Pension-Plan Reform and the Investment Consultant: Addressing the Financial Risks of Plan Sponsors

BY CHAD GOERNER, CIMA, CFP, AND TOM APPELGATE, CFA

Editor’s Note: The U.S. Senate approved Senate Bill 1783, the Pension Security and Transparency Act, on November 16, 2005, with significant bipartisan support. This comprehensive reform legislation is intended to protect the interests of workers, retirees, and taxpayers by shoring up the health of the traditional defined-benefit pension system. “Our nation’s pension laws are outdated and broken, placing at risk the retirement security of millions of Americans who rely on our worker pension system,” said Rep. John Boehner (R-Ohio), chairman of the U.S. House Committee on Education and the Workforce. “With today’s vote, we seized the opportunity to advance real change by passing the most comprehensive reforms to worker pension laws in more than a generation.” For more information about the Pension Security and Transparency Act, visit the Senate Health, Education, Labor, and Pensions (HELP) Web site at http://help.senate.gov/. The U.S. House of Representatives passed House Bill 2830 on the IMCA Web site at www.imca.org, then click on Legislation.

With the pension-reform proposals currently under consideration in Congress, the probability that we’ll see a more transparent environment for measuring the health of pension plans has increased. Such a scenario likely could have an immediate financial impact on plan sponsors and may affect how institutional consultants address plan-sponsor needs in the months and years ahead.

Pension reform represents an opportunity for the investment consultant to enhance existing client relationships and gain new business. The traditional consulting model and the common four-step consulting process—investment policy, asset allocation, manager selection, and performance measurement—will always remain. Each step, however, will need to be expanded upon to better integrate the consulting process with what could be increased financial concerns for the plan sponsor.

Proposed Reforms

Under current law, it has been difficult to determine the health of a plan’s funding status because of the multiple measures allowed in calculating liabilities and determining plan contributions. The push for reform centers about improving the transparency of defined-benefit plans with a uniform measure of plan liabilities, i.e., using one method to calculate minimum and maximum contributions and basing funding targets on the health of the company.

The Bush administration’s reform proposal that is making its way through both houses of Congress could alter the asset allocation of a plan from an asset-return focused model to an asset-liability matching model by using a more uniform method to assess a plan’s funding status.

While its details likely will change as a result of bipartisan compromise, the three most important concepts behind the administration’s proposed reforms are the following:

1. Reform funding rules. Funding rules would be based on more accurate asset and liability measures. Specifically, all interest-rate discounting would be based on a AA yield curve provided by the U.S. Treasury. Plans would be required to make up shortfalls within a reasonable period.
and employers would be allowed to make larger tax-deductible contributions when the plans are fully funded to provide financial stability during future difficult-operating environments. In addition, funding requirements may be based on the sponsoring company’s financial condition. For example, companies with bond ratings that fall below investment grade may need to fund a plan at an accelerated rate.

**Improve disclosure.** The Department of Labor report calls for improved disclosure of funding status and funding trends, making publicly available certain information filed with the Pension Benefit Guaranty Corporation (PBGC) by underfunded plans, and providing for more timely reporting of this information in plan annual reports.

**Alter PBGC premium structure.** PBGC premiums would be restructured by increasing the flat per-participant premium from $19 to $30 and charging a risk-based premium based on the gap between a plan’s funding target (established by the final pension reform bill) and its assets.

Essentially, the proposed reforms create a standard for measuring a plan’s funded status and comparing it with others. By increasing transparency and forcing higher PBGC premiums for plans with higher funding risk, the reforms encourage plan sponsors to maintain healthy plans.

### Revisiting Asset-allocation Design

Traditional asset classes (stocks, bonds, and cash) within the pension-plan asset-allocation model often haven’t matched plan liabilities. This has been true in the past five years, when the return on assets has not matched the growth in liabilities. The result has been an increased volatility in the plan’s funding status, leading to significant increases in unfunded liabilities (see table 1).

Current defined-benefit-plan allocation design can be attributed to the plan’s cost of funding as it relates to the capital markets return assumption of equities (see figure 1). Pension reforms in the Netherlands and Denmark, however, have increased transparency, resulting in allocation shifts to long-term fixed-income instruments.

This happens because as reforms require transparency and more uniform funding methods, plan sponsors begin to better match plan assets with future liabilities. In doing so, they often are forced to focus on the longer end of the yield curve because of the baby-boom demographic’s increasing life expectancy.

Thus, one can conclude that when reforms are enacted, the appetite for fixed income will increase here at home. In many countries that have enacted some

---

**TABLE 1 Revisiting Asset-allocation Design**

<table>
<thead>
<tr>
<th>INDEX</th>
<th>WEIGHT</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>5%</td>
<td>6.49</td>
<td>4.97</td>
<td>1.75</td>
<td>1.04</td>
<td>1.22</td>
</tr>
<tr>
<td>Lehman Aggregate</td>
<td>30%</td>
<td>11.63</td>
<td>8.44</td>
<td>10.25</td>
<td>4.10</td>
<td>4.34</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>60%</td>
<td>–9.09</td>
<td>–11.86</td>
<td>–22.08</td>
<td>26.69</td>
<td>10.87</td>
</tr>
<tr>
<td>MSCI EAFE International</td>
<td>5%</td>
<td>–13.87</td>
<td>–21.11</td>
<td>–15.64</td>
<td>39.17</td>
<td>20.70</td>
</tr>
<tr>
<td>Assets (Based on traditional static asset allocation)</td>
<td>100%</td>
<td>–2.50</td>
<td>–5.40</td>
<td>–11.41</td>
<td>20.04</td>
<td>8.92</td>
</tr>
<tr>
<td>Liabilities</td>
<td>100%</td>
<td>25.96</td>
<td>3.08</td>
<td>19.47</td>
<td>1.96</td>
<td>9.76</td>
</tr>
<tr>
<td>Assets – Liabilities</td>
<td>–28.46</td>
<td>–8.48</td>
<td>–30.88</td>
<td>18.08</td>
<td>–0.84</td>
<td></td>
</tr>
</tbody>
</table>

**SURPLUS/DEFICIT AS OF 12/31/1999**

| Assets ($) @ Market Value | 218,051,716 | 212,600,423 | 201,120,000 | 178,174,208 | 213,884,319 | 252,968,575 |
| Liabilities ($) @ Present Value | 174,447,532 | 219,734,111 | 226,501,922 | 270,601,846 | 275,905,642 | 302,834,033 |
| Surplus/Deficit ($)         | 43,604,184  | (135,388)  | (25,381,922) | (94,427,638) | (62,021,323) | (69,865,459) |

Assumes no contributions or benefit accruals

*Source: Ryan Labs: Asset–Liability Ratios December 31, 1999–December 31, 2004*

---

**FIGURE 1 Average DB Plan Asset Allocation**

[Diagram showing asset allocation]

This happens because as reforms require transparency and more uniform funding methods, plan sponsors begin to better match plan assets with future liabilities. In doing so, they often are forced to focus on the longer end of the yield curve because of the baby-boom demographic’s increasing life expectancy.

Thus, one can conclude that when reforms are enacted, the appetite for fixed income will increase here at home. In many countries that have enacted some
type of pension reform, the demand for long-term fixed income continues. Gordon Latter, pension strategist at Merrill Lynch, recently wrote about France issuing a 50-year bond in February 2005 that took advantage of the voracious global appetite for long-duration fixed income and resulted in the yield going from 4.21 percent to 3.915 percent.3

Where We Go from Here
How quickly will asset allocation change once the reforms make it through Congress? That’s impossible to answer. A 2005 survey released by the Association for Financial Professionals Committee on Investment of Employee Benefit Assets (CIEBA), however, asked its members to evaluate their plans’ potential for asset-allocation shifts given hypothetical scenarios based on some of the Bush administration’s pension reform proposals. Of the 47 investment officers who responded, more than two-thirds said they would reduce equity exposure, with 36 percent indicating they would reduce it by 11 percent–15 percent or more.4

This suggests that, to accommodate the debt-oriented nature of plan liabilities, allocation design gradually will shift away from equities. This shift could be accelerated if the Financial Accounting Standards Board (FASB) changes the accounting treatment of off-balance sheet items that include defined-benefit plans.

Potential Solutions
Appropriate investment solutions for pension plans must address the true risks associated with sponsoring such plans. This true risk is not addressed solely through asset volatility or investment returns as demonstrated in the traditional efficient frontier approach. Instead, the real risk in a pension plan is the asset–liability mismatch risk that occurs when movements in assets and liabilities are uncorrelated, causing unanticipated drops in a plan’s funded status and, consequently, unforeseen contribution requirements.

With this in mind, an appropriate solution first reduces the volatility of the assets and funded status without increasing the expected contributions, then reduces the expected costs, which may improve earnings and cash flow.

One simple and often overlooked way to reduce asset and funded status volatility is to further diversify the equity portion of the portfolio into less-correlated asset classes. Additional allocations to foreign markets (both developed and emerging) and real estate through real estate investment trusts (REITs) often can provide enough diversification to reduce asset volatility without jeopardizing current return. Managed futures and other alternative investments, including commodity funds, are becoming more prevalent and also can provide increased plan diversification.

To better dampen the funded status volatility and reduce the asset–liability mismatch, however, fixed-income allocations can be moved from intermediate-term portfolios to longer-term portfolios that better match the interest-rate sensitivity of the plan’s liabilities. These longer-term portfolios can be created either by directly investing in longer-term obligations or using interest-rate futures to alter the duration of an existing intermediate-term portfolio. Beyond the traditional approach to pension management, interest-rate immunization strategies are available using interest-rate futures or interest-rate swaps. By using some degree of leverage, these strategies often can reduce or even eliminate the asset–liability mismatch using only a small portion of the pension assets. This leaves the remaining assets engaged in more traditional alpha-generating strategies, with expectations of additional return to drive the overall long-term costs of the plan downward.

Expanding the Institutional Consulting Model
The institutional consultant’s service model must expand to meet the changes that reform will bring. Consultants also must understand the strategies that can be used to help plan sponsors cope with the increased balance-sheet volatility that may result from greater pension-plan transparency.

The traditional consulting model is shown in table 3.

At each stage, a consultant may find it necessary to engage a pension consultant or integrate some or all of the following:

Investment policy. Identify pension constraints and risk budgets. Discuss the potential for a modification in plan return objectives and asset-allocation design with a liability-focused return objective.

Asset allocation design. Model allocation solutions by incorporating plan

![FIGURE 2 Traditional Consulting Model](https://example.com/figure2.png)
liabilities and expand allocation design to include nontraditional asset classes and strategies. For example, designs may include alternative investments (hedge funds, private equity, REITs, or managed futures), risk overlays, and portable-alpha strategies using derivatives, insured solutions, and/or enhanced or protected securities.

Manager selection. Aside from traditional manager searches in equity and fixed-income classes, the asset-allocation design may point to adding or re-allocating in alternative investments. The consultant should bring in proper resources and perform due diligence in screening potential candidates.

Performance measurement. Track performance of not just traditional assets but liabilities using a custom liability benchmark in the quarterly reporting periods. Incorporate custom benchmarks for any nontraditional strategies as well.

As reforms make their way through Congress, consultants will be required to go beyond the standard consulting structure and build models that address the expanding needs of plan sponsors to control plan costs and manage plan risk. By understanding the strategies and methods to address these issues, consultants will develop stronger bonds with current clients and open doors to new relationships.

Chad Goerner, CIMA, CFP, is an institutional consultant and senior financial adviser with Merrill Lynch in Princeton, N.J. He focuses on assisting firms in managing their retirement benefit programs and the financial risks associated with them through plan design, cost control, and addressing fiduciary liability concerns. He earned a B.A. from The George Washington University. Contact him at chad_goerner@ml.com.

Tom Applegate, CFA, manages the retirement group’s investment product development and management team with Merrill Lynch in Pennington, N.J. He previously managed development of an asset–liability management process to help plan sponsors assess and mitigate pension risk and served as an institutional retirement plan investment consultant. He earned a B.A. in business and accounting from Muhlenberg College. Contact him at tom_applegate@ml.com.

Endnotes


The views expressed above are those of the authors and do not represent the views of Merrill Lynch.