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From the Editor

Inefficient Frontier: New Paradigm of Pension Investing

Investment professionals agree that the best long-term investment strategy is a steady, diversified mix of equities and fixed income, perhaps supplemented with some “alternatives” like real estate, hedge funds, and private equity. The accepted wisdom is that each investor should seek the efficient frontier in which the optimum asset allocation maximizes potential returns without undue risk.

Since stocks generally outperform bonds over time, for decades defined benefit (DB) plan and other long-term investors have been encouraged to load up on equities. Today, the typical corporate-sponsored DB has a target asset allocation in the neighborhood of the traditional 60 percent equity/40 percent fixed income investment split. The goal for employers was that, over time, higher returns would result in lower company contributions.

While the theory behind this investment strategy remains largely unquestioned, the masters of money are now exhorting many pension plans to dump their stocks in favor of corporate bonds. Is it closet market timing? Inflation fears? Global warming? No, the Pension Protection Act (PPA) and new FASB rules jointly have turned an investment strategy that is expected to under perform into a logical and sound choice for many DB sponsors to seriously consider.

Under the new PPA funding rules being phased in this year, an employer must contribute enough money to the plan to cover each year's benefit accrual, plus whatever amount will be needed to eliminate past under funding over a seven-year period. Benefit liabilities are measured under PPA using the blended interest rate of a pool of high-quality corporate bonds with maturity dates that approximate the expected pension payment schedule. In other words, the

DB's obligation to pay pensions is measured as a long-term IOU. If corporate bond yields decline, the value of a DB plan's accrued benefits increases, and vice versa. In the asset-side of the plan funding equation, the PPA limits an employer's ability to use smoothing techniques to average out investment performance over time. Thus, sub-par investment performance must be "paid for" over seven years of higher company contributions. The upshot is that, more than ever, a company's annual required pension contribution will be driven by the vagaries of corporate interest rates and investment returns.

At the same time, Financial Accounting Standards (FAS) 158 has changed the impact of pension costs on company financials. Each year, a DB sponsor's balance sheet must be adjusted by the difference between its DB plan's assets and its pension liabilities using a blended yield curve approach to measure pension liabilities. However, unlike the PPA funding rules, the accountants measure pension plan liability based on the higher projected benefit liability and do not permit any asset smoothing.

The result is that PPA and FAS 158 impose an annual reckoning on sponsors of DB plans based on that year's stock and bond markets. The short-term impact on corporate cash flow and reported financial results of this mark-to-market approach can be huge. If corporate bond yields decline, pension liabilities can skyrocket. Unless the DB plan's investments appreciate by as much as its liabilities grow, the company's cash flow and balance sheet take a double hit of higher contributions and lower reported net worth.

Still, it would be easier for companies to stomach the additional market uncertainties imposed by the new funding and accounting rules if they could at least profit from the full fruits of good investment performance. Unlike other investors, however, the upside on a DB plan's investment returns is limited by restrictions on an employer's ability to use pension surpluses. Since 1986, Internal Revenue Code Section 4980 has imposed an excise tax, in addition to regular income taxes, on excess assets that are returned upon a plan termination. Currently, the excise tax is 20 percent if one-fifth of the excess is used to increase benefits under the terminating DB plan or one-quarter of the excess is transferred to a replacement plan. The entire excise tax also can be avoided in certain cases where the excess is used to fund retiree health benefits or transferred to an ESOP. However, the excise tax swells to 50 percent if the employer pockets the entire excess. Employers still have ways to use their pension surplus—for example by merging an over funded DB plan with an under funded plan (perhaps one acquired through a corporate acquisition) or by taking a "contribution holiday." But at some point, the over funding ends up having little, if any, value to the employer. In the DB world it is actually possible to be too rich.

The long-term economics of a pension plan have not changed: There must be sufficient money on hand to pay all benefits as they come due. But the new PPA funding and FAS 158 accounting rules are forcing employers into a short-term mind set. Once a DB plan approaches full funding, the plan's investments now will offer little upside and a lot of downside risk because an unfavorable market in which plan liabilities "outperform" assets can cause a company-financial crisis.

Enter Liability-Driven Investing. LDI is a straightforward concept, but one that can be extremely complicated to put in place. Essentially, it means that a DB plan invests in a fixed income basket that mirrors the yield curve or duration of the plan's benefit obligations. The employer doesn't worry about how its investments perform or where interest rates are headed, because the DB plan's assets and liabilities will respond identically to changes in interest rates. If interest rates go down, plan liabilities and the market value of assets will increase in lock-step; if rates move up, liabilities and assets decline. Investment risk is thereby largely eliminated, except for the possibility of debtor default. Of course, so is the possibility of investment gain. But there is no point of an employer's betting on the market if it cannot keep the winnings.

Several years of substantial contributions, solid market returns, and/or benefit freezes have brought many plans to full funding. It makes eminent sense now for their sponsors to begin considering an LDI strategy, even if its long-term performance is expected to be mediocre. Thus, a new paradigm of fixed income investing is being driven by adding changes in the funding and accounting rules to existing excise taxes that, together, remove the upside while increasing the downside of traditional investment strategies.

Ironically, this scenario is unfolding even as the White House, Congress, Department of Labor, IRS, employers, and investment pundits all urge employees to invest their 401(k) accounts in diversified, equity-oriented portfolios. Call it DAISI—Do As I Say Investing.

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