Evaluating Stable Value Investments in an Challenging Market Environment

Fi360 National Conference
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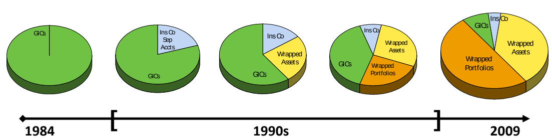
Introduction to Stable Value

Stable Value products have evolved from traditional GICs



GICs or Fixed Accts:	Guaranteed Investment Contract Issued by Insurance Company Book Value Contract	**Wrapped Asset:**	Single Fixed Income (Bond) Asset Wrapped by Bank or Insurance Company Market Value Asset + Book Value Wrap
Insurance Co. Separate Accts:	Insurance Co. Sep Account Issued by Insurance Co. Book Value Contract	**Wrapped Portfolio:**	Multiple Fixed Income (Bonds) Assets Wrapped by Bank or Insurance Company Market Value Assets + Book Value Wrap

Introduction to Stable Value

What is Stable Value?

Stable value is designed to provide a high-quality fixed income portfolio wrapped to achieve the stability of a money market but with an enhanced return potential.

Key Objectives:

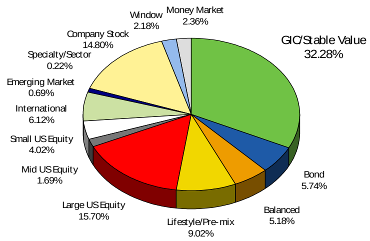
1. Stability & Predictability of Returns,
2. Liquidity to Pay Plan Benefits,
3. Capital Preservation, and
4. High Credit Quality.

Desired Benefits:

1. Relatively Low Risk – high quality Fixed Income portfolio,
2. Low Market Volatility – less market risk than most stock & bond funds, and
3. Designed to Provide Consistent Returns – generally stable NAV regardless of stock & bond market volatility.

Introduction to Stable Value

401(k) Asset Allocation as of 12/31/08

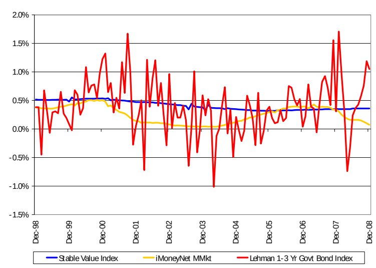


Source: Hewitt 401(k) Index

Introduction to Stable Value

Stable value has consistently out-performed money market funds over a ten-year period, without the volatility of bond funds

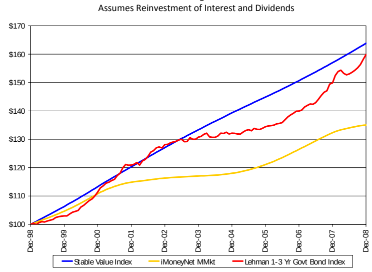
10 Yrs Ending 12-31-08
Monthly Returns



Introduction to Stable Value

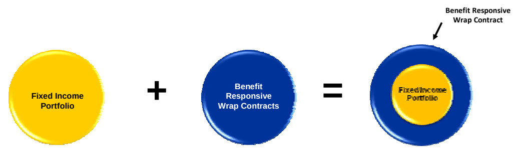
Stable value has produced similar long-term performance as bond funds over a ten-year period & out-performed money market funds

10 Yrs Ending 12-31-08
Assumes Reinvestment of Interest and Dividends



Key Components of a Stable Value Fund

(A) Fixed Income Portfolio | (B) Wrap Contracts | (C) Stable Value Fund

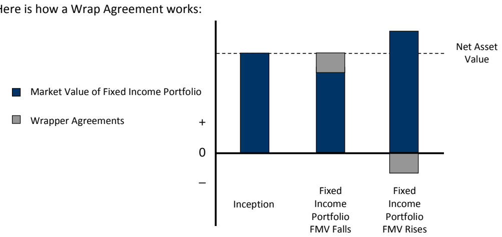


- Diversified bond portfolio,
- Typically AA/AAA avg. credit quality,
- Managed portfolio/credit analysis,
- Marketable securities, and
- 2 to 4 year duration.

- Issued by a bank/insurance company,
- Offsets price fluctuations in bond portfolio,
- Maintains BV record of covered assets (bond portfolio), and
- Payment obligations of wraps help ensure investors receive a positive NAV.

How Do Wrap Agreements Work?

1. Intended to offset principal fluctuations of the covered assets and provide liquidity to assure participants receive contract value for benefit responsive withdrawals
2. Participant withdrawals funded at BV regardless of portfolio's underlying MV
3. Here is how a Wrap Agreement works:



Understanding Risks with Stable Value

Traditional Risks:

1.Risk of Using Wrap Contracts – Because the value of the securities held by a fund will fluctuate; there is the risk that the fund will lose money if it cannot enter into wrap contracts covering all it's assets, or if the wrap provider cannot meet its obligations.

2.Credit Risk – The risk that the issuer of a debt security will be unable to make the required payments of interest and/or repay principal when due.

3.Interest-rate Risk – The risk that any increase in market interest rates may decrease the value of debt securities held by the fund.

4.Regulatory Risk – A fund may not be able to maintain a stable NAV if governmental or self-regulatory authority determines that the book valuation of wrapped assets is inappropriate.

Understanding Risks with Stable Value

Current Risks:

1.Market-to-Book Ratios Diverge – Stable Value portfolios experienced unprecedented valuation markdowns due to several factors:

- A widening of credit spreads due to spiking interest rate volatility,
- A vacuum of trading liquidity, and
- A deterioration in fundamentals.

2.Shrinking Wrap Contract Capacity – Due to recent market events there has been significant changes within the Wrap provider ("issuer") community. The combination of:

- issuers exiting the marketplace,
- extreme dislocation in the financial services industry, and
- management's reevaluation of the implicit risks in the historically "low-risk" wrap contract business (concerned about increased probability that unrealized losses on investments will need to be insured).

have caused remaining wrap providers to significantly reduce their risk exposure.

Understanding Risks with Stable Value

Current Risks:

3.Investment Portfolio Structure Changes – Stable Value funds experienced large positive investor "flight-to-quality" cash inflow throughout 2008 – enabling managers to:

i. avoid having to sell illiquid and troubled assets; and

ii. to position portfolios anticipating that some participants would move out of Stable Value after the markets normalized.

4.Tightening Wrapper Underwriting Standards – Issuers have tightened underwriting standards as a result of increased internal balance sheet scrutiny.

5.Fund Credit Rates Diverge – Crediting rates are likely to diverge across Stable Value funds as a function of respective client cash flow, underlying fixed-income portfolio duration and quality, and investment strategy.

Basic Wrap Contract Provisions Fiduciaries Should Understand

Plan Fiduciaries should understand the following basic provisions:

1.Benefit Responsive Withdrawals: Book value benefit provisions allow participant driven bona fide benefit withdrawals and transfers to **non-competing funds** at book value. These benefit withdrawals include:

- death,
- termination (other than corporate layoffs),
- disability,
- hardship,
- retirement, and
- loans and in-service withdrawals.

Basic Wrap Contract Provisions Fiduciaries Should Understand

Plan Fiduciaries should understand the following basic provisions:

Transfers to **competing funds** generally must be held in a non-competing investment option for a minimum of 90 days ("equity wash") before a subsequent transfer to a competing option may occur.

Competing funds include:

a) stable value funds,
b) money market funds, and
c) other fixed-income investment options with a duration of less than three years.

Typical Wrap Contract Provisions (con't.)

2. **Crediting Rate:** The crediting rate calculation and methodology is stated within the contract. The crediting rate is reset on a monthly or quarterly basis to adjust for the timing and amount of the underlying asset cash flows. There must be a 0% floor on the crediting rate. (With market value losses being experience today, crediting rates are being adjusted downward.)

3. **Participating Withdrawals:** If it is necessary to access the contract for benefit payments, a portion of the underlying assets is liquidated to meet the liquidity need. The difference between book and market value is amortized through the crediting rate over the remaining life of the contract.

4. **Termination of Agreement by Contract Holder:** Can terminate wrap contract at any time. This could be a result of replacing the wrap provider or terminating the entire contract at market value.

5. **Issuer Termination Upon Event of Default:** The issuer may, in its sole discretion, terminate the contract if the Plan is terminated or the cessation of, or substantial reduction in, employer contributions to the Plan.

Typical Wrap Contract Provisions (con't.)

6. **Immunization Election:** The issuer or the contract holder may terminate the contract in accordance with the immunization provisions in the wrap contract. In addition, the issuer can force immunization based upon the underperformance of the portfolio according to a specific formula identified in the contract.

   Once immunization is in effect, the portfolio must be managed according to the immunization guidelines which typically require the liquidation of all securities rated below AAA and in certain cases may require the portfolio to be invested 100% in a Treasury strategy.

7. **Representations:** Wrap contracts contain representations by the parties. In the event that these representations are violated, either party has the ability to terminate the contract.

Sponsors Must Understand Withdrawals Restrictions

Plan-Sponsor Directed Withdrawals or Liquidation

Most funds require a 12-month advance written notice for any other book value withdrawal of assets invested in the Fund that are "**Plan-Sponsor Directed**." This notice requirement can be waived by the fund.

Plan Sponsor-Directed actions can include:

- Plan Sponsor-directed reallocation of investments,
- layoffs/termination of groups of employees,
- Business transaction that results in the transfer or termination of employees,
- Terminating the Fund as an investment option of the plan, and
- Communications intended to induce participants to take actions that would induce withdrawals from the fund.

In addition, Plan Sponsor changes to the employer contributions could also trigger wrap contract issues.

Action Steps a Plan Fiduciary Should Consider

1. **Gather and analyze the controlling documents (e.g., collective investment trust documents, investment guidelines, wrap contracts).**

2. **Consult with the Stable Value Fund provider regarding:**
   - The fund's current fair market value of assets and book value of those assets,
   - The provider's view of the fund's future,
   - The actions the provider has taken regarding the fund in response to what has happened in the markets over the last year, and
   - Any future actions the provider is considering taking.

Action Steps a Plan Fiduciary Should Consider, (con't)

3. **To the extent necessary, consult with experts regarding you're the Stable Value Fund's situation:**
   - Are there concerns about the fund's ability to continue to use book value accounting,
   - Were the steps taken by the provider to address these unusual market conditions appropriate,
   - Are there steps the provider should be considering,
   - What changes (if any) should the fiduciary consider making, and
   - If the fiduciary decides to make changes, what options are available.

Action Steps a Plan Fiduciary Should Consider, (con't)

4. Review participant communications to determine if they should be clarified:

- Do they provide participants with enough information so they can make an informed decision,
- Do they inform participants about the investments that make-up the portfolio (e.g., how much is invested in mortgage backed securities, treasuries, etc.),
- Do they discuss the book value accounting used by the fund, and
- Do they disclose to participants the possibility that the fund could be required to switch to fair market value accounting,

Once the dust settles…predictions

The following six things are likely to occur as a result of the recent financial crisis:

1. Wrap fees have increased, which will result in lower crediting rates;
2. Investment guidelines have become more specific and constrained;
3. Wrap contract features have become constrained;
4. Reporting requirements will increase;
5. Plan flexibility will decrease; and
6. Wrap capacity will slowly return to the market.

"Good people, given good information, make good choices"

- Theresa "Tess Malone