



August 2005

## Asset / Liability Scoreboard

Index	Returns YTD 2005	Estimated Weights
<b>Liabilities :</b>		
Market (Treasury STRIPS)	11.30 %	100 %
Pension Act (Corporates)	7.34	
ROA (8% constant rate)	5.34	
<b>Assets :</b>		
Ryan Cash	1.81 %	5 %
Lehman Aggregate	2.89	30
S&P 500	1.93	60
MSCI EAFE Int'l	4.81	5
Asset Allocation Model	2.42 %	100 %
<b>Assets – Liabilities</b>		
Market	-8.88%	
Pension Bill	-4.92	
ROA	-2.92	

A significant rally in interest rates in August allowed pension liabilities to outgrow pension assets by 3.48% (3.46% vs. -0.02%) thereby increasing the Asset/Liability deficit for the year 2005 to **-8.88%** using market valuations (i.e. STRIPS); by **-4.92%** using the new Pension Act valuation (moving average of three corporate indexes with a duration of 12 years); and by **-2.92%** 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	2.42
Pension Liabilities	25.96	3.08	19.47	1.96	9.35	11.30
Difference	-28.46	- 8.48	-30.89	18.08	-0.43	-8.88
Cumulative		-34.53	-54.75	- 46.57	-46.80	-51.52

**God Bless Pension America !**

### **Generic Bond Indexes are NOT Liability Barometers**

As I warned practitioners for numerous years, there are no generic bond indexes that can be used to calculate pension liability growth. This year is a good example. The Lehman Aggregate shows little growth (2.89%) at a time liabilities have grown double digits (@ 11.30%). Even the long sector of the Lehman Aggregate just shows 2.71% growth. Only a CUSTOM Liability Index can provide accurate growth rates !

### **30 year Treasury is Back !**

On August 3<sup>rd</sup>, the Treasury announced the return of the 30-year bellwether auction series ... Amen! No size was indicated for the initial auction in the first quarter of 2006 but Tim Bitsberger, Treasury Assistant Secretary, suggested that \$20 to \$30 billion annually is being considered. The Treasury might eliminate the three year auction to make room for this auction. Hopefully, the Treasury will realize that STRIPS are critical to Asset/Liability Management (ALM) for Pensions, Lotteries, Insurance Products, etc. and that most of the STRIPS come from the 30-year Treasury auctions. Unfortunately, the Treasury has no plans for a 50-year auction series like France... write your Congressman to consider.

### **SEC Report to the President and Congress**

The SEC released a Report & Recommendations to Section 401© of the Sarbanes-Oxley Act of 2002 to the President and Congress in August 2005. The SEC took issue with the fact that pension liabilities are based on the lower ABO valuation rather than the higher PBO valuation. The SEC staff agreed with the CFA institute that the balance sheet is not transparent as to the true funded status of pension plans and that additional clarity is needed. Check our web site [www.ryanalm.com](http://www.ryanalm.com) for the full report.

### **Medical Liabilities ... the next Tsunami**

In the wake of the Pension Crisis, most corporations, cities and states face a second financial wave of trouble from Post Retirement Medical Benefits. These liabilities are longer with a higher inflation component so they tend to grow faster. In time, they swell to unbelievable proportions (compound interest). General Motors announced recently that this liability is estimated at around \$77 billion. Boeing announced that their medical liabilities are almost completely unfunded totaling around \$8 billion.

### **San Diego Sues Consultant and Actuary**

On August 16, the San Diego city attorney filed suit against Callan Associates for conflicts of interest that contributed to pension losses. They have been the city consultant since 1982. The lawsuit also named Gabriel, Roeder, Smith & Company for endorsing the unsound handling of the pension fund by city officials and for concealing the fund's problems. The root of this scandal is the granting of large benefits at a time of pension deficits which now total \$1.4 billion. How this soap opera plays out could have an effect on several Public Pension Plans with similar problems.

### **PBGC Update**

Latest study shows that the PBGC has picked up 3,200 failed pension plans since its creation in 1974. PBGC is now estimated to have a \$63 billion deficit.

### **Hurricane Katrina**

I was born and raised in New Orleans for 30 years. My prayers go out to the huge masses affected by this tragedy. I recommend the Salvation Army as an organization to support with your contributions (800-sal-army). I went with them during Hurricane Betsy and witnessed their genuine God-like work.

*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.