

PUBLIC AGENDA ITEM - #6b

6b. Review, Discussion and Consideration of the Contract Renewal on the Stable Value Product

August 25, 2009

BACKGROUND:

In February of 2000, the Employees Retirement System of Texas (ERS) Board of Trustees (Trustees), as trustee for the TexaSaver Deferred Compensation Program (TexaSaver Program), approved an additional investment product to be offered in the TexaSaver 401(k) and 457 plans. The product was called Stable Value Fund offered by Aetna Life & Annuity Co. Subsequently, Aetna Life & Annuity Co was purchased by ING Life Insurance & Annuity Co (ING). Currently, this product is administered by ING.

A stable value fund, also known as Guaranteed Interest Contract (GIC), is an investment instrument whose holdings include investment grade bonds ranging from AAA to BBB-, and often includes a mixture of U.S. government securities, corporate debentures, securitized products such as Mortgage Backed Securities (MBS), and other institutionally traded bonds. The fund's portfolio is a mix of fixed income investments beyond the average term and allowable credit quality of a money market fund managed by an investment manager, which for the TexaSaver portfolio is ING Investment Management. The stable value contract provides for a guaranteed return of principal at a specified rate of interest established by the stable value vendor, which is commonly known as a wrap guarantee.

A key feature of a stable value fund is its treatment from an accounting standpoint. According to Generally Accepted Accounting Principles (GAAP), stable value instruments can be held at contract value, provided that established criteria are met. Contract value, also known as *book value*, is the acquisition cost plus accrued interest, adjusted to reflect any additional deposits or withdrawals. Book value accounting eliminates the market value fluctuations experienced by other types of investment options. This is accomplished by the wrap provider using a formula that provides a smoothing effect on returns to set the crediting rate. As a result, the wrap guarantee in the contract agreement pays participant-initiated withdrawals at book value. Stable value investment funds seeks to provide a stable crediting rate by managing portfolio cash flows, the duration, quality and diversification of the underlying fixed income investments, amortizing the market value based on portfolio gains and losses over the duration of the portfolio assets.

A stable value investment fund has been attractive to two types of defined contribution participants; those seeking principal safety and those seeking to diversify their investments. Over the past nine years, participants have invested in this product in such volume that it has become the single most invested product in the TexaSaver portfolio. As of June 2009, \$244 million, or 22.4 percent, of the assets in the TexaSaver 401(k) plan and \$61.6 million, or 24.2 percent, of the 457 plan were invested in the Stable value fund.

ERS is currently in contract negotiations as the current contract expires on August 31, 2009.

Stable Value Fund Issue:

Since the economic downturn in late 2008, the investments made by the fund manager have not performed as desired. During the first quarter of calendar year 2009, the securities in the stable value fund had a market value of 89 percent of the book value credited to the TexaSaver accounts. ING has been lowering the crediting rate on this fund, which in the beginning of the third calendar quarter of 2009 had been reduced to 3.5 percent from 12 months before, when the crediting rate was 5.25 percent. The market value of these securities has shown some improvement and stood at 92 percent of the book value ending June 2009.

The market-to-book value relationship and crediting rate reductions have been disclosed to TexaSaver members on the quarterly ING Stable Value Fund fact sheet on the TexaSaver website, so that they can be aware of the performance of the product.

The Benefit Contract staff along with the TexaSaver Product Review Committee has met with ING regarding the product multiple times. These reviews have included a discussion of the investment results, the impact on the member's investments and the future of the product.

Re-contracting status:

Prior to beginning contracting negotiations with ING, Benefit Contracts division staff, as part of its diligence, solicited and ultimately contracted with an investment advisory consultant. This firm was asked to audit the stable value product and make recommendations to ERS on ways to re-structure the product to help protect members' investments.

Based on the consultant's recommendations, staff has requested, through current contract negotiations, that ING change the product structure as follows:

- Utilize a Synthetic Guaranteed Interest Contract (Synthetic GIC). This product type allows ERS to hold the securities rather than the wrap provider, ING, that currently hold TexaSaver securities.
- Allow ERS to contract directly with a new investment manager.
- Allow ERS to set its own investment strategy. This provision would allow ERS staff to direct the type of investments which are available to the investment manager for purchase.

Should ING and ERS not be able to execute a new agreement satisfactory to both parties, the contract will expire. It is staff's intent to request that ING agree to a continuation of the current agreement from its current expiration date of August 31, 2009 for one additional month to September 30, 2009 to give sufficient time for both parties to reach an agreement.

If no agreement can be reached, the current agreement has termination provisions to settle the current portfolio at book value settlement, which will allow for an orderly discontinuance of the product by protecting the investments of the members at book value.

This agenda item is for discussion purposes only and is intended to inform the Board, as trustee of the TexaSaver Program, of the contracting status of one of the investment products in the TexaSaver Program.

STAFF RECOMMENDATION:

No action is required on this item.