Pension Missiles: Is the Cure Worse than the Disease?

EBRI/ERF Policy Forum #55
Richard Berner and Trevor Harris
May 6, 2004
Key Points

• Is there a role for DB plans?

• Is there still a problem?
  • Demographics
  • Deficits / returns / contributions
  • Promises vs Reality
  • Transparency

• What needs to be done?
  • Enhanced transparency
  • Improved incentives to fund regularly
  • Relate “costs” to risks

• Implications of changes for markets
Pension Fund for a Young Company

New Participants, if business stable or declining

Actives

New Participants, if business growing

Current Pensioners

Source: Morgan Stanley Research, See “Pension Missiles: Is the Cute Worse than the Disease?” March 25, 2004
Pension Fund for a Mature Company

Source: Morgan Stanley Research, See “Pension Missiles: Is the Cute Worse than the Disease?” March 25, 2004
Retirees Now Outnumber Active Participants
The Trend Is Unfavorable

Source: US Department of Labor, including estimates, See “Pension Missiles: Is the Cute Worse than the Disease?” March 25, 2004

Sources: Company reports, Morgan Stanley Research
Note: 2004E assumes an 8% actual return on plan assets and no funding.
See "Pension Missiles: Is the Cute Worse than the Disease?" March 25, 2004
Contributions as % of Total Service Costs: S&P 500

Source: Morgan Stanley Research, Company Reports, See “Pension Missiles: Is the Cute Worse than the Disease?” March 25, 2004

Please see analyst certification and other important disclosures starting on page 19
Ratio of Pension Contribution to Benefits Paid for S&P 500 and CIEBA Sample

Source: CIEBA Pension Survey, Morgan Stanley Research, Company Reports, See “Pension Missiles: Is the Cute Worse than the Disease?” March 25, 2004

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Source: Morgan Stanley Research Estimates, Company reports. See “Pension Missiles: Is the Cute Worse than the Disease?” March 25, 2004

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## Missiles’ Impact: Plan Sponsor Changes to Equity Allocation

<table>
<thead>
<tr>
<th>Percentage point change in equity allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1  FASB elimination of smoothing              -9.0%</td>
</tr>
<tr>
<td>2  Treasury requires the use of an unsmoothed corporate yield curve -8.1%</td>
</tr>
<tr>
<td>3  PBGC alters premium system so that premiums are based on equity allocation -7.0%</td>
</tr>
<tr>
<td>4  Discount-rate process altered to allow use of a single long-term growth rate -0.8%</td>
</tr>
<tr>
<td>5  Rating agencies treat the PBO as “debt” -7.0%</td>
</tr>
<tr>
<td>6  Broad adoption of S&amp;P’s definition of core earnings -5.5%</td>
</tr>
<tr>
<td>7  FASB requirement to disclose expected returns -0.3%</td>
</tr>
<tr>
<td>Collective impact                            -12.7%</td>
</tr>
</tbody>
</table>

*Note: Includes US and international equity.*

*Source: CIEBA Pension Survey, Morgan Stanley Research*

*See “Pension Missiles: Is the Cute Worse than the Disease?” March 25, 2004*
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Global Stock Ratings Distribution (as of March 31, 2004)

<table>
<thead>
<tr>
<th>Stock Rating Category</th>
<th>Count</th>
<th>% of Total</th>
<th>% of Coverage Universe</th>
<th>% of Investment Banking Clients (IBC)</th>
<th>% of Rating Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overweight</td>
<td>619</td>
<td>35%</td>
<td>262</td>
<td>41%</td>
<td>42%</td>
</tr>
<tr>
<td>Equal-weight</td>
<td>785</td>
<td>44%</td>
<td>280</td>
<td>44%</td>
<td>36%</td>
</tr>
<tr>
<td>Underweight</td>
<td>375</td>
<td>21%</td>
<td>101</td>
<td>16%</td>
<td>27%</td>
</tr>
<tr>
<td>Total</td>
<td>1,779</td>
<td></td>
<td>643</td>
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<td></td>
</tr>
</tbody>
</table>

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