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CORRESPONDENCE MEMORANDUM

DATE: February 15, 2011

TO: Wisconsin Deferred Compensation Board

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Stable Value Fund Equity Wash Expansion

This memo is for informational purposes only. No Board action is required at this time.

As of March 31, 2011, the ninety-day equity wash provision required by the Wisconsin Deferred Compensation Program's Stable Value Fund will be expanded to include the Schwab Personal Choice Retirement Account (PCRA). This is in addition to the three funds already subject to the equity wash restriction: the Vanguard Admiral Treasury Money Market Fund, the FDIC Bank Option and the Federated U.S. Government Securities Fund.

"Equity wash" generally refers to restrictions that prevent participants from being able to transfer funds out of a stable value fund into what is considered a "like" or competing investment. Instead, funds must first be invested in equities and thus exposed to market risk for a period of time, usually ninety days. Equity wash requirements are intended to minimize arbitrage, which negatively impacts those participants who choose to remain in the stable value fund.

The attached January 10, 2011, memo from Mike Norman at Galliard Capital Management provides a very brief explanation why the Stable Value Fund's equity wash transfer limitations are expanding to include the Schwab PCRA. As was mentioned at the Board's December 2011 meeting, since the market decline many stable value fund wrap providers have begun to look at self directed brokerage windows and mutual fund windows as competing funds to the stable value options in deferred compensation plans. The newest wrap provider for the WDC's Stable Value Fund, ING, is requiring the equity wash expansion.

The Investment Committee discussed Mr. Norman's memo on the expansion of the equity wash at its meeting on February 10, 2011 and had three questions for Galliard. Mr. Norman's February 15, 2011 memo includes his responses to the questions.

Staff from Galliard and the Department will be available to discuss this with you at the Board meeting on March 1, 2011.

Attachments: January 10, 2011, Galliard memo on equity wash expansion
February 15, 2011 Galliard follow-up memo

Reviewed and approved by Anne Boudreau, Deputy Division Administrator, Division of Retirement Services

Signature _______________ Date 02-16-2011

Board	Mtg Date	Item #
DC	03.01.11	10

Galliard Capital Management
www.Galliard.com

January 10, 2011

Ms. Shelly Schueller
Wisconsin Department of Employee Trust Funds
Via email

RE: Equity wash provisions for stable value options

Dear Shelly:

Book value contract providers to your stable value fund require certain transfer limitations to be established, in the event the plan has what are deemed "competing funds" in the investment line-up. The transfer limitation, commonly known as a "90 day equity wash", means that if a participant wants to transfer assets from the stable value fund to a competing fund, they must first transfer it to a non-competing fund for 90 days. Book value contract providers require this transfer restriction in order to help manage unexpected interest rate arbitrage during times of rapidly rising short term interest rates. This provision also helps to protect stable value fund holders who remain in the fund (it helps to limit the amount of sales of the underlying portfolio that may need to be done in an adverse [rising interest rate] bond environment).

The definition of a "competing option" is currently 1) a high quality fixed income option with a duration of 3 years or less; 2) a blended option (i.e. target date, asset allocation, lifestyle fund, etc.) that has an allocation of 70% or more to a high quality fixed income option with a duration of 3 years or less; and 3) a self directed brokerage option. The self directed brokerage option is included because participants have the ability to potentially invest in a competing fund through that window. The definition of a competing is subject to change. In the event the definition evolves we will work with you to make sure you are aware of the changes.

Thank you for your help in implementing the equity wash for the self directed brokerage option. If I can answer any questions, please let me know.

Sincerely,

Mike Norman
Principal
612.667.3219

Galliard Capital Management
www.Galliard.com

February 15, 2011

Ms. Shelly Schueller
Wisconsin Department of Employee Trust Funds
Via email

RE: Follow-up questions to the equity wash provision for participant transfers from stable value

Dear Shelly:

Thank you for discussing with the Committee the equity wash rules for transfers from stable value to the self directed brokerage option. You had a few follow up questions. My responses can be found below.

Questions:

1) What is "high quality" as used in the first line of the second paragraph (fixed income options, 3 yrs or less)

"High Quality" is typical construed as funds that have an average credit quality of "A" or above. Occasionally we will see a short duration fixed income option that focuses on high yield investments (Bonds that are rated below BBB-) and those historically have not been treated as a competing option.

2) Where do money market funds fit -- are they considered fixed income products as well?

Yes, money market funds are considered competing options – in fact they are the usual option that a plan may have in place that is considered competing.

3) "Why does it matter where [the funds] go [I think meaning a competing option or elsewhere] as long as they are held 90 days?"

The 90 day equity was provision is in place to prevent arbitrage of rates. The question above is valid – it does not matter where the funds are transferred, but more important it's the ability to make an immediate transfer from the stable value fund in order to chase (or arbitrage) interest rates. The theory is that if you have two fixed income options in a plan (let's say a money market fund and a stable value fund), the wrap providers require the 90 day equity wash for transfers to the competing option to protect the stable value fund from participants trying to time rates. For instance, assume there was a rapidly rising interest rate environment where all of a sudden short term interest rates spiked and now money market rates were over the stable value fund yield. If participant were able to directly go to the money market fund, the stable value fund may need to sell securities to meet those transfer requests. Assuming a lot of participants were doing this transfer, the stable value fund may be forced to sell some of the underlying bonds in the portfolio in order to meet the liquidity needs. Because of the rapidly rising rates, we may be forced to sell those bonds at a loss (remember the price of bonds is inversely related to it's yield – when interest rates rise rapidly, the bonds you hold are typically worth less because you can now get bonds at a higher rate). Because those bonds were sold at a loss, the losses will eventually affect the stable value fund's yield (it will go down as the fund amortizes those losses). The equity wash provision is in place to help mitigate the potential impact to the fund that may result from participants trying to immediately arbitrage those rates. Inverted yield curves (where short term rates are higher than long term rates) are pretty uncommon and typically don't last very long. The equity wash provision helps minimize the issue of "hot" money, where participants trade back and forth. The wrap providers require the 90 day transfer restriction because they are looking to minimize any impact to them (remember, the wrap contracts will make up the difference between the market value of the security sold and the book value which participants trade at). Finally, the equity wash provision is also in place to protect remaining stable value fund holders

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from other participants that may be trying to chase the yield – as I described above, if participants are chasing yield and trying to time rates, the fund holders that are staying in the stable value fund for the long haul bear the impact of those participants trying to jump in and out. The 90 day wait period is in place to help minimize any effects on participants that remain in the fund through the cycle.

If we can get you any other information, please let me know. I'm looking forward to seeing you and the Committee in March.

Sincerely,

Mike Norman
Senior Principal