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**Obama's Retirement Initiatives**

On Labor Day Weekend, President Obama proposed a number of initiatives to help more American families save for retirement. The President highlighted four key measures to increase retirement savings:

**Expanding Automatic Enrollment in 401(k) and Other Retirement Plans**

- The Administration will work with the IRS to streamline the adoption process of the auto-enrollment feature, making it simpler for mid- and small-sized plans. The administration intends to release rules on automatic increase features as well.
- The Treasury Department is working on guidance to help employers implement automatic enrollment in SIMPLE-IRA's, which would boost participation in retirement plans among small businesses.

**Allowing American families to more easily save their tax refunds by purchasing U.S. Savings Bonds**

- The Treasury Department is seeking to simplify the direct-deposit of tax refunds by allowing taxpayers to use it to purchase U.S. Savings Bonds.

**Allowing Unused Vacation and Leave to be converted to 401(k) Savings**

- The Treasury Department and IRS are issuing rulings on methods allowing employees to contribute unused vacation and leave to their 401(k) Plan. The current framework generally leads to the employee spending this benefit as opposed to dedicating it to savings.
- The ruling would also provide employers the option to direct their contribution of this amount to an employee's 401(k) account.

**Explanation of Retirement Savings Options**

- The Administration is addressing the fact that many employees changing jobs are unaware of their options with regards to their retirement plan assets.
- As a result, the Treasury and IRS will issue a simple "Road Map" for rollovers of retirement accounts in order for savings to be maintained in tax-favored accounts until retirement – as opposed to invoking early withdrawals and tax penalties.
- The Road Map would be directly provided to departing employees, illustrating how to rollover account balances, what potential decisions to make, and possible tax consequences to consider.

**Implementation of LDI Strategies**

Regulatory changes (PPA & FASB) and the extreme market meltdown produced an evolution in LDI products that either broadly match the economic characteristics of pension fund liabilities or seek out-performance relative to a liability-based benchmark. These changes generated a new perspective on plans, whereas it is no longer sufficient to focus only on plan assets and liabilities, but also to evaluate the interaction of the plan and the sponsoring corporation. The strategies outlined below are not meant to be a comprehensive review of all the various permutations of LDI, but rather a broad overview of several differing LDI strategies and issues.

**100% Immunized Portfolio**

- Cash flow matching: construct a portfolio of assets, usually bonds, that generates cash flows matching the liability cash flows
- Example: match a \$100 annual liability by investing in a bond that pays \$100 annually in coupon payments
- Invest 100% in actively managed bond portfolios or bond funds that match the duration of liabilities

**Advantages:**

- Plans that have frozen plan benefits may potentially immunize themselves against mismatch and interest rate risk

**Disadvantages:**

- This approach eliminates the opportunity to generate excess returns (lowering plan costs) with equities and other investments
- Open plans face a service cost that increases the liabilities over time and therefore will benefit by equities and other assets to cover that service cost
- Even for frozen plans, demographic risk impacts mismatch of liabilities to assets

**Extended Duration Bond Portfolio**

- Shift the duration of the fixed income allocation from a core duration (4 to 5 years) to a long duration (10+ years)
- Use bond manager or bond funds to extend duration of overall portfolio to more closely match liability duration

**Advantages:**

- Increases the duration of the overall plan while maintaining the existing asset allocation framework
- Relatively simple to explain with a single benchmark and manager change for implementation
- Transparent investment approach avoiding derivatives

**Disadvantages:**

- More restricted investment universe may lower active return, increasing plan cost
- Increases plan asset volatility
- Overall plan may not fully match total liability risk

**Duration Overlay**

- Extend duration of portfolio with “overlay” of swaps and futures and zero coupon bonds to get the portfolio duration closer to the plan specific level
- Typically uses a portion of the assets to support interest rate hedging to liabilities

**Advantages:**

- All portfolio investments are available for return generation assets
- Return generation assets seek an excess return over liabilities
- Relative size of return generation vs. liability hedging assets is determined by plan’s return and risk targets

**Disadvantages:**

- Economies of scale may require upwards of \$100 million in the LDI portfolio
- Derivatives are typically required to leverage the duration of the liability hedging assets
- Counterparty risk
- “Perfect” hedge is often unattainable
- May require more frequent rebalancing and monitoring of the plan portfolio

**LDI Strategy Monitoring**

- Evaluation continues on a quarterly basis; metrics monitored include:
  - Liability demographics (turnover, retirement, mortality)
  - Funding ratio and funding volatility; risk of a large contribution
  - Sponsor contribution status and economic impact on free cash flows
  - Asset allocation and rebalancing
  - Tail risk monitoring, also credit and default risk

**Managing Interest Rate Risk**

Unlike equity markets, where stock prices are determined by factors such as anticipated earnings, market share, and expectations of future profitability, bond prices move inversely with interest rates. An important goal of a fixed income portfolio manager is to accurately measure and manage interest rate risk and reward, which comes in the form of percentage price changes from a given change in interest rates and is measured by duration. The duration is the approximate percentage by which the value of the bond will fall for a 1% annual increase in market interest rates. Therefore, longer portfolio duration means higher interest rate sensitivity.

As an example, in the long-term, it is likely that U.S. Treasury rates will rise from their record low levels. These possible increases in the interest rates are likely to be non-parallel, rising more at the short end, as the shapes of the LIBOR and U.S. Treasury yield curves flatten out. As traditional duration and convexity risk measures are valid only when the whole yield curve moves in a parallel fashion, managers of portfolios comprised of fixed income securities and derivatives can utilize key rate duration to manage against the effects of non-parallel yield curve shifts. This method divides the term structure of interest rates into separate segments and then immunizes the bond portfolio against changes in each segment of the term structure. The key rate duration of a portfolio of bonds can be obtained by taking weighted averages of the key rate durations of individual bonds. The model allows for any number of key rates, and therefore interest risk can be modeled and hedged to a high degree of accuracy.

To minimize the impact of interest rate changes, investors may wish to diversify their bond portfolios based on varying maturities or use a manager that can allocate tactically across maturities. Diversification may be achieved with “bond laddering”. By spreading out the maturities among short-term, intermediate term, or long-term bonds, the bondholder is investing at different interest rates, with the shorter-term bonds paying a lower rate than the longer-term bonds. Laddering can be accomplished by purchasing individual bonds or bond mutual funds. If current income is not an objective, bond mutual funds offer the advantage of income reinvestment, allowing the investor to purchase additional bonds at current price levels. Mutual funds do not have a set maturity date and may invest in bonds with varying maturities.

### **Expiration of Treasury Guarantee Program**

While the U.S. Treasury Guarantee Program expired September 18, 2009, efforts have been made to secure investor confidence and promote the stability of the money market industry.

The Securities and Exchange Commission (SEC) continues to monitor money market funds by obliging money managers to continue to report holdings and valuation information in certain circumstances, including funds that did not participate in the guarantee program. Under the new requirement, which is effective for one year, if a fund’s net asset value (NAV) falls below \$0.9975, the fund must notify the SEC by email and provide a portfolio schedule no later than the next business day.

In addition to continuous monitoring, in June of 2009, the SEC proposed amendments to Rule 2a-7 in an effort to strengthen the resilience of money market funds to market disruptions and to increase transparency for the benefit and protection of shareholders. Rule 2a-7 was established to govern activities of money market funds and provide parameters for portfolio quality, maturity, liquidity, and diversification. The proposed amendments are created to tighten risk-limiting conditions by restricting the quality, types, and maturities of investments in which money managers can invest, holding higher levels of cash, and stress testing periodically in hypothetical events. An additional change to the Rule is proposed to secure the timely processing of redemptions in the unlikely event that a fund is unable to maintain a stable NAV. Specifically, this amendment requires the board of a money market fund to determine at least annually the capability to redeem and sell fund shares at current NAV.

The SEC requested comments on potential fundamental reforms to the regulatory structure governing money market funds. Possible regulatory modifications under consideration include:

- 1) Limiting holdings to first-tier only securities (disallowing 5% holdings in second-tier)
- 2) To disclose risks associated with structured investment vehicles (SIVs) and asset-backed commercial paper
- 3) Reducing the maximum permitted maturity for non-government securities from 397 days to 270 days
- 4) Limiting dollar weighted average maturity to 60 days from 90 days currently
- 5) Replacing the stable \$1.00 NAV with a floating rate
- 6) Disallowing illiquid securities
- 7) Repurchase agreements are collateralized by cash, cash equivalents, or government securities

Public comments on the proposed changes were due September 8<sup>th</sup> and the President’s Working Group on Financial Markets is scheduled to recommend changes in December.

Asset managers are also helping to prepare possible private sector solutions that may prevent an unprecedented crisis like the one last fall. Fidelity and Vanguard are among firms planning to organize an emergency cash reserve pool, which would allow asset managers to handle substantial shareholder withdrawals. Funds would simply pay a fee to an entity called the Liquidity Exchange Bank where the cash reserve is built. The liquidity bank will not seek to insure money funds against losses from defaulted securities. Rather, it is designed to provide cash to help funds meet redemptions during a market upheaval.

### **Update on Investment Advice Regulation**

In early 2009, the DOL announced the final regulations concerning investment advice to 401(k) plan participants. The effective date was originally set for the end of the first quarter, but was delayed twice while the EBSA sought more comments and was then delayed indefinitely a few weeks ago. The original regulations allowed investment advice by investment companies, who may be perceived as having conflicts of interest based on the advice provided. The original final regulations met strong opposition in Congress, specifically led by Congressmen Rob Andrews (D-NJ) and George Miller (D-CA).

Near the end of the second quarter of 2009, Andrews and Miller introduced the 401(k) Fair Disclosure for Retirement Security Act and the Conflicted Investment Advice Prohibition Act. Andrews' and Miller's Conflicted Investment Advice Prohibition Act will change the way investment advice is given to employees as many employees currently have access to a self-interested or conflicted investment adviser. This Act would require investment advice to be given by an independent investment adviser. The Act also states that an independent adviser must not provide or manage any plan assets and the fees charged for their advice must not vary based on the advice provided. These fees must be flat-dollar, flat percentage based on assets or based on a per-participant fee.

It is unclear as to whether the 401(k) Fair Disclosure for Retirement Security Act or the Conflicted Investment Advice Prohibition Act will become law in the immediate future. PEI will continue to monitor the proposed regulations and update our clients as soon as more information is available.

### **Routing Out the Hidden Volatility in Your Asset Classes**

For decades, the mean/variance approach has become the standard for developing asset allocation strategies. However, developing the mean/variance assumptions for each asset class is a tricky process, filled with uncertainty. Historical biases, non-normal distributions, inconsistencies in variance over time, all serve to muddy the waters and make for uncertain predictions. One issue that is becoming more prevalent is serial correlation in a return series. Serial correlation refers to the tendency of one period's return influencing the next period's return. This is especially common in alternative investments due to the nature of these assets. Often these assets are illiquid or rely on an appraisal method for valuation. Previous period appraisals often have an anchoring effect on current period appraisals, thereby inducing dependence over time. In addition, herding behavior and investor's propensity to avert losses can induce period to period correlations.

Why is this important? The effect of serial correlation is to make assets appear less volatile than they really are. This does not necessarily affect the expected return on the asset, but it will affect the amount of expected variation in that return. This can be a serious concern because investment strategy is based on how much return we are getting for the level of risk that we are assuming. For those decisions to be reliable we need to have a full understanding of the riskiness of each asset class. PEI uses a Durbin-Watson test to check for the presence of first order serial correlation. When found, we use the Fischer-Geltner-Webb un-smoothing technique to create a new return series.

### **What's New at PEI**

Consultants David Hudak and Fred Stewart spoke at the PSCA National Conference in September. They co-presented a session titled "Managing Your Stable Value Fund: What You Need to Know". Copies of the presentation are available upon request.

Underpinning our success has been our core philosophy – do everything in the best interest of the client. By being true to this tenet, we hope to continue to help our clients in achieving their investment objectives and meeting their responsibilities as fiduciaries, as well as to continue to grow as a firm.

*This newsletter has been prepared exclusively for informational purposes. Every effort has been made to provide accurate and authoritative information in regard to the subject matter in this newsletter; however, accuracy and completeness cannot be guaranteed and is not warranted as such. Numerous sources were used in compiling the data for this newsletter. PEI does not assume responsibility for the accuracy or completeness of such information. The information contained in this newsletter is provided with the understanding that PEI is not engaged in rendering legal, accounting, or actuarial advice. If such advice is required, the services of a competent professional of this kind should be sought. The information contained in this newsletter does not constitute the recommendation of any investment advisor or their services nor does PEI assume responsibility for the conduct of any investment manager.*