SVIA STABLE TIMES

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Former National Security Advisor Sees Hope, Struggle in War Against Terror

Randy Myers

While the U.S. has had some success in the war against terror–eliminating many members of Al Qaeda and bringing down the Taliban in Afghanistan, which probably dents their ability to stage coordinated attacks such as those that devastated the country on September 11, 2001-the battle is far from over. "If we've broken the beehive, we haven't killed the bees," warns Samuel Berger, former national security advisor to President Bill Clinton.

As a keynote speaker at the SVIA Forum in Washington, DC on October 12-14, Berger described a world in which the U.S. still has the ability to be part of the solution to the terror problem, but only if we proceed "pragmatically, keep our guard up, and our hands outstretched to the

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Brookings Fellow Argues for Fewer Hurdles for Lower-Income Savers

Randy Myers

More than 20 years after the creation of the first 401(k) retirement savings plan, American workers would seem well on their way toward building a secure retirement. Assets in 401(k)s and similar defined contribution plans reached $2.9 trillion by year-end 2003, according to the Investment Company Institute, a mutual fund industry trade group. Assets in Individual Retirement Accounts (IRAs) totaled another $3 trillion, while government and private pension plans and annuities accounted for another $6.2 trillion, bringing the retirement market total to $12.1 trillion. That's about $41,000 for every man, woman and child in the nation,

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The Politics of Retirement: Legislative Proposals Hinge on Election

Randy Myers

With Americans widely acknowledged to be saving too little for retirement, with employers continuing to back away from offering defined benefit plans, and with Social Security insolvency in less than 40 years, it is not surprising that legislators are looking for ways to make sure that a vast swath of the Baby Boomer generation isn't forced to live on government handouts and charity.

"With the aging of the Boomers, retirement issues have become first tier political issues," observes James Delaplane, a Partner in the law firm of Davis & Harman LLP.

Speaking at the SVIA Forum, Delaplane noted that the Republican and Democratic parties are sharply dividend in their approach to retire-

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Investors, Managers Keeping the "Stable" in Stable Value

Randy Myers

Despite a volatile economy, financial markets and world political stage, stable value investments have provided steady and consistent returns to their investors over the past five years. Even as returns on money market funds were slipping below one percent and intermediate bond funds were bouncing around like a rubber ball-the Lehman Brothers Intermediate Government/Credit fixed-income index earned 0.4 percent in 1999, 10.1 percent in 2000, then slumped in each of the next three years until it posted a return of 4.3 percent in 2003-returns on stable value funds motored along smoothly, easing from about 6.5 percent in 1999 to about 5 percent this year.

Part of that steady performance is attributable, of course, to the structure of stable value funds. By virtue of their book value accounting methodology, stable value funds smooth out the ups and downs that plague ordinary intermediate-term bond funds. But their steady performance also reflects the behavior of investors and stable value managers over the past five years.

The chief risk to stable value funds in volatile markets is that investors will bail out of the funds when competing investments, such as interest-rate sensitive money market funds or even the stock market, are rising rapidly. Especially during periods of rapidly rising interest rates, this could force stable value managers to liqui-

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Brookings Fellow Argues for Fewer Hurdles for Lower-Income Savers

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not including any Social Security benefits to which they might be entitled.

But it's not enough, and not nearly as evenly distributed as it needs to be, says Peter Orszag, a senior fellow in economic studies at the Brookings Institution, co-director of the Tax Policy Center sponsored by the Urban Institute and the Brookings Institution, and director of the Brookings Institution's Retirement Security Project. Speaking at SVIA's Forum, Orszag cited a litany of troubling statistics. Half of U.S. households nearing retirement have $10,000 or less in a 401(k) or IRA. Roughly a quarter of the people eligible to participate in a 401(k) plan fail to do so, and only about five percent of those who do contribute the maximum allowable amount. Many fail to adequately diversify their investment portfolios. When they change jobs, many retirement plan participants cash out their accounts rather than roll their assets into a new plan.

The reasons for these troubling statistics, Orszag said, go beyond the problem many workers have of trying to set money aside while simultaneously paying their current living expenses. They include, he said, a retirement savings system riddled with obstacles that discourage rather than promote savings. And he argued that government policy changes enacted in recent years have moved that system further in the wrong direction.

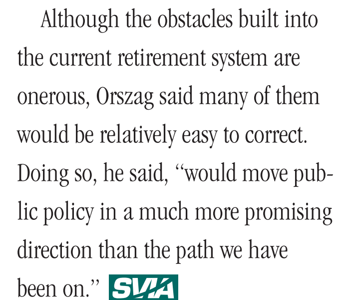
High atop the list of misguided government policies, said Orszag, is a tax code that, because it is graduated, gives the strongest savings incentives to higher-income households least likely to need to save more for retirement, and the smallest incentives to lower-income households who most need to save more. Further, he said, tax legislation that in 2001 raised the maximum amounts that can be contributed to IRAs and employer-sponsored plans will have little impact on the vast majority of workers who could not meet the previous maximums.

At the employer level, Orszag said, too many companies make it easy for workers not to participate in retirement plans by forcing them to take action to join the plan, decide how much to save, and determine how those savings should be invested. A preferable system, he said, would be one in which automatic enrollment is the norm (workers would have to take action to opt out of the plan), coupled with a so-called SMART (Save More Tomorrow) feature in which workers' contribution levels automatically increase at set intervals, such as when they receive an annual pay raise. The federal government, he added, should adopt legislation making it clear that such features would not violate any state labor laws.

Orszag also suggested the federal government make it easier for people to save by allowing their federal income tax refunds to be deposited in whole or part into retirement savings accounts. Low-income workers, he added, also could benefit from a law that would allow employers to match their contributions to retirement savings plans at a higher rate than they do for high-income workers. Also, he said, the federal government could improve the "saver's credit" provided for by the 2001 tax legislation by making the credit refundable (payable to low-income workers who have no tax liability that can be offset by the credit), by extending the credit further up the income scale, by phasing the credit rate down more smoothly than is done now, and by extending the credit beyond 2006, when it is set to expire. Finally, Orszag said, the government should consider eliminating asset tests for social programs such as Food Stamps, Medicaid and college Pell Grants, in which savings held in a retirement account can disqualify applicants from receiving those benefits. Such tests actually discourage lower-income workers from saving for retirement, he argued.

Orszag dislikes the idea, pushed by the Bush Administration, of creating self-directed individual accounts within the Social Security system. He argued that this would create a huge cash deficit during the implementation to the new setup, which would be difficult to fill at a time when the federal government is already running record deficits. He also worried that too many workers facing a cash crunch-whether to care for a sick family member or buy a new car-might be tempted to take their money out of their individual accounts long before they reached retirement. Congress, he warned, would be under intense political pressure to allow such early withdrawals.

Although the obstacles built into the current retirement system are onerous, Orszag said many of them would be relatively easy to correct. Doing so, he said, "would move public policy in a much more promising direction than the path we have been on." SVIA



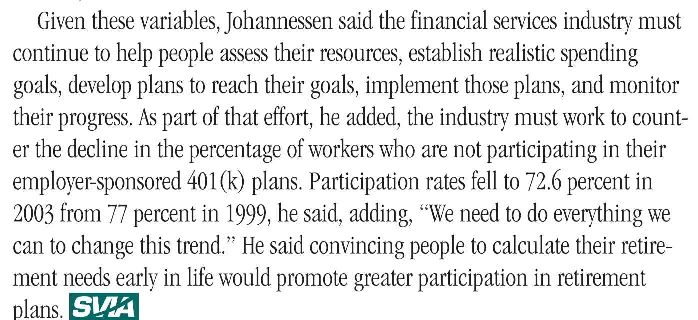
Financial Planner Says Americans Not Saving Enough for Retirement

Randy Myers

The U.S. may be the wealthiest nation in the world, but it's not so wealthy that most of its citizens can forego saving for retirement. Yet few do so adequately, according to certified financial planner Mark Johannessen, a senior planner with the financial advisory firm of Sullivan, Bruyette, Speros & Blayney.

Johannessen told attendees at the SVIA Forum that Americans save too little for a variety of reasons. Many underestimate the amount of money they'll need in retirement, or have unreasonable expectations about their ability to work past normal retirement age to supplement their retirement savings. Some are able to save, but are simply unwilling. Developing a convincing message that will encourage Americans to have better saving habits and to improve their odds of achieving financial security in retirement, he said, will depend in part on understanding these hurdles and the other variables that impact people's ability to retire.

The most important variables, Johannessen said, are those that people can control: when they retire, how much they save between now and then, and their spending levels once they stop working. Other important but less controllable factors, he said, include the amount of retirement savings they've already put aside, their future investment returns, their life expectancy, their health outlook, and the rate of inflation.



Given these variables, Johannessen said the financial services industry must continue to help people assess their resources, establish realistic spending goals, develop plans to reach their goals, implement those plans, and monitor their progress. As part of that effort, he added, the industry must work to counter the decline in the percentage of workers who are not participating in their employer-sponsored 401(k) plans. Participation rates fell to 72.6 percent in 2003 from 77 percent in 1999, he said, adding, "We need to do everything we can to change this trend." He said convincing people to calculate their retirement needs early in life would promote greater participation in retirement plans. SVIA

The Politics of Retirement

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ment security issues. Where the Republicans tend to favor defined contribution plans and individual responsibility, Democrats tout the value of corporate-sponsored defined benefit plans. In the tax arena, Republicans prefer to tax investment income lightly and generally support a flatter income tax, while Democrats seek to tax investment income more heavily and favor a more progressive income tax. As the *New York Times* put it on April 13, Delaplane observed, much of the war between the two parties in this area “boils down to a basic question: should Americans save for old age collectively as a nation, or as individuals through private savings and investments?”

President Bush has been pushing for the latter. Most prominently, he has called for the creation of self-directed individual accounts within the Social Security system. Elsewhere, he has proposed creating a variety of new tax-favored savings vehicles, including general-purpose Lifetime Savings Accounts (LSAs), Retirement Savings Accounts (RSAs), which would replace the various types of IRAs now available to investors, and Employer Retirement Savings Accounts (ERSAs), which would replace all types of employer-sponsored savings plans. All of these proposals would continue the trend of placing more responsibility for saving for retirement on individuals.

Delaplane said that of these measures, RSAs have the best chance of becoming a reality, whatever the political landscape after November 2. When President Bush defeated Democratic Senator John Kerry in the presidential election, other proposals dropped off Capitol Hill's radar screen.

In contrast to the more radical change that President Bush has been proposing, Delaplane noted that Democratic Representative Benjamin Cardin of Maryland has been working with Republican Representative Rob Portman of Ohio on legislation that would merely simplify and refine the existing retirement plan system. Among other things they are considering: expanding access to IRAs, promoting automatic enrollment and reducing vesting schedules in employer-sponsored retirement savings plans, renewing the federal income tax “saver's credit” now set to expire in 2006, and providing tax breaks on annuity distributions from retirement plans. Portman and Cardin have worked successfully together on retirement legislation in the past, Delaplane observed, suggesting that their legislation-first introduced in 2003-should get a fair hearing.

In the defined contribution plan arena, Delaplane said two issues that have generated much talk in recent years do not appear to have much chance of making it onto Congress' legislative agenda in 2005. One is the stalemate over whether offering investment advice to plan participants presents conflict-of-interest issues for plan sponsors, and the other is the use of employer stock in retirement savings plans and whether such use should be restricted. The latter was a hot topic in the wake of the Enron Corp. meltdown, which wiped out billions of dollars in employee retirement savings, much of which had been parked in Enron stock. Data compiled by Hewitt Associates indicate that company stock accounts for about 23 percent of the assets held in 401(k) plans right now.

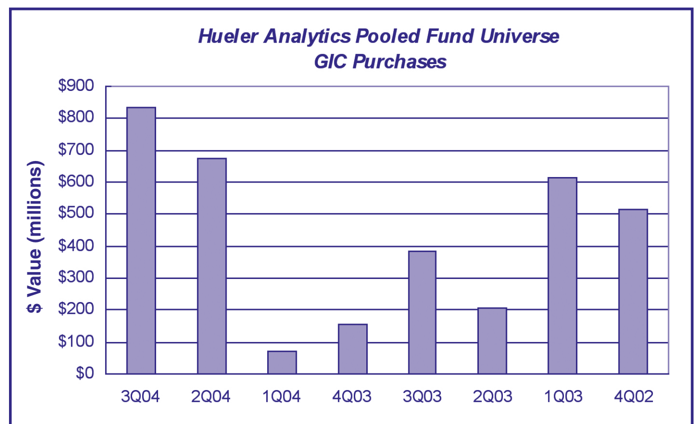
Another popular 401(k) investment is mutual funds, which are capturing more of the government's attention. The Securities and Exchange Commission (SEC) has already introduced some reforms to the mutual fund industry in a bid to bolster fund governance and prevent future incidents of the late-trading and market-timing abuses that surfaced in 2003. Delaplane said it is probable that more reform is in the offing. One change that's been proposed by the SEC is a so-called “hard close” at 4 p.m. to prevent late trading. The proposal has been vigorously challenged by the retirement plan industry, however, because it would make it difficult for participants in employer-sponsored plans, especially those on the West Coast, to be assured of receiving same-day trading capabilities. Delaplane said the SEC is not likely to abandon the issue, but may well soften the “hard close” before implementing it. He said the SEC also is likely to push for greater transparency and disclosure of mutual fund fees.

In the defined benefit plan arena, Delaplane said, Congress can be expected to continue wrestling with a number of issues in 2005. High on their radar screens: the troubled financial status of the airline industry, which has left some airlines struggling to meet their pension obligations. Already this year, United Airlines, which is operating under bankruptcy protection laws, has said it “likely” will terminate its pension plan, and US Airways has sought bankruptcy court permission to suspend some contributions to its plan. If United wins bankruptcy court approval to dump its plan, its obligations would fall into the hands of the deficit-ridden Pension Benefit Guaranty Corporation, which itself could become insolvent under the strain of this new burden. Delaplane said Congress also may revisit next year the issue of what interest rate plan sponsors must use to calculate their pension liabilities and the degree to which employers should be allowed to convert traditional defined benefit plans to cash-balance plans. SVIA

Recent Stable Value Pooled Fund Purchase Trends

Kerry Clements, Hueler Analytics

The Hueler Analytics Pooled Fund Universe, representing 22 funds totaling $70 billion in assets, saw a sharp increase in the dollar value of GIC purchases over the past two quarters. Although the dollar value of new synthetic purchases and additional dollars being deposited into existing synthetic contracts still outweighs GIC purchases, the dollar volume of GIC purchases during second and third quarter 2004 was the highest in the last two year period. As the graph shows, the GIC purchases jumped from approximately $70 million during first quarter 2004, up to almost $700 million in second quarter 2004 followed by $835 million of GIC purchases during the third quarter 2004. SVIA



Former National Security Advisor Sees Hope, Struggle in War Against Terror

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world." More specifically, he said, the U.S. must stay on the offensive (get the terrorists before they get us), strengthen its defenses (despite strides in securing air travel, we've made little progress on the chemical plant, cargo, cyber security and non-air transportation fronts), and fight not just a war of weapons, but a war of ideas. "This war's front line is not Iraq, but wherever we are," Berger said. "So it is essential for the world to understand who we are-particularly when we are using the hard edge of our power."

Berger called the situation in Iraq "bad and not improving," leaving the U.S. with three options: withdrawal, a full-scale assault on the insurgents who have been terrorizing US and Iraqi forces, or a strategy of containment. While withdrawal holds appeal for many Americans, Berger warned, it is also a dangerous idea. Although he didn't spell it out, many foreign policy experts have warned that a U.S. withdrawal could allow Iraq to slide into a full-scale civil war, threaten to throw the entire region into chaos, and call American resolve into question. While there have been hints that the U.S. and Iraq may be considering a full-scale assault on the insurgents before year end, Berger discounted the possibility that it could work. "Brute force hasn't succeeded for the Russians in Chechnya or for the Israelis in Palestine," he observed. "You need a political solution."

That leaves containment, which Berger said would require building an effective Iraqi security force, launching a stronger dialogue with Iraq's moderate Shiites as well as with neighboring Iran and Syria, significantly accelerating the distribution of the $18 billion in reconstruction aid targeted for Iraq, and creating sufficient security to permit elections in Iraq. "This will not be easy," Berger warned, "because we've dug ourselves a pretty deep hole."

Other trouble spots throughout the world cannot be ignored while working toward a resolution of the problems in Iraq, Berger continued, observing that the entire Middle East is being divided by modernists and traditionalists. He said the U.S. can expect to assist in resolving their differences only to the extent that it aligns itself with the internal dynamics in those countries rather than forcing a U.S. view on them. Unemployment in Arab states is among the highest in the world, he noted, which is helping to fuel the volatile environment in the Middle East.

He offered the following assessment of U.S. challenges and opportunities in other parts of the world:

North Korea. Berger termed North Korea "one of the most dangerous places in the world today," saying it has developed the capacity to produce six to eight nuclear weapons within six months "and soon up to 20 per year if they wish." He said North Korea has shown that it is willing to sell dangerous weapons, and observed that the world now has terrorists willing to buy from them. "We're seeing the development of the world's first nuclear weapon Wal-Mart," he said, and argued that the U.S. "cannot kick this problem down the road."

As with Iraq, Berger said the U.S. has three options for dealing with North Korea. One is to accept that country's role as a "nuclear Wal-Mart" and do nothing. The other is to go to war, recognizing, he said, that one million Koreans could die in the process. Finally, there is negotiation. While calling none of them "good options," Berger said he would prefer negotiation. He said the U.S. should tell North Korea that if it gives up its nuclear program in a verifiable way, it can rejoin the world. "Only then will we know their intent and be able to rally the world against them."

China. Berger painted China as a country of opportunity, thanks to its rapidly growing economy, but also one of challenges, thanks to its weak environmental policies, its political tensions and its corruption. "Government can manage any one of those issues, but the challenge is to do all of them," he said. He called Taiwan "the only fly in our relationship with China," and said it must stop pushing for independence from China. Meanwhile, he said, it is essential for the U.S. to broaden the scope of its engagement with China to include not just monetary policy and human rights but also security, health care and other important issues.

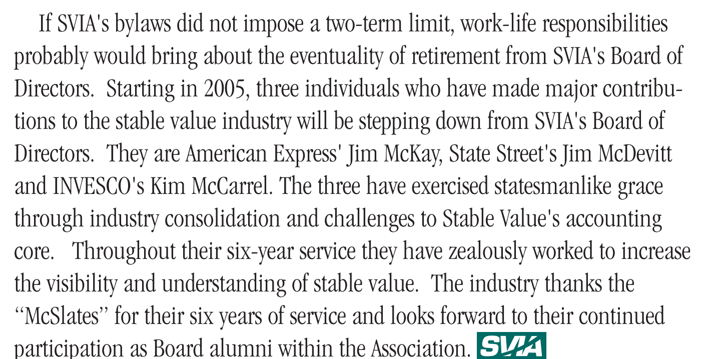
Russia. Russia is also a challenging world partner, Berger said. But he observed that despite its economic growth and greater openness to outside investors, the country is plagued by ethnic tensions, uneven sharing of its new prosperity, and a poor infrastructure. It is, he said, the only industrial country where male longevity is declining because of a poor health care system. Despite the problems facing Russia, Berger said he does not see a threat to President Putin's leadership there, even though "all we hear about him are the bad things." He conceded that Putin is "no little 'd' democrat," but said Putin still needs the industrial world, and, economically at least, is likely to stay on the reform course down which Russia has been headed. Berger also said Russia must develop a political rather than military solution to the conflict in Chechnya.

Europe. In Europe, Berger said simply that the recent expansion of the European Union to include many formerly East Bloc countries ultimately will present the U.S. with "a more formidable ally or adversary, depending on how well we manage our relationship" with those countries. SVIA

Eight Elected to SVIA Board of Directors

Maybe our political parties could learn something about increasing voter participation from the SVIA Board elections. Without having to turn to provisional ballots or get-out-the-vote drives, Internet voting for the eight seats broke past records. Seventy-six percent of the membership voted. Ben Allison, INVESCO Institutional; Don Butt, QWEST; Mark Devine, AT&T Investment Management Corp.; Robert Fox, Cultural Institutions Retirement System; Doris Fritz, Fidelity Investments; Robert Madore, T. Rowe Price Stable Asset Management, Inc.; Marc Magnoli, JPMorgan Chase Bank; and Ken Quann, New York Life Investment were elected to the Board for a three-year term, beginning January 1, 2005.

Three Retire from SVIA Board



If SVIA's bylaws did not impose a two-term limit, work-life responsibilities probably would bring about the eventuality of retirement from SVIA's Board of Directors. Starting in 2005, three individuals who have made major contributions to the stable value industry will be stepping down from SVIA's Board of Directors. They are American Express' Jim McKay, State Street's Jim McDevitt and INVESCO's Kim McCarrel. The three have exercised statesmanlike grace through industry consolidation and challenges to Stable Value's accounting core. Throughout their six-year service they have zealously worked to increase the visibility and understanding of stable value. The industry thanks the "McSlates" for their six years of service and looks forward to their continued participation as Board alumni within the Association. SVIA

Getting the Message Across: Better Ways to Talk about Saving for Retirement

By Randy Myers

Cultural and demographic changes are forcing employers to change the way they communicate with their employees about their retirement savings plans, according to Michael Avis, Vice President and Director of Participant Relations for JPMorgan Retirement Plan Services.

Not so many years ago, Avis told attendees at the SVIA Forum, U.S. workers tended to spend much of their lives working for one employer-an employer who often rewarded their loyal service by providing them with a pension upon retirement. That cozy relationship changed dramatically over the past few decades as employers began shifting responsibility for retirement savings directly to their employees, often by replacing their pension plans with defined contribution plans such as 401(k)s-plans that are funded, in whole or part, by employees themselves.

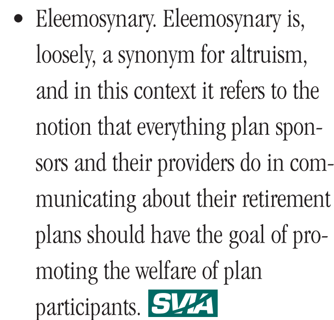
The pace of change has not let up. Today, workers not only save for their own retirement, they also move from job to job more often than ever, usually changing retirement plans in the process. While they are inundated with information about how to invest for retirement, he adds, what they hear tends to be off-the-shelf material that in too many cases has little relevance to their personal circumstances. At the same time, the volatility of the financial markets over the past several years-stocks soared in the late 1990s, crashed in 2000, slumped in 2001 and 2002, then rebounded last year-has left them more worried than ever about how to achieve financial security in retirement.

The solution, Avis says, is for retirement plan sponsors and their plan providers to develop communication programs tailored to their plan, their plan participants, and the investment options available to them. "There is not a one-size-fits-all solution that will work for all plans," Avis insists. "Nor is there a one-size-fits-all solution for all participants. Your communication program will matter to your participants when you recognize that each person is unique."

The need for more effective communication is evidenced in part by the number of plan participants who withdraw money from their retirement accounts before they actually retire. Avis reported that statistics from the Internal Revenue Service show Americans paid $3.3 billion in penalty taxes due to early withdrawals from qualified retirement plans in 2001. Of that amount, 50 percent was paid by people earning less than $75,000 per year. Four million tax returns included income from a premature distribution, most by people between the ages of 29 and 39-exactly the group for whom the message should be to join a retirement plan, not take money out of it.

Avis outlined a five-point plan he called "SCORE" for improving participant communication programs:

- Shared commitment. Plan sponsors and their plan providers, he said, must have mutually agreed upon goals for their communication plan.
- Consultative. Plan sponsors should insist that their providers consult with them about the sponsor's goals for its retirement plan, and the cultural and demographic characteristics of its participant population, to ensure that the communication program is aligned with the sponsor's goals and the participants' needs.
- One-to-one communications. The communication program should be tailored as much as possible to address the needs of the individual participants in the plan and communicated to them when possible on a one-to-one basis, Avis said.
- Relevant. Avis encouraged plan sponsors to use a multimedia approach to communicating with participants, so that every segment of the participant population is reached in the manner that works best for them.
- Eleemosynary. Eleemosynary is, loosely, a synonym for altruism, and in this context it refers to the notion that everything plan sponsors and their providers do in communicating about their retirement plans should have the goal of promoting the welfare of plan participants.



Keeping the "Stable" in Stable Value

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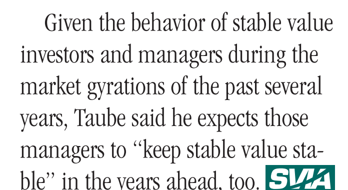
date some of the fixed-income assets in their portfolios to meet shareholder redemptions at exactly the time the value of those assets has been compromised. This, of course, would reduce returns for the remaining investors in the fund.

As it happens, few investors have tried to trade in and out of stable value funds to exploit other short-term opportunities over the past five years. Addressing SVIA's Forum, Doris Fritz, Vice President in the Investment Services Consultant Group for Fidelity Investments, reported that among the more than eight million participants enrolled in defined contribution plans for which Fidelity provides recordkeeping services, only 13 percent transferred any of their money from one fund to another in 2003. Among that slim minority that did make changes, most-58 percent-did so on only one day of the year, and only two percent made exchanges on four or more days.

It is true, of course, that stable value assets as a percentage of total assets in retirement plans fluctuated quite a bit over the past five years. According to the Hewitt 401(k), stable value investments accounted for 19.9 percent of the assets in 401(k) funds at year-end 1999, shot up to 27 percent by the end of 2002, then backtracked to 23.2 percent by the end of last year. But much of that volatility had to do with the performance of the stock market. As stock prices plunged from 2000 to 2003, reducing the value of stock funds held in retirement plans, the percentage of plan assets represented by stable value funds increased, in part, by default. Through most of that time, contributions to stable value funds rose only moderately. In December 1999, for example, investors in the 401(k) plans tracked by Hewitt were steering 19.4 percent of new contributions into stable value products; by year-end 2002, that figure was just a bit higher at 21.5 percent.

Richard Taube, Assistant Vice President for Institutional Products with Pacific Life Insurance Company, says stable value managers have been similarly steady in managing their investment portfolios. Pacific Life provides wrap contracts that insure the book value guarantee promised by stable value funds. As such, it has a keen interest in knowing whether or not its clients-stable value managers-are adding more volatile investments to their portfolios in a bid to capture higher returns. "We don't see people pushing the limits," Taube told the SVIA Forum. "The vast majority of managers have extended the duration of their portfolios over the past year," he said, "but on average only by about 0.2 years." (Extending the duration of a portfolio typically allows managers to capture higher yields on their bonds, but at the expense of greater volatility.) While some managers increased the duration of their portfolios by as much as one year, Taube noted that some actually shortened their fund's duration.

Given the behavior of stable value investors and managers during the market gyrations of the past several years, Taube said he expects those managers to "keep stable value stable" in the years ahead, too.



Stable Value Finding a Home in Increasing Popular Lifestyle Funds

Randy Myers

Lifestyle funds are becoming popular investment options in defined contribution plans, presenting new opportunities for the stable value community to reach and help U.S. workers saving for retirement.

A lifestyle fund is a "fund of funds" designed to make it easier for investors to build a diversified investment portfolio using just one investment option. Fund companies marketing them usually offer a series of lifestyle funds, with each fund in the series distinguished by its risk profile. In some fund families, the portfolios are static, meaning the risk profiles never change. Investors might be able to choose from, say, an aggressive fund, a moderate fund, a conservative fund and an income fund, each featuring a progressively smaller allocation to equities. Other fund families offer lifestyle funds targeted to specific retirement dates, and they gradually alter the asset allocation mix in each fund as the target date approaches. The idea is to avoid making investors calculate their risk profile or change funds as that profile changes. Instead, investors are encouraged to simply choose the lifestyle fund that most closely matches the year they expect to retire and hold it in perpetuity.

Addressing the SVIA Forum, Anne Lester, a Vice President and Portfolio Manager with JPMorgan Fleming Asset Management, said asset allocation funds such as lifestyle funds are now offered in more than 50 percent of the 401(k) plans tracked by Hewitt Associates, and where available are used by more than 33 percent of participants.

Brian Murphy of AEGON Institutional Markets added that stable value funds are strong alternatives to cash (money market funds) or fixed income (bond funds) in a lifestyle fund. Historically, stable value funds have provided higher returns than money market funds (similar to bond funds), but have exhibited lower volatility than bond funds (similar to money market funds). And, of course, they feature a book-value guarantee that protects investors' principal. Murphy noted that because a majority of defined contribution plans already offer a stable value option, most plan sponsors shopping for lifestyle funds to add to their investment lineup will already be familiar with stable value's unique benefits.

Telecommunications company Qwest is already sold; it is among the many plan sponsors already offering lifestyle funds to its plan participants, and it includes a stable value component in two of its three-lifestyle offerings. Don Butt, who oversees the company's $2.9 billion 401(k) plan, says it includes three tiers of investment options: three risk-based lifestyle funds (conservative, moderate and aggressive), six core individual asset class funds, and a brokerage account. Plan participants have allocated 26 percent of their plan's assets to the lifestyle funds, which feature static asset allocations.

Qwest's conservative lifestyle fund has 30 percent of its assets allocated to stable value, 30 percent to bonds, and 40 percent to equities. The moderate fund has a 10 percent allocation to stable value, 30 percent to bonds, and 60 percent to equities. This fund also serves as the default option in the plan for participants who do not choose their own investment options. The aggressive fund has no stable value component, allocating 20 percent of assets to bonds and the remainder to equities.

Lester and Butt agreed that the biggest challenge to including stable value in lifestyle funds is figuring out how big the stable value slice should be. Because stable value's returns are so smooth, portfolio optimization models tend to recommend extraordinarily high allocations to it. Despite the low volatility exhibited by stable value funds, it can be difficult to develop the forward-looking assumptions and correlations needed for optimization models. For example, stable value will outperform cash in a falling interest rate environment, but under perform bonds in the same environment. Conversely, stable value can under perform both cash and bonds in certain rising rate environments.

The upshot is that firms creating lifestyle funds must make informed but ultimately subjective decisions about how much stable value to include. "It is," Lester allowed, "more art than science."

At Qwest, Butt said he and his colleagues overseeing the company's 401(k) plan took into account the results of portfolio optimization modeling and the recommendations of outside vendors, and also looked at how other plan sponsors and mutual fund managers were using stable value in their lifestyle funds, to come up with its asset allocation strategy. It reevaluates the asset allocation mix annually, and rebalances the lifestyle portfolios monthly whenever their actual asset allocation varies from the target by more than one percent.

For plan sponsors contemplating including stable value funds in a lifecycle portfolio, Lester said, key considerations include deciding whether stable value should replace what would otherwise be the cash allocation or the fixed income allocation, or both. Other practical concerns center on custody issues, fund accounting and cash flows, all of which can come into play when buying or selling additional stable value assets to keep the lifestyle fund at its targeted asset allocation mix. Finally, Lester noted that if a sponsor wants its lifestyle funds to use mutual funds as their core underlying investments, it could be difficult to include a stable value component since most stable value mutual funds have disappeared. It would be simpler, she explained, to use underlying investments that are all of the same structural type-all commingled or pooled funds, for example. While it would be possible to mix mutual funds and a pooled stable value fund in the same lifestyle fund, she said, recordkeeping would be more complex. SVIA

PIMCO Strategist Sees "Bull Market in Democracy" Driving Inflation

Randy Myers

The political tide is shifting, and moving the economy toward a period of mildly higher inflation, says noted investment strategist Paul McCulley, Managing Director and Portfolio Manager at Newport, California-based Pacific Investment Management Co., one of the world's leading fixed-income fund-management companies.

Speaking at SVIA's Forum, McCulley said a "bull market in capitalism" drove inflation down during the 1980s and 1990s as the nation's appetite for unfettered economic growth outweighed its taste for government regulation. The stock and bond markets responded with the greatest bull market in U.S. history. All that changed, though, when the tech stock bubble burst in 2000, the rest of the stock market plunged in sympathy, and the business world then erupted in a tangle of accounting scandals and phony profit reports.

Chastened by these debacles, the public turned to the federal government for redress. It responded in 2002 with the Sarbanes-Oxley Act, which imposes a

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Stable Value Industry Sees Ample Wrap Capacity Despite Fewer Providers

Randy Myers

Like the premature rumors of Mark Twain's death, fears that the stable value industry is running out of wrap capacity appear to be exaggerated.

Wraps are contracts that guarantee investors will be able to make withdrawals from their stable value funds at the book value of the underlying investments (principal plus accumulated interest), regardless of their market value. Without them, stable value products would not exist. While the number of banks and insurance companies selling wrap contracts has declined in recent years, there remains ample capacity to meet the volume needs of stable value managers, most industry participants agree. They concede, however, that the shrinking universe of providers means that stable value managers cannot always parcel their business out among as many different providers as they might like for purposes of risk diversification.

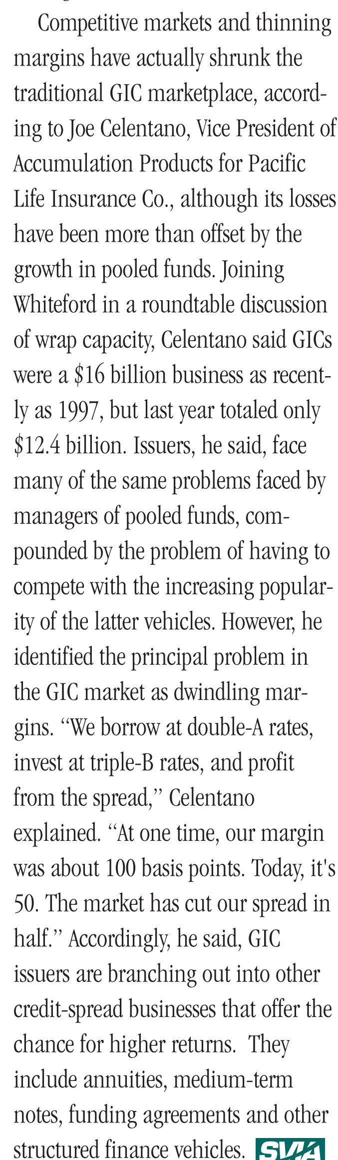
Speaking at SVIA's Forum, Kelli Hueler, President of stable value research firm Hueler Analytics reported that the number of providers in its pooled fund universe declined by half in the five years since December 31, 1998, when there were 50 Guaranteed Interest Contracts (GIC) providers and 34 wrap providers. An even smaller number of providers dominate the business. Hueler said eight providers wrap approximately 70 percent of all synthetic contracts, and that each holds seven percent or more of the market. By contrast, only three providers wrapped five percent or more of the market five years ago.

This shrinking of the provider community comes at a time when stable value products are increasingly popular with investors. Data compiled by the consulting firm Hewitt Associates shows that at year-end 2003, stable value products, including traditional Guaranteed Investment Contracts, accounted for more than 23 percent of the assets in 401(k) plans, second only to equity funds. That was down from 27 percent at year-end 2002, but up from 17.5 percent as recently as year-end 2000. And Hueler Analytics reports that the pooled funds it tracks had total assets of $67.9 billion at mid-year 2004, up from $63.4 billion 12 months earlier and just $32.7 billion as recently as June 30, 1999.

Robert Whiteford, Managing Director of Global Structured Products for Bank of America, cited several reasons for the declining number of wrap providers, including the growing size of financial institutions. As banks and insurers merged with one another over the past few decades, he noted, stable value came to represent, for some of them, an immaterial portion of their business. For some other firms, the problem was just the opposite: as their stable value business took off, senior management began to worry that it was representing too much of their total book of business, and thus presented too concentrated of a risk. Finally, the presence of so many players in the market in years past led to competitive price-cutting, which produced thinner margins and convinced some providers to exit the business.

While managers of stable value funds say they would like access to more wrap providers, Whiteford observed that they do not appear willing to do two things that would attract more participants: pay higher fees for the wrap contracts they buy, or retain more of the risk now shouldered by their wrap providers. Nor, he said, is it likely that many new firms will try to enter the business due to significant barriers to entry. Those barriers include the time and cost involved in developing a risk model, the travails of navigating the approval process with senior managers who may not understand the stable value market, setting up the middle office needed to monitor risk and manage work flow, and developing market credibility. Most stable value managers, Whiteford said, prefer to work with larger, established wrap providers. "The bigger you are," he observed, "the more credibility you have and the more business walks through the door."

Competitive markets and thinning margins have actually shrunk the traditional GIC marketplace, according to Joe Celentano, Vice President of Accumulation Products for Pacific Life Insurance Co., although its losses have been more than offset by the growth in pooled funds. Joining Whiteford in a roundtable discussion of wrap capacity, Celentano said GICs were a $16 billion business as recently as 1997, but last year totaled only $12.4 billion. Issuers, he said, face many of the same problems faced by managers of pooled funds, compounded by the problem of having to compete with the increasing popularity of the latter vehicles. However, he identified the principal problem in the GIC market as dwindling margins. "We borrow at double-A rates, invest at triple-B rates, and profit from the spread," Celentano explained. "At one time, our margin was about 100 basis points. Today, it's 50. The market has cut our spread in half." Accordingly, he said, GIC issuers are branching out into other credit-spread businesses that offer the chance for higher returns. They include annuities, medium-term notes, funding agreements and other structured finance vehicles.



PIMCO Strategist Sees "Bull Market in Democracy" Driving Inflation

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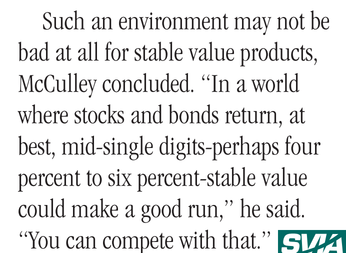
hodgepodge of expensive new corporate governance and financial reporting mandates on public companies in a bid to prevent future accounting scandals. This part of historical precedent suggests that this resurgence of government intervention in the marketplace-what he refers to as a new "bull market in democracy" also promises to be inflationary.

That may not be entirely bad right now. As McCulley explains it, fiscal policy over the past two decades was largely shaped to wage war against inflation, which had flamed out of control in the 1970s following the energy crisis. That coincided with the peak of the last bull market in democracy, when Jimmy Carter was President. Now, says McCulley, with the war against inflation won, the new challenge is to win "the peace of price stability." It's tricky business. If the government were to continue hammering away at what remains of inflation and let capitalism run amuck, McCulley warns, it would risk driving the economy into a period of deflation, the growth-sapping malaise that hamstrung Japan in the 1990s.

To be sure, McCulley and his colleagues at PIMCO are not predicting a return to 1970s-era inflation. In a speech earlier this year, for example, McCulley projected that over the course of the next five years the rate of inflation might move up "100 basis points or so." In his talk before SVIA, he described it as "a mild up drift which erodes the return on financial assets."

Such an environment may not be bad at all for stable value products, McCulley concluded. "In a world where stocks and bonds return, at best, mid-single digits-perhaps four percent to six percent-stable value could make a good run," he said. "You can compete with that."



Investors, Plan Sponsors Grow More Cautious Following Mutual Fund Scandals

Randy Myers

The Securities and Exchange Commission (SEC) responded to last year's mutual fund scandals-findings that several major fund companies had engaged in late trading, market timing and kickback schemes-with a round of new legislation aimed at preventing such abuses in the future. More legislation is on its way. But what of investors and their employers who sponsor retirement savings plans? How have they responded to scandal in an industry that controls more than $7 trillion of their money?

To find out, the American Associated of Retired Persons (AARP) surveyed more than 1,900 investors aged 50 or older in February of this year. The AARP found that most investors have more confidence in the ability of their brokers and mutual fund managers to conduct transactions for them than they do in themselves, and prefer to rely on those professionals to manage their investments.

Nonetheless, the surveyed investors are hardly sanguine about the financial markets. Roy Green, a Senior Legislative Representative with AARP for Housing and Financial Services Issues, told the SVIA Forum that nearly two-thirds of the respondents said they fear losing money in the stock market, 61 percent worry about a lack of ethics in the marketplace, and 55 percent worry about the economy and its effects on their investment portfolios. More than one in three said they are concerned about the accuracy of published financial statements, and more than half said "big problems" for the securities industry include dishonesty, insider trading, lack of accountability, lack of consumer protections, lack of recourse for harmed investors, and a lack of internal checks and controls.

More than 40 percent of survey respondents also identified "incompetent fund managers" and "incompetent independent directors" as big problems for the securities industry, along with conflicts of interest between fund boards and managers, between fund managers and shareholders, and between brokers and shareholders. They also complained about excessive transaction fees and insufficient disclosure of risks to investors.

Not surprisingly, 78 percent of survey respondents said they would like the securities market to be regulated more strongly than it is today. The AARP, Green noted, is campaigning for reforms that would address many of their concerns.

Similar concerns are driving employers who sponsor retirement plans to what David Wray, President of the Profit-Sharing/401(k) Council of America, calls a "new definition of prudence." It will no longer be permissible for prudent plan sponsors to select mutual funds to be offered in their retirement plans without doing a full course of due diligence that looks not just at their investment strategy and past performance but at expenses, redemption fees, fund governance and more. "This is going to be expensive and hard," Wray warned, noting that there is already a trend among sponsors to hire intermediaries to help them with their burgeoning fiduciary responsibilities.

As a result of these new fiduciary concerns and some of the proposed legislation aimed at preventing past mutual fund wrongs from recurring, Wray predicted that some plan sponsors may pull mutual funds out of their retirement plans altogether and replace them with privately managed pooled funds or separate accounts. He also warned that the increased legislation attendant to reform may prompt some smaller employers to avoid offering retirement savings plans altogether. That, he said, would be unfortunate. "We must have employer plans," Wray said, "or 80 percent of American workers will not save for the long haul." SVIA

Editor's Corner

Steve LeLaurin, INVESCO Institutional

Alert readers, when they aren't busy giving humorist Dave Barry insights into the world, certainly have noticed one of the enduring *Stable Times* traditions: the last issue of the year is typically devoted to a recap of the SVIA National Forum. However, unlike for Dave Barry (who is taking a sabbatical in 2005 - boo hoo!), *Stable Times* alert readers haven't supplied us with really interesting human tidbits to keep our interest levels high. So we had to create them ourselves with the National Forum. This year is no different in the focus of our final issue.

As we often do, we asked skilled writer Randy Myers to provide us with succinct but complete summaries of many of the sessions at our October time in Washington, D.C. Randy unfailingly gets at the heart of presentations, and we are often amazed at how little we editors can add to his work. So we will let it speak for itself.

If you looked for them, there were some upbeat thoughts in our Forum and in the weeks following. Stable value is making inroads into Lifestyle options. Despite fears, there doesn't really seem to be a shortage of wrap capacity. As a minor remedy to insurance companies concerns over low margins in GICs, GIC purchase activity showed a big surge during the year. Paul McCulley from PIMCO thinks that expected inflation could result in favorable relative performance for stable value portfolios compared to other asset classes. Samuel Berger sees hope in the worldwide struggle in the war against terror. While we "lost" three distinguished colleagues from our SVIA board as they reached their two term limits, we re-elected talented Board members and added wonderful new ones.

Now that I have mentioned the SVIA Board, I must say one thing about my most admired and trusted INVESCO colleague: Kim McCarrel. This issue accurately points out that Kim has finished her two term limit. But there is more to Kim's presence on the Board. She got there initially by filling the remainder of a term from retiring Dennis Donahue. Then she got elected twice. But even before that, she served as Board member many years before when she was a consultant at Wyatt. I think she has been on the Board much longer than anyone in SVIA history. There has hardly been a time when Kim hasn't been one of the SVIA leaders. Our INVESCO colleague Ben Allison has some big shoes to fill, but I think he is up to the challenge.

As a final nostalgia and "so there!" comment, I couldn't help but notice something in last year's final issue. Greg Wilensky, artful and capable Editor for quite a few issues, ended his *Editor's Corner* last year by saying he wouldn't get his hopes up for the Red Sox or Cubs in 2004. But he did get one thing quite right: the 2004 National Forum was a winner.