Securities Lending in US DC Funds

What to Look For

Securities lending has become a focal point in the fiercely competitive investment management industry. A well-managed lending program can provide a fund with precious additional returns. However, complexity and a lack of transparency can make an objective comparison among programs difficult to achieve.

Asset owners and their consultants should understand and evaluate three key dimensions when comparing asset managers' securities lending programs. Use these questions to ensure you can make an "apples to apples" comparison and determine the lending program most suited to your investment objectives.

Returns	Securities lending returns are relatively straightforward to assess. Generally, returns are expressed in basis points and represent the net annual lending return to the fund divided by net assets in the fund. However, as with most investments, returns often reflect risk in the program, and should be considered along with the objectives and risk tolerances of the program. It is important to confirm that return figures provided are net of all costs and fee splits, and are provided relative to total fund assets.	Questions to ask: 1. Are the returns indicated net of all fees? Are the returns expressed relative to total fund assets? 2. Is the program focused on intrinsic value of securities lending, or enhancing returns with aggressive reinvestment guidelines? 3. Does the fund benefit from preferential withholding rates for retirement funds on foreign dividends?
Risk Management	The risks associated with a securities lending program can be complex to identify and measure. Investors should understand and consider three primary types of risk associated with securities lending: 1. **Reinvestment risk** derives from the reinvestment of cash collateral received to secure a loan. 2. **Borrower default risk** derives from a borrower's inability to return securities in accordance with agreed terms. 3. **Operational risk** derives from the increased transaction volumes and management complexity associated with a lending program.	Questions to ask: 1. Do your collateral reinvestment funds adhere to quality, maturity and diversification requirements set forth in Rule 2a-7? 2. What are the maximum weighted average life (WAL) and weighted average maturity (WAM), and other liquidity guidelines for the collateral reinvestment pools? What are the credit quality guidelines and permissible instruments for the reinvestment pool? 3. Do you accept non-cash collateral? What types of non-cash collateral do you accept? 4. Is there borrower default indemnification? What entity provides it? 5. Do you have dynamic lending limits at the fund and position level? What determines those limits?

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Costs	There can be significant costs associated with managing a securities lending program, and it is important to understand where the costs are borne, and who is receiving compensation. While the "fee split" is often the headline expense communicated by an investment manager, there are many ways this fee can be calculated. Additionally, the "fee split" may not be the only expense paid in a lending program. There are often fees embedded within the cash reinvestment pool, or additional operational or administrative fees applied to the program either by the lending agent or the lending fund manager. This all needs to be understood to make an informed decision regarding a securities lending program.	Questions to ask: 1. What is the fee split with the lending agent? Are there other fees charged to the lending program? 2. Are all transactional costs borne by the lending agent? Does the lending fund manager charge any additional fees? 3. What are the total expenses of the cash collateral reinvestment vehicle? 4. Does the lending fund manager (or an affiliate) benefit from the fees charged to the reinvestment fund? 5. Are there any conflicts of interest inherent in the lending program?

Look to State Street Global Advisors

Combining the scale and experience of one of the largest asset managers in the world with a business practice that promotes transparency in fees and returns, State Street is proud to provide securities lending capabilities designed to align our investment solutions with the best interests of our clients.

For more information about our range of solutions and a copy of our securities lending white paper, contact your State Street relationship executive.

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Important Information:

Investing involves risk including the risk of loss of principal.

Securities lending programs and the subsequent reinvestment of the posted collateral are subject to a number of risks, including the risk that the value of the investments held in the collateral may decline in value and may at any point be worth less than the original cost of that investment. The value of the debt securities may increase or decrease as a result of the following: market fluctuations, increases in interest rates, inability of issuers to repay principal and interest or illiquidity in the debt securities markets; the risk of low rates of return due to reinvestment of securities during periods of falling interest rates or repayment by issuers with higher coupon or interest rates; and/or the risk of low income due to falling interest rates. To the extent that interest rates rise, certain underlying obligations may be paid off substantially slower than originally anticipated and the value of those securities may fall sharply. This may result in a reduction in income from debt securities income.

The information provided does not constitute investment advice and it should not be relied on as such.

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