislative assistant to former United States Senator Harold Hughes of Iowa and to Congressman Joseph Resnick of New York. Mr. Berger also served as deputy director of the policy planning staff, United States Department of State under Secretary Cyrus Vance from 1977 to 1980.

Stan Greenberg is "widely considered the father of modern polling techniques," reports the *London Times* while *Esquire* voted Greenberg one of the top twenty-one innovators, creators and thinkers of the 21st century. As the Chairman and CEO of Greenberg Quinlan Rosner Research, he provides strategic advice and research for companies, organizations and campaigns trying to advance their issues amid shifting social currents. He has served as polling advisor to President Bill Clinton and Vice President Al Gore, Prime Minister Tony Blair, Presidents Nelson Mandela and Thabo Mbeki, Prime Minister Ehud Barak, German Chancellor Gerhard Schroeder, President Gonzalo Sánchez de Lozada of Bolivia and their national campaigns. Greenberg is author of the new book, *The Two Americas: Our Current Political Deadlock and How to Break It,* which has been described by James Carville as "the most important book on American politics in my memory ... maybe since 1960, *The Making of the President.*" Greenberg is also the author of *Middle Class Dreams.*

William Kristol is editor of the influential Washington-based political magazine, *The Weekly Standard.* Widely recognized as one of the nation's leading political analysts and commentators, Mr. Kristol regularly appears on FOX News Sunday and FOX News Channel. Named The Hottest Pundit in Town by *Washingtonian* magazine, he has pushed forward the debate on American foreign policy since September 11th and continues to drive the conversation as co-author of *NY Times'* best seller *War Over Iraq: Saddam's Tyranny and America's Mission.* Before starting *The Weekly Standard* in 1995, Mr. Kristol led the Project for the Republican Future, where he helped shape the strategy that produced the 1994 Republican Congressional victory. Prior to that, Mr. Kristol served as chief of staff to Vice President Dan Quayle during the Bush Administration; and to Secretary of Education William Bennett under President Reagan



Paul McCulley is a Managing Director, generalist portfolio manager, member of the investment committee and head of PIMCO's Short-Term Desk. He also leads PIMCO's Cyclical Economic Forum and is author of the monthly research publication *Fed Focus.* Mr. McCulley joined the firm in 1999, previously serving as Chief Economist for the Americas for UBS Warburg. During 1996-98, he was named to six seats on the Institutional Investor All-America Fixed Income Research Team. He has twenty-one years of investment experience and holds a bachelor's degree from Grinnell College and an MBA from Columbia University Graduate School of Business.