Ryan ALM, inc.

Asset/Liability Management

The Solutions Company

The Ryan Letter

November 2005

Index	Returns YTD 2005	Estimated Weights
Liabilities :		
Market (Treasury STRIPS)	5.86 %	100 %
Pension Act (Corporates)	9.69	
ROA (8% constant rate)	7.33	
Assets :		
Ryan Cash	2.74 %	5 %
Lehman Aggregate	1.47	30
S&P 500	4.86	60
MSCI EAFE Int'l	8.94	5
Asset Allocation Model	3.85 %	100 %
Assets – Liabilities		
Market	- 2.01 %	
Pension Bill	-5.84	
ROA	-3.48	

November was a good month for equities and relatively flat for bonds with some growth on longer bonds. As a result, asset allocation should have outperformed liabilities by about 1.67% for the month (Assets = 2.38%, Liabilities = 0.71%). This improved the Asset/Liability deficit for the year 2005 to **-2.01%** using market valuations (i.e. STRIPS); to **-5.84%** using the new Pension Act valuation (moving average of three corporate indexes with a duration of 12 years); and to **-3.48%** 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).

God

Total Returns	2000	2001	2002	2003	2004	2005
Pension Assets	- 2.50	- 5.40	-11.41	20.04	8.92	3.85
Pension Liabilities	25.96	3.08	19.47	1.96	9.35	5.86
Difference	-28.46	- 8.48	-30.89	18.08	-0.43	-2.01
Cumulative		-34.53	-54.75	- 46.57	-46.80	-47.87

Bless

Pension America !

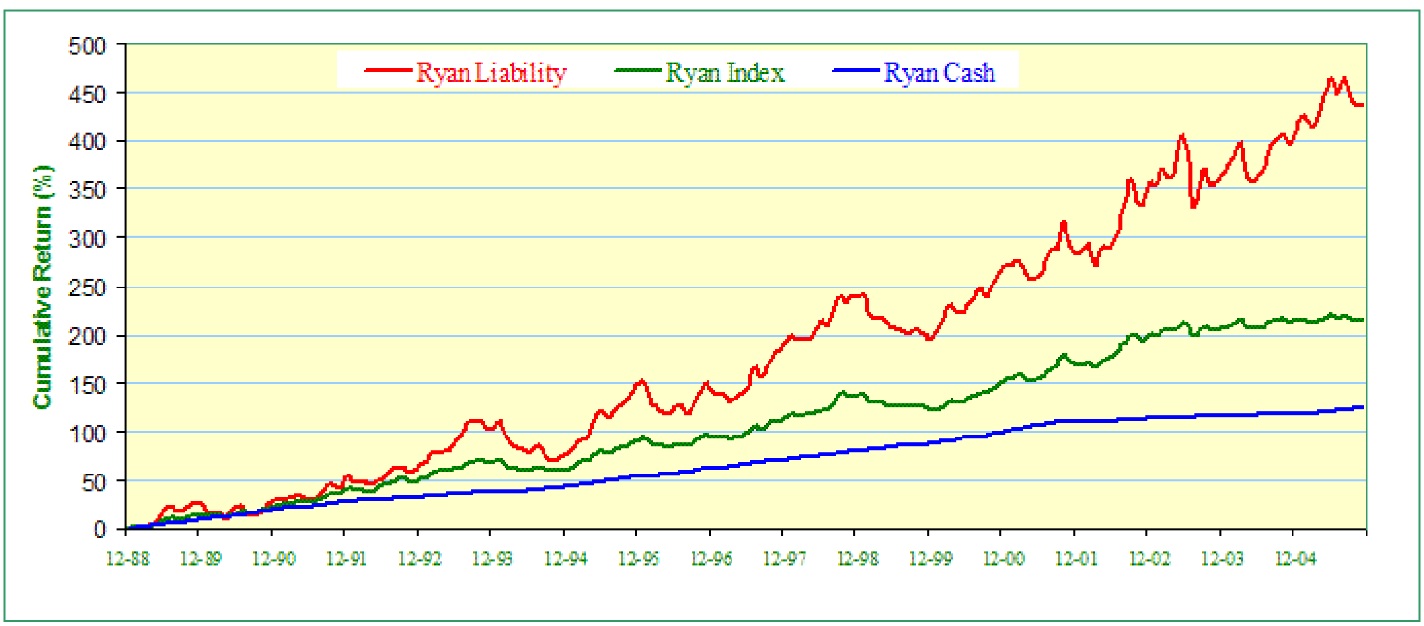
The Ryan Indexes

When I left Lehman in October 1982 as Head of Fixed Income Research, I founded the Ryan Financial Strategy Group (RFSG). Quickly, we designed several index innovations :

1st Daily Bond Index ("Ryan Index")
1st Cash Index ("Ryan Cash Index")
1st STRIPS Index (Composite = "Ryan Liability Index")

These indexes are the most complete Treasury yield curve and Liability yield curve indexes available in the world today! The data series goes back to the birth of STRIPS and all continuous Note and Bond auctions data. When I started Ryan Labs, I brought these personal assets with me. On October 7, 2005 I terminated my agreement with Ryan Labs to maintain my family of Ryan Indexes. Ryan ALM will now calculate and maintain all Ryan Indexes. To receive these indexes, please go to one of the following web sites :

www.RyanIndex.com **www.RyanALM.com** **www.LiabilityIndex.com**



San Diego Pension Officials Face Criminal Charges

Six former city of San Diego pension officials are charged with felony violations. The key issue is a 2002 pension pact (Managers Proposal 2) that freed the city from a large pension payment and concurrently gave city employees richer pension benefits. The scapegoat for all this seems to be Bob Blum, fiduciary counsel hired by SDCERS, who advised both the trustees and the city actuary that this agreement was sound. The city auditors have withheld their certification of the last three years of financial statements barring the city from a credit rating and access to the municipal bond markets. Moreover, the city budget is now strained by having to make much higher pension contributions. How this litigation ends may create precedence among other public pension plans with similar issues. Many public pension plans have increased benefits over the last five years at a time they could ill afford to do so. They will cry that they were informed that they were "actuarially sound" or properly funded. As I have preached for so long, due to bad rules, assets and liabilities are not valued correctly leading to erroneous funded ratio calculations that could be overstated by as much as 47% for public plans… see **www.ryanalm.com/research/pension crisis**.

PBGC Gets Relief

On Nov. 16, Congress passed S.1783, the **Pension Security and Transparency Bill of 2005**. The measure passed 97-2, with Michigan Democratic Senators Carl Levin and Debbie Stabenow being the only two opponents. The White House supports pension reform but believes that this legislation remains inadequate with respect to the level of required plan contributions and the premiums needed to return the PBGC to solvency and avert a taxpayer bailout. The House is expected to consider its own pension-plan legislation in December. The PBGC reported in its annual Performance and Accountability Report released in November, that it had assets of $56.5 billion with liabilities of $79.2 billion equal to a $22.7 billion deficit. According to the proposed legislation, PBGC premiums increase from $19 per participant to $30. Any funding gaps are required to be corrected within seven years for most companies and 20 years for airlines. Lump sum distributions would be stopped if assets fall below 60% of total pension obligations. It also requires any company filing for Chapter 11 bankruptcy protection to pay an additional fee to the PBGC. According to a PBGC study of this legislation, companies would put 8 percent less into their pension funds than if no changes were made to the current law according to the New York Times. The study found that companies would save $21 billion in pension contributions in 2006 alone. Their total savings over the next 10 years would be $70 billion. Corporate pension plans face an estimated $465 billion deficit or funding gap. Twenty years ago, the PBGC insured 112,000 pension plans. Now it insures fewer than 30,000.

FASB Votes To Reconsider Pension and OPEB Accounting

The Financial Accounting Standards Board (FASB) voted in November to reconsider its guidance in Statement No. 87 (Pensions) and 106 (Postretirement Benefits other than Pensions). In a November 10 press release, FASB said that its objective in undertaking the project is to improve financial statement reporting making it more useful and transparent. I had the honor to have lunch with Sir David Tweedie, the chairman of the International Accounting Standards Board recently. He confirmed that FASB wants convergence and that they will most properly adopt similar rules as FRS 17 and IASB 19 within 2006. If Sir David forecast is accurate, many accounting changes will transpire such as removal of "smoothing" and "amortization" techniques. Assets and liabilities will be required to mark to market accurately. This may cause a permanent shift in asset allocation models since to reduce funded ratio volatility you will have to better match assets to liability behavior which is bond-like rather than use a magic pencil.

Pension Watch - Delphi

Delphi had requested the bankruptcy court to let it pay bonuses to senior executives. Seems to fit the pattern here. After strong objections by the UAW, investors and the PBGC, Delphi has delayed its application until January.

Inflation Watch

Barron's Alan Abelson has proclaimed that the CPI … is ***bogus***. This is especially true when it comes to medical costs which the Bureau of Labor Statistics (BLS) has grown at 4% for the last 12 years. Health care insurance premiums have risen at double digit rates for many years. Moreover, the BLS has healthcare spending at only 6.4% of the CPI when it accounts for 15% of the GDP. Perhaps, Gold is the best indicator of inflation as it has now surpassed $500/oz which is the highest level since we had record inflation levels in the early 1980s.

According to a study by McClellan Financial Publications there is a high correlation of inflation to gold based upon a 14 month constant lag for inflation. Since the Federal budget is tied to the CPI, could there may be a connection here ?

Fed Ceases M3

On November 9, the **Fed announced that effective March 23, 2006 it will cease the publication of the M3 monetary aggregate as well as the components (large denomination time deposits, RPs and Eurodollars)**. No explanation was given. At the end of October 2005, M3 exceeded $10 trillion in size. Money supply is best measured in terms of total quantity of dollars in circulation. Many are already questioning if the Fed is trying to hide what may be coming … massive amounts of dollar creations to fund the worse trade and budget deficits in our history.

Pension Accounting (repeated from October by special request)

The SEC is investigating GM, Delphi, Ford, Boeing and others on the misuse of pension accounting to enhance earnings and their financial statements. My best guess is **they did nothing wrong … they followed the rules**. It is the accounting rules that are at fault for allowing companies to enhance earnings in an aggressive way. I wrote up a more complete story in my latest research article **"The Pension Crisis"** that you can find on our web site under research. Here are some examples: Pension is an expense that hurts earnings. The offset is the ROA assumption. The accounting rules permit companies to forecast the ROA a year in advance. Well, since you know your pension expense a year in advance, you know the ROA you need to wash this expense out. But why stop there? Why not forecast a higher ROA to create phantom earnings. Indeed, this has become a national trend. Some of the companies under investigation have ROAs that have boosted EPS by over 30% in the past. This type of pension gymnastics is supported by the fact that the ROA has to be validated by an auditor. Moreover, they compare the actual ROA to the forecasted ROA and this difference is then amortized over the life of the pension plan. GM announced in 2003 that this difference (called "Actuarial Gain/Loss") amounted to over $30 billion and would be amortized over 20 years costing future EPS over $1.5 billion per year. GM is unique in that it also issued a Pension Obligation Bond in 2003. The accounting here is amazing. GM issued around $13.5 billion at an average interest cost of about 7.50%. Interest is a tax deduction suggesting the net cost is @5.00%. They sent these funds over to the pension plan as a contribution and got another tax deduction. According to the accounting rules, GM then forecasted their ROA at 9.00% (tax free). It cost 5.00% and GM believed they would earn 9.00% creating an interest rate arbitrage and phantom earnings of $540 million per year.

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

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.** Key problems are :

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.

II. 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 (CLI)**
Pension Solution # 2 **Portable Alpha Liability System (PALS)**
Pension Solution # 3 **Liability Index Fund (LIF)**

III. 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**

IV. 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

V. 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 !**

Given the Wrong Index … you will get the Wrong Risk/Reward
Confucius