Public Employees' Retirement Board
March 5, 2013

Topic: **Stable Value RFP reconsideration**

Discussion:

Discussions with state procurement regarding contract requirements under the procurement process as well as the existing evergreen clause in the current stable value contract have added complexities to the RFP process.

Exhibits:

PIMCO Presentation documents

Staff Recommendation:

Do not post an RFP for the Stable Value Fund.

Direct PIMCO as our QPAM meet the following goals:

1. Board wishes to maintain ownership of existing plan assets
2. Negotiate wrap contract with optimally one wrap provider, or more as necessary. Ensure that any wrap contract terms are negotiated to allow MPERA to terminate the contract with notice.
3. Negotiate improved investment guidelines with wrap provider(s) to optimize crediting rate.
4. Maintain PIMCO as investment manager to the greatest extent possible.

Board Motion:

☐ Uphold Staff Recommendation

☐ Other.

____

____

____

____
Moved by

____
Seconded by

____
Vote

RFP Discussion Items:

- **State Procurement**: Requires that all contracts issued under the RFP process expire at the end of 7 years. MPERA worked very hard in the past to remove investments from the RFP process.

- **Transamerica Contract**: The current "Evergreen Clause" in the Transamerica/Aegon contract is unusual in the stable value environment and appears to be a result of Procurement's past requirement to have a contract expiration date within the state contract.

  Most wrap contracts typically have terms that allow the termination of the wrap provider, with notice, at the contract holder's option. The typical result is the contract terminates, the contract holder retains the assets (at market value), and nothing is owed to the issuer other than accrued but unpaid fees. Notice periods vary, but are usually not longer than 30 days. This preferred type of contractual term effectively gives MPERA the right to terminate the contract at any time within the notice period.

- As our QPAM PIMCO has the authority to negotiate new wrap contracts on our behalf, outside of the state procurement process.

Stable Value Concerns:

- Transamerica continues to push to change the current structure.
  - They wish to reduce their exposure to our contract to 33%
  - Implement a cash buffer (approx. 4-5% of total portfolio). This cash buffer would sit outside of the wrap contract – would not be wrapped – to facilitate daily trade transactions.
  - Renegotiate contract and guidelines – DC and 457 become one fund/with one wrap contract. Plan and participant assets would continue to be accounted for separately.

Stable Value Options:

- Maintain current structure (no cash buffer) and replace Transamerica with a new, sole wrap provider.
  - Risk: Could take time. Transamerica could terminate contract.

  - Disadvantage: Maintain single issuer risk, may require movement of asset to a different manager due to wrap requirements.

  - Advantage: No change in current structure or process and maintains current quarter crediting rate reset.

- Create a single stable value Separate account under the Group Trust.

  - Risk: No quarterly declared rate, guidelines will change. GW and SSKC roles will change.
  - Disadvantage: Uses a cash buffer, may require some funds to transfer to different manager, and may require multiple fixed income portfolios.
  - Advantage: Currently the most common stable value structure, wrap issuer diversification, new wrap issuers like this structure, easy to hire, renegotiate or fire wrap issuers, operates more efficiently.

PIMCO

Your Global Investment Authority

MPERA call on stable value options

15 February 2013

Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660, 949-720-6000

This material is to be used for one-on-one separate account presentations to institutional investors and not for any other purpose.

For Institutional Investor Use Only

A company of Allianz

MPERA objectives

- Maintain plan ownership of assets (i.e., wraps only, no insurance contracts)
- Preference for a single wrap provider, but open to more
- No cash buffer and, if required, minimize impact within wrap(s)
- Seek improved guidelines to optimize crediting rate
- Prefer to maximize PIMCO investment management
- Improve processes and increase efficiencies regarding fund administration
  - Calculation and reconciliation of crediting rate

Additional considerations

- Priorities regarding:
  1. Fund/plan structure
  2. Wrap provider(s) and type of coverage
  3. Investment management

- Transamerica's requirements to maintain capacity
  – Hire stable value manager (complete)
  – Reduce exposure to ~33%
  – Implement a cash buffer
  – Renegotiate contract and guidelines

- Alternative wrap capacity may have no, similar, additional, or more restrictive requirements

- All solutions and structures have trade-offs

Discussed but dismissed options

1. Maintain current structure with Transamerica	⟶	▪ Not acceptable to Transamerica
2. Replace Transamerica with an insurance company stable value fund	⟶	▪ Not a wrap ▪ Will lose all PIMCO management
3. Add new wrappers / cash buffer (if required) but keep current operational and administrative processes and overall structure	⟶	▪ Current operational inefficiencies increase and complexities multiply making this extremely difficult to administer ▪ May lose some PIMCO management
4. Consider different options for the 401(a) vs. 457 (i.e., 401(a) invests in a stable value commingled investment trust)	⟶	▪ State restrictions regarding investments

Remaining options for consideration

Option	Uncertainties	Disadvantages	Advantages
1. Maintain current structure & Replace Transamerica with a single wrapper	• May take time during which Transamerica may terminate • Guidelines will change	• Maintain single issuer risk • May lose some / all of PIMCO management • Current operational inefficiencies continue • Roles of service providers unchanged	• No change to the current structure or process • Likely maintain a quarterly declared rate
2. Unify separate plans into single fund under the Trust, Hire one or more wrap issuers	• Guidelines will change • Operational and service providers have to adapt to new roles and responsibilities • No quarterly declared rate – MPERA/PIMCO would calculate	• Uses a cash buffer • May lose some PIMCO management • May require multiple fixed income portfolios	• Most common stable value investment structure • Improved issuer diversification • New wrap issuers likely to prefer this portfolio structure • Easier to hire, re-negotiate, or fire wrap issuers or restructure fixed income portfolios / managers • Operationally more efficient • Roles of service providers normalized to appropriate responsibilities

Appendix

Timeline of developments in the stable value market

Pre – 2008	2008–2009	2010 – Today
▪ Ample wrap capacity available for qualified plans via banks, insurance companies, and other financial institutions ▪ 30-year bull market in rates perhaps lulls some contract providers to underestimate tail-risk of product ▪ Single digit wrap fees ▪ Less demand for insurance company traditional and separate account GICs ▪ Most wrap guidelines were less strict; some included HY, EM, and other non-USD debt	▪ Volatile markets caused many market-to-book ratios to fall below 90% as well as large "flight-to-quality" to stable value by participants ▪ Some wrap providers desired to reduce book or leave marketplace entirely ▪ Most wrap providers sought to de-risk and de-lever wrapped assets: providers began negotiating changes to fees, guidelines, and contract terms ▪ If providers are unable to successfully re-negotiate, they often refuse plan amendments or changes ▪ Wrap providers' attention focused on "problem" managers ▪ New capacity demand filled by insurance company separate accounts, "wrap" of affiliated managers, or insurance GACs ▪ Portfolios began to recover in 2009 with improving market-to-book ratios	▪ Stabilization of the financial markets ▪ Many participants continue to favor stable value, especially in a low interest rate and volatile equity environment ▪ Many stable value funds are experiencing restructuring (contracts and bond strategies) ▪ Providers are re-focusing on their broader book of business – managing risk via contract changes or reductions in exposure to "outliers" ▪ Underwriting standards are stricter and providers want more frequent delivery of underwriting data for plans ▪ New wrap capacity entering the market but demand still exceeds supply

For illustrative purposes only

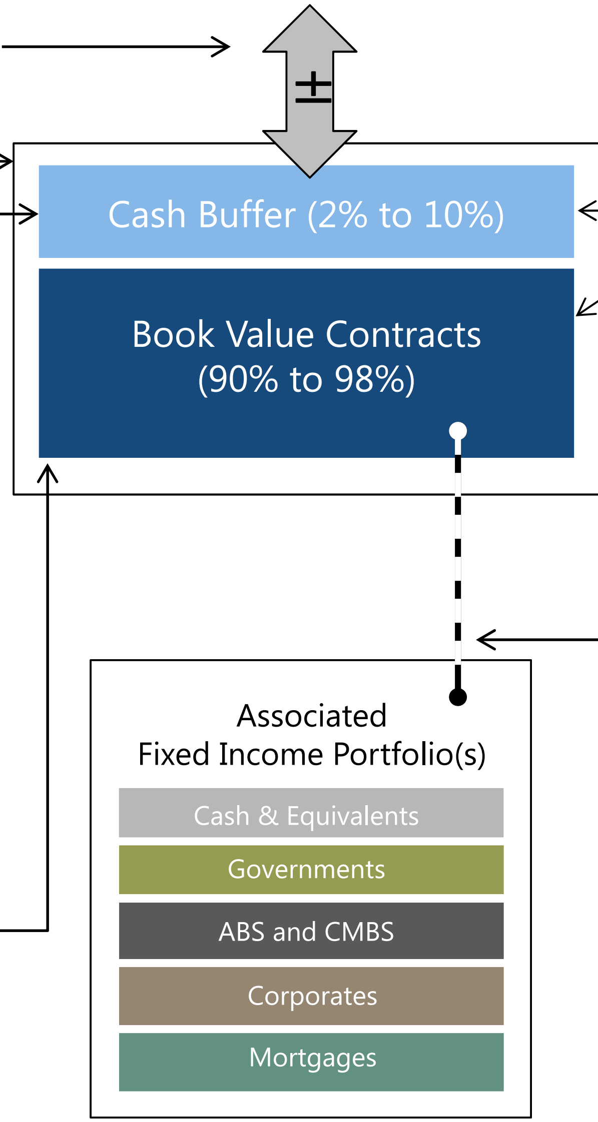
What does a typical stable value fund look like?

1. Net daily participant cash flow from all plans participating in the master trust flows into or out of the Fund as executed by custodian* at direction of the recordkeeper* -- cash flows occur through the Cash Buffer

2. Custodian will have a "valuation account" that sums to the total value of the Fund and total owed to investors on any given day

   a. A liquidity buffer to provide day-to-day cash availability for participant activity – typically a STIF offered by the custodian. This structure is partly risk management and partly to 'buffer' the book value contracts from the operational costs of tracking daily flows.

   b. Three to six stable value investment contracts
      — Wrap contracts
      — Insurance separate accounts



4. The Stable Value Manager will typically direct the Custodian to rebalance allocations *within the Fund* between the Cash Buffer and the Book Value Contracts / Fixed Income Investments
   – Within the Fund a transfer is directed into/out of the Associated Fixed Income

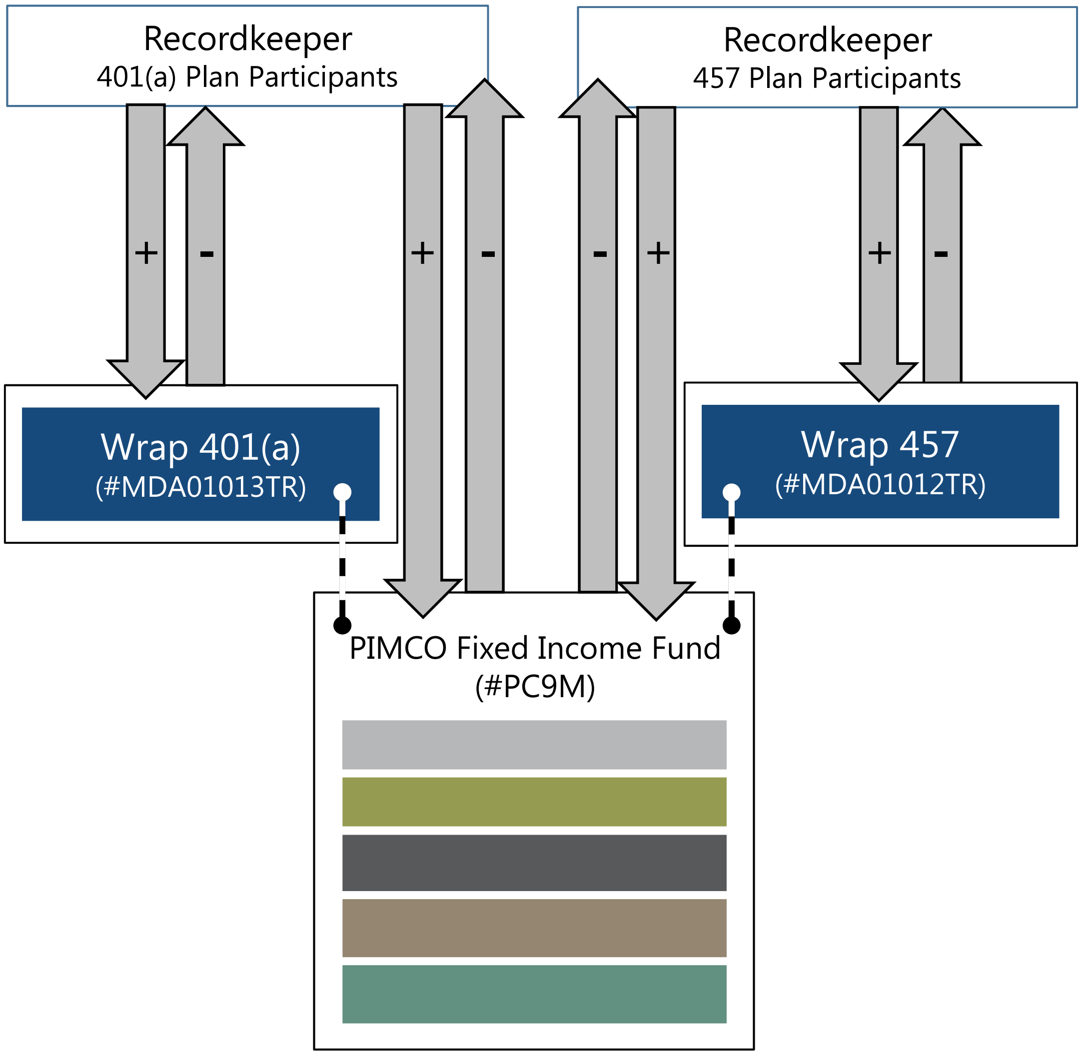
3. Each contract is "linked" with one or more "wrapped" fixed income portfolio
   – Diversified, investment grade fixed income investments
   – 2.5 to 3.5 year average duration
   – Important – these portfolios are not used to daily value the Fund

For illustrative purposes only.

* The recordkeeper tracks participant ownership and aggregates and directs participant activity. The custodian sends/receives balances as instructed, values the Fund (if it is a separate account), and tracks and settles transactions within the Fund.

What does the MPERA "fund" look like?

Two options (i.e., two separate contracts) with one fixed income portfolio



- Each plan owns its own wrap separately
- Each plan invests in the same pool of fixed income assets
  - One PIMCO fixed income account (#PC9M) associated with two wraps
- Daily participant flows in both plans are deposited or withdrawn directly to #PC9M
  - Great West notifies State Street
  - State Street notifies Transamerica and PIMCO about daily activity
- Daily participant cash flow is tracked via eight (8) daily numbers
  - Net cash flow in and out per each plan
  - Net cash flow in and out of the PIMCO fund for each plan
- Great West (as recordkeeper) and not State Street (as custodian) tracks book value accounting related to the Transamerica contracts
  - Daily cash flow results in changes to the wrap contract values on a daily basis

For illustrative purposes only. Information provided is based on PIMCO observations. This illustration is not representative of any specific stable value fund and actual allocations and characteristics will vary.

Transamerica requests post-2008 investment crisis

Transamerica

1. Montana engages a professional stable value manager
2. Reduce Transamerica outstanding book value exposure to MPERA to 33%
3. Implement a Cash Buffer to capture daily participant flows
4. Given 2 & 3, unify the separate plans (401a and 457 plans) into a single fund under the Trust
5. Discuss updating the contract and guidelines

Previously discussed objectives for PIMCO / Montana

1. Agreed to begin implementing Transamerica requests
2. Revise the Contract to remove the “Termination” as of 12/31/12
   - ➢ Extend termination to 12/31/13
   - ➢ Eventually remove to make contract a standard “evergreen” or “constant maturity” contract
3. Provide flexibility on timing and overall wrap percentage given capacity constraints in the wrap market
   - ➢ For example, move initially to 66% and not 33% Montana SV Fund exposure
4. Longer-term, consider replacing Transamerica capacity if better contracts available