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The Ryan Letter

March 2006

Index	Returns YTD 2005	Estimated Weights
Liabilities :		
Market (Tsy STRIPS)	- 5.39 %	100 %
IRS (30 yr Treasury)	1.58	
ROA (8% constant rate)	2.00	
Assets :		
Ryan Cash	1.04 %	5 %
Lehman Aggregate	- 0.64	30
S&P 500	4.21	60
MSCI EAFE Int'l	9.47	5
Asset Allocation Model	2.84 %	100 %
Assets – Liabilities		
Market	8.23 %	
IRS	1.26	
ROA	0.84	

March witnessed a sharp spike up in interest rates causing liabilities to show negative growth (-5.39%). Assets posted decent equity returns which lifted the total returns to @ 0.64%. This is exactly what pensions needed and illustrates the tremendous error in pricing liabilities at any discount rate except the market rates. Pension assets are up vs. liabilities for the year by about **8.23%** using market valuations (i.e. STRIPS); but only **1.26%** under the IRS Contribution rules; and by just **0.84%** 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 -45% since 1999** (see table below).

Total Returns							
	2000	2001	2002	2003	2004	2005	2006
Assets	- 2.50	- 5.40	-11.41	20.04	8.92	4.43	2.84
Liabilities	25.96	3.08	19.47	1.96	9.35	8.87	- 5.39
Difference	-28.46	- 8.48	-30.89	18.08	-0.43	-4.44	8.23
Cumulative		-34.53	-54.75	- 46.57	-46.80	-49.16	-44.98

God Bless Pension America !

Thoughts on Bankruptcies, Freezing DB plans and Switching to DC Plans

There is a growing trend among corporations towards freezing defined benefit plans, switching to 401K plans and even deciding to go bankrupt turning over the pension plan to the PBGC. Bad accounting rules allowed corporations to enjoy a long pension holiday and not make contributions for several years, if not decades. Such bad rules overstated assets (smoothing), understated liabilities (too high a discount rate) creating a higher funded ratio than economically valid. As a reaction and strategy to the significant contributions projected to restore pension viability, corporations want out of the defined benefit employee compensation.

My constant theme in the many speeches I have made in the last year is that **this is an opportune time for DB plans going forward ... don't give up! With interest rates at the lowest levels in about 40 years, liabilities can not grow much.** Just like the yield to maturity of a bond, liabilities behave and grow like a bond portfolio. Mathematically, this means that liabilities should grow about 4.75% to their maturity (benefit payment dates). If interest rates go up over the short term (next 3 years) liabilities should record negative growth (around -7% for every 100 basis points). This year is a good example so far. If the non-bond assets of asset allocation (Alpha Portfolio) earn historical average returns (@ 8%) then the funded ratio of DB plans can recover quickly. Assets should outperform liabilities over time thereby increasing the funded ratio and reducing required contributions. Defined contribution plans are more budgetable but require a contribution every year for every qualified employee. Over time this should be more expensive than traditional DB plans. **We need to resolve the pension dilemma today by instituting more relevant accounting rules and more prudent asset allocations focused on liabilities not by abandoning these valuable compensation plans.**

FASB announces Phase 1 of Pension & OPEB Proposal

On March 31, FASB issued its phase one proposal to remedy pension and OPEB accounting. If enacted, companies will be forced to disclose the funded status of their plans on their balance sheet. The proposal would go into effect for fiscal years ending after 12/15/06. Credit Suisse estimates that this would reduce shareholders equity for the S&P by about \$255 billion or 7%. The change in the fair value of plan assets and liabilities will be recorded in Other Comprehensive Income (a component of shareholder's equity) as a mark-to-market approach. Phase II will deal with costs on the income statement whenever it is proposed. The new FASB proposal has a 60-day comment period.

PBGC Executive Director, Brad Belt, to resign May 31

Brad Belt, the head of the PBGC and certainly one of the most outspoken intellects on the pension crisis, announced that he will step down on May 31. He did not announce his future endeavors. I would like to personally wish Brad all the best and thank him for his leadership and insights into how to solve one of America's worst financial nightmares. In a recent speech, Brad warned how the pension accounting rules have led companies down the wrong road as if "we have followed Alice down the White Rabbit's hole into a looking glass world that is disconnected from economic reality."

Pension Watch : GM

GM announced two major changes in their benefit plans in March. First, they are freezing their defined-benefit plans for its 36,000 salaried employees to switch to a defined contribution plan.

Second, they are offering hourly workers compensation up to \$140,000 if they give up the retiree health care coverage (OPEB) that has become a crippling burden. GM announced in late 2005 that their projected OPEB expenses were estimated at \$77 billion (@ 3x their net worth).

Pension Watch : San Diego City Employees Retirement

Mayor Jerry Sanders announced March 17 that the city will make a required \$162 million contribution payment. Actuaries project the deficit around \$1.39 billion with a funded ratio of 68%. However, if liabilities were marked to market San Diego faces a pension deficit estimated to be high as \$2 billion. Such a dilemma was caused by agreements in 1996 and 2002 to increase benefits while allowing the city to pay less in contributions than the city needed. This story can be repeated almost everywhere in Public Fund land due to bad actuarial (ASOP 27) and accounting rules (GASB).

Pension Reform

The Bush Administration proposal here would abandon the 30-year Treasury rate as a discount rate for determining funded status (and minimum contribution) in favor of a zero-coupon corporate yield curve based on a 90-day average of interest rates. As I have preached for years (since 1991) the only discount rate yield curve that works here is the Treasury STRIPS yield curve. The facts are clear: ***Corporate zero-coupon bonds do not exist*** causing an undervaluation of pension liabilities due to a higher discount rate. Moreover, **you can not defease liabilities with these imaginary securities**. Also using **any moving average of rates distorts the true economic value (present value/market value) of liabilities**. Although a 90-day average is far superior to the 4-year moving average traditionally used, it is still not accurate. For a review of our critique on this proposal, please go to www.ryanalm.com/research and read first the **Treasury White Paper on Pension Discounting** (dated 2/07/05) and then read **Critique of Treasury White Paper** (dated 03/04/05).

The best way to price liabilities is the Treasury STRIPS yield curve. In March 1995, when STRIPS were born, my team and I at the Ryan Financial Strategy Group created the first STRIPS Index. To view this index data go to :

www.RyanIndex.com

Pension Monitor

In order to closely watch the ever evolving tragedy of the Pension Crisis, we have designed the **Pension Monitor**. This web based site is a chronology of press clippings and research reports on what's happening with pensions throughout the world. Currently, there are over 1,300 press articles going back to 2002. We believe that this is the most comprehensive site for pension articles in the world today. To view, please go to :

www.PensionMonitor.com

Pension Monitor
the latest pension articles and news from around the world

Pension Ideas

I. Pension Problems :

Key pension problems itemized in [www.RyanAlm.com/Research/The PENSION CRISIS](http://www.RyanAlm.com/Research/The%20PENSION%20CRISIS) :

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 :

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|-----------------------------|---|
| 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 (CLI)

Ryan ALM provides the Benchmark for ALM with accurate daily pricing **that best represents the present value of the projected benefit payment schedule.** Ryan ALM builds Custom Liability Indexes based on market rates or any discount the client wants.

IV. Beta + Alpha Portfolio

For pensions, **Beta is the portfolio that matches liabilities** not some generic market index. Without a CLI it would be difficult to match liabilities. **Beta is best as a Liability Index Fund.** This is where investment grade bonds should go since they have little or no Alpha vs. liabilities. **Alpha is the excess return above liability growth.** It is certainly not excess returns above a **generic** market index. If you outperform a market index but lose to liabilities, **...you LOST ! Alpha is best as non-bonds portfolios that do not correlate to liabilities.**

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 where the Alpha portfolio is non-bonds (i.e. Equity, Real Estate, etc.) and the Beta portfolio is 100% bonds matched to liabilities. **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. When our Alpha portfolio achieves 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*