



June 2005

Asset / Liability Scoreboard

Index	Returns YTD 2005	Estimated Weights
Liabilities :		
Market (Treasury STRIPS)	11.09 %	100 %
Pension Act (Corporates)	5.53	
ROA (8% constant rate)	4.00	
Assets :		
Ryan Cash	1.28 %	5 %
Lehman Aggregate	2.52	30
S&P 500	-0.82	60
MSCI EAFE Int'l	-0.85	5
Asset Allocation Model	0.31 %	100 %
Assets – Liabilities		
Market	-10.78%	
Pension Bill	-4.22	
ROA	-3.69	

Pension liabilities outgrew pension assets by about 1.78% in June (2.11% vs. 0.33%) widening the Asset/Liability deficit for the year 2005 to **-10.78%** using market valuations (i.e. STRIPS); by **-4.22%** using the new Pension Act valuation (moving average of three corporate indexes with a duration of 12 years); and by **-3.69%** using the ASOP 27 methodology of a constant ROA (i.e. 8.00%). This year is proof evident that if you do not price Liabilities using the STRIPS yield curve you can not capture the true interest rate sensitivity of Liabilities since they are a yield curve of long duration payments. **Coupon corporate bonds do not have durations longer than 16 years so they could never price long liabilities !** Moreover, the Pension Equity Act of 2004 uses one single discount rate which does not capture the always changing shape of the yield curve. As a result, the growth rate difference of pricing pension Liabilities at the market (i.e. STRIPS) vs. the Pension Act version is significant (11.09% vs. 4.51% = 7.00%). Most pension funds enjoyed a funded ratio surplus in 1999. However, this **funded ratio has been reduced by about -50% since 1999** (see table below).

Total Returns						
	2000	2001	2002	2003	2004	2005
Pension Assets	- 2.50	- 5.40	-11.41	20.04	8.92	0.31
Pension Liabilities	25.96	3.08	19.47	1.96	9.35	11.09
Difference	-28.46	- 8.48	-30.89	18.08	-0.43	-10.78
Cumulative		-34.53	-54.75	- 46.57	-46.80	-52.54

God Bless Pension America !

Northwest Airlines Might Crash ?

Rumors were spreading in June from a Wall Street article indicating that Northwest Airlines is near bankruptcy. Andrea Fischer Newman, Senior VP of Government affairs is seeking time from Congress to close their pension funding gap estimated at \$3.8 billion from five years to 25 years. At the same time Gary Wilson, Northwest's chairman, sold nearly 60% of his holdings since mid-May. Then the Aircraft Mechanics Fraternal Association has authorized a strike in response to Northwest's attempt to cut labor costs by \$1.1 billion. Union members have until 10 a.m. on July 19 to cast their votes. NWA stock fell 25% in June.

What Asset Class Grew 20% this Year ?

Would you believe long Treasury STRIPS did? Fed Chairman Greenspan called it a “**conundrum**” wherein **short rates went up @90 bp** and **long rates went down @50 bp** on nominals while long STRIPS witnessed rates going down @90 bp. This conundrum produced returns of @20% on long STRIPS year to date based on the **Ryan STRIP Index series** :

15 year Ryan STRIPS Index = 12.03%
20 year Ryan STRIPS Index = 17.78%
25 year Ryan STRIPS Index = 23.48%

As a result, if long STRIPS did 20% returns, **what growth rate did long liabilities have in 2005 ... 20%**

Note – When STRIPS were born in March 1985, Ron Ryan and his team created the **1st STRIPS Index series** for each annual constant maturity series (1 thru 30 years) plus a composite index. **This Index is the most thorough risk/reward calculation of interest rate sensitivity in the market today.** Ron Ryan is the owner of the STRIPS Index series.

Senate Budget Committee Hearing on PBGC

On June 15, there was a Senate hearing on the Solvency of the PBGC. Eight senators were in attendance with Senator Judd Gregg of New Hampshire as the chairman. Brad Belt, Executive Director of the PBGC and Dr. Doug Holtz-Eakin, Director of the Congressional Budget Office fielded the inquiry. Many insightful comments were made such as :

1. The need for **Transparency**, didn't we learn from the S&L crisis.
2. There should be no **Benefit** increases if you are in a deficit position
3. **Contribution** limits need to be increased
4. **Bankruptcy** laws must be changed so pension obligations can not be shed
5. **PBGC** needs to enforce liens

Chairman Gregg and Brad Belt were most eloquent in describing how pensions should be viewed as an Insurance Asset/Liability Management approach but with accurate market valuations. To read and see the entire two hour hearing, go to :

www.Senate.gov/~budget/republican/hearing_schedule_and_testi.html

Pension Ideas

I. Pension Problems :

A detailed review of key pension problems can be found on our web site www.RyanALM.com under **Research / The PENSION CRISIS :**

Problems :

- 1. Discount Rate** = Wrong rate(s) creates wrong present values
- 2. Smoothing** = Distorts / Overstates market values by about 29%
- 3. ROA** = Dictates Asset Allocation and Discount Rate for Public Funds.

Pension Solutions :

- 1. Custom Liability Index** = **No two pension liabilities are alike. Only a Custom Liability Index could accurately represent the true pension objective.**
- 2. Liability Index Fund** = **Buy Time ! ... thru a term structure and duration matched portfolio that out yields liabilities + matches the interest rate sensitivity.**
- 3. PALS** = **Portable Alpha Liability Strategy.**

II. The Quest for Alpha

Alpha is the excess return above a benchmark. But... **What is Alpha for a Pension Fund?**

It is certainly not excess returns above a **generic** market index benchmark. If you outperform a market index but lose to liabilities, did you win or lose?...**you LOST !** Did you earn Alpha? ...of course not ! The best equity managers in 2000-2002 lost big time to the spectacular growth of pension liabilities for those years :

	2000	2001	2002	Cumulative
S&P 500	- 9.09	- 11.86	- 22.08	- 37.51%
Pension Liabilities	25.96	3.08	19.47	55.12
Difference	- 35.05	- 14.94	- 41.55	- 92.63

III. Portable Alpha

Portable Alpha strategies should be liability driven since that is their true objective. Instead, most Alpha portfolios are given benchmarks different than liabilities and most Beta portfolios have poor correlation to pension liabilities (not matched). Ryan ALM designed our CORE product "**PALS**" as a Portable Alpha Liability Strategy with a heavy allocation to non-bond assets (i.e. Equity, Real Estate, etc.). **Our Alpha portfolio mission is to cure the pension deficit by outperforming target liabilities (Alpha) over a time horizon equal to the liability payment dates.** Based on a Custom Liability Index we build for each client, we know the total return of the target liabilities we are managing to and ultimately funding. When we have achieved the client goal (i.e. full funding) we **port over to the Beta portfolio to match liabilities and secure the victory !**

IV. Custom Liability Index

Ryan ALM provides accurate daily pricing and valuation of pension liabilities through the creation of a **Custom Liability Index that best represents the present value of the projected benefit payment schedule.** Ryan ALM builds Custom Liability Indexes based on any rate structure the client and their consultants and actuaries feel is appropriate. Currently, Ryan ALM prices liabilities using :

1. **Market Rates (STRIPS)**
2. **Single Discount Rates (ROA, New Pension Bill, Moody's AA rate, etc.)**
3. **Annuity Rates**

V. Pension Solutions !

Ryan ALM has a series of Pension Solutions research papers.

Please refer to our **RESEARCH** section on our web site for our latest releases :

- Pension Solution # 1... Custom Liability Index**
- Pension Solution # 2... Portable Alpha Liability System (PALS)**

VI. Press

Ryan ALM is a vigilant **watchdog** on pension trends, news and events. We created a **PRESS** section on our web site to isolate those stories we feel are the most newsworthy for our readers. Please browse for any important story and give us your thoughts.

Finance is the art of passing money from hand to hand until it finally disappears... *Robert Sarnoff*