



July 2005

## Asset / Liability Scoreboard

Index	Returns YTD 2005	Estimated Weights
<b>Liabilities :</b>		
Market (Treasury STRIPS)	7.58 %	100 %
Pension Act (Corporates)	5.17	
ROA (8% constant rate)	4.67	
<b>Assets :</b>		
Ryan Cash	1.45 %	5 %
Lehman Aggregate	1.59	30
S&P 500	2.87	60
MSCI EAFE Int'l	2.20	5
<b>Asset Allocation Model</b>	<b>2.44 %</b>	<b>100 %</b>
<b>Assets – Liabilities</b>		
Market	-5.14%	
Pension Bill	-2.73	
ROA	-2.23	

Pension assets outgrew pension liabilities by about 5.18% in July (2.12% vs. -3.06%) thanks to higher interest rates thereby reducing the Asset/Liability deficit for the year 2005 to **-5.14%** using market valuations (i.e. STRIPS); by **-2.73%** using the new Pension Act valuation (moving average of three corporate indexes with a duration of 12 years); and by **-2.23%** using the ASOP 27 methodology of a constant ROA (i.e. 8.00%). 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	2.44
Pension Liabilities	25.96	3.08	19.47	1.96	9.35	7.58
<b>Difference</b>	<b>-28.46</b>	<b>- 8.48</b>	<b>-30.89</b>	<b>18.08</b>	<b>-0.43</b>	<b>-5.14</b>
<b>Cumulative</b>		<b>-34.53</b>	<b>-54.75</b>	<b>- 46.57</b>	<b>-46.80</b>	<b>-49.54</b>

**God Bless Pension America !**

### **S&P 500 2004 Pension Status Report**

On July 18, S&P presented a comprehensive report on the status of pensions for the companies in the S&P 500. There are 369 corporations in the S&P 500 offering defined benefit (DB) pension plans. Of these, 311 had pension deficits amounting to \$164 billion underfunded with an **average funding status ratio of 89%**. This funded ratio has steadily declined from a high of 128% (surplus = \$280 billion) at the end of 1999. The report shows that **pensions have been a steady source of income which have contributed to earnings with a high of 29.7% of earnings in 2001**. Given the consistent growth of earnings in the last three years, pension income fell to 2.6% of earnings in 2004. What seems to amaze everyone is that corporate operating earnings have seen new records and double-digit increases for 12 consecutive quarters but corporations make only the minimum pension contributions. This contradiction is a result of inappropriate accounting rules that smooth asset and liability valuations, allow for aggressive ROA assumptions plus amortize the poor ROA results of 2000 thru 2002 over the average life of the pension plan (actuarial losses on ROA expectations). Good job David Blitzer, Ph.D. and his team (Howard Silverblatt and Dave Guarino) ! We need more watchdogs on the financial health of companies defined benefit plans and their affect on corporate profitability and solvency.

### **San Diego May File Bankruptcy ?**

In a special mayoral election on July 26, the city of San Diego voted on a new mayor to save the city from bankruptcy due to its pension dilemma. They believe they have a pension deficit near \$2 billion with a city budget of \$817 million suggesting the city can not afford the necessary contributions to reach proper funding. Moreover, these numbers are based on an erroneous discount rate. According to rule ASOP 27, San Diego and all public plans use a discount rate equal to their ROA rate (estimated @ 8.00%). That would suggest that **San Diego liabilities are at least 35% higher than they think if accurate market valuations are used for liabilities !** Fitch downgraded the city bonds to BBB+ and **S&P withdrew their rating since the city has not filed financial statements for the last three fiscal years**. The mayoral election did not have a majority winner so there will be a runoff in November between Republican Jerry Sanders who would like to work out the pension dilemma and Democrat Donna Frye who wants a court appointed receiver placed in charge of the pension. God Bless San Diego and its new mayor.

### **Index of Leading Indicators Recalibrated !**

On July 21, the Confidence Board released a revamped Index of Leading Economic Indicators (LEI) because it was previously showing too much economic weakness. The revamped index debuts without the yield curve deduction. The yield curve has been one of the best economic indicators. Now it is being recalibrated because it has been predicting too little growth. Henceforth, the yield curve will be subtracted only when fed funds invert with notes. **This will change the LEI's 1.9% loss for the last 12 months to a 1.8% gain for the year ending June 2005**. The LEI will now be revised back to 1959. The last revision was 1996 when the Confidence Board took over the LEI from the Commerce Department. Most economic data (i.e. bond yields, wages, IRS data, jobs) shows weakness in the economy except GDP. Apparently, all these indicators must be wrong and must be recalibrated.

*The easiest thing in the world is to tell the truth. Then you don't have to remember what you said.*

**Robert Evans**

# Pension Ideas

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## I. Pension Problems :

A detailed review of key pension problems can be found on our web site [www.RyanALM.com](http://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
<b>S&amp;P 500</b>	- 9.09	- 11.86	- 22.08	- 37.51%
<b>Pension Liabilities</b>	25.96	3.08	19.47	55.12
<b>Difference</b>	- 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.