2007 Research Roundtable Series

# Today's Pension Investing Playbook: Key Strategies for a New Era

## Defined Benefit Survey Results

**EBRI Policy Forum**

*The Impact of PPA and FASB on Defined Benefit Plans*

**May 3, 2007**
**Washington, D.C.**

Pyramis GLOBAL ADVISORS
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# I. Kick-Off and Welcome

## 2006 Survey Background—5th Annual Survey Designed by Pyramis Global Advisors*

- When: Fielded in October through November of 2006
- Who: 214 of the largest defined benefit (DB) plans in the U.S.
  - 124 Corporates (58%) and 90 Publics (42%)
  - Large plan tilt: 61% over $1billion; median plan is in the $1–$5billion range
- How: Online questionnaire
- Pyramis responsible for interpretation of results
  - Liabilities-related questions based on 214 responses from individuals in HR/Investments functions
  - Investments-related questions based on 158 responses from individuals in Investments functions

*Survey was executed by Asset International, Inc., publisher of *PLANSPONSOR* magazine and *Global Custodian* magazine.

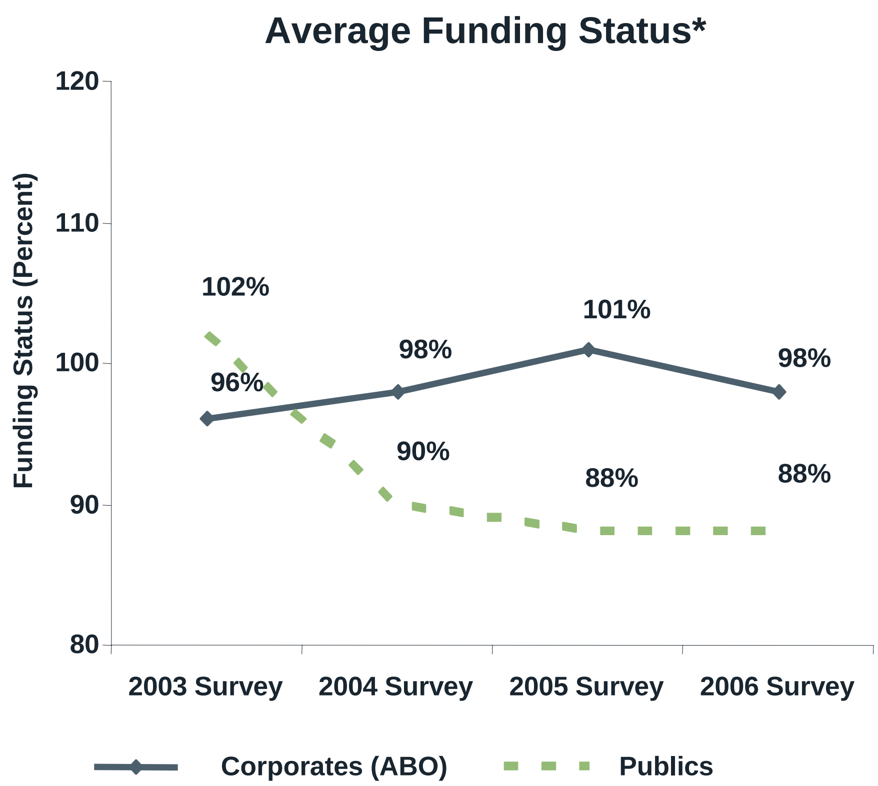
# Executive Summary

- Despite the regulatory challenges and conventional wisdom that "everybody's freezing," DB commitment to existing employees remains surprisingly strong
- Corporates and Publics have historically had different concerns and motivations, but these differences became magnified in 2006
- Despite motivational differences, they share the same investment challenge—meeting return targets in a low-return, low-yield market environment
- The investment playbook is all about *expanding alpha opportunities* to close the "return gap"
  - Loosening constraints
  - Rethinking alpha and beta
  - Alternative assets

# II. The Playing Field: A Dramatic 2006

- Review of 2006: Regulatory, Accounting, and Other
- Funding Status: 2006 and Trend Data
- Corporates and Publics: Strong Commitment to DB, but Differing Concerns
- Other Post-Employment Benefits (OPEB) Health Care and Government Accounting Standards Board (GASB) 45 Implications

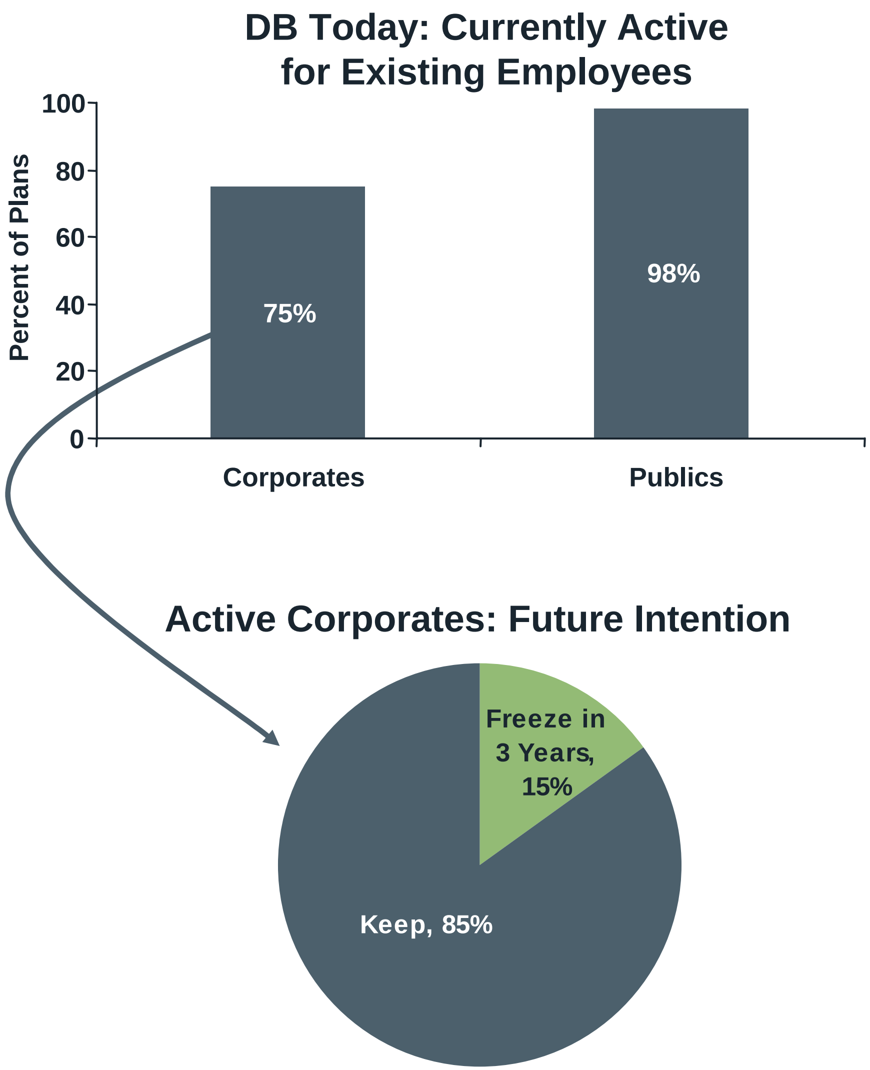
# Funding Status Stabilizing




- Relatively benign capital markets and higher-than-normal contributions
- Corporates: Funding status moves to the spotlight in 2006
  - PPA raises minimum requirements
  - PPA changes formulas for calculating funded status
  - Funding status determines "at risk" categorization
  - FASB: Funding status moves to the balance sheet
- Publics have stabilized, but still below 90%
  - Actuarial Accrued Liability (AAL)

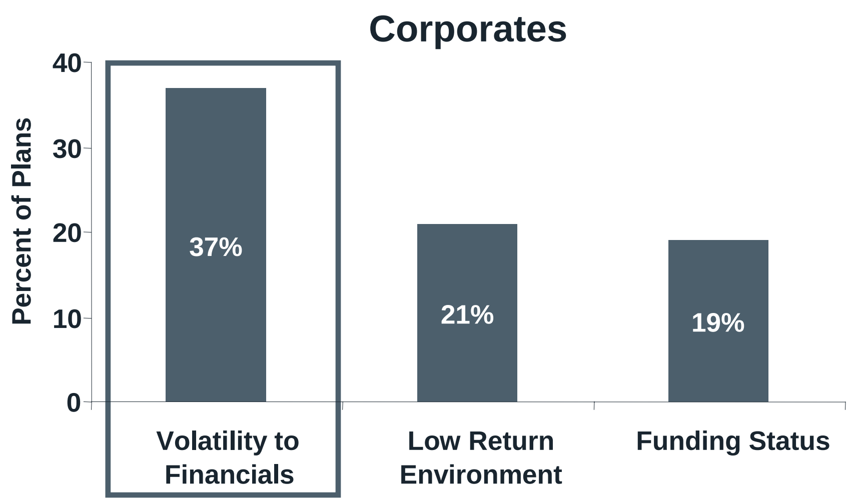
* Survey of 163 plans in 2003, 100 plans in 2004, 189 plans in 2005, and 214 plans in 2006. No data for 2002. Funding status is determined by their respective methodologies.

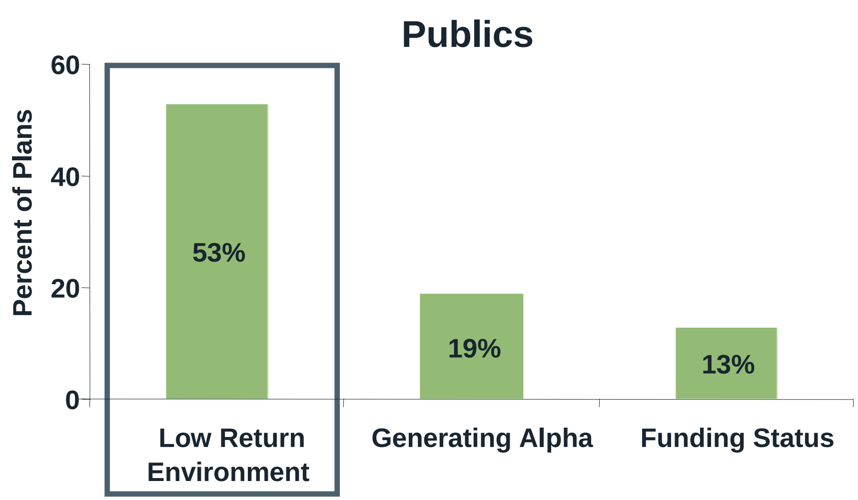
# Strong Commitment to DB…




- Publics: Committed to the DB model, with unwavering loyalty
  - No plan in our survey is considering freezing
- Corporates:
  - 75% were active for current employees (EE's); 25% had already frozen
  - Much of the headline news regarding "freezing" is about "closing" to new EE's
- Corporates: Looking forward, 85% will remain active
  - Freezing phenomenon appears to have played itself out

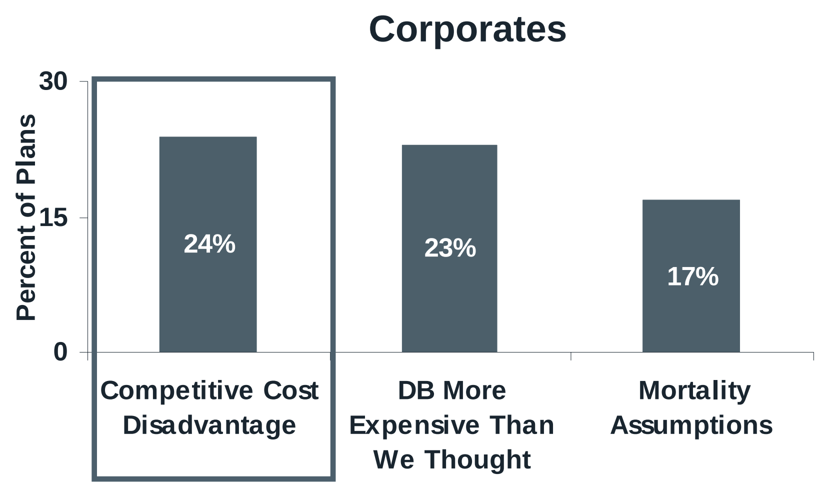
# Corporates and Publics: Top Concerns Differ



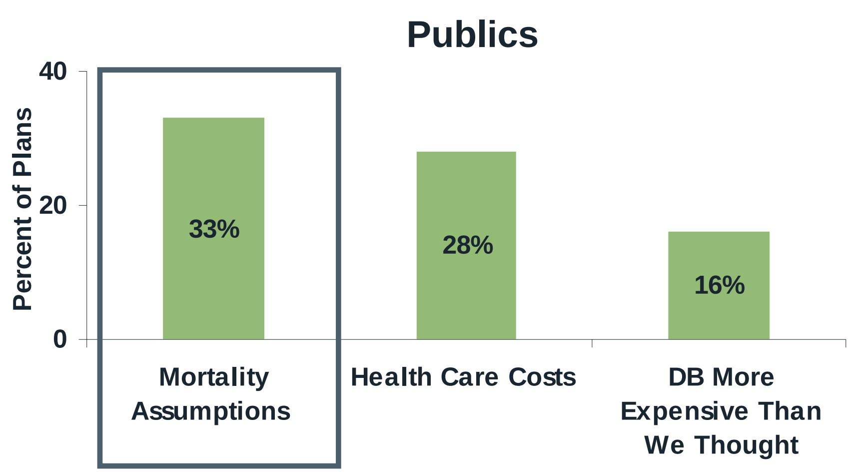




- Corporates
  - "How do I better insulate our financials from pension volatility?"
  - "How do I reach my return targets?"
- Publics
  - "How do I reach 8% when bond yields are below 5%?"
  - "Will my managers achieve alpha objectives?"

# Corporates and Publics Worry About Different Costs



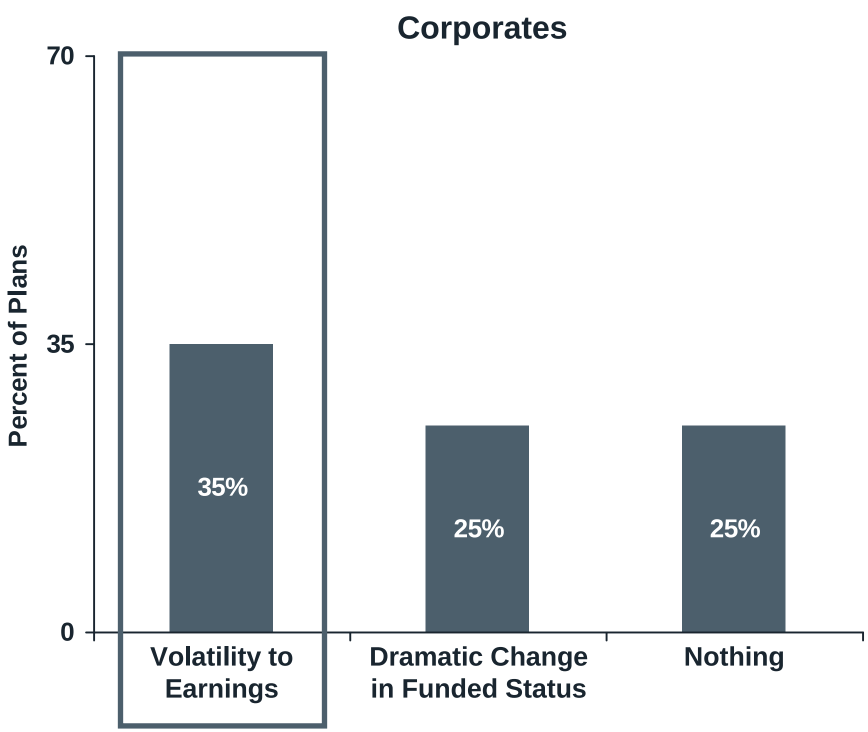

- Corporates
  – "Does the DB plan put us at a cost *disadvantage* vs. our competitors?"

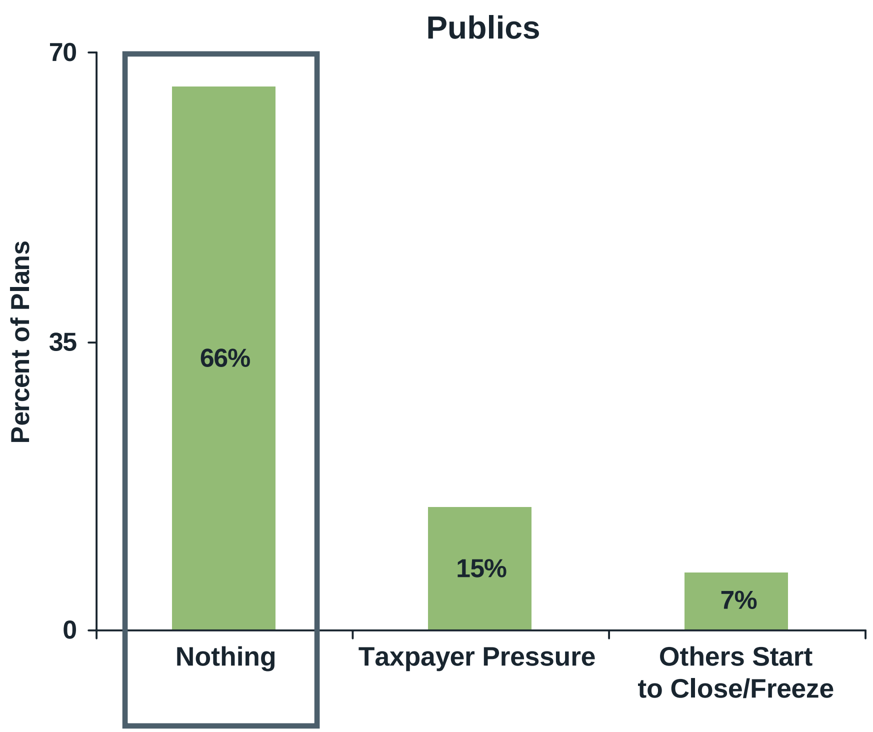



- Publics
  – Worry over mortality assumptions underscores the larger concern—are my liabilities even *bigger* than what we assumed?

# Corporates vs. Publics Likelihood to Revisit Their Commitment

**"What Could Change Your Commitment to DB?"**



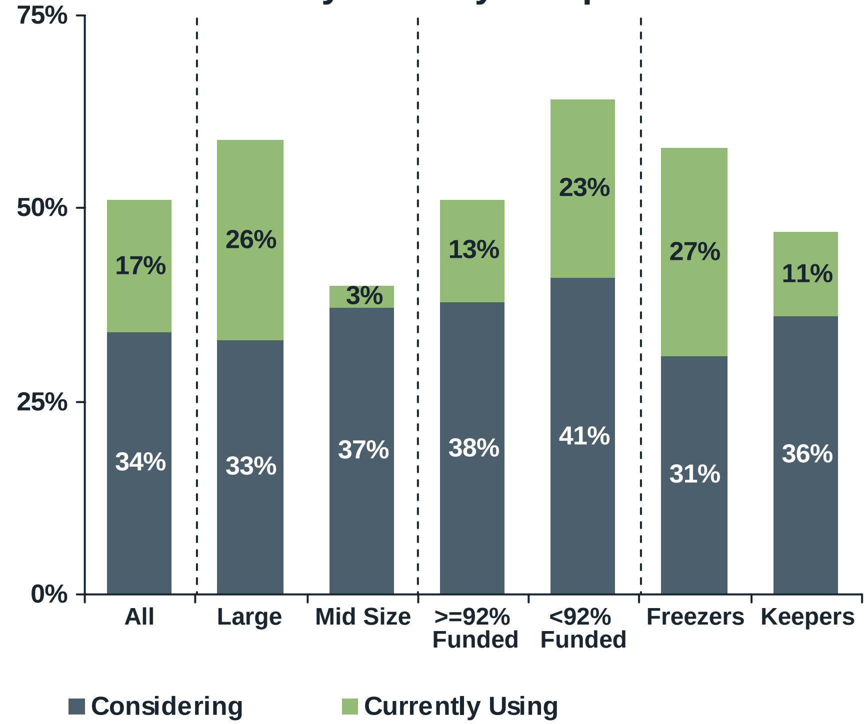



# Solving for Volatility Comes with a Price Tag

**Corporates will probably add more fixed income…**

- 26% of Corporates plan on adding bonds
- Average return expectation for fixed income is 5.5%
- 75% of Corporates expect long-term rates to rise

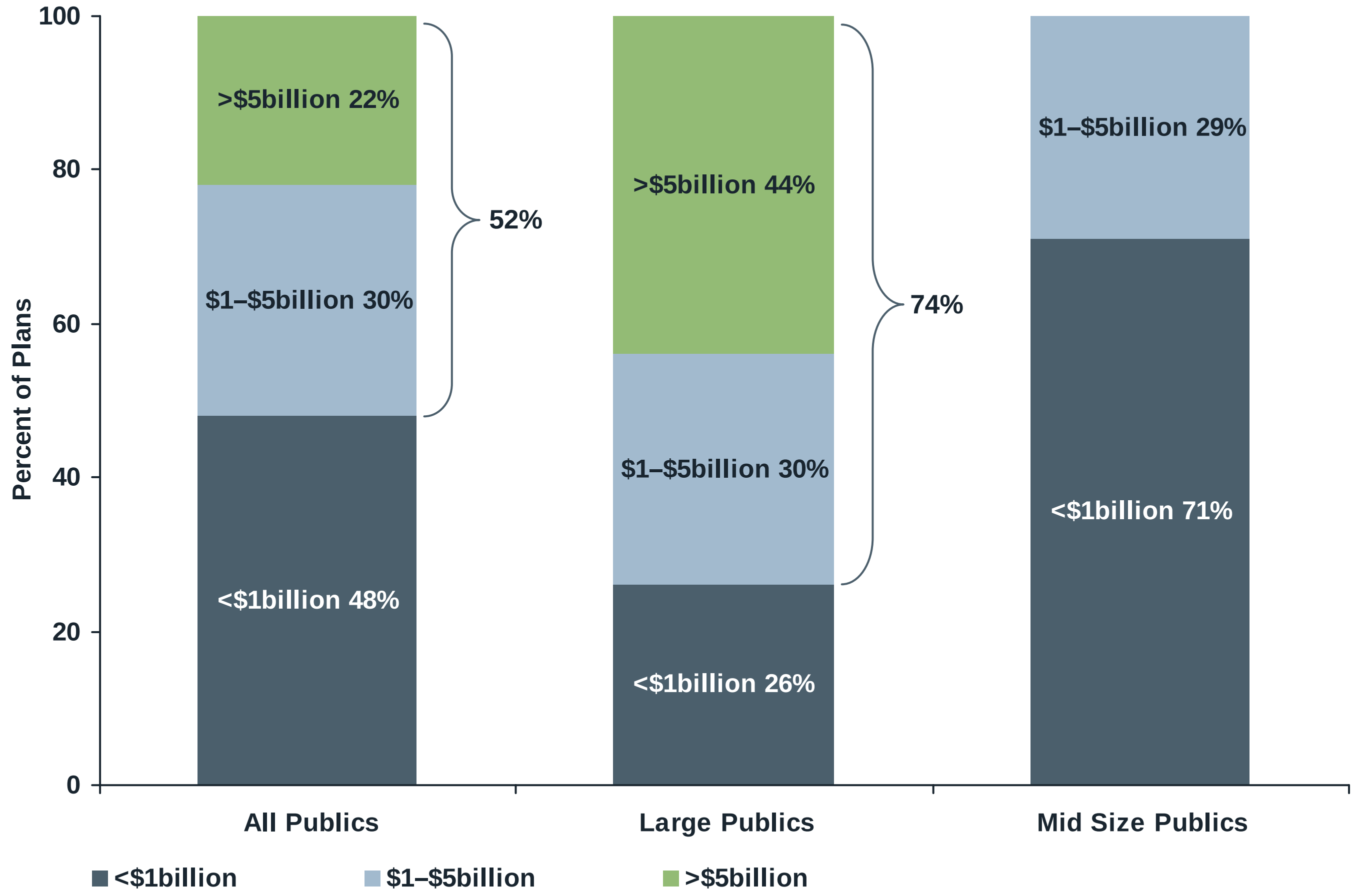
**…and they are very receptive to LDI**




**Lower overall return expectations from beta portfolio**

Note: Large Corporates are plans with over $1billion. Mid Size Corporates are plans with $200million to $1billion.

# New Worry for Publics: Sizeable Health Care Liability*




*Health care liability is called OPEB (Other Post-Employment Benefits)
Note: About half of respondents did not respond to OPEB-*related* question(s). It may have been because at the time of the survey, the liability calculation had not been completed. Large Publics are plans with over $5billion. Mid Size Publics are plans with $200million to $5billion.

# GASB 45 Likely to Trigger Funding

- GASB 45: Starting in 2006, and for the first time ever, Publics will recognize retirement health care liabilities (OPEB)
- Over 40% of Publics believe that other “trusts” will be established
- 30% suspect that OPEB funding could impact pension funding
- Is this competition for pension funding?

# Recap & Discussion

**Committed to DB**

**Corporates**

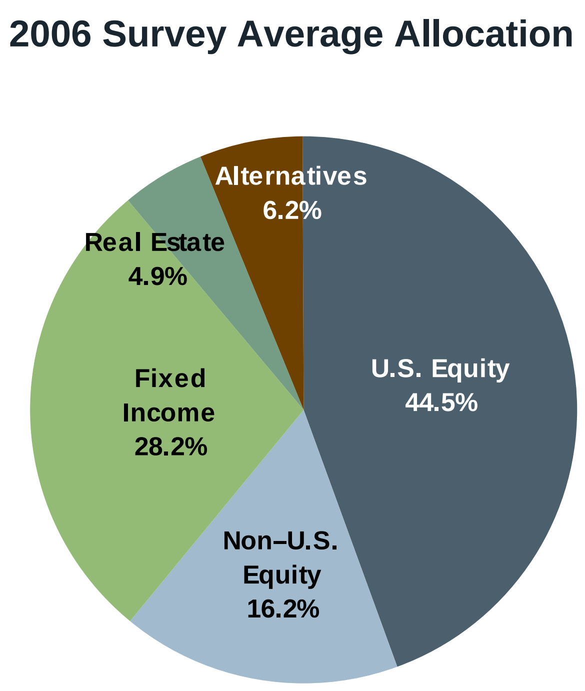
- FASB and PPA = more volatility = more bonds
- More bonds = lower returns, in already low return environment

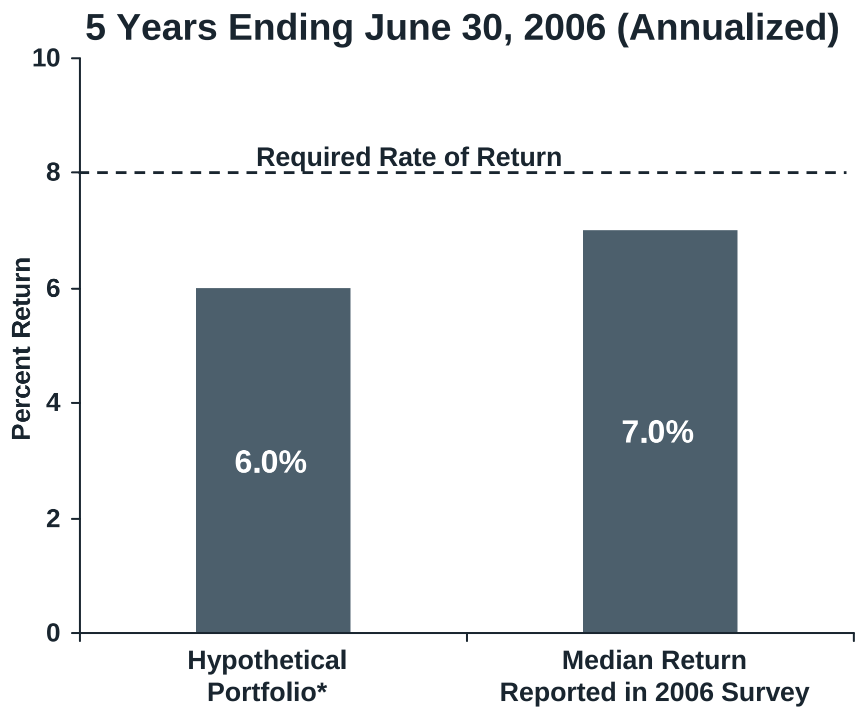
**Publics**

- Low return environment
- Alpha
- Funding status
- Mortality assumptions
- New health care liability

**"How do I close the return gap?"**

# Longer Term, Hurdle Rates Are Challenging

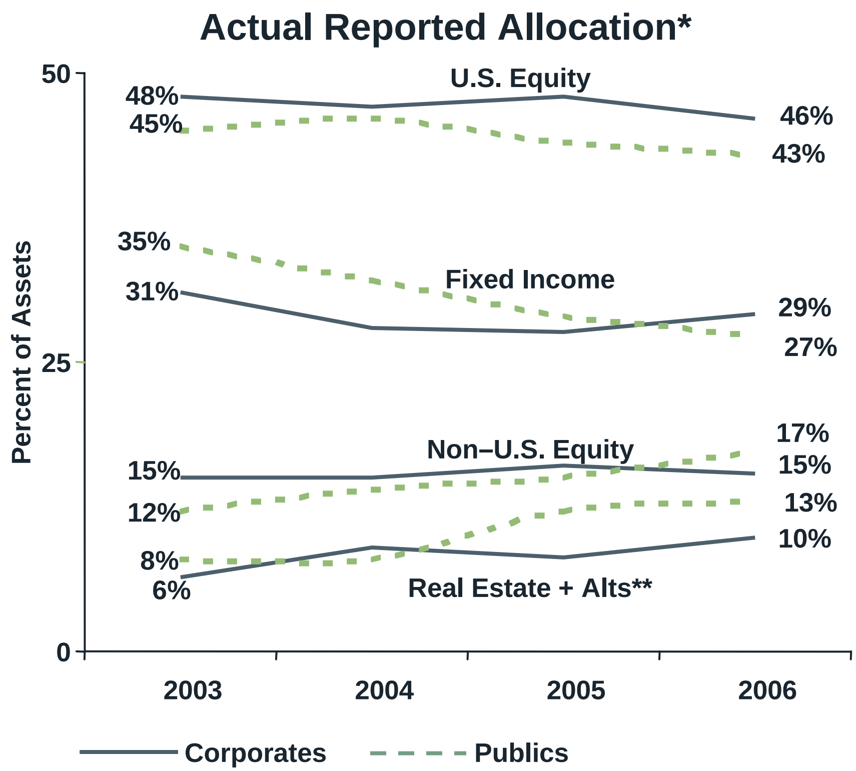



***Hypothetical Portfolio**
**44.5% Russell 3000**
**16.2% MSCI EAFE**
**28.2% Lehman Aggregate**
**4.9% NAREIT**
**3.1% Thompson Private Equity Performance Index (PEPI)**
**3.1% HFRI Fund of Fund index**
**100.0%**

Note: Hypothetical portfolio assumes monthly rebalancing. The hypothetical portfolio represents the retroactive application of the average current asset allocation of the survey respondents invested in appropriate index for each asset class. Hypothetical performance information has certain inherent limitations and may not reflect the effect that any material market or economic factor may have had on use of the model. Index performance is gross of any fees and expenses, including advisory fees, which when deducted will reduce returns. Because Thompson’s PEPI monthly data not available, assumed equal returns throughout. For illustrative purposes only. Past performance is no guarantee of future results.

# Strategic Allocations Have Remained Largely Stable

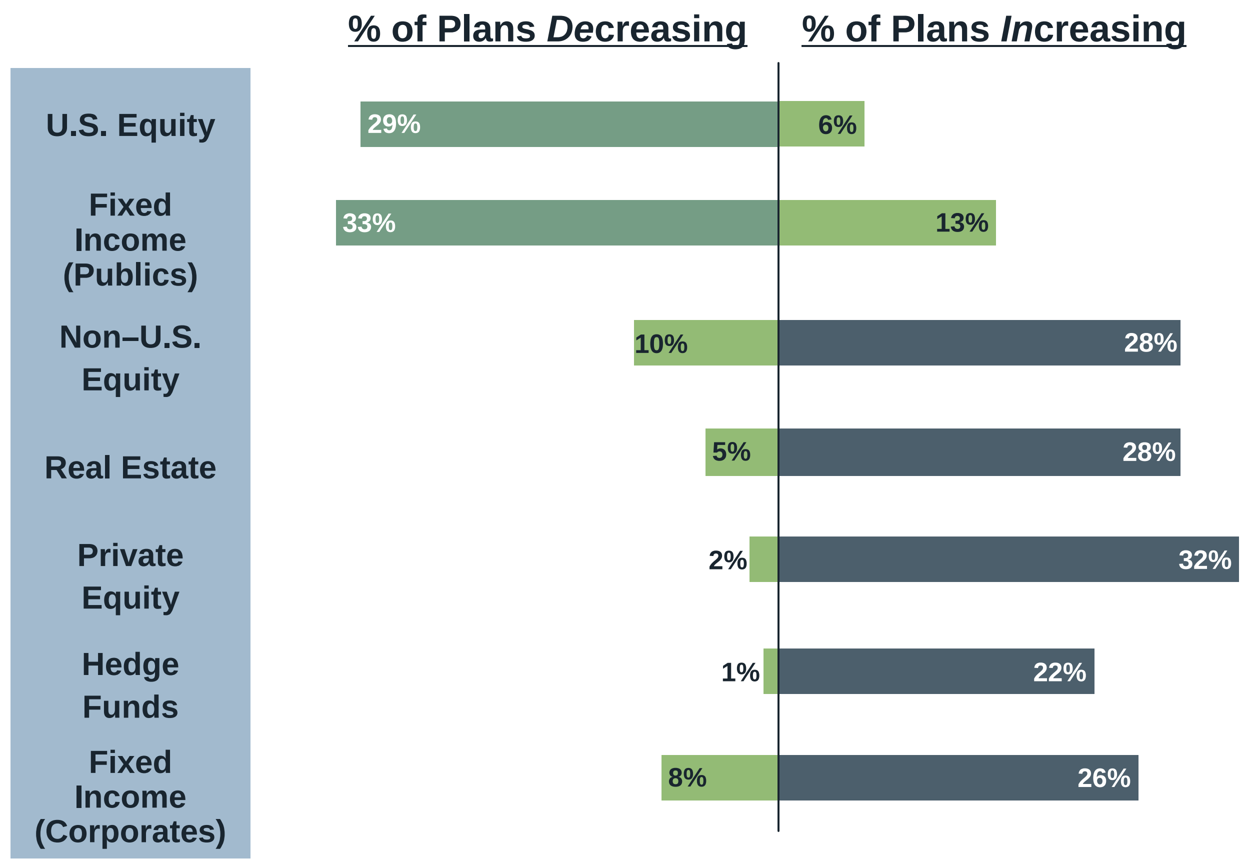



- Fixed income: Corporates adding, while Publics subtracting
- Non–U.S.: Publics have had an 500 bps shift
- Alternatives and Real Estate: Modest shifts but direction is clear

* Source: Fidelity plan sponsor surveys

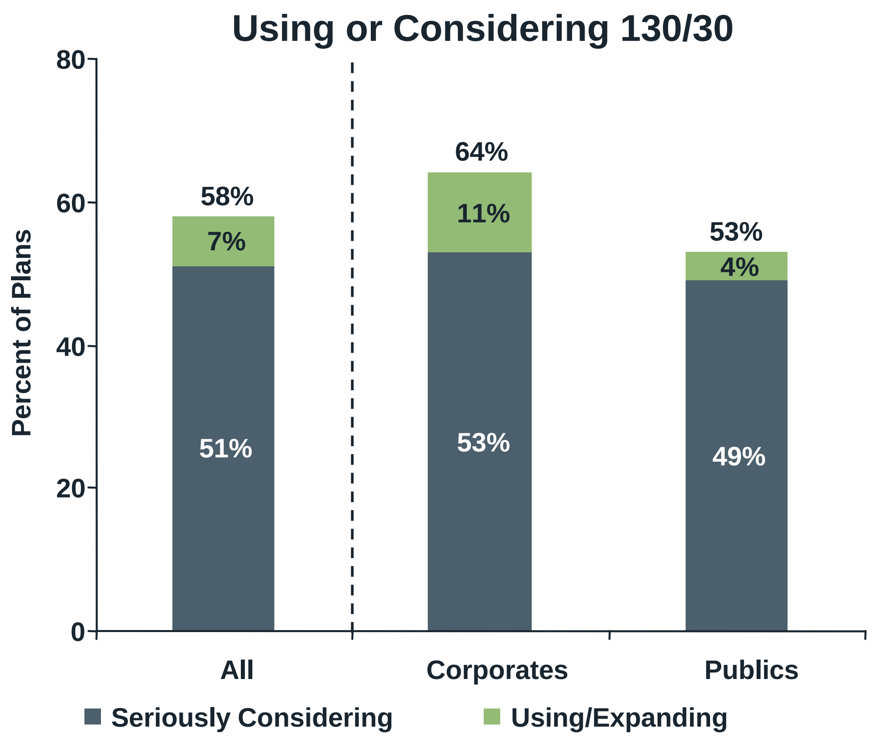
** Alternatives includes Private Equity and Hedge Funds, but also includes commodities, GTAA, cash.

# Shifts to Non–U.S., Real Estate, and Alts—One Exception



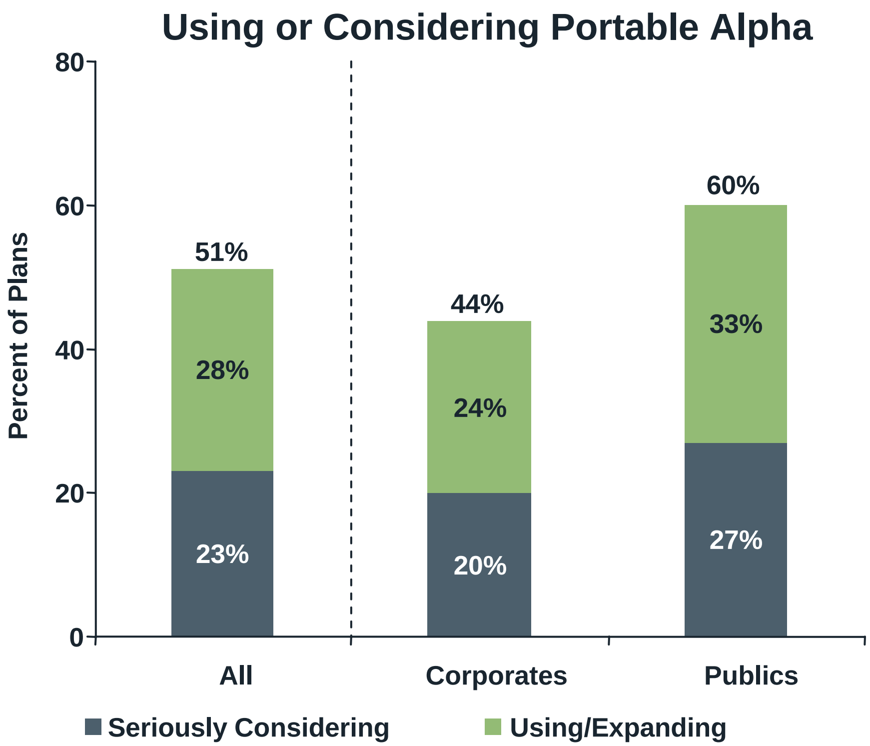
# U.S. Equity: Loosening the "Long-Only" Constraint

New 130/30 Is of High Interest



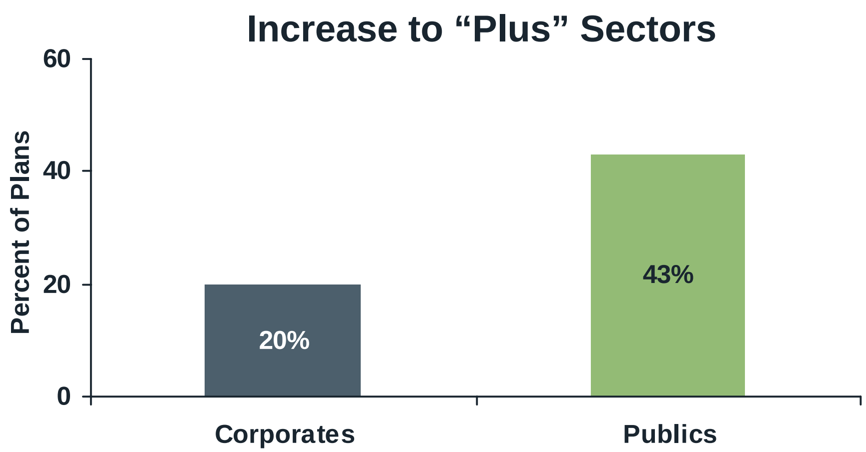

- Large plans are much more interested: About three-quarters seriously considering 130/30
- Main reasons plans are NOT considering are due to investment guidelines

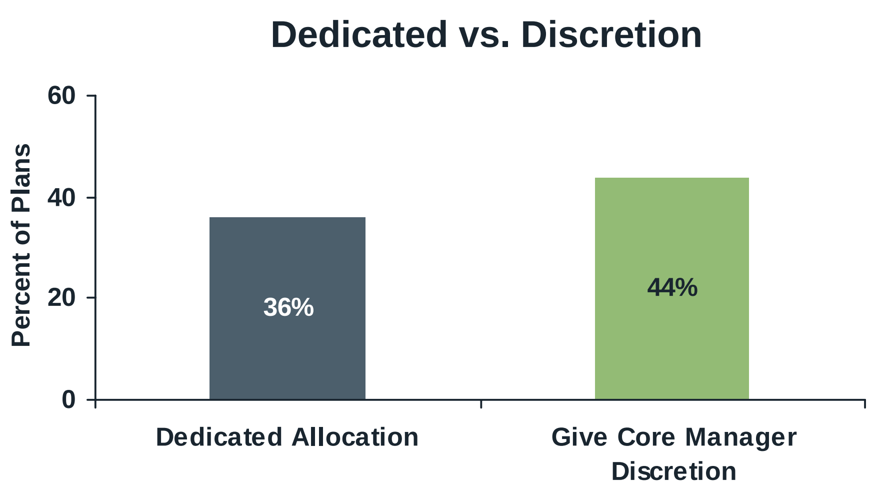
# U.S. Equity: Rethinking Alpha and Beta




- Almost 30% of all plans currently using or expanding their portable alpha program
- Large Publics have endorsed portable alpha
  - One-third of all Publics are using
  - 83% of large Publics are either using or considering
- The alpha is typically a diverse mix of active strategies, fund-of-funds, and equity market neutral
- Most common beta: S&P 500 index (51%)

# Fixed Income: Loosen the Credit Quality Constraint

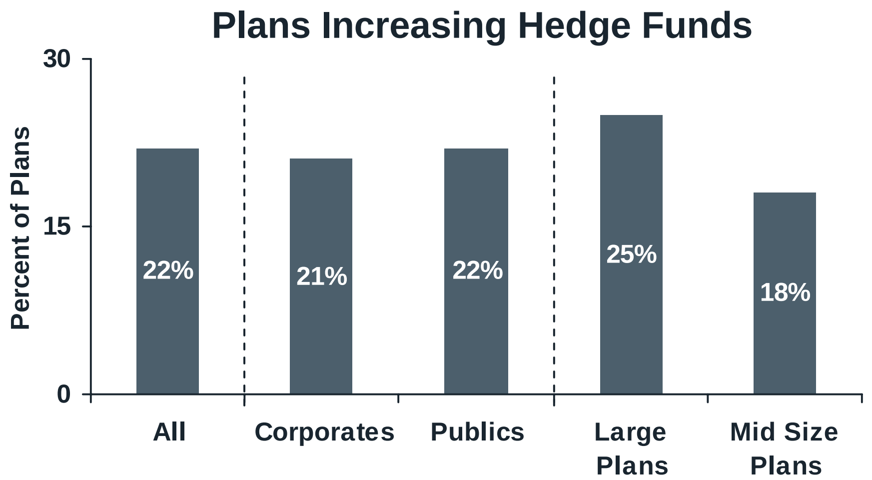


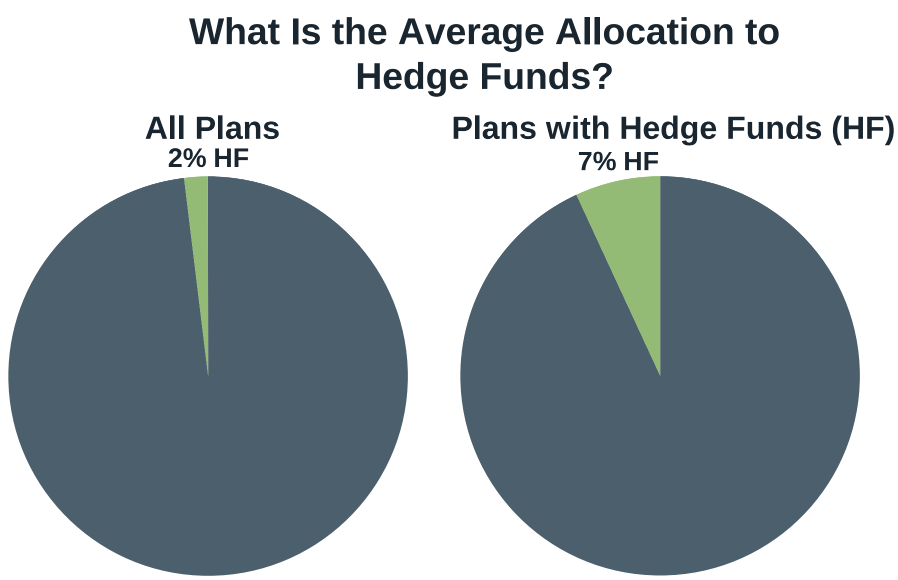




- Plans migrating from Core to Core-Plus (Plus sectors include below-investment grade, such as High Yield, Emerging Market Debt, etc.)
- Publics more interested in “Plus” sectors than Corporates
- On balance, plans want to give active managers the discretion on “Plus” sectors

# Hedge Funds: High Interest but Modest Allocations

Due to Key Concerns




- Top three areas of concern: #1: transparency; #2: risk management; #3: fees
- Of those who have hedge funds, (20%), 65% have no plans to increase
- 80% of plans have no exposure to hedge funds, so most of the activity is from *new* allocations, *not increasing* allocations

# The Investment Playbook Recap

| Traditional Playbook | | The Alpha Playbook |
|---|---|---|
| Long-only | → | Long-short |
| Alpha *with* Beta | → | Alpha *Separated from* Beta |
| Core Bond | → | Core-Plus |
| EAFE | → | Core-Satellite and ACWI |
| Alternatives: “Should we?” | → | Alternatives: “How much?” |
| Derivatives & Leverage: “No way!” | → | “No way we can do our jobs without them.” |

# Appendix

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