Ryan ALM, inc.

Asset/Liability Management

The Solutions Company

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The Ryan Letter

October 2008

Index	Returns YTD 2008	Estimated Weights
Liabilities :		
Market (Tsy STRIPS)	2.75 %	100 %
IRS (Corporates)	0.81	
ROA (8% constant rate)	6.67	
Assets :		
Ryan Cash	2.69 %	5 %
Lehman Aggregate	- 1.73	30
S&P 500	-32.83	60
MSCI EAFE Int'l	-43.25	5
Asset Allocation Model	-23.25 %	100 %
Assets – Liabilities		
Market	-26.00%	
IRS	-24.06	
ROA	-29.92	

Based on the Asset Allocation above, year to date 2008 pension assets **underperformed** liabilities by **-26.00%** using market valuations (i.e. STRIPS); lost by **-24.06%** under the IRS Contribution rules (PPA Corporate rates); and lost by **-29.92%** using the ASOP 27 methodology of a constant ROA (i.e. 8.00%). Such valuations show the significant difference in not using proper *market* valuations. Most pension funds enjoyed a funded ratio surplus in 1999. However, **assets have underperformed liabilities by about -114.25% since 1999** on a compounded index basis starting at 100 on 12/31/99!

(see Graphs and Index disclosures in Pension Scoreboard section)

Total Returns

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Assets	-2.50	-5.40	-11.41	20.04	8.92	4.43	12.25	6.82	-23.25
Liabilities	25.96	3.08	19.47	1.96	9.35	8.87	0.81	11.76	2.75
Difference:									
Annual	-28.46	-8.48	-30.89	18.08	-0.43	-4.44	11.44	-4.94	-26.00
Cumulative		-37.60	-73.40	-60.08	-66.13	-76.75	-64.60	-78.38	-114.25

God Bless Pension America !

Worst Pension Deficit Ever?

According to Howard Silverblatt, an analyst at S&P, companies in the S&P 500 are faced with the worst pension deficit ever exceeding the record shortfall of $218.5 billion in 2002. Higher contributions will be the effect of such a deficit. Based on S&P data, the S&P 500 companies projected an average 8.00% return on assets (ROA). So far thru 10/31 the S&P 500 had a YTD return of -32.83% including dividends. According to Ryan ALM's calculations on the first page, this is the third worst pension year on record so far. But what an incredible disaster this decade has been such that **pension assets have underperformed liabilities by -114.25% in cumulative growth!** Our calculations suggest:

Worst Pension Underperforming Years

	Year	Asset Return	Liability Growth	Difference
	2002	**- 11.41%**	**19.47 %**	**- 30.89 %**
	2000	**- 2.50**	**25.96 %**	**- 28.46 %**
YTD	**2008**	**- 23.25**	**2.75 %**	**- 26.00 %**

New Pension Trade Group to Lobby Congress

A new trade group whose members include Dow Chemical, General Motors and Lockheed Martin are urging Congress to help them cure a $200 billion pension gap among the private DB plans that have pension assets of around $1.1 trillion. The Committee of Employee Benefit Assets started its lobbying efforts on 10/29. This group represents 110 companies and almost half of the private pension assets in America. One of its missions is to delay the PPA provision on Dec. 31 that forces companies to pay higher contributions if certain funding ratio targets are not met (94%) which drains cash flow. This Committee asserts that there are better uses of this cash. Congress returns from recess on Nov. 17 so they have six weeks to resolve the PPA issue.

Pension Crisis: Contributions

The true pension crisis will be found in higher contributions and worsening balance sheets that damage credit ratings. Municipalities are faced with spiking contributions (see New York in my Public Pension Watch section). They cannot afford such budget shocks yet public pension plans continue to allow for benefit increases and automatic escalations which are doomed to failure. San Diego has become the model. They allowed for three rounds of retroactive increased pension benefits which cost taxpayers $451 million without funding. In addition, they provided a Deferred Retirement Option Plan (DROP) at an estimated cost of $200 million. Facing a billion dollar and growing deficit, the city had to reduce infrastructure costs (i.e. road repair, fire prevention, etc.) to find a way to pay such costs. The SEC described the problem as "the City would have difficulty funding its future annual pension contributions unless it obtained new revenues, reduced pension benefits, or reduce City services." Year after year, the City opted to reduce services. Total contributions from the City and City employees increased from $81 million in 2000 to $236 million in 2007. Total contributions during this period amounted to $1.42 billion. Over the same period $1.7 billion ($300 million more than contributions) were paid in pension benefits. These benefits have increased from $127 million in 2000 to $315 million in 2007 (148% increase).

Pension Crisis: Actuarial Gain/Loss

Under FASB accounting rules, corporations are allowed to forecast the return on pension assets instead of using actual returns to calculate pension expense. This is a serious mistake as corporations will naturally forecast a robust positive number. By doing so this reduces pension expense. In fact, if high enough it may create pension income (i.e. ***phantom earnings***). In 2005, Lucent Technology reported that pension income amounted to 92% of earnings. In fact, pension income was the largest contributor to earnings in most recent years before their sale to Alcatel. Such a FASB rule was designed to reduce volatility on income statements. Instead, it has reduced the quality of earnings. FASB requires that corporations compare the actual return of earnings to their ROA forecast. Any difference is amortized over the life of the pension (@ 12 years) and appears as a line item …Actuarial Gain/Loss. Given the disaster of 2008 and this decade, most corporations' future earnings will be hard hit by this rule. Since pensions tend to be one the largest assets of most major corporations this line item can be a significant drag on earnings. Imagine a $10 billion pension plan who has forecasted an 8% ROA each year of this decade. According to our calculations on page 1, the ROA for the nine years of this decade is around 1% per year, if that. That is a 7% difference per year for nine years or about 63% cumulative. Amortized over 12 years is about 5% per year or $500 million in earnings reduction every year for the next three to 12 years. The year 2008 alone is around a 31% error in ROA forecast divided by 12 = 2.6% amortization or $260 million earnings reduction for the next 12 years.

To Freeze or Not To Freeze … that is the DB Question

The National Institute on Retirement Security (NIRS) warns that freezing a defined benefit plan (DB) can hit a company with unanticipated problems and ***higher costs***. Executive Director of NIRS, Beth Almedia says "The requirement of the Pension Protection Act (PPA) for companies to fund up shortfalls over a very short period of time is well worth policymaker's consideration. What we've already seen over the last several years is this trend towards companies freezing plans." There are signs that this trend will accelerate because the PPA causes too much volatility on the balance sheets. The PPA requires companies must mark-to-market pension assets and liabilities with no smoothing of gains and losses. Companies must amortize losses over seven years and reach a 94% Funded Ratio in 2009 or face higher contributions. The NIRS report suggests moving to a defined contribution (DC) plan does not eliminate these issues. Companies moving new employees to a DC plan will now face the burden of two plans. Client servicing for DC plans can be quite expensive and time dilutive. DB plans are managed as pooled assets while DC plans are individual portfolios and accounts. Christian Weller, associate professor at the University of Massachusetts Boston, says that DC plan fees range between 0.8% to 1.5% of assets while DB plans are 0.2% to 0.6%. As far as I am concerned telling the financial truth is always my preferred recommendation. Once we know the real truth (how big a deficit there is) we can then deal with it. To hide the truth through smoothing and non-market discount rates methods creates a bigger problem. It is not fair to stockholders to overpay for a stock that is not valued correctly (i.e. improper calculation of EPS x P/E multiple). What I recommend is to give the pension plan a longer time period to cure their deficit … namely before the average life (duration) of the plan which is usually between 10 and 13 years instead of the seven years the PPA has mandated.

Signs of Recession

September layoffs were the highest in seven years (2,269). The number of new jobless claims rose by 26.19% to 235,681 the highest since Hurricane Katrina hit in September 2005.

Lehman, AIG, CDS … Oh, My!

Unprecedented huge sums of debt and questionable contracts still haunt the financial markets. AIG, now nationalized, required another $38 billion on top of of the $85 bail-out and may need more. AIG is the biggest writer of credit protection. Then there is the moot subject of Lehman CDS which settle in mid-November. The CDS market is "completely lacking in transparency and completely unregulated" according to Chris Cox, chairman of the SEC.

The recent settlement auction on Lehman CDS contracts was a catastrophe as creditors received just nine cents on the dollar. The biggest players were Goldman Sachs and Deutsche Bank but they were mainly transacting business for their clients. The insurers of the debt will have to pay 91% or $400 billion in contracts. This may have a domino effect and lead to other counter-parties defaulting. Hindsight now tells us that the decision to let Lehman go bankrupt set off a chain reaction in the world financial system forcing North America, Britain, Europe, Australia and even Asia. Ben Bernanke's observations on Lehman were that the Fed lacked the legal power to take on the vast liabilities stemming from a Lehman rescue. He commented, "A public-sector solution for Lehman proved infeasible, as the firm could not post sufficient collateral to provide reasonable assurance that a loan from the Federal Reserve would be repaid, and the Treasury did not have the authority to facilitate Lehman's acquisition by another firm. Consequently, little could be done. The new legislation passed by Congress". My solution would have been to make Lehman a bank then the Fed would provide liquidity which would buy time to orchestrate a rescue plan.

Here Come the Treasuries!

On November 3, the Treasury announced its estimates of borrowing for the Oct. – Dec. quarter at $550 billion in marketable debt. This includes $260 billion for the Supplementary Financing Program (SFP). This borrowing is $408 billion higher than announced in July 2008. It also estimates borrowing $368 billion for the January – March 2009 quarter.

Stimulus Checks

The Treasury announced on October 31that they had issued $95.038 billion in stimulus checks since the program started April 28.

China Announces $586 billion Economic Stimulus Package

China announced on Nov. 9 a huge fiscal stimulus package of nearly $600 billion (about 15% of their GNP). The money is to be spent by the end of 2010. Apparently, only 60% of this stimulus is actually new spending since the rest was already earmarked for earlier projects.

Congratulations to U.S. President-elect Barack Obama and the Democratic Party!

In God We Trust ! … (Not in our Financial Institutions)

U.S. Currency

<u>Public Pension Watch</u>

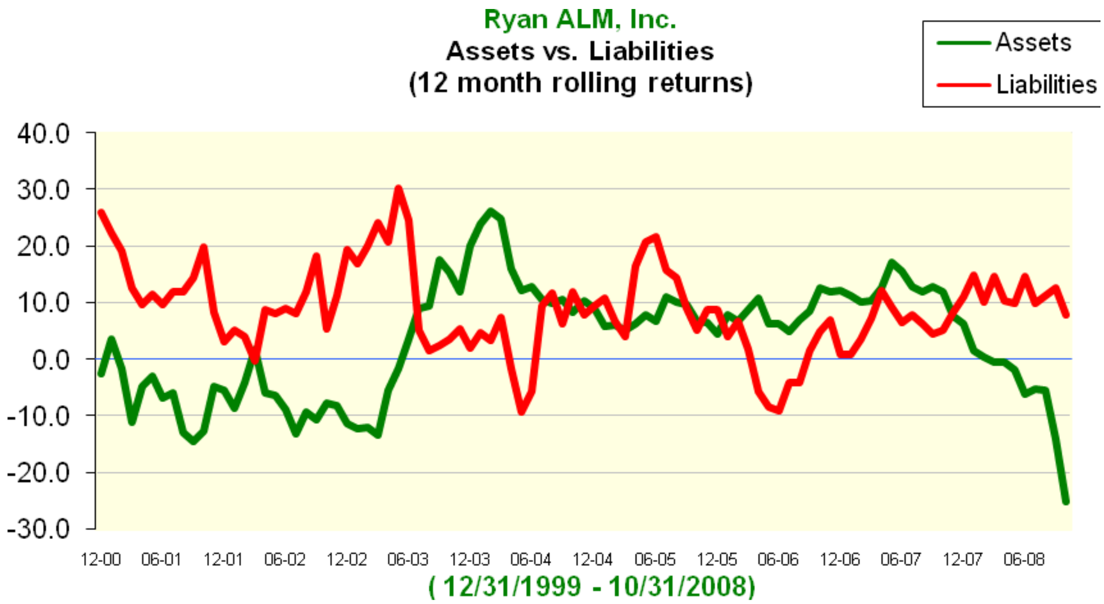
There seems to be an avalanche of recent Public Pension announcements concerning the growth of pension + OPEB deficits and the mismanagement of such funds. **Potential municipal bankruptcies are waiting to erupt across America due to budget crises stemming mainly from unaffordable pension and OPEB contributions!** As I have preached since 1991, the accounting and actuarial rules (GASB and ASOP 27) governing Public Pension plans are the start of the pension crisis since they do not *mark to market* the liabilities (market rates @ 5.00%). Instead, they value the liabilities at the ROA rate (discount rate @ 8.00%). Such a discount rate methodology has *undervalued public pension liabilities by 30 to 55%* in the last 7 years. Moreover, they do not mark to market assets using a smoothing technique that can undervalue or overvalue assets. Currently, this method *overvalues assets*. As a result, reported funded ratios are not accurate and need to be reduced accordingly. These inappropriate rules have led to inappropriate … benefit decisions, contribution decisions and asset allocation decisions. It all links! Here is an update on some municipalities:

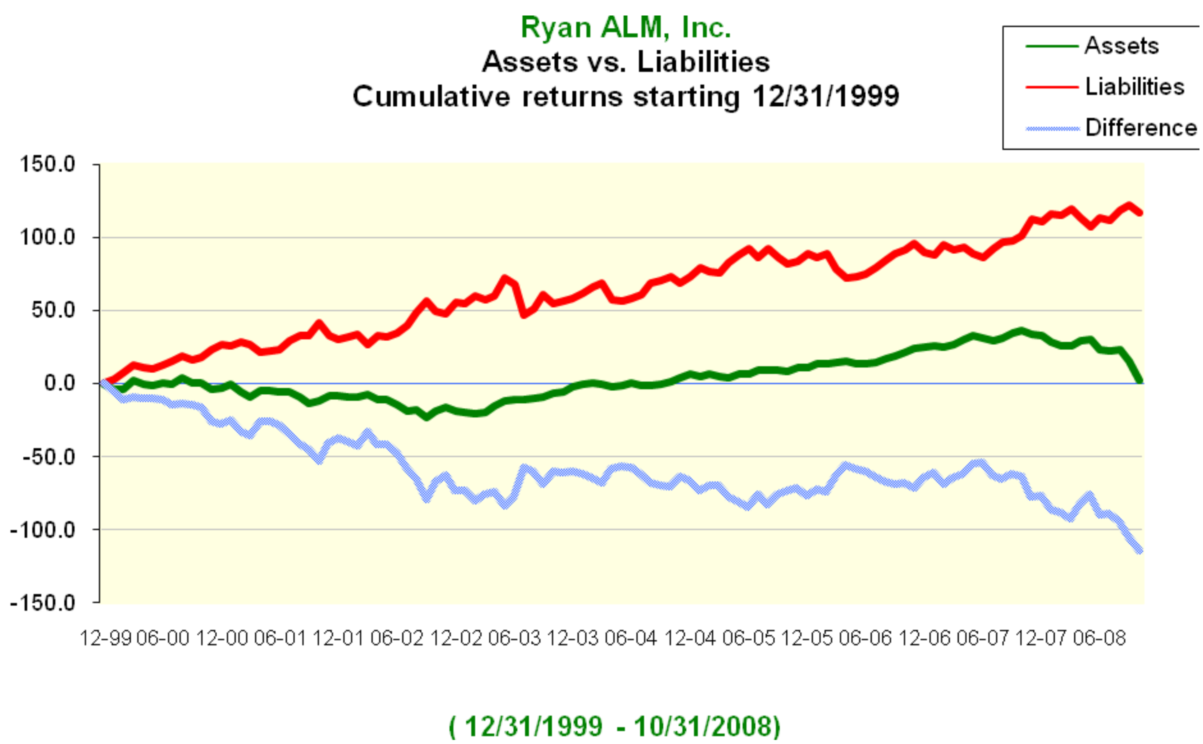
California - The CA Public Employees Retirement System (PERS) witnessed a decline of $50 billion in pension assets or a 21% reduction in assets from $240 billion to $190 billion due to the fall in the stock market this year. Ron Seeling the fund actuary said "cushioning the impact of investment setbacks is the fact that Calpers experienced double-digit gains in the four years leading up to 2008 fiscal year. We had saved 14% of the fund for cushioning the blow of a future market downturn and our smoothing policy is working as it should." CA State Teachers Retirement System (STRS) is America's second largest fund with $147 billion in assets saw a drop of 9.4% in asset value this year.

New York City - The Wall Street fiasco means a New York City fiasco in tax collections. Mayor Bloomberg is preparing for the worst. He has called for revoking a $400 property tax rebate, eliminating a 7.5% property tax reduction, reducing the municipal workforce by 3,000, cutting city agencies budgets by 7.5% and then raising sales and income taxes. But the mayor biggest problem is the five city pensions. According to the NY Post, **pension contributions to the five different employee-pension funds has risen from $1.1 billion in fiscal 2001 to $6.3 billion in fiscal 2009!**

Pension Scoreboard

The graphs below show asset vs. liability rolling 12 month and cumulative growth since 1999. The cumulative growth difference is **– 114.25% suggesting any pension Funded Ratio below 211.75 in 1999 has a deficit today!** As the Pension Crisis watchdog, we designed the **Pension Monitor** to capture world pension news: **http://www.pensionmonitor.com**





Indexes

Custom Liability Indexes

The best way to price (discount rate) and understand the interest rate sensitivity of liabilities is the **Ryan Treasury STRIPS yield curve indexes** known as the **LIABILITY BENCHMARK or LIABILITY INDEX**. In March 1985, when STRIPS were born, my team and I at the Ryan Financial Strategy Group (RFSG) created the **1st STRIPS Index.** Based upon these Ryan STRIPS indexes we created the **1st Liability Index in 1991** as the proper liability Benchmark for liability driven objectives (Pensions, Lotteries, NDT, Insurance Cos., etc.).

Since 1991, the Ryan team has developed hundreds of Custom Liability Indexes (CLI). Similar to snowflakes, no two pension funds are alike in that they have unique benefit payment schedules due to different labor forces, different mortality and different plan amendments. **The true objective of a pension is to fund liabilities at the lowest cost to the plan with prudent risk**. Without a Custom Liability Index it would be difficult, if not impossible, for assets to be managed vs. this liability objective. Until a CLI is installed as a set of economic books, the asset side is in jeopardy of managing vs. the wrong objective (i.e. generic market indexes) **If you outperform generic market indexes, but lose to the CLI … the plan loses !**

Ryan Indexes …Enhanced !

In March 1983, my index team and I at the Ryan Financial Strategy Group (RFSG) created the **1st Daily bond Index … the Ryan Index** as a *Treasury Yield Curve* index series for each auction maturity series (from Bills to Bonds). The best way to understand the interest rate behavior of bonds is to use the Ryan Treasury constant maturity series for each Treasury *auction* series with two composite indexes … **Ryan Cash and Ryan Index.**

The daily reports on these indices have been greatly expanded and enhanced to over 100 daily pages + many pages of research and methodology including :

Returns
Yield History
Yield Spreads
Percentage Spreads

To view all Ryan Indexes data go to : www.RyanIndex.com

Note: In October 2005, Ron Ryan terminated his license agreement with Ryan Labs to distribute and calculate the Ryan Indexes and Ryan STRIPS Indexes. Ron Ryan and Ryan ALM have no affiliation with Ryan Labs. Any use of the formulas, methodologies and data of any of the Ryan Indexes without Ron Ryan's written permission is prohibited

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

Index Funds

Liability Index Funds (Liability Beta Portfolio)

The best way to match assets to liabilities and reduce the volatility of the Funded Ratio is through a Liability Index Fund or Liability Beta Portfolio. Immunization is a popular strategy to match liabilities but has a mathematical problem in that it matches the *average duration* of liabilities instead of the entire *term structure* of liabilities. Only a Liability Index Fund correctly matches and fully funds each liability payment. This requires a Custom Liability Index. Ron Ryan was the inventor of both the Custom Liability Index and Liability Index Fund (Liability Beta Portfolio) concept.

ETFs

Powershares Launches ETF based on Ryan/Mergent 1-30 year Maturity Ladder Indexes

On October 11, 2007 Powershares launched a fixed income ETF based upon the Ryan/Mergent 1-30 year Treasury Maturity Ladder index. This index is an equal-weighted diversified portfolio of 30 distinct maturities. For more info on this ETF and index, please go to :

www. Powershares.com (click on fixed income portfolios)

KLD U.S. Corporate Bond Indexes

On August 7, 2008 KLD, Ryan ALM and Mergent launched a family of U.S. Environmental, Social and Governance (ESG) Corporate Bond Indexes. These are the ***First ESG Ratings Criteria as U.S. Corporate Bond Indexes***. These investable indexes are the first to apply environmental, social and governance (ESG) performance factors to a U.S. fixed income asset class. The KLD 1-3 Year U.S. Corporate Bond Index, KLD 1-5 Year U.S. Corporate Bond Index, and KLD 1-10 Year U.S. Corporate Bond Index are available for licensing as both generic and custom indexes. The KLD USCB series is the product of collaboration by three firms: KLD Research & Analytics, the leading ESG research and index provider since 1988; Ryan ALM as the fixed income index architect and calculation agent; and Mergent, the fixed income data provider. “These bond indexes provide an **additional asset class** for investors wanting to integrate KLD’s ESG factors into their fixed income portfolios,” said Peter Ellsworth, Business Development Manager for KLD Indexes. “Our clients have made it clear that environmental, social and governance issues are as important to fixed income investors as they are to equity investors.” “The KLD USCB series provides index solutions that minimize ESG risk factors and limit exposure to any one issuer,” said Ron Ryan, CEO of Ryan ALM. “Traditional bond indexes are market-weighted, so companies who issue more bonds gain a larger share of the overall index. The KLD USCB indexes are equal-weighted with a 5% cap, so no one issuer could ever become a significant weight factor,” Ryan explained. “Moreover, the USCB indexes only use the largest issues of each issuer, which provides the best liquidity and pricing.”