

## Here We Go Again: Plunging Funded Ratios

Joseph Miletich, CFA  
 Managing Director,  
 Global Investment Strategist



### EXECUTIVE SUMMARY

In the movie “Groundhog Day”, Bill Murray plays Phil Connors, an arrogant big city television weatherman who grudgingly travels to the backwoods of Pennsylvania to cover Punxsutawney Phil on February 2nd. After a miserable winter’s day, he goes to bed thankful that he will return to “civilized” life in the big city the next day. When he wakes, he mysteriously discovers that he is reliving the same miserable groundhog day all over again, day after day after day. Such is the experience of corporate sponsors of defined benefit (“DB”) Pension Plans who have yet to adopt an liability driven investing (LDI) risk management program.

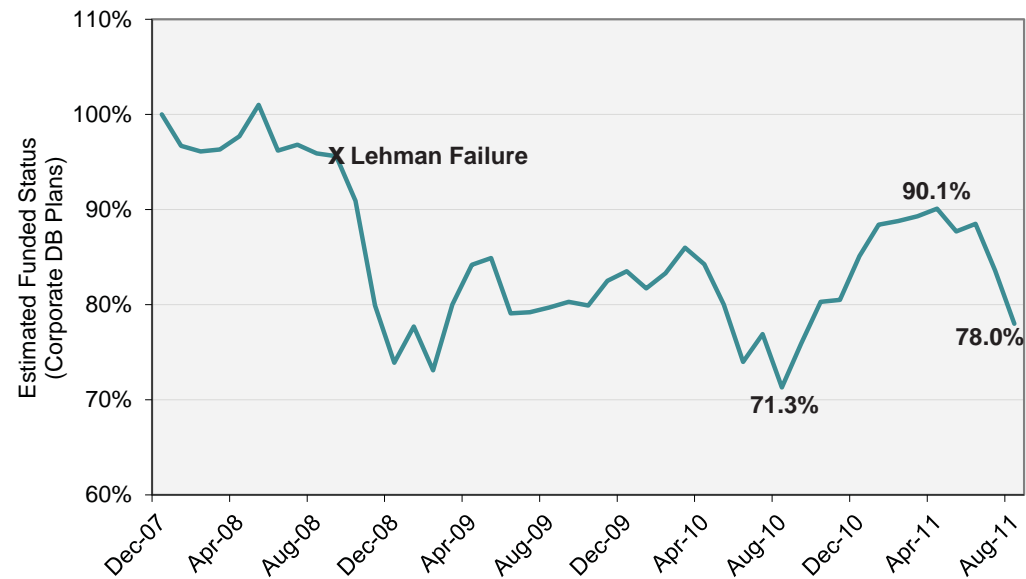
Our latest estimates of the average funded status of a typical corporate DB pension fund (*Figure 1*) has declined by more than 10% in just the last two months alone. This dramatic decline in funded ratio has ceded two-thirds of the aggregate improvement from August 2010 through April 2011, when the funded ratio estimate rose from a trough of 71.3% to a peak of 90.1%.

Figure 1: Historical Estimated Funded Ratios of the Hypothetical Corporate Pension Fund

December 2007 - August 2011

THIS CHART REFLECTS A HYPOTHETICAL PLAN—SEE DISCLOSURES FOR MORE INFORMATION

Data Source: BNY Mellon Pension Services



While we have seen more funds gradually adopt LDI risk management programs, mostly through extending the duration and credit exposure of their existing bond portfolios, it seems the market has yet to grasp what we believe are several key elements of well- managed LDI programs. Specifically:

1. The need for timely and significant action in response to fast changing pension plan fundamentals,
2. The need for second generation LDI strategies that deliver high returns in addition to excellent liability hedging characteristics,
3. The still-too-large impact of the risky asset (or non-hedging) portfolio on funded status volatility.

We have been concerned that the consensus opinion that “rates could only rise” has once again shown that many sponsors are relying on hope instead of an actual strategy. How long can this go on?

Bill Murray’s character was only able to escape his recurring nightmare when he began to change his behavior. We are republishing the research paper titled “Implementing High Return, Liability-Hedging Portfolios” so that you may also escape from your pension plans recurring groundhog day.

#### **Update to Implementing High Return, Liability – Hedging Portfolios by Joseph Miletich, CFA September 2011**

##### **Disclosure Statements**

The estimates and assumption in Figure 1 that underlie the funded status are from BNY Mellon Pension Services, and do not reflect actual or future results. This is presented for illustrative purposes only.

This does not constitute investment advice. You should keep in mind that no allocation plan can always ensure a profit or protect against a loss.

CERTAIN INFORMATION INCLUDED IN THIS PRESENTATION REFLECTS A HYPOTHETICAL PORTFOLIO AND ACCORDINGLY, HAS CERTAIN INHERENT LIMITATIONS. UNLIKE THE RESULTS SHOWN FOR AN ACTUAL PERFORMANCE RECORD, ANY SIMULATED OR HYPOTHETICAL RESULTS DO NOT REPRESENT ACTUAL TRADING. ALSO, BECAUSE TRADES HAVE NOT ACTUALLY BEEN EXECUTED, SIMULATED RESULTS MAY HAVE UNDER- OR OVER-COMPENSATED FOR THE IMPACT, IF ANY, OF CERTAIN FACTORS, SUCH AS LACK OF LIQUIDITY. SIMULATED OR HYPOTHETICAL TRADING PROGRAMS IN GENERAL ARE ALSO SUBJECT TO THE FACT THAT THEY ARE DESIGNED WITH THE BENEFIT OF HINDSIGHT. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE BEING SHOWN.

This presentation reflects the opinion of the authors as of the date noted and is subject to change without notice. The information in this presentation has been developed internally and/or obtained from sources we believe to be reliable; however, Mellon Capital does not guarantee the accuracy or completeness of such information. This presentation is provided for informational purposes only and is not provided as a sales or advertising communication nor does it constitute investment advice or a recommendation for any particular investment product or strategy for any particular investor. Economic forecasts and estimated data reflect subjective judgments and assumptions and unexpected events may occur. Therefore, there can be no assurance that developments will transpire as forecasted in this presentation. Past performance is not an indication of future performance.

Any funds or securities referred to herein are not sponsored, endorsed or promoted by MSCI, and MSCI bears no liability with respect to any such funds or securities or any index on which such funds or securities are based.

## CONTACT US

<b>BUSINESS DEVELOPMENT</b>	Sheryl Linck, Managing Director 412.234.9439 sheryll@mcm.com
<b>CLIENT SERVICE</b>	Earl Kleckner, Managing Director 412.236.3936 earlk@mcm.com
<b>CONSULTANT RELATIONS</b>	Andy Pellegrino, Managing Director 412.234.1909 andyp@mcm.com
<b>CORPORATE OFFICE</b>	San Francisco 50 Fremont Street Suite 3900 San Francisco, CA 94105 415.546.6056
<b>WEB</b>	<a href="http://www.mcm.com">www.mcm.com</a>