

MARKET MONITOR

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BRETT HAMMOND
CHIEF INVESTMENT
STRATEGIST

LEO KAMP
CHIEF ECONOMIST

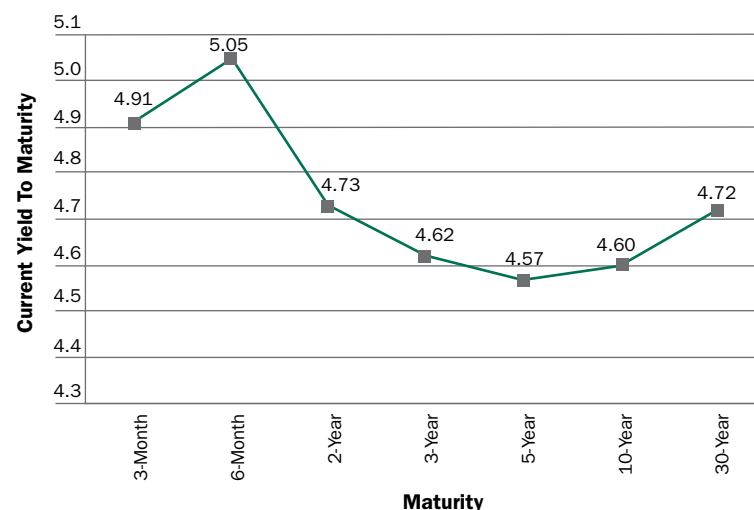
DOUGLAS FORE
DIRECTOR OF PORTFOLIO
ANALYTICS

Interest Rates and the TIAA Payout Dividends

Last week, it was no surprise that the Federal Reserve Board decided to keep the Fed funds rate—the shortest-term interest rate—steady at 5.25%. More unusual, as illustrated in the graph, the Treasury yield curve is at present slightly inverted. Each U.S. Treasury security has a set maturity date and a current market-determined yield-to-maturity. Together, these points form a yield curve running from short-dated bills to long-dated bonds.

- Why is the yield curve inverted right now?
- What does it mean for longer-term investors?
- Are there special implications for traditional annuity investors?

U.S. TREASURY YIELD CURVE 12/18/06



Source: Bloomberg



Most of the time, the Treasury yield curve slopes upward. Investors in longer-term Treasuries face more uncertainty about inflation and real returns than investors in shorter-term Treasuries, so they usually demand a higher yield to compensate them for taking the extra risk. Right now the yield curve slopes downward and, except for the very longest maturities, longer-dated Treasuries have lower yields than shorter-dated Treasuries. In effect, investors aren't being compensated for the extra uncertainty of owning longer-dated securities. This unusual yield curve inversion can challenge investors to sort out the implications for the behavior and attractiveness of various fixed-income investments, including money market funds, bond funds, and more traditional annuities.

There are a number of reasons that the U.S. Treasury yield curve can slope downward instead of upward. At the short end of the curve, the Federal Reserve Board raised the overnight fund rate starting in 2003 from 1.0% to today's 5.25%. Other short-term interest rates or yields were naturally affected by the Fed's actions and rose along with the overnight rate.

Often, Fed actions at the short end can affect longer-term yields, but at present the effect is modest. How could this be? Perhaps the most important reason is that foreigners are still interested in a safe investment haven for recycling dollars they earn as a result of the current U.S. trade imbalance where we are importing more goods and services than we are exporting. As we know, the trade imbalance with China is particularly acute and China is a leader in the international market for U.S. Treasury bonds. But China isn't the only Treasury bond buyer and, with demand for bonds remaining high, the prices investors are willing to pay remains relatively high, thus pushing down bond yields. In addition, inflation fears remain low. So while short-term yields are around 5%, heightened demand by foreigners and low inflation expectations are keeping longer-term yields between 4.50% and 4.75%.

What does the inverted yield curve mean for investors? First, money market funds invest in highly liquid, short-dated fixed-income securities and some of them are paying higher returns than some fixed-income funds that typically hold longer-dated bonds. Investors have

noticed the difference and, according to the Investment Company Institute, asset flows to money market funds have increased. However, in the past, yield curve inversions haven't lasted and we don't expect this one to become permanent either because of the fundamental principle that long-term investments usually have higher yields than short-term investments.

Second, since corporate bonds are heavily influenced by movements in the Treasury curve, yields on all bonds are low right now compared to historical averages. But it is possible that yields will increase at some point over the next year or two. Since bond mutual funds are marked to market every day, rises in bond yields are translated into a decline in bond prices. If that happens, then the returns on bond mutual funds could moderate.

A third implication for investors has to do with more traditional insurance products, such as fixed annuities. The prices of securities held by fixed annuities, unlike bond funds, aren't market to market. Instead, the performance of the annuity account is a direct function of the yields on the securities it holds. So in the current environment, new premiums or contributions are being invested in longer-term securities that in many instances are paying less than what those premiums would have earned a few years ago. Consider, for example, that mortgage rates are lower today than several years ago and so yields on mortgage bonds held in a fixed annuity account will be somewhat lower today as well.

The result is that the new money crediting rate for the TIAA Traditional Annuity, which holds very long-term investments, is 5.25%, a little above the current yield on the CREF Money Market Account. The TIAA Supplemental Retirement (SRA) Annuity new money crediting rate is 4.50%, a little lower than current yield on the Money Market Account.

Under these circumstances it might seem advantageous to transfer all assets from fixed annuities to a short-maturity money market or bond fund. However, most fixed-annuity investors aren't just investing at the new money crediting rate. They may also have previous contributions that were invested when assets had higher yields than they do now. One way TIAA-CREF participants can check this is to look

at the current value of their TIAA Traditional or SRA Account and compare it with last year's value. After subtracting out contributions during that period it is possible to roughly estimate the total return of the participant's account.

Similarly, in a low long-term interest rate environment, retirement income for a fixed annuity depends in part on the prevailing yields when the original premiums were invested, but only in part. For 2007, TIAA life annuity monthly income for the standard payout method will remain the same as in 2006. So even though long-term yields aren't rising, monthly income is remaining steady.

As we can see, the effects of an inverted yield curve on investors are not always straightforward, since the additional effects of time and previous investments play a role in the returns an investor experiences. So investors should consider carefully their actions in light of current circumstances, including previous investments that may be enjoying higher yields. In a subsequent Market Monitor, we will examine another key element of the current environment, namely the relatively low spreads (yields in excess of U.S. Treasuries) that other fixed-income investments are experiencing.

The TIAA Traditional Annuity is a guaranteed fixed annuity account, guaranteeing principal and a contractually specified interest rate, based on TIAA's claims-paying ability.

The CREF Money Market account is neither insured nor guaranteed by the Federal Deposit Insurance Corp. or any other U.S. government agency.

TIAA-CREF is a national financial services organization and the leading provider of retirement services in the academic, research, medical and cultural fields with more than \$390 billion in combined assets under management (9/30/06). Further information can be found at www.tiaa-cref.org.

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Brett Hammond, Leo Kamp and Douglas Fore are available to comment on economic data. If you wish to speak with them, please contact Chad Peterson, Media Relations, 212-916-4808 or email cpeterson@tiaa-cref.org.

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