

Investor Resources, Inc.

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Pension Woes

In a seeming contradiction to both HS Dent research and FASB concerns, the *Wall Street Journal* on January 23rd published “Pension Plans Take Healthy Turn” by Theo Francis. This article may at first seem to refute a recent special report “The Death of Pensions” by H.S. Dent which reports quite the opposite.

Analyzing the pension plans of Fortune 100 companies, Francis reports, “after years of steep under funding, pension plans are now healthy, thanks to several years of double-digit investment gains and rising interest rates.” By the end of 2006, the Fortune 100 companies had 102.4% of the assets needed to pay pensions. Francis explains “stock markets gains were the biggest factor in the plan’s recovery, averaging about 12% in 2006. In addition, rising interest rates likely reduced plan liabilities by about 3% - interest rates determine how the company converts future pension payout into a liability on its books today.” This has led Francis and others to believe that the pension crisis is exaggerated.

The problem is, Francis did not cast his net wide enough. Had Francis broadened the scope of data, he would have discovered that the pension system is still in a precarious state. Francis’s analysis covered only the companies in the Fortune 100 – not exactly a good representation of corporate America in general. Expanding the data set to include the companies of the S&P 500 gives a very different representation of pension funding. Examining this larger data set reveals that in 2005, the companies of the S&P 500 only had 90.4% of the assets needed to pay pensions. They were under funded by \$140.4 billion - a much uglier statistic than those for the Fortune 100. It is also worth mentioning that there were only 47 firms out of 500 that had fully funded plans.

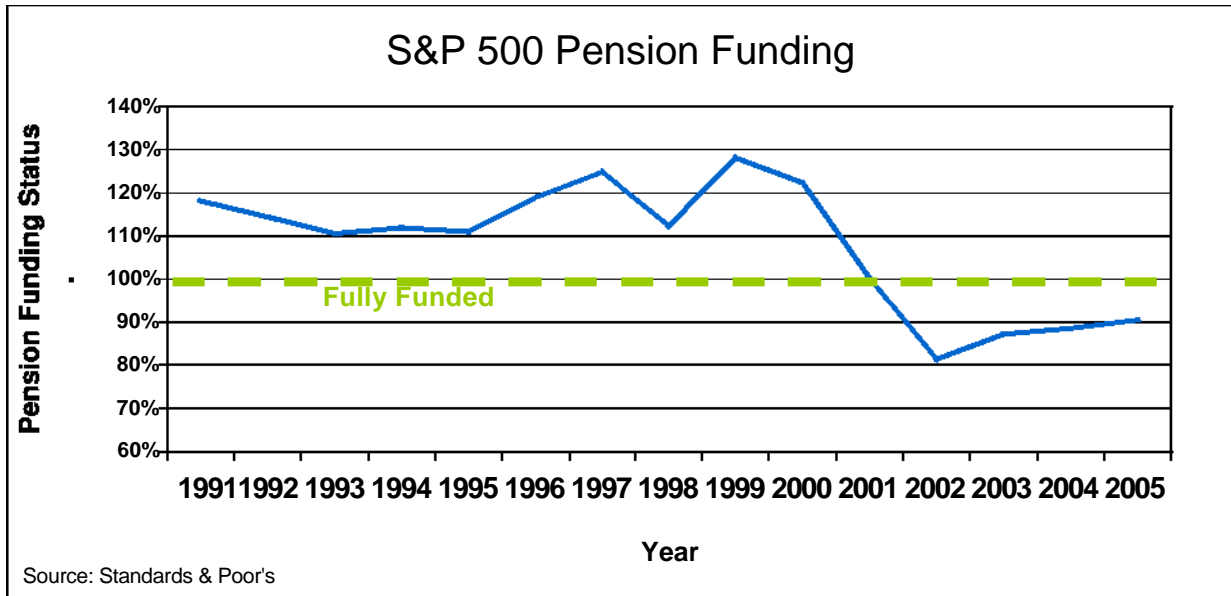


Chart 1, S&P 500 Pension Funding Status

In all fairness, Francis is absolutely correct when he says that pension funding has improved in recent years; this is true of both the Fortune 100 and the S&P 500. And 90% funding is not a crisis, all else equal. The problem is, the funding ratio is a moving target. In the late 1990s, S&P 500 pensions were actually *over* funded before diving into a sea of red ink.

Chart 1 illustrates how quickly pensions can go from being over funded to under funded. In 1999 at the height of a bull market, the companies of the S&P 500 had 128% of the assets needed to pay pensions; they were over funded by \$280 billion. Three years later, after the recession of 2000-2001, the companies of the S&P 500 has only 81% if the assets needed to pay pensions. That is a staggering 47% decrease in pension funding during the bear market. So why are these pensions so volatile? Two reasons: asset allocation and sensitivity to interest rates.

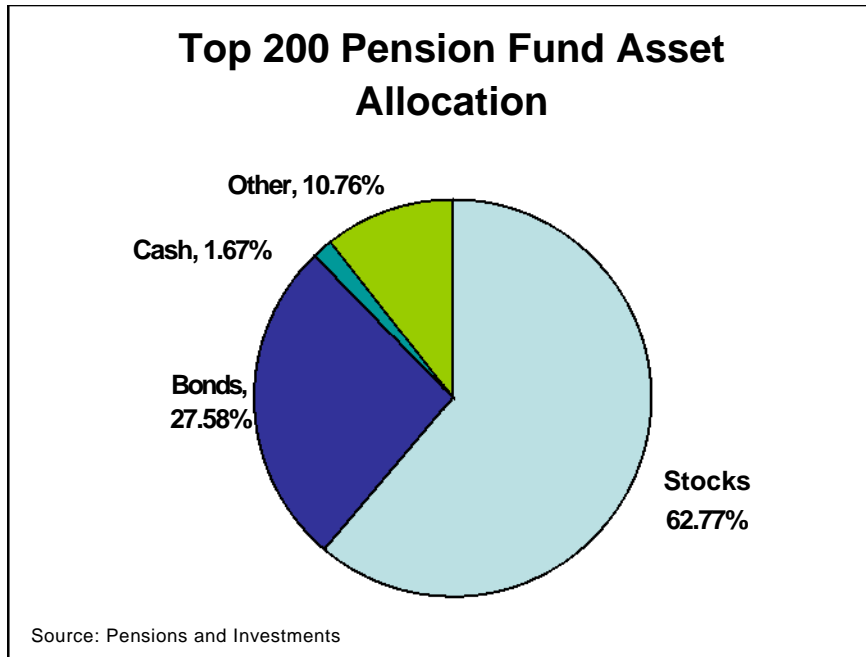


Chart 2, Top 200 Pension Fund Asset Allocation

Asset Allocation

Chart 2 illustrates pension funds invest have almost 63% of their assets in equity. This is a double edged sword. Pensions have prospered from the past three years of bull market. This high level of equity investment, however, can be disastrous for pensions during bear markets, which is exactly what we saw at the beginning of this decade.

If the ongoing economic bubble finally bursts around 2010 and stocks enter a long-term bear market as we are predicting, pensions will suffer dramatically. Funding ratios could easily collapse as quickly as they did during the 2000-2002 bear market, but there will not be a sustained bull market to bail them out next time.

The negative effects of a bear market will cause company pension funds to become critically under funded. These companies will be forced by FASB regulations to pour money into their pension funds in order to maintain acceptable funding ratios. That means there will be less money to pay out in dividends and less money to reinvest into the company for new factories, technology, etc. Ultimately, this leads to less growth, less profit, and presumably a much lower stock price for the company. The perpetual insolvency crisis that American auto companies and airlines face is a fine example.

Interest Rates

Armed with an understanding of the time value of money, it is easy to see that the amount you have to set aside today in order to pay a bill in the future depends on the rate you expect to earn on your money between now and when the bill is due. If the bill a year from now is \$10,000, and you expect to earn 8%, then you must set aside \$9,259 today. If the rate you expect to earn is 5%, then you must set aside \$9,523. While the difference in this example is only \$264, what if the bill in question was not \$10,000, but was **\$1**

billion? This is exactly the situation faced by pensions. As interest rates fell during the 2000s, the rate at which pensions discounted their future obligations also fell. Remember, a lower discount rate means you have to set aside higher amounts today.

Unfortunately, many pensions are counting on rates rising in order to lower their under funding status. While we do see a mild trend toward higher rates, it will not be anything like what these pensions would need in order to get their financial houses in order. It certainly will not be enough to increase the earnings on fixed income securities to a level sufficient to offset pension under funding.

Unfortunately, as we move into the next economic season, we will most likely experience a falling stock market in conjunction with lower rates, leaving pensions nowhere to run when looking for sufficient earnings to pay what they owe.

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