



STABLE VALUE INVESTMENTS AND DEFINED BENEFIT PLANS

With high bond market volatility and rising interest rates, pension funds with an allocation to a stable value fund have fared better than those with only traditional bond portfolios in their fixed income allocations. As rates rise and bonds decline in value, the impact is muted in a stable value fund. Essentially, losses are amortized or smoothed over time as a result of the use of book value accounting rather than market value accounting.

To elaborate, the total return for a bond takes into account both the income, or yield, a bond receives as well as the rise or fall of the bond's price. When interest rates rise, the price of a bond falls. In a traditional bond portfolio, as interest rates rise and fall, a bond's pattern of return can be volatile. What a stable value portfolio does differently is to credit the income, or yield, while keeping the price of a bond steady. When interest rates rise and bond prices fall, a bond's expected rise in yield is credited to the stable portfolio for that period of time without showing the negative impact of the falling price. This stable value type of return is referred to as "book value" and can at times be different from a traditional bond's "market value" return. This is why a stable value portfolio can be very attractive in a rising interest rate environment.

Expectations of continued interest rate increases and weak performance in core fixed income has renewed interest in Stable

Value products. Currently, however, there is debate underway regarding whether or not the book value accounting aspect of stable value investments is appropriate for defined benefit plans.

This issue goes back to 1992 when the Financial Accounting Standards Board (FASB) issued FAS 110. This rule stated defined benefit plans had to value all plan assets at "fair value," or market value. In 1994, the American Institute of Certified Public Accountants (AICPA) affirmed in Statement of Position (SOP) 94-4 that defined contribution and 401(k) could continue to carry stable value investments at book value, but did not reference defined benefit plans at all. While this uncertainty led some defined benefit investors to exit the the stable value marketplace, many continued to invest there. Some auditors worked around FAS 110 theorizing that the difference between book and market value was immaterial and/or the cost to determine market value in the contract would not have been in the best interest of beneficiaries. Around the same period, the Comptroller of the Currency indicated that for stable value funds market value equaled book value, which gave investors additional comfort with the asset class.

Fast forward to Fall of 2004, the Securities and Exchange Commission (SEC) informally recommended that investment companies



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operating stable value funds ensure contracts be accounted for at market value, in accordance with the Investment Company Act of 1940. As a result, the AICPA Planning Subcommittee requested that FASB provide guidance on the issue. FASB recently met in March of 2005 to review this issue, but did not discuss the impact of the SEC's guidance on defined benefit plans, only on 401(k) and defined contribution plans. In the absence of any formal guidance or regulations, the stable value investment community had slowed or even stopped the acceptance of new defined benefit assets.

It appears that the ambiguity has finally been resolved. At its June Board meeting, FASB decided that all Defined Contribution plans will be allowed to continue carrying stable value investments at book value and they grandfathered Defined Benefit plans, so that those plans with allocations are not required to divest. However, new investments will not be permitted after the effective date of the new policy. A draft of the new Statement clarifying the issues will likely be released in mid-June, followed by a 45-day comment period. We would expect final regulation in the Fall with an effective date of December 15. We will continue to monitor this situation and keep you updated on this issue.

MCG staff frequently attends annual shareholder meetings to present proposals filed by our clients or to raise issues of concern to them. There is no additional charge to our clients for this; it is part of our overall consulting package. This year Greg Kinczewski, General Counsel and Head of Proxy Services, has or will be attending meetings for the following firms: Sempra Energy, DuPont, Union Pacific, Aon, FirstEnergy, Comcast, OfficeMax, Home Depot and Progress Energy. Greg notes that we are attending fewer meetings this year; typically the number has been between 12 or 15. The reason for the reduction is not that our clients are filing fewer proposals or engaging fewer companies. Rather, many companies have shown a much greater willingness to negotiate and therefore some proposals have been withdrawn.

One recent example of a company's meeting we attended is Sempra Energy, a San Diego based firm that held its meeting in London. Greg attended to present two shareholder proposals. The first, proposed by the Laborers International Pension Fund, was to include the cost of options in the company financial statements. This received a majority vote. The second, proposed by IBEW Pension Benefit Fund, was a requirement for future option grants to be performance-based. In discussions after the London meeting, the Company agreed to follow-up meetings with the Laborers and IBEW personnel back in the States.