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TO PRESERVE AND PROTECT

A New Look At Conservative Investments In Defined Contribution Plans



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Defined contribution plans have experienced dramatic changes since their inception in the early 1980s. Yet conservative investment options haven't always kept up with the changing needs of plan sponsors and their participants. Most notably, stable value funds, which were once considered to be the only conservative option a plan sponsor might need, may no longer be enough on their own to meet the needs of all participants.

As plan sponsors take meaningful steps to strengthen the offerings in their DC plans, we recommend they consider reevaluating the conservative (principal preservation) category on their investment menu.

In this paper, SSgA presents a framework to help plan sponsors evaluate and deliver investment choices that meet the needs of investors seeking principal preservation.

Executive Summary

Since their initial formation in 1983, defined contribution plans have looked to provide investors with a conservative investment choice to protect the value of participants' investments and shield assets from the volatility that often characterizes other asset classes, such as equities. Historically, stable value funds played a central role in DC plan lineups. In the early years, they frequently were a default investment and often the sole conservative choice.

Today, as DC plans serve a broader population and act as the primary vehicle for future retirement security, it is important that plan sponsors answer the following when considering the conservative option in their investment menu:

- > What is the role of the conservative investment option in a DC plan?
- > What investment solutions can meet those objectives?
- > How can the investment menu be built and the investment choices be framed to help plan participants make suitable choices?

Retirement investing is traditionally set forth as an investment problem that requires the consideration of a lengthy time horizon. Risk and return must be managed over multiple decades. With new views on longevity, a 20-year-old could face up to 70 or 80 years of saving, investing and spending retirement savings. Participants must often face this significant challenge on their own.

Adding to the challenge of solving this investment dilemma is the fact that individual participants often suffer from inertia, procrastination, a lack of sophisticated investment knowledge and growing anxiety about security.

Many investment experts would suggest that DC plan participants should rarely put their nest egg solely in cash or a conservative investment and

forfeit the potential for market returns. However, DC plan participants of all ages may occasionally need or want to preserve capital. Conservative investment choices may appeal to participants in different stages of the retirement planning process, including those who:

- > Seek to protect their account balances from market fluctuations
- > Prepare to make withdrawals for retirement income
- > Have an investment strategy outside of their DC plan that warrants a conservative approach within their employer-based retirement account

In this paper, we look at the different types of investments that plan sponsors can choose from to help broaden the conservative choices in their DC plan menu. We also offer practical steps for plan sponsors to reevaluate and update their plan design and investment choices if they have legacy stable value funds in their investment lineups.

Finally, we offer a reminder to plan sponsors that you shouldn't wait for a market crisis to make changes to your investment menus. Adding or replacing funds can be a lengthy process, so we recommend reviewing your investment lineup when market conditions are less volatile. That will help you make thoughtful, well-informed decisions with appropriate due diligence.

The 2008 market crisis caught many plan sponsors off guard, without enough time to respond to participants' requests for a more conservative investment choice in their plan menus. In order to ensure that you offer the optimal investment choices for all investment options, including those focused on capital preservation, we suggest that you take a proactive approach to reconsidering the number and type of conservative options you offer, the options on your plan that are aimed at providing capital preservation.

Broadening Choice and Diversification

One problem for participants is that their conservative investment choices are often limited. It is estimated that fewer than 20% of DC plans offer a money market option in their core menu and about 20% offer both money market and stable value.¹ Meanwhile, many plan sponsors have continued to offer stable value funds as their most conservative choice (about 60%).² While stable value funds may seem simplistic as a cash-like vehicle, when examined more closely they reveal a greater complexity. These funds are often likened to a money market solution, but they aren't structured like a cash vehicle, nor do they behave like one.

If your goal as a plan sponsor is to offer participants the full spectrum of risk and return, consider providing a broader range of conservative options on the investment menu.

An Unintended Gap: Clarifying Your Conservative Choices

When it comes to the capital preservation choices, many plan sponsors today may have an unintended gap in their investment menus. If you seek to offer participants the full spectrum of risk and reward, you may need to review the conservative end of your investment menu. Are your current offerings meeting the investment needs of your participants as well as the parameters established by your benefits committee?

We believe that your DC investment menu should offer conservative investments, including capital

preservation, that meet the following criteria:

- > Protect principal in challenging market environments
- > Rely only upon fund assets to satisfy liquidity demands
- > Be independent of the corporation's insolvency risk

Common solutions that plan sponsors can use (but often overlook) to build out their conservative investment category include Treasury money market, government money market, and/or prime money market funds. In our view, Treasury money market strategies offer plan sponsors an optimal solution for capital preservation and can help diversify the conservative investment choices within the plan lineup.

Treasury Money Market Strategies Typically Offer the Most Protection

A Treasury money market invests typically in overnight Treasury bills, making it the highest credit and shortest duration conservative investment option you can offer participants. As a result, a Treasury money market fund is designed to function as an optimal cash substitute, offering participants maximum liquidity and principal protection.

In our view, a Treasury money market fund is an ideal option for providing participants with the highest potential for capital preservation. The 2008 financial crisis demonstrated the many advantages of including a Treasury money market solution in a defined contribution plan. For example, in moments of financial uncertainty, investors tend to flock to Treasuries for safety as these instruments tend to hold or increase in value

1. Callan 2007 DC Plan Survey

2. Callan 2007 DC Plan Survey

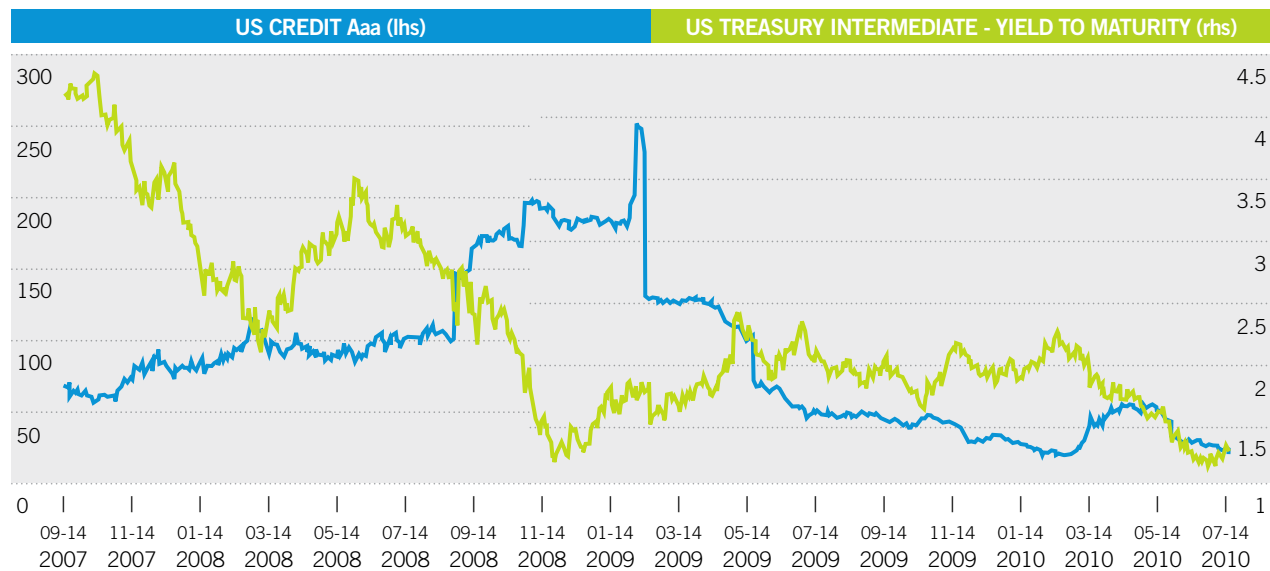
as market volatility increases. Having a Treasury money market solution in your plan allows participants to dial down risk and protect principal in a market crisis with the highest-quality credit available.

In addition, a Treasury money market fund relies exclusively upon the fund’s assets to satisfy liquidity demands, so the fund should perform as expected, day in and day out, with full transparency into its underlying assets. Finally, a Treasury money market fund is independent of insolvency risk of any corporation and doesn’t rely upon an insurance wrap to maintain its value. This ensures that participants are able to withdraw assets regardless of the financial health of their employer or the solvency of an insurance company.

Demand for Treasury Securities in 2008

During periods of market turmoil, the intense flight to quality and high demand for low-risk, high-quality investments typically increases asset flow into Treasury securities. This is due to their transparency, liquidity and the fact that they are backed by the full faith and credit of the US government. In 2008, for example, investors were willing to pay more for Treasuries than for corporate bonds with the same AAA credit quality. As illustrated in Figure 1, spreads between AAA corporate bonds and Treasuries widen during periods of stress. This indicates strong investor preference for the government securities. Even investors with longer time horizons, including retirement savers, may at times prefer to give up excess yield in favor of maximum safety.³

FIGURE 1: COMPARING CORPORATE AND TREASURY BONDS DURING THE CRISIS



Source: Bloomberg, September 14, 2010

3. Krishnamrthy and Vissing-Jorgensen, *ibid*

Government and Prime Money Market Funds Offer Potential for Consistent Performance

Government money market funds invest in Treasury bills as well as government agency bonds. Prime money market funds invest in Treasury bills, government agency bonds and high-quality corporate bonds. In most market conditions, government and prime money market funds offer participants the potential for relatively consistent performance. However, the more non-Treasury securities you introduce into a fund, the more variations you have in credit quality.

If you currently offer or are considering offering a government or prime money market fund, take a close look at the strategy's parameters for credit quality and maturity dates, as defined in its prospectus. Make sure they match your goals for offering participants a truly conservative investment option.

Stable Value Funds Offer Potential for Higher Yields, with Higher Risks

Stable value funds were once thought to be the answer for a DC plan's capital preservation option, but many plan sponsors have since discovered there is more risk in the underlying assets than most had realized or wanted. If conditions aren't right for a fund's insurance wrapper, for example, losses to principal may go uncovered and all stable value investors share in the loss. Because of their many complexities, stable value funds are characterized by some as sophisticated investment vehicles for an unsophisticated audience.

In the past, stable value funds have offered participants the potential to generate excess yield over cash funds. Stable value funds, which use an insurance wrapper to guarantee participant flows at par, deliver a return premium to cash with reduced mark-to-market volatility due to book value accounting.

While stable value funds work well in normal market environments, in times of extreme market stress, these funds have three significant limitations. With closer examination, these limitations may include:

Limited Protection: Most wrap contracts only provide protection from market value loss up until default. Therefore, in extremely difficult environments, when corporate bankruptcies increase dramatically, these funds may not be able to maintain a par value for all investors. In 2008, some stable value funds removed defaulted securities from the wrap. In these cases, participants received only the recovery value (the market value of the asset) established in bankruptcy proceedings.

Potential Liquidity Issues: Because stable value funds are marked at par even when the net asset value of the underlying holdings is below par, liquidity needs can't always be satisfied by the underlying fund's assets.

Conditional Return Principal: Wrap contracts, under which insurers must return principal to participants, are not enforceable when a plan event, such as a large-scale layoff or bankruptcy, occurs. If such an event occurs when the fund's market value is below par, participants invested in

the stable value fund will receive less than the stated value of their investments.

Is Stable Value Aligned with Your Plan Objectives?

Automated enrollment and savings increases, diversified defaults, simplified investment choices and focused communications are some of the leading improvements many progressive plan sponsors have initiated recently. These plan changes are significant steps to getting participants on track with saving and investing without asking them to carry the full burden of retirement planning. Some plan sponsors are concerned that stable value funds may not fit with their new approach to building an effective plan.

For example:

- > Stable value guidelines can prohibit certain types of plan communications. This can make it more challenging for plan sponsors to enact far-reaching plan changes.
- > Some stable value providers are not required to maintain par value in the face of plan events such as re-enrollments. This can make it harder to ensure that all participants benefit from a plan restructuring.
- > Stable value funds' guidelines often restrict plan sponsors from being able to add other guaranteed products to the investment menu.
- > Stable value funds may also increase administrative and governance costs for plan sponsors. Employers are required to report underlying assets in the fund, information about wrap providers, cost and fees, and market value information. These reporting requirements can add substantial costs that are specific to stable value funds.

A Changing Landscape for DC Plans

There may be many reasons to consider reviewing your conservative investments. Rather than one big change in the industry, we believe that a series of small but important shifts have occurred that may require plan sponsors to take a fresh look at their investment options. These include lessons learned from the 2008 financial crisis, ongoing regulatory changes for plan sponsors and changing workforce demographics.

In the financial crisis of 2008, many participants were surprised to see their stable value funds' NAV drop. As a result, some plan sponsors wanted to quickly add new conservative options to their menus, but discovered that some money market funds were closed to new investors because of the market crisis. In a crisis, investors tend to gravitate toward conservative options, making it hard for money market funds to keep up with demand from existing shareholders, let alone new ones. As plan sponsors began to pay more attention to the fine print in their stable value fund wrap contracts, they realized that it would be impossible to liquidate a stable value fund on short notice. Because it's difficult to make changes to your investment lineup quickly, it is prudent to review and update your plan during periods of relatively calm market conditions.

Ongoing regulatory changes may also affect your decision to review your conservative investment options. With new safe harbor rules for qualified default investment alternatives (QDIA), many plan sponsors are now using target date funds rather than stable value as their default investment choice. If your plan no longer uses stable value

funds as a default option, now may be a good time to review your conservative options and the role of each in your plan design and operations. In addition, new legislation will require plan sponsors to more fully disclose plan fees to participants. Further, at some point in the future, financial reform focused on regulating derivatives could result in many stable value funds being closed entirely.

Updating Your Plan: A Roadmap for Plan Sponsors

As a plan sponsor, now may be an ideal time to review the conservative investment options in your plan. Secondly it is important to make deliberate, conscientious decisions about the level of risk present in the conservative options in your investment menu. You may need to reevaluate your goals and in turn reevaluate your investment lineup. As part of this process, it may make sense

to specify how you would like conservative options to perform in a down market and make changes to the investment lineup accordingly by offering your participants a full spectrum of conservative investment opportunities.

Step One:

Set up the conservative options as a category, not a single choice

As Columbia University professor Sheena Iyengar notes in her book, *The Art of Choosing*, having too many choices can overwhelm us, but that problem can be solved by breaking down multiple choices into sensible categories. Consider if restaurant menus listed foods by calories or alphabetically rather than appetizer, main course and dessert. For retirement plan participants, choice framing is expressed in several ways. First, guiding the initial investment decision into three tiers helps people make decisions based on involvement and knowledge base.

FIGURE 2: THREE-TIER INVESTMENT MENU DESIGN



Then, within the second tier, the trend is to further categorize choice under the theme of asset class: conservative/capital preservation, fixed income and equity. This also allows plan sponsors to indicate the risk level associated with each asset class. From here, participants can build their own portfolios based on those categories.

When choosing equity options for your plan, there's a good chance that to provide for portfolio diversification within the stocks category, you offer more choices than simply a large-cap growth fund. You may also have a small-cap, mid-cap and international fund. Similarly, you may need more than one choice for the conservative category on your plan menu. These could include any legacy stable value funds you have, as well as new conservative investment options that you decide to add, such as a Treasury, government or prime money market fund.

Step Two:

Make sure you have a true cash equivalent investment option in your menu

If you only have a stable value fund as a conservative option, we encourage you to consider adding a Treasury money market strategy or other suitable cash equivalent investment choice if possible under your stable value guidelines. This would offer maximum capital preservation to participants. You may also consider offering additional conservative choices with higher yields, such as a short-term Treasury option.

Step Three:

Educate participants about the role of conservative options in retirement planning

Show participants how conservative investing plays a role in their retirement goals. This is an important chapter in the retirement planning story. Illustrate the retirement story across the time horizon and cite situations where conservative investing comes into play, depending on financial goals and needs. This can teach a valuable lesson about the role of conservative investments. When suggesting protection of assets in times of market volatility, remind investors to revisit their goals and needs when markets calm down. After 2008, many investors sought shelter in cash vehicles, but then also missed out on the market recovery.

Possible Communication Themes:

- > Describe how cash is a distinct category that complements stocks and bonds.
- > Discuss some situations in which participants might want to seek capital preservation, such as protecting assets from market fluctuations and preparing to make withdrawals.
- > Explain your conservative investment options to participants in clear, easy-to-understand language.
- > Remind participants to monitor and review all of their holdings, including their cash equivalents.

FIGURE 3: CORE MENU MULTIPLE-INVESTING



Note: If you are not permitted to have cash options on the plan per your stable value agreement, you may need to engage in a dialogue with your wrap provider prior to adding additional conservative investment strategies.

A Proactive Approach to Participant Communications

Effective Participant Communications:

- > Use simple, clear language
- > Layer information with benefits on top, details below
- > Use imagery and narrative creatively to capture attention
- > Include a call to action that drives people to make use of the information

Most participant communications focus on guiding participants to select an appropriate stock/bond mix. However, we believe that bringing cash back into the conversation with participants can help them make investment decisions that are better aligned with their needs and goals. Stronger communications can help participants to use cash in more appropriate ways and help to reduce overallocations. We have developed communications that can help you encourage participants to move from education into action.

Communication Tips For Participants:

Evaluate, choose, monitor and rebalance

- > Evaluate: If you're seeking capital preservation or want to focus more on protecting your account value than growing it, consider a Treasury money market fund.
- > Choose: Understand your needs first. Then select an investment that meets your needs.
- > Monitor: Review the performance of all investments, including cash.
- > Rebalance: You may occasionally need to rebalance your investment portfolio to keep your plan on track. Remember, an investment in a cash fund is not expected to grow at the same rate as a diversified portfolio. Therefore, you may need to save more in order to be adequately prepared for retirement.

Reviewing Your Options

The challenges that plan sponsors face today go beyond those that existed when many DC plans were designed. To meet the needs of DC plan participants more fully, it is important that sponsors ensure that the conservative component of the plan is as complete as other elements within the investment lineup. Equally important is to make sure that participants have a good understanding of—and are capable of choosing from among—these investment options.

We believe that reframing the conservative investments in your plan menu to include Treasury money market strategies and other options outside of stable value broadens the spectrum of choices and improves the opportunity for participants to meet their investment needs.

If you are reevaluating your conservative options, we believe including a Treasury money market option in your search process can help you compare available solutions and more clearly define your

objectives. We encourage you to begin a dialogue within your DC plan benefits committee about the role of conservative investment options in your plan. Specifically, we would recommend that you consider employing our test for principal protection: stability of unsupported asset values and independence from both insurer and corporate solvency.

Opening a dialogue with your benefits committee around ways to enhance your conservative investment category will ensure that you and your participant base will be prepared if volatility returns or if regulations limit your ability to continue offering a stable value fund in the future. Further, reevaluating the conservative options you offer will position your plan to meet the needs of all your investors more effectively, and in the end, ensure that your participants, both young and old, are able to plan for their retirement effectively.

SHORT-TERM FIXED INCOME INVESTMENT OPTIONS

Options	Index	Performance*			Overview
US Short-Term Treasury	Barclays Capital US 1-3 Year Treasury Bond Index	1 Year 1.50%	3 Years 2.34%	5 Years 4.16%	Products benchmarked to this index typically seek to provide current income, follow market value accounting and invest in Treasury securities with maturities between 1 and 3 years.
US Short-Term Government/Credit Bond	Barclays Capital US 1-3 Government/Credit Bond Index	1 Year 1.98%	3 Years 3.03%	5 Years 4.50%	Products benchmarked to this index typically seek to provide current income, follow market value accounting and invest in Treasury securities, US Agency bonds and investment grade corporate bonds with maturities between 1 and 3 years.
US Intermediate Government/Credit Bond	Barclays Capital US Intermediate Government/Credit Bond Index	1 Year 4.36%	3 Years 4.49%	5 Years 5.59%	Products benchmarked to this index typically seek to provide current income, follow market value accounting and invest in Treasury securities, US Agency bonds and investment grade corporate bonds with maturities between 1 and 10 years.

*Average annualized returns of the index as of 2/28/11

Index returns are unmanaged and do not reflect the deduction of fees or expenses. Index returns reflect all items of income, gain, and loss and the reinvestment of dividends and other income.

Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.

The Barclays Capital US 1-3 Year Government/Credit Bond Index includes all public obligations of the US Treasury and all publicly issued debt of the US Government agencies and quasi-federal corporations with maturities ranging from 1 to 3 years. It also includes all publicly issued, fixed-rate, non-convertible, investment grade, US dollar denominated, SEC registered corporate debt with maturities ranging from 1 to 3 years. Barclays Capital US 1-3 Year Treasury Index is an unmanaged index of US Treasury securities with maturities ranging from 1 to 3 years. The Barclays Capital US Intermediate Government/Credit Index is a broad-based, unmanaged index of intermediate investment grade government, corporate and non-corporate (sovereign, supranational, foreign agency and foreign local government) bonds. The Barclays Capital index names are registered trademarks of Barclays Capital, Inc.

Source: Barclays Capital POINT/Global Family of Indices. © 2011 Barclays Capital Inc. Used with permission.

MONEY MARKET INVESTMENT OPTIONS

Options	Index	Performance*			Overview
Treasury Money Market	iMoneyNet Treasury & Repo Institutional Average	1 Year 0.02%	3 Years 0.34%	5 Years 1.98%	Products benchmarked to this index typically seek to maintain \$1 NAV, use amortized cost accounting, invest in Treasury and Treasury repurchase agreement securities, have a weighted average maturity of 60 days or less and seek to maintain daily liquidity.
Government Money Market	iMoneyNet Government Institutional Average	1 Year 0.03%	3 Years 0.56%	5 Years 2.22%	Products benchmarked to this index typically seek to maintain \$1 NAV, use amortized cost accounting, invest in Treasury and Treasury repurchase agreement securities and US Agency debt, have a weighted average maturity of 60 days or less and seek to maintain daily liquidity.
Prime Money Market	iMoneyNet First Tier Institutional	1 Year 0.08%	3 Years 0.79%	5 Years 2.42%	Products benchmarked to this index typically seek to maintain \$1 NAV, use amortized cost accounting, invest in Treasury and Treasury repurchase agreement securities, US Agency bonds, asset-backed securities, investment grade corporate bonds and have a weighted average maturity of 60 days or less and seek to maintain daily liquidity.

*Average annualized returns of the index as of 2/28/11

Index returns are unmanaged and do not reflect the deduction of fees or expenses. Index returns reflect all items of income, gain, and loss and the reinvestment of dividends and other income.

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iMoneyNet Treasury & Repo Institutional Index includes only institutional government funds that hold US Treasuries and repurchase agreements backed by the US Treasury. One cannot invest directly in an average or an Index.

iMoneyNet First Tier Institutional Index includes only non-governmental institutional funds that are also not holding any second-tier securities. Portfolio holdings of first-tier funds include US Treasury, US Other, Repos, Time Deposits, Domestic Bank Obligations, Foreign Bank Obligations, First Tier CP, Floating Rate Notes and Asset Backed Commercial paper. One cannot invest directly in an average or an Index.

iMoneyNet Government Institutional Index includes institutional government funds that may invest in US Treasuries, US Agencies, repurchase agreements and government-backed floating rate notes. This category is composed of all funds in the Treasury Institutional, Treasury & Repo Institutional, and Government & Agencies Institutional categories. One cannot invest directly in an average or an Index.

State Street Global Advisors

State Street Global Advisors (SSgA) is a global leader in asset management, entrusted with more than \$2.1 trillion* in assets. As one of the premier managers for US defined contribution plans, SSgA has more than 30 years of experience in the DC market with over \$205 billion in global DC assets. DC clients rely on SSgA to provide a powerful, global investment platform that offers access to every major asset class, capitalization range and style, including low-cost index funds, a suite of QDIA-eligible target date and balanced funds, and distinct DC share classes. Beyond investment solutions, SSgA provides a dedicated DC client engagement team that assists you with the onboarding process and participant communications to deliver client-focused solutions.

*This AUM includes the assets of the SPDR Gold Trust (approx. \$58 billion as of June 30, 2011), for which State Street Global Markets, LLC, an affiliate of State Street Global Advisors, serves as the marketing agent.

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The views expressed in this material are the views of SSgA Defined Contribution and Cash Groups through the period ended March 31, 2011, and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance.

Although bonds generally present less short-term risk and volatility risk than stocks, bonds contain interest rate risks; the risk of issuer default; issuer credit risk; liquidity risk; and inflation risk. Risk associated with equity investing include stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions.

Investments in mid-sized companies may involve greater risks than in those of larger, better known companies, but may be less volatile than investments in smaller companies.

Investments in small-sized companies may involve greater risks than in those of larger, better known companies.

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Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

State Street Global Advisors is the investment management business of State Street Corporation (NYSE: STT), one of the world's leading providers of financial services to institutional investors.