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The Economic Recovery: The End of the Transition Is Within Sight

Nearly four years after the end of the Great Recession, the U.S. economy's transition from recovery to normalcy is not yet finished. But it is finally in sight. And while it may have seemed a long time coming, Michael Simpson,[1] head of strategic portfolio management for the AEGON U.S. life insurance companies, says the timeline has been very much in keeping with historical precedent.

"We're right on trend," Simpson told participants at the 2013 Transamerica Stable Value Summit in Baltimore, Maryland, in February.

Recovering from a severe financial crisis is traditionally a slow process, Simpson explained, citing the research of economists Carmen Reinhart and Kenneth Rogoff. Their work has shown that in the 10 years following a severe crisis, a country's gross domestic product declines by a median of 1 percent. At the end of that 10-year period, unemployment remains above pre-crisis levels, median home prices are 15 percent to 20 percent lower, and the real value of government debt is much higher. The deleveraging process associated with the aftermath of the crisis typically lasts about seven years.

The U.S. economy is largely following that blueprint. GDP had been growing at just over a 3 percent annual rate prior to the crisis, but since then has been growing a little below 2 percent. The value of government debt has doubled, and total credit as a percentage of GDP, per capita, is falling. The Case-Shiller home price index is down 28 percent from its pre-crisis levels, while inflation has gone up a total of

Cont. on page 3

[1] The information included in this article should not be construed as advertising, investment advice or a recommendation for the purchase or sale of any security. This material contains general information only on investment and macroeconomic matters; it should not be considered as a comprehensive statement on any matter and should not be relied upon as such. The information does not take into account any investor's investment objectives, particular needs or financial situation. Any opinions, estimates and projections included herein constitute the current judgment of the person quoted herein.

In This Issue

ALL ARTICLES WRITTEN BY RANDY MYERS

Dodging Bullets: Credit Market Outlook

FOR MUCH OF THE PAST DECADE, economists predicted that bond prices would soon start falling and bond yields would start rising. It still hasn't happened, but with bond yields at or near historic lows, expectations for change are about as high as they have ever been. After several years of channeling the bulk of their money into bond funds, investors flocked to stock funds in early 2013. Some market analysts are suggesting this may mark the start of a "great rotation" out of bonds and into stocks.

It may, says Rick Perry, head of investment grade credit for AEGON USA

Cont. on page 5

Emerging from the Storm: 401(k) Plans Handled Crisis Well

Few corners of the financial world came through the 2008 credit crisis and its aftermath unscathed, and 401(k) plans were no exception. As the economy struggled to regain its equilibrium, retirement plan sponsors were forced to make hard decisions to conserve cash. Some imposed layoffs and downsizings. Some froze salaries and eliminated bonuses. And some reduced or eliminated employee benefits, including employer contributions to 401(k)s and similar retirement savings plans. In the five years from 2007 through 2012, the percentage of plan sponsors offering matching contributions to such plans fell to 70 percent from 80 percent, according to research from the nonprofit, private foundation, the Transamerica Center for Retirement Studies®.[3]

In the end, though, cutbacks on retirement benefits proved to be the exception rather than the rule. In its new white paper, "Emerging from the Economic Storm: Retirement Plans in the United States, 2007-2012," the Transamerica Center for Retirement Studies found that the vast majority of employers with 10 or more workers continued to offer employee-funded retirement savings plans. In fact, the proportion offering such a plan actually rose, to 82 percent from 72 percent. And by 2012, half of those who had reduced or suspended matching contributions had reinstated them. Among baby boomers, retirement-plan account balances increased during that six-year period by an average of 33 percent, to nearly $100,000 from about $75,000. "What we found is that 401(k) plans held up surprisingly well," Catherine Collinson, president of the Transamerica Center for Retirement Studies, told participants at the 2013 Transamerica Stable Value Summit in Baltimore, Maryland. "But," she added, "we can do better."

Collinson explained that a close look behind the headline numbers shows that there are still sizeable opportunities to expand the reach of 401(k) plans and encourage better use of them by working Americans.

Consider, for starters, the growth in the percentage of employers offering retirement plans over the past five years. Some of that was attributable to small companies starting plans, Collinson said. But a bigger explanation was that many small companies that were economically unsustainable, and had not been offering plans to begin with, went out of business. The net result is that the actual number of plans did not dramatically increase.

Access to plans, and the rate at which employees participate in them, also needs to improve, Collinson said. While 85 percent of full-time workers say they have access to a retirement plan, only 57 percent of part-time workers do. Also, only 70 percent of workers at companies with 10 to 99 employees say they have access to a plan.

Among workers who did have a plan available to them during and after the financial crisis, participation rates stayed "rock solid" at about 77 percent, Collinson said. The median percentage of salary they contributed to their plans did dip briefly, to about 6 percent, before rebounding to the 7 percent level that was the norm before the crisis. While those numbers are encouraging, "we know as an industry we can and should do better than a 77 percent participation rate, and that workers

Cont. on page 6

[3] *The Transamerica Center for Retirement Studies® ("The Center") is a nonprofit, private foundation. The Center is funded by contributions from Transamerica Life Insurance Company and its affiliates and may receive funds from unaffiliated third-parties. For more information about The Center, please refer to www.transamericacenter.org.*

Revamping Retirement Savings: The Legislative Outlook

There are higher-profile issues on the Congressional agenda this year, like reining in budget deficits and perhaps rethinking the sequestration spending cuts. But for at least one Senator, Tom Harkin of Iowa, chair of the Senate Committee on Health, Education, Labor and Pensions (HELP), improving the nation's retirement savings system remains an important goal, too.

At a speech in February at the Center for American Progress, Sen. Harkin noted that there has been "a breakdown of the traditional pension system," with a defined-pension benefit available to just one out of every five workers. In addition to bolstering Social Security, Harkin stated that improving the private retirement system is critical to tackling the retirement crisis "in a robust way."

Last year, Harkin issued a white paper entitled "The Retirement Crisis and a Plan to Solve It." It argues for, among other things, the creation of so-called USA Retirement Funds, which it describes as "a new type of private pension plan that would give people the opportunity to earn a secure benefit and would be easy for employers to offer."

USA Retirement Funds—the acronym stands for "Universal, Secure and Adaptable"—would essentially be privately trusteed, open, multi-employer plans. They would allow small employers to take advantages of economies of scale, farming out management and oversight of the plans to experts. From an employer's perspective, they would look much like a defined contribution plan, with contributions fixed as a percentage of payroll and no opportunity for underfunding; benefits would be determined by the contributions made by, or on behalf of, participants, and the investment performance of those contributions over time.

Employers who already offer retirement plans with automatic enrollment and a minimum level of employer contributions would not be required to offer employees access to a USA Retirement Fund. Those who do not have existing plans would be required to do so, but their responsibilities would be minimal. Their only obligation would be to automatically enroll employees, ensure that employee contributions are processed, and make modest contributions to the fund.

Diann Howland, vice president of legislative affairs for the American Benefits Council, an organization whose members are primarily Fortune 500 companies, said her group supports the concept of multiple-employer plans. "We think they could help a lot of small businesses get comfortable enough to participate in a retirement plan for their employees," she said during a panel discussion at the 2013 Transamerica Stable Value Summit in Baltimore, Maryland.

Cont. on page 3

The Economic Recovery, cont. from page 1

13 percent, meaning that real, or after inflation, home prices are down about 45 percent. By January 2013, unemployment was down to 7.9 percent from its recession high of 10 percent, but it remained nearly 3 percentage points above where it was in 2007.

The employment situation looks even worse if you consider the number of people employed as a percentage of the entire population, Simpson said, noting that the employment participation rate is down 5 percentage points. He also observed that the productivity spike that followed the recession suggests the nation may have suffered permanent job losses. The country still has to create three million more jobs just to get back to the number it had before the crisis.

Despite this seemingly glum news, there have been signs recently pointing toward economic improvement on several fronts. Housing prices appear to have stabilized, and new housing starts are on the upswing.

Auto sales are relatively strong. Initial unemployment claims are moving in the right direction. More households are being formed, and monthly debt obligations as a percentage of disposable income are decreasing.

What's next for the economy now that it's come this far? Simpson outlined three possible scenarios. The first, what he called "fiscal strangulation," would bring weaker economic growth as the economy gets weighed down by the political quagmire in Washington, D.C. There, policymakers have shown an alarming inability to agree on how to address the nation's annual budget deficits and growing federal debt. That dysfunction was highlighted most recently by Washington's failure to stave off the sequestration spending cuts that started taking effect on March 1. Under the "fiscal strangulation" scenario, the Congressional Budget Office looks for GDP growth of just 1.4 percent in 2013.

More recently, Simpson said, the CBO has been offering a second, more positive scenario, one that calls for accelerating economic growth once the fiscal restraints imposed by sequestration have been digested. Under this more optimistic outlook, which Simpson said seems to be becoming the base case on Wall Street, GDP could resume its pre-recession trajectory starting in 2015.

> *the rate of job growth could accelerate over the next 12 to 24 months to a 3 percent rate*

Of course, no forecast of economic growth can be made with complete certainty. The third possible scenario, Simpson said, is one where "something goes boom in the night." It could be a new flare up of the debt crisis in Europe, a natural disaster, or a decision by the Federal Reserve to abandon its expansive monetary policy before the economy has sufficiently recovered. In the extreme, such an event might lead to slower economic growth than what is forecast under the "fiscal strangulation" scenario, perhaps even an economic contraction.

Beyond the potential for surprises, Simpson noted that the U.S. is wrestling with a number of factors that weren't present during many previous financial crises, here or abroad. The U.S. population is aging, he said, and as a result either government-funded healthcare benefits will have to be reduced or taxes will have to go up. Meanwhile, the competitiveness of developed markets has been weakened by high labor costs relative to those in emerging markets. Also, the U.S. continues to run a current account deficit, which generally aids a country during a recovery but over time can be linked to the creation of a financial crisis.

Simpson's view is that the rate of job growth could accelerate over the next 12 to 24 months, to a 3 percent rate, as fiscal and economic headwinds fade. When the number of people employed approaches the peak level that existed before the crisis, he theorizes, there should be a pick-up in residential and commercial construction, creating a "positive economic feedback loop." In other words, with more people working, demand for homes and office space alike should increase. Unemployment is likely to continue falling at a gradual rate, he added, with 150,000 to 175,000 jobs being created per month. That would moderately outpace the natural growth rate of the U.S. labor force, which is about 100,000 per month. Although unemployment will likely remain uncomfortably high for several more years under this scenario, that would be in keeping with historical patterns.

What all that means for the economy this year, Simpson said, is that GDP growth is likely to be in the 2 percent to 2.5 percent range, held down in part by less debt-financed consumption than we had before the financial crisis. Growth in that range would not be fast enough to close the economy's output gap, he added, meaning that inflation should remain subdued and long-term interest rates contained.

Revamping Retirement, cont. from page 2

But Howland said the Council also remains a vigorous proponent of 401(k) plans, which, despite their successes, remain a relatively new type of savings vehicle with room for improvement. (The first 401(k) plan was launched in 1981.)

The Council also supports tax policy that increases the attractiveness of 401(k) plans for plan sponsors and plan participants alike, Howland said, arguing that various proposals to reduce existing tax benefits would be disruptive to the system.

Among improvements the Council recommends, she said, are the increased use of automatic enrollment of employees into 401(k) plans, and of automatic escalation of participant deferrals into 401(k) plans. The Council also favors changing current law to allow automatic deferral rates to start at up to 6 percent of salary rather than 3 percent. The Council also proposes to allow employers to report account balances to participants not only as a lump sum but also as a stream of income that sum

Cont. on page 6

Efficient Frontier: Excess Returns and Tracking Error

You probably already knew that adding stable value to an investment portfolio can improve the risk/return tradeoff for low-risk investors. But could you demonstrate that to a colleague or client with a click of a mouse?

Dick Mattison, senior vice president for risk management at Transamerica Stable Value Solutions, is constantly developing new models aimed at helping his firm and its clients better understand the risks inherent in stable value investing and how those risks can best be managed. At the Transamerica Stable Value Summit in 2012, he gave summit participants a peak at his team's FIRE, or Future Interest Rate Environments, model. It allowed for quick if simple projections of stable value crediting rates, book values and market values, as well as potential claims and losses on stable value wrap contracts, using proprietary, dynamic, and participant-withdrawal assumptions.

At Transamerica's 2013 Stable Value Summit, Mattison debuted a new "efficient frontier" model—it doesn't as yet have a formal name—designed to help stable value managers evaluate how well a portfolio's market value matches a stable value fund's liability. It defines that liability as the book value of the portfolio, growing at the fund's crediting rate.

The new model uses standard mean-variance equations to solve for "optimal" risk versus return tradeoffs. It can be used to explore optimal asset allocations from a plan participant's perspective (i.e., absolute risk versus return tradeoffs), and from a manager's perspective relative to a benchmark (i.e., excess return versus tracking error). Here, excess return is defined as the difference, month by month, of the portfolio's return over the benchmark's return. Tracking error is the standard deviation of that excess return.

Mattison explains that a stable value portfolio with a low tracking error will have a market value that tracks more closely to book value than will a portfolio with a high tracking error. But while tracking error is important, managers are interested in balancing it with excess return. A portfolio strategy that adds 25 basis points to expected excess return and 15 basis points of tracking error, for example, might be considered an appropriate risk-return tradeoff by many managers.

In his presentation, Mattison gave a quick example of how the new model could be used to assess a stable value investment strategy from a retirement plan participant's perspective. Working with historical data from January 2000 through September 2012, the model showed that a portfolio incorporating stable value assets along with equities and fixed income could achieve returns comparable to those from a portfolio using only stocks and bonds but with less risk, particularly at the lower levels of acceptable risk.

While that is a compelling message for investors, stable value managers face unusual challenges that demand further analysis of portfolio characteristics and performance. Unlike a fixed-income manager who is tasked with tracking, say, a U.S. Treasury benchmark, and can invest directly in Treasury securities, a stable value manager cannot directly invest in his or her benchmark: a stable value crediting rate that never falls below zero percent. That makes it difficult to eliminate tracking error. "Unless you can invest in somebody else's stable value fund, you can't have a zero-tracking-error portfolio," Mattison observed. "The question for stable value managers, then, is how do you invest in bonds and always have a zero floor for returns? It's very difficult."

To find answers, Mattison asked his new efficient-frontier tool to examine the characteristics of portfolios that would have at least a positive return and a tracking error of, ideally, less than 2 percent. Tracking error would be measured against a crediting rate determined by the Barclays U.S. Government/Credit 1-5 Year Bond Index.

Based on historical data, the model showed that a diversified portfolio that included not only that index but also three-month Treasury bills, mortgage-backed securities, AAA-rated asset backed securities and even a small allocation to commercial mortgage-backed securities could provide a better tradeoff between excess return and tracking error than a portfolio invested 100 percent in the index. Over the past 12 years, the lowest-risk portfolio would have had zero basis points of excess return and 160 basis points of tracking error relative to the crediting rate. The sample "optimal" portfolio would have generated 25 basis points of excess return and 179 basis points of tracking error, while the index would have generated 67 basis points of excess return and 249 basis points of tracking error.

"This is a tool you can use to think about the tradeoffs of incorporating various asset classes into your portfolios," Mattison told participants at the Stable Value Summit.

Mattison noted that the new tool incorporates a number of simplifying assumptions. It assumes, for example, that crediting rates are based solely on the Barclays U.S. Government/Credit 1-5 Year Bond Index, regardless of the investment strategy being tested. The model isn't being used formally inside Transamerica right now. Nonetheless, Mattison characterized it as a useful tool for generating insights and ideas, and one that his team will be refining and enhancing over time. In fact, he later confirmed, his team is already working to develop a version for use by clients who have expressed an interest in it.

Dodging Bullets, cont. from page 1

Investment Management, LLC (AUIM).[2] But in a presentation at the 2013 Transamerica Stable Value Summit in February, he noted that bond mutual funds have continued to attract new inflows of cash, too. "I think it (the great rotation) is happening," he said. "We just don't know the magnitude yet. We don't think it's going to be insignificant, but we don't think it will be massive, either."

Perry conceded that more money would begin shifting from fixed-income to equities if interest rates start to rise and bond returns turn negative. That hasn't been happening yet, however, in part because the still-sluggish economy has prompted the Federal Reserve to maintain its accommodative monetary policy. This year, the Fed will buy about $1 trillion in bonds, mostly in the Treasury and agency-mortgage sectors of the market, adding substantial support to bond prices and keeping interest rates low.

To be sure, the outlook for the fixed-income markets, particularly in the investment-grade sectors, isn't as bright as it was a year ago. In 2012, bonds issued by industrial companies in the Barclays U.S. Investment Grade Corporate Index posted a total return of 7.55 percent, and those issued by financial companies returned 14.65 percent.

But the outlook isn't totally negative, either. On a scale of -2 to +2, with +2 representing the best possible conditions, Perry said, fundamentals for investment-grade credits were +1 heading into the new year. He cited generally supportive corporate credit metrics, but said leveraged buyouts and M&A activity will likely cause volatility in individual names and sectors. The market's technical indicators also were positive at +1, he said, with excess demand versus supply a dominant theme. Only bond valuations looked suspect at -1, Perry said, with yields less attractive than they were a year ago and the long-term risk/reward relationship not as compelling as it was then.

In assessing the outlook for financials versus industrials, Perry said the massive rally in financials in 2012 is likely to continue in 2013. Option-adjusted spreads for financials exceeded the OAS for industrials by 153 basis points at year-end 2011, a difference that narrowed to 22 basis points by year-end 2012 and only about 10 basis points by mid-February. Eventually, financials are likely to trade through industrials, achieving a narrower OAS spread, said Matt Buchanan, a portfolio manager with AUIM who also attended the Stable Value Summit. Valuations in the financial sector are still attractive, Buchanan observed, adding that banks, which have done a good job of bolstering their balance sheets, are once again beginning to be seen as a safe haven by investors.

Perry added that AUIM tends to view banks and insurers as better credit risks than do the major credit rating agencies. "In 2012, the banking sector returned over 15 percent in the U.S.," he noted, "even though almost all the major banks around the world were downgraded."

AUIM also sees value in other sectors of the fixed-income market, Buchanan said, including, in the securitized sector, commercial mortgage-backed securities. For higher-beta mandates, Perry said, the firm prefers pre-crisis residential mortgage-backed securities, where it can buy at discounted prices and find loss-adjusted yields in the mid-to-high single digits. For lower-beta mandates, it generally looks to the commercial mortgage backed securities sector. "We feel it provides a relatively good pickup for the risk, versus corporates, and the underwriting is much, much better than it was pre-crisis," he said.

Perry hazarded that if there is a bubble anywhere in the bond market, it is in U.S. Treasury securities. "On the credit, or spread side, I wouldn't say we're in a bubble, although it's starting to look like one," he said. "One of the things that created a bubble the last time around was leverage in the system, and we're starting to see that come back into the market, as you can see by the low yields that are available. Investment managers have to do something to get some yield, and adding leverage is one of the things they are doing."

Asked how stable value managers can guard against the fallout from a bubble, Perry noted that AUIM prefers short-duration portfolios in this environment. "But," he added, "look at the correlations between corporate credit and the securitized and Treasury markets. The correlation between corporates and the government market is much lower than the correlation between the securitized market and the government market. So we think we can afford to get a little bit of spread duration—a little bit out on the curve—in terms of the credit sector, whereas we don't generally feel that way in the securitized space."

Perry said the sequestration spending cuts that began to take effect on March 1 should not have a big impact on the corporate credit market. "We've been dealing with a fiscal drag on spending for the last two years in the form of reduced state and local government spending," he said. "Now it will be coming

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[2] AEGON USA Investment Management, LLC is an SEC Registered Investment Adviser. This material contains the current opinions of the manager and such opinions are subject to change without notice. This material contains general information only on investment matters; it should not be considered as a comprehensive statement on any matter and should not be relied upon as such. The information it contains does not take into account any investor's investment objectives, particular needs or financial situation. The value of any investment may fluctuate. Results achieved in the past are no guarantee of future results.

Revamping Retirement, cont. from page 3

could reasonably be expected to generate for the participant in retirement. Howland noted that plan participants also need more education about how healthcare costs will impact their income needs in retirement.

The panel discussed that in all of the debates relating to federal budget deficits and the federal debt, the nation's retirement system is at least partially in the crosshairs since there is a lot of money in the retirement system, and there are a lot of tax expenditures associated with it. The discussion emphasized the constant need to remind members of Congress about the effects any cuts in those tax expenditures would have on the retirement system as a whole.

In a question and answer session after the panel discussion, there were questions as to whether USA Retirement Funds would buy or issue annuities for plan participants. It was noted that Harkin has previously explained that the intent would be to allow for flexibility on such issues. In the lifetime income space, there are a variety of different products and new ones being developed every day, so Harkin wants the legal framework to allow for innovation.

Emerging from the Storm, cont. from page 2

should be saving more than 7 percent of their salary," Collinson said. The opportunity to boost participation rates among part-time workers is particularly great, she argued, since only 60 percent of them participate in plans now, versus 83 percent of full-time workers.

Employers could improve participation rates, she suggested, if more of them would adopt automatic enrollment of employees, and automatic escalation of employee contributions to their plans. Among companies with 500 or more employees, the use of automatic enrollment rose to 45 percent from 31 percent from 2007 to 2012. Smaller employers shied away from it, though, so that among employers of all sizes, the percentage using it fell to 18 percent from 23 percent. A common comment from small employers was that they felt their plan participation rates were already high enough.

Automatic escalation is even less popular; among large plan sponsors using automatic enrollment, only about a third also use automatic escalation.

Collinson also encouraged more employers to offer Roth 401(k)s, which differ from traditional 401(k) plans in that they are funded with after-tax dollars and withdrawals during retirement are not subject to federal income taxes. The number of sponsors offering Roth accounts increased over the past five years to 32 percent from 19 percent, Collinson said. But 49 percent of workers who still don't have access to them said they would like to see them offered.

In addition to getting more people to participate in 401(k) plans—and getting those who do participate to contribute more—Collinson has called for the retirement industry to help minimize "leakage" from those plans. In short, she wants plan participants to do a better job of keeping what they have saved until they retire. The number of participants who took loans from their 401(k) accounts increased in the aftermath of the financial crisis. By 2012, one in five reported taking a loan, 48 percent of them within the prior 12 months.

Loans from retirement savings plans are "a wolf in sheep's clothing," Collinson contended. They reduce the amount of money compounding in a worker's 401(k) account, and create a break in saving, too. Also, workers who leave their jobs often owe repayment in full at that time, and if they can't make repayment the loan is then characterized as an early distribution. That makes it subject to income taxes, and, if the participant is under age 59½, an additional 10 percent tax penalty.

Convincing participants to avoid loans may require educating them on a broad range of personal finance issues, Collinson said, noting that the reasons participants take loans or hardship withdrawals are often compelling, such as paying off medical bills or high-interest debt, or to cover living expenses after losing their jobs. But participants sometimes take loans to pay for things like college tuition, too, that could be funded by other means.

Collinson encouraged plan sponsors and retirement plan providers to continue their efforts to educate retirement plan participants. In particular, she said, the industry should educate low-to-moderate-income savers about claiming the Saver's Credit on their tax returns. It also must encourage workers to develop written strategies for achieving their retirement savings goals, and provide them greater help in transitioning from saving for retirement to creating income from retirement savings.

"We have seen that over the last five years 401(k) plans have held up remarkably well," Collinson concluded. "Participation rates have held steady, and sponsors have been adding plan features. The vast majority of employers continue to view retirement benefits as important for attracting and retaining employees. But we still have a lot more work to do to ensure that more workers, or just about all workers, can enjoy a financially secure retirement."

Emerging from the Economic Storm: Retirement Plans in the United States, 2007-2012 was derived from a comprehensive report, Weathering the Economic Storm: Retirement Plans in the United States, 2007-2012. Both the whitepaper and full report can be found at www.transamericacenter.org.

Dodging Bullets, cont. from page 5

from the federal side of government."

Perry also said that liquidity in the corporate bond market, which has been a problem lately, isn't likely to improve in the coming months and years. "A lot of managers, including us, don't want to sell bonds because they're afraid they won't be able to buy them back," he said. He added that when federal regulators finally issue rules for implementing the long-delayed Volcker Rule, which is designed to prohibit proprietary trading by banks, it could help improve liquidity by relieving uncertainty about its ultimate impact.