STOLZ COMMUNICATIONS

Work Sample

Speaking Out

DB pension plans can now learn lessons from recent troubles, take remedial steps

By XXX

The erosion of the financial strength of the nation's defined benefit system will continue until pension sponsors learn some important lessons from the road we've just been down. While the stock market's nose-dive that began nearly five years ago was the most conspicuous cause of the deterioration in the funded position of so many pension plans, there's a lot more to the story, with important implications for immediate action.

Although it is now painfully clear to everyone that current federal funding rules need serious overhaul, don't hold your breath. Following are some other, perhaps more subtle, lessons to bear in mind while restoring the health of pensions:

1. Don't focus on minimum funding as the key measure of a plan's health. True, where a plan stands in relationship to minimum funding standards has been a standard barometer of a pension plan's financial condition (and must be monitored to avoid incurring costly excise taxes); plan sponsors need to look well beyond those standards to judge the soundness of their plans.

2. Actuaries do not have crystal balls. The numbers in a traditional actuarial report won't give you an accurate picture of what will happen in the future. Actuarial valuations are merely a year-end audit process, based on today's knowledge, to tie up all the numbers for reporting purposes.

3. Plan sponsors need to focus more on the overall picture, not just investments. Plan sponsors typically are buried under quarterly performance reports from investment managers who, naturally, cast their results in the most favorable light. This focus on short-term investment returns often comes at the expense of looking at the impact that such returns have on the total picture.

4. Volatility in investment return by itself is not the greatest risk pension plans face. How investment volatility impacts unfunded liabilities and contribution requirements is different for each plan and is a function of the plans' net cash flow position (contributions less benefits), its funded status (assets over liabilities), and the ratio of contributions being paid to benefits being earned in the future (contributions over normal cost).

Adding it all up

So what do these lessons tell us to do? The first three suggest a move from the traditional static annual review of a plan's overall condition, to a more frequent and dynamic form of reporting and analysis.

Actuarial analysis should always use the most recent reported returns, and not only project what is expected to happen, but also "stress test" what could happen to the plan under a variety of investment, actuarial, and plan change scenarios. The certainty of variable investment returns makes this a necessity; traditional reporting and analysis techniques used by actuaries, while useful, provide little (if any) measure of the real risks plan sponsors face in the future.

This isn't the first time a financial crisis has demanded superior analysis by actuaries. It happened in the 1980s, when a major insurance company suddenly, and with little warning, nearly toppled. That prompted insurance actuaries to move from static snapshot valuations to dynamic financial analysis, where future projections are tested under a wide range of scenarios, and probabilistic results are presented, instead of just expected results.

Better risk controls needed

Another needed change in actuarial techniques involves identifying and better controlling investment risk. Investment volatility by itself is not a true risk if it does not result in funding deterioration or the need to increase contributions and/or reduce benefits. In the 1960's and up through the 1980's this was more often the case than not, and plan sponsors grew used to ignoring volatility, indeed often embracing it in the hope of achieving higher returns.

But in today's "aging baby boomer era," investment rate volatility translates into much higher volatility in required contributions and funding ratios as pension plans mature in step with the Boomers.

This demands that pension plans reassess how they are invested for the long term. The time-honored 60/40 stock/bond investment allocation formula simply does not work for maturing plans. Nor can investment allocation strategy be determined – and performance judged – simply by reference to what other funds are doing.

A second key implication of our recent experience: In evaluating various investment asset classes and fund allocations, choices must to be analyzed not only in terms of achieving full funding, but also in minimizing downside deviations on required contributions or funding ratios.

What becomes clear is that to avoid the devastating impact of downside deviations in returns, a “premium” needs to be paid, much like an insurance policy, which necessarily results in a reduction in expected earnings otherwise available. For example, all experts will agree that shifting money from equities to cash flow matching and annuitization reduces volatility but at a cost of also reducing expected returns.

However, in the current economic environment with low interest rates, that “premium” cost to avoid downside deviation may look too expensive. But the cost/benefit analysis may show that this is not the case, in particular, if a plan is fully funded. Lesson number three: Plan sponsors should focus the investment consultant’s duties on assisting in asset class and asset allocation advice, as well as in the manager selection. Sponsors should not rely on that consultant to rate his own performance on selecting manager candidates; reporting on results needs to be produced by the investment consultant, but then presented to the plan sponsor by an independent party.

Third party review

Similarly, investment managers should not present their performance directly to Trustees but answer questions after their results have been introduced by an unbiased third party.

An added benefit to this approach is eliminating the disconnect between investment performance and overall plan performance -- including liabilities. Investment consultants have been raised to believe that their advice and value is measured strictly by reported time-weighted annual returns, and fund performance percentile rankings.

While these are important measurements, meeting long-term annual return targets does not equate to successful asset performance measured in dollars. The plan’s cash flows and liability structure, in contrast, do. Each pension fund is unique, and needs to be evaluated based on its own circumstances.

Regrettably, many funds will resist these recommendations. One reason is that ERISA’s “prudent man” rule has promoted herd mentality among pension sponsors who define prudence as doing what everyone else is doing. This leads to our final recommended change: Overhaul ERISA’s prudent man rule to require plan sponsors to guide their pension fund in a manner more suitable to their condition and circumstances, instead of just following the herd.

Hindsight, as the saying goes, is 20-20. But that doesn’t mean you can’t take advantage of it. Pension trustees’ fiduciary responsibility demands nothing less.

(“Author” biographical information)