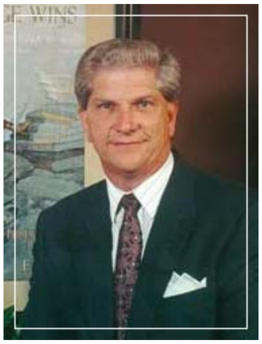
Ryan ALM, inc.

Asset/Liability Management

The Solutions Company



The Ryan Letter

October 2005

Index	Returns YTD 2005	Estimated Weights
Liabilities :		
Market (Treasury STRIPS)	5.11 %	100 %
Pension Act (Corporates)	9.03	
ROA (8% constant rate)	6.67	
Assets :		
Ryan Cash	2.39 %	5 %
Lehman Aggregate	1.02	30
S&P 500	1.04	60
MSCI EAFE Int'l	6.31	5
Asset Allocation Model	1.44 %	100 %
Assets – Liabilities		
Market	- 2.72 %	
Pension Bill	-7.59	
ROA	-5.23	

Another spike up in interest rates in October saw liability present value growth decline by about **-2.24%** for the month. Although asset growth was negative (**-1.37%**), this 0.87% A/L gain improved the Asset/Liability deficit for the year 2005 to **-2.72%** using market valuations (i.e. STRIPS); to **-7.59%** using the new Pension Act valuation (moving average of three corporate indexes with a duration of 12 years); and toy **-5.23%** 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	1.44
Pension Liabilities	25.96	3.08	19.47	1.96	9.35	5.11
Difference	-28.46	- 8.48	-30.89	18.08	-0.43	-2.72
Cumulative		-34.53	-54.75	- 46.57	-46.80	-48.25

God 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). Within six months, we created the first daily bond index (“**The Ryan Index**”) and the first **Cash Index**. When STRIPS were born in 1985, we created the first **STRIPS 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 continous 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 and deliver 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**

SEC Investigates GM et al

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 ovder 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.

PBGC to get Conressional Relief

On October 18, the U.S. Senate approved a plan to raise PBGC premiums from $19 per employee to $46.75 per participant. This would hurt earnings of any labor intensive industry but rightfully so. The plan also would penalize companies who shed their pensions over to the PBGC in bankruptcy at a cost of $1,250 per employee. It now goes to the House for their approval or pension reform proposal.

Inflation Watch

The September CPI was the largest monthly increase in 25 years and biggest year over year change (**+4.4%**) since 1990 although still well understated. The October 18 release of the September PPI showed the highest PPI inflation in 15 years (**+1.9% month, 6.9% year**). The ISM Non-Manufacturing index showed prices paid the highest in the eight year history of the index. Crude oil at over $65 a barrel may seem high, but check out fuel prices over the last 12 months : Gasoline **+52%** ($2.94 a gallon from $1.93), Heating Oil **+50%** ($2.08 a gallon from $1.39), Natural Gas **+108%** ($14.02 per million mBtu from $6.73) versus Crude Oil **+31%** ($65.47 a barrel from $49.91). And as reported in our September Letter, Medicare Premiums will rise 13.2% in 2006.

New Bankruptcy Act

Passed by Congress and signed by President Bush on April 20, 2005 this Act went into effect on October 17, 2005. What is missing is how easily Corporations can file for bankruptcy due to pension costs which has become a growing and alarming trend! The PBGC reports 154 companies filed for bankruptcy in 2004 and 142 the year before. Guess who really pays for these pension costs … the American taxpayer.

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 :**

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 !**
   Term structure and duration matched portfolio that out yields liabilities + matches 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.

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