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Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5669
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, DC 20210
Attention: Default Investment Regulation

***Re: Default Investment Alternatives Under Participant
Directed Individual Account Plans***

Ladies and Gentlemen:

AEGON Institutional Markets, Inc. would like to take this opportunity to comment on the regulation proposed by the Department of Labor (the "Department") regarding default investment alternatives under participant-directed, individual account plans. 71 Fed. Reg. 56806 (Sept. 27, 2006). While we agree with the Department that encouraging employers to incorporate automatic enrollment features into individual account plans can improve participation in retirement savings plans, we strongly disagree with the proposed regulation's failure to include stable value funds ("SVFs") as a qualified default investment alternative ("QDIA").

AEGON Institutional Markets is a marketing affiliate of a number of life insurance companies that are members of the AEGON Group.¹ AEGON Institutional Markets' affiliates maintain over \$50 billion in balances for stable value funds within U.S. defined contribution plans.

More broadly, members of the Stable Value Investment Association (the "SVIA") provided stable value for over \$397 billion in investments by more than 25 million defined contribution plan participants as of year-end 2005.² Stable value investment options are included in more than two-thirds of participant-directed 401(k) plans and represent approximately 21% of the assets of such plans.³

¹ AEGON Institutional Markets' affiliates include Transamerica Occidental Life Insurance Company, Transamerica Life Insurance Company, Transamerica Financial Life Insurance Company, and Monumental Life Insurance Company.

² Tenth SVIA Annual Investment and Policy Survey on Stable Value Funds.

³ See Hewitt Associates LLC, Hewitt 401(k) Index (found at <http://www.hewittassociates.com/Intl/NA/en-US/OurServices/IndexObservationList.aspx> as of Nov. 2, 2006).

We believe the proposed regulation's current range of QDIAs will not best serve the varied interests and needs of retirement plan participants, for a number of reasons. First, by omitting stable value, the regulation ignores the specific direction given by Congress in the Pension Protection Act of 2006 (the "PPA")⁴ to address the "appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both" and is therefore inconsistent with one of the objectives of the legislation. Second, as we set forth more fully below, the Department's conclusions that led to the omission of this asset class are based upon faulty assumptions. Third, the proposed regulation would cause harm to numerous existing plan participants as plan sponsors eliminate stable value funds as a default option and, in some cases, as an allocation option.

Much of what follows will likely mirror comments submitted by the SVIA and the American Council of Life Insurers (the "ACLI"). While we may not cover them in the same depth, please note that we are entirely in agreement with the comments of these groups and particularly with their request that stable value funds be included among the QDIAs.

Proposed QDIAs Not Consistent with Congressional Intent With Respect to Capital Preservation

The PPA strongly favors the inclusion of stable value funds within the definition of QDIAs. The PPA specifically directs the Department to issue regulations addressing the "appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both" (emphasis added).⁵ "Capital preservation" appears here as a separate category, signifying the Congressional intent that at least one QDIA emphasize capital preservation. The three categories currently included in the proposed regulation are designed to provide a mix of "capital preservation *and* long-term capital appreciation" – which suggests that the Department reads the word "or" out of the statute and substitutes the word "and" in its place. No category of QDIA focuses specifically on capital preservation. The addition of stable value funds would address that omission by including an asset class that preserves capital while simultaneously achieving a rate of return that is relatively high for a fixed-income investment. Moreover, this would be consistent with the Department's goal to avoid asset classes that could "erode" the value of a participant's account in the long-term.

Flawed Assumptions Led to Omission of Stable Value Funds: More-appropriate Data Points

The assumptions underlying the Department's proposal that QDIAs should include only include lifecycle and balanced funds and should exclude stable value funds are flawed for three reasons: (1) They overstate historical equity returns while at the same time understating stable

⁴ Pension Protection Act of 2006, Pub. L. 109-280 § 624.

⁵ Nearly identical language is found in the Technical Explanation of the PPA. Technical Explanation of H.R. 4, the Pension Protection Act, No. JCX-38-06, at 148 (Aug. 3, 2006).

value funds returns; (2) they underestimate fees and the risk of losses; and (3) they do not take into consideration real-life participant behavior (especially over shorter time periods).

Overstated Equity Returns, Understated Stable Value Returns

The exclusion of stable value is premised in part on the conclusion that stable value, as an asset class, produces returns that are on a par with money market returns and are significantly lower than equities. This conclusion, however, overstates by a significant degree both the similarity of money market and stable value returns and the strength of equity performance. Notwithstanding the Department's characterization of stable value in proposing the regulation, stable value is, in fact, competitive with lifecycle and balanced funds on a risk/return basis.

The Department states that it wants to designate QDIAs that will maximize retirement savings and cites statistics to support its selection of portfolios with a substantial portion of equity holdings over lower-risk asset classes such as stable value funds. The Department arrives at an equity premium 6.70 percentage points over fixed income by comparing average annual equity returns over a 78-year period (10.40%) with average annual Treasury bill return data compiled over that same period (3.70%).

Aside from the fact that the Department selected data from a time frame that predates defined contribution plans and stable value funds, the comparison with Treasury bills lacks relevance with regard to stable value funds. A more relevant comparison – both for the asset classes involved and their experience over a similar timeframe and range of economic cycles – would examine return data for the S&P 500 over the past 15 years (8.59% average annual rate of return) and return data for the Hueler Stable Value pooled fund index (5.92% average annual rate of return).⁶

Using these more relevant data sources over this more relevant investment horizon, the equity premium over stable value funds is only 2.67 percentage points – a number that is approximately two and a half times less than the Department's equity premium.

We are not alone in questioning this premium. A Department peer reviewer, Harvard University professor David Laibson, comments that a premium of 6.70 percentage points is not expected by most economists in the near future and recommends a smaller premium.⁷ Another peer reviewer of the Department's proposal, Nellie Liang of the Board of Governors of the Federal Reserve System, notes that "the equity premium that has been realized since 1926 is higher than can be justified by reasonable levels of investor risk aversion or risk under many asset pricing models."⁸ She suggests that an alternative scenario that assumes a lower equity premium of approximately two percentage points would be more useful.

⁶ Hueler Analytics Stable Value Pooled Fund Comparative Universe. The Hueler Analytics Stable Value Pooled Fund Comparative Universe, first made available to the marketplace in 1989, is recognized today as the industry standard for monitoring pooled funds and the stable value marketplace.

⁷ Peer Review for Default Investment Safe Harbor Regulation by Prof. David Laibson, Harvard University, Department of Economics, at 1 (June 5, 2006).

⁸ Peer Review for Default Investment Safe Harbor Regulation by Nellie Liang, Board of Governors of the Federal Reserve System, at 3 (June 2006).

The Department's "lumping" of stable value funds with money market funds is also flawed. Over the past 15 years, the stable value fund average annual return of 5.92% cited above outpaces the money market return of 3.91%.⁹ The standard deviation in stable value returns has been a modest 0.43%, while for money market funds it has been 0.79%.¹⁰

Finally, the risk/reward characteristics of stable value funds hold up well versus those of a balanced fund. For instance, over the past 15 years a balanced fund comprised of 70% stocks and 30% bonds would have averaged 7.91% in average annual returns, with a standard deviation of 10.33%, compared with a stable value fund's average annual return of 5.92% and standard deviation of only 0.43%.¹¹ These performance and risk numbers provide further strong support for adding stable value as a QDIA.

Underestimated fees and risk of loss

Fees and risk appear to have been given little consideration in the assumptions underlying the Department's proposed QDIAs.

Cost is an important consideration in selecting investment funds.¹² Stable value funds have relatively low costs compared to lifecycle, target retirement date, and balanced funds, particularly those that use a "fund of funds" structure. According to a 2004 study by IOMA, Inc., a business information firm, annual fees for stable value funds average 42 basis points, compared to 74 basis points for lifestyle funds (a category that is analogous to lifecycle and target retirement date funds) and 78 basis points for balanced funds.¹³ Recent data on stable value pooled funds show average fees ranging from 29 basis points to 40 basis points (varying based on size), while several stable value pooled funds charge fees as low as 12 basis points.¹⁴

Obviously, fees reduce returns, and the difference between stable value fund fees and the fees for the proposed QDIAs is significant. Laibson, in his peer review, warns that "fees that exceed 100 basis points will have a significant deleterious impact on accumulation of retirement wealth."¹⁵

Risk of loss is an additional investor concern that appears underestimated or perhaps neglected by the current proposal's default investments. This view is supported by Liang, who notes that the "presentation of risk results [in the Department's PENSIM econometric model]

⁹ Lehman U.S. Treasury Bellwether Three Month Index.

¹⁰ Lehman U.S. Treasury Bellwether Three Month Index.

¹¹ Index data compiled from Bloomberg and other sources by AEGON Institutional Markets.

¹² The Department has, in the past, emphasized that cost is an important consideration in selecting investment funds. See, e.g., the Employee Benefits Security Administration publication "Understanding Retirement Plan Fees and Expenses" (May 2004), available at <http://www.dol.gov/ebsa/publications/undrstndgrtrmmt.html>.

¹³ Plans in Transition: IOMA's Annual Defined Contribution Survey (2004). Similarly, a more recent study focused on lifecycle funds found the total average expense ratio of such funds (including the costs of the underlying funds) to be 71 basis points. Turnstone Advisory Group LLC, Popping the Hood: An Analysis of Major Life Cycle Fund Firms, Appendix B (2006).

¹⁴ *Hueler Analytics Stable Value Pooled Fund Comparative Universe*.

¹⁵ Peer Review for Default Investment Safe Harbor Regulation Department of Labor by Prof. David Laibson Harvard University, at 1 (June 5, 2006).

does not consider risk aversion.”¹⁶ Liang also notes that, “[f]or lower income workers, it could be the case that the additional expected income from the life-cycle fund may only come with an unacceptable additional amount of risk.”¹⁷ Nonetheless, the wide adoption of stable value funds shows that many participants care deeply about capital preservation and steady, safe returns. Moreover, the psychological comfort imparted by these products may lead many participants to contribute more than what they would if they were limited to more-volatile alternatives.

The following illustration is instructive: Over the past 15 years, a balanced fund portfolio comprised of 70% stocks and 30% principal-protected investments would have delivered 18 quarters with negative returns, while stable value funds would have delivered none.¹⁸ Ignoring the real-world behavior of participants when reacting to quarterly losses could well lead to the undesirable outcome that retirement plan participation will decrease under the proposed QDIAs.

Other Flawed Assumptions Regarding Participant Behavior

The one-size-fits-all solution embodied in the proposed QDIAs neither meets the needs nor mirrors the behavior of the broad range of participants and plans in the United States.

First, the Department appears to assume everyone stays in the same job from age 25 to age 65, while in the real world many people start new jobs in their 50s and 60s, and for these workers stable value can be an entirely appropriate default option.¹⁹ Moreover, in today’s environment of high employee turnover, many workers have shorter time horizons and may not want to be exposed to the potential for short-term losses if they cash out or convert to new plan. Since it is likely that many default investors are inexperienced and in a learning phase, it is possible that a short-term loss could lead such participants to drop out of or minimize contributions to defined contribution plans in the future.²⁰

Second, the Department appears to give too great a weight to investment allocations rather than contribution/deferral rates. A recent study by Putnam suggests that well over 90% of accumulation is attributable to contribution rates while less than 10% is due to investment returns.²¹ The research demonstrates that a one percentage point change in contributions has

¹⁶ Peer Review for Default Investment Safe Harbor Regulation by Nellie Liang, Board of Governors of the Federal Reserve System, at 4 (June 2006).

¹⁷ Id. at 3-4.

¹⁸ Index data compiled from Bloomberg and other sources by AEGON Institutional Markets.

¹⁹ The assumption that employees have long investment horizons is contradicted by data supplied by the Department of Labor’s Bureau of Labor Statistics. According to a report by Nobscot Corporation, employee turnover, as measured by annual total U.S. separations, was over 44.9% in private industry from September 2005 to August 2006. Turnover varied by industry, with construction (at 61.1%) and retail trade (at 54.7%) as the highest. The median number of years with a firm was four years for all employees. http://www.nobscot.com/survey/us_total_separations_0806.cfm.

²⁰ Dallas L. Salisbury, president and chief executive of the nonprofit Employee Benefit Research Institute, has noted that employees who cash out of their retirement account in the short term will be subject to wild swings in the market and could end up losing money. “The options should allow plan sponsors to default to the more conservative money market and stable value funds. Many employees with relatively small amounts of money in their 401(k)s do cash out when they change jobs.” *Plan Sponsor*, Oct. 2, 2006, http://www.plansponsor.com/pi_type11/?RECORD_ID=35066.

²¹ “Defined Contributions Plans – Missing the Forest for the Trees,” Putnam Investments (Aug. 2006).

twice the effect of moving from a conservative portfolio to a growth portfolio over a 16-year period. If contribution rates are even only slightly affected by periods of losses (and, as we have shown above, losses do occur in balanced funds), then the vast majority of excess returns predicated in the Department's assumptions is suspect. With default investors, any period of losses could well lead to lower lifetime contributions.²²

Other Potential Negative Results of Excluding Stable Value from QDIA Status

Not only will the exclusion of stable value funds from QDIA status incline plan sponsors toward putting participants in default options with higher risks and higher fees, it is also likely to cause a number of transitional issues detrimental to plans and participants.

If the exclusion remains, plan sponsors are likely to shift default investments out of stable value funds, and this may lead to undesirable consequences. Such transfers, not being initiated by individual plan participants, may be subject to delays of up to 12 months and/or may be paid out at below book value. The remaining participants in the stable value fund may be exposed to undue risk because there would be fewer assets supporting the fund's obligations, thereby depressing future crediting rates.

As discussed above, the majority of plans with a default investment option currently use principal-protected investments or stable value funds. In not including these options among the QDIAs, the Department appears in effect to be casting a vote against principal-protected investments or stable value funds. We are concerned about the negative impression of stable value this decision may create in participants' minds, possibly causing unnecessary confusion and lower contributions.

Finally, we are concerned about the potential market disruption that could occur if the regulation does not permit principal-protected vehicles as appropriate default investments. In this regard, we anticipate that plan sponsors who currently use stable value or other forms of non-qualifying default options would seek to move those investments into a QDIA shortly after the Department publishes its final regulation. This would mean that billions of dollars in 401(k) plan assets would be moved almost simultaneously to investment products that qualify for QDIA treatment. Such a massive shift of assets could exert inflationary pressure on the cost of those "equity-based" products, while simultaneously diluting their value for existing investors. In addition, plans will incur significant expenses in the form of required notifications, administrative and transaction costs and processing fees, all of which will reduce participant account balances and investment returns.

²² One peer reviewer suggests a myriad of other factors like this when he states that the "PENSIM model's forecasts ...are based on a largely mechanical 'accounting calculation' that fails to account for a number of different behavioral responses by individual workers and by employers that could largely undo or mitigate the forecasted impacts on [the proposed regulation]." Peer Review for Default Investment Safe Harbor Regulation by John Philip Rust, University of Maryland, Department of Economics, at 5 (Aug. 14, 2006).

Conclusion

The proposed regulation, in effect, ignores the “capital preservation” component of the PPA by failing to provide a safe harbor for stable value funds as a QDIA.

In addition, the Department has relied on a highly unlikely combination of flawed assumptions that in effect force stable value funds out of the QDIA mix. These assumptions include: the assumption that equities will tend to perform as they did in the period from 1926 to 2004 rather than as they have over the past 15 years – which two of the proposed regulation’s peer reviewers criticized as unrealistic; the assumption that stable value funds and money market funds have returns on a par with those of money market funds and Treasury bills; and the assumption that investment risk will have no meaningful effect on participation and contribution rates.

The Department’s proposed regulation favors equity products, which on average have higher fees and higher risk. Finally, the proposed regulation may very well result in market disruptions and diminished returns – certainly not the desired outcome of the PPA.

We strongly urge the Department to add stable value as an additional QDIA and thank the Department for this opportunity to comment on the proposed regulation.

Sincerely,

/s/ Christopher B. Tobe

Christopher B. Tobe, CFA
Director, Pension & Savings

Appendix

	1926-2004 Return	Std Dev
T-Bills	3.70%	3.10%
Corp bonds	5.90%	8.60%
Stocks	10.40%	20.30%
Reference pg 56817 Fed Register Vol. 71 no 187 Proposed Rule on Default Option		
From Stocks Bonds & Inflation 2005 Yearbook Ibbotson at 117 Table 6-7		

Historical Performance Statistics of Various Indexes ²³ 1991 through September 30, 2006									
Index	Five Year Period			Ten Year Period			Fifteen Year Period		
	Annualized Return	Standard Deviation	Correlation with S&P 500	Annualized Return	Standard Deviation	Correlation with S&P 500	Annualized Return	Standard Deviation	Correlation with S&P 500
Equity Funds	5.12%	15.52%	1.0000%	6.87%	17.44%	1.0000%	8.59%	14.81%	1.0000%
Bond Funds	4.33%	3.56%	-0.5240	5.59%	3.38%	-0.4590	6.30%	3.73%	-0.1820
Money Market Funds	2.22%	0.64%	-0.1777	3.68%	0.87%	0.0250	3.91%	0.79%	0.1030
Stable Value Funds	4.81%	0.27%	-0.4060	5.59%	0.43%	-0.0140	5.92%	0.43%	0.0490

Expected Performance Statistics of Balanced Funds 1991 through September 30, 2006						
Index	Five Year Period		Ten Year Period		Fifteen Year Period	
	Annualized Return	Standard Deviation	Annualized Return	Standard Deviation	Annualized Return	Standard Deviation
Balanced Fund 70/30	4.88%	10.64%	6.59%	12.02%	7.91%	10.33%
Balanced Fund 60/40	4.80%	9.04%	6.50%	10.24%	7.68%	8.88%
Balanced Fund 40/60	4.64%	4.64%	6.32%	6.80%	7.22%	6.14%

²³ Apart from Hueler Companies' *Hueler Analytics Stable Value Pooled Fund Comparative Universe*, which is the source for stable value fund data, the underlying data for this letter was compiled from Bloomberg information on market indices. Equity fund returns were based on the S&P 500 Index; bond fund returns, the Lehman Intermediate Government Credit Index; money market returns, Lehman U.S. Treasury Bellwether Three Month Index; and Balanced Fund returns are expected weighted returns based on actual historical returns of the S&P 500 Index and the Lehman Intermediate Government Credit Index using the proportionate weights and allocations (70/30, 60/40, 40/60).