ASSET ALLOCATION FOR A FROZEN PLAN

Asset Allocation Committee

Introduction

Corporate pension plans face many challenges and changes that may prompt a review of asset allocation. We believe that freezing a plan most clearly highlights the need for comprehensive financial management. Our *frozen plan framework* seeks to define what risks are taken along the path to termination, while retaining flexibility for the specific objectives of each plan.

A plan freeze significantly changes the investment horizon. Benefits for each participant are known with certainty, and future benefits are curtailed. This is very different than an ongoing plan or a closed plan. We define a plan as closed if there will be no future entrants (also called a "soft freeze"), but current participants will continue to earn benefits. A closed plan has significant future benefits earned by participants, and requires an asset allocation similar to an ongoing plan. It is the elimination of future benefits (or "hard freeze") that calls for a special review of asset allocation.

Concept #1 Investment horizon shortened.

Background

The recent increase in plan freezes can be attributed to several factors, notably:

- The bad equity market and lower interest rates in 2000-2002
- Changes in contribution rules (Pension Protection Act)
- Changes in balance sheet accounting (Financial Accounting Standard 158)
- Expected changes in income statement accounting
- Evolving views on the benefit promise and the ongoing switch to DC plans
- Increased scrutiny of pensions by bond ratings agencies and other interested parties

Freezing a plan is often considered a solution for unwanted risk. While a plan freeze does eliminate future benefit risk, it does very little to change current financial risks. The strategies outlined in this paper can materially reduce risk, while maintaining return expectations. These techniques also work for ongoing plans and could reduce the need for future plan freezes.

Most recent plan freezes have occurred among corporate pension plans, because they are most impacted by the changes in rules. Public and Taft-Hartley plan trustees should also understand the issues currently facing corporate plans, and consider the potential impacts on their own planning.

Objectives

While a plan freeze eliminates future accruals, expenses and risks will continue. In fact, PBGC premiums, vendor fees, and other administrative costs are likely to increase over time. Cash contributions and balance sheet accounting will be more volatile under new rules. For these reasons, we believe that the ultimate objective of a frozen plan is to be terminated, with benefits paid in lump sums or sold to an insurance company. This clearly meets the primary goal of providing secure benefits to participants.

Concept #2: Ultimate objective is termination.

We consider termination a medium-term objective for most plans. If a plan is fully funded or borrowing to fund is feasible, it may be advantageous to terminate a frozen plan in the near-term. However, insurance company annuity quotes are significantly higher that ongoing liability estimates (due to lower discounting rates, expected longevity improvements, etc.), so the cost of immediate termination is often a barrier. Many frozen plan sponsors hope to decrease future cash contributions through high asset returns and/or higher interest rates.

An interim goal may be to grow to full funding under the new PPA rules. With no contributions expected, the investment policy would then work to increase assets towards termination liability. Whether the stated goal is full funding or termination liability, risk management is critical.

Concept #3: Cash or borrowing can help.

Risk Management

As stated above, a freeze significantly diminishes the investment time horizon. Given typical assumptions, *a plan will cover less than half of the workforce within ten years of a freeze.* This reduces the focus on long-term risks and rewards, especially given new rules that reduce smoothing and amortization. The major financial risks taken by any pension plan are concentrated for frozen plans. These risks are highlighted below:

1. *Interest rate risk* – Although a freeze curtails future benefits, the interest rate exposure of liabilities will often be the largest financial risk, even if the plan has a cash balance structure. This risk can be mitigated with liability-driven investment (LDI) products that use cash or derivatives to better match liabilities. Products using derivatives allow a plan to retain the earnings power of other investments.

2. *Equity risk* – The typical plan has 60% equity exposure, with the investment based on a very long-term time horizon. A frozen plan sponsor may decide to retain high equity exposure to reduce expected contributions, but should consider capturing gains and reducing equity risk over time.

3. *Manager risk* – For most plans, manager risk (tracking error) is very small relative to duration and equity risks. Frozen plans can benefit from an increase in active risk, but illiquid investments should be avoided.

4. *Contribution risk* – This risk covers the downside of all the others, especially with Pension Protection Act rules beginning in 2008. Few plans can expect to grow their way to full funding with assets alone, so contributions are usually a part of the solution.

One additional risk that is not generally a concern for ongoing plans is the risk of overfunding. Upon termination, a plan with a surplus must pay an excise tax before reverting any proceeds to the corporation. Because of this, many frozen plans aim "close" to termination funding, without going over. This results in a stated contribution target that is available when the funding gap is closed and other risks are removed.

Concept #4: Risks should be defined and managed.

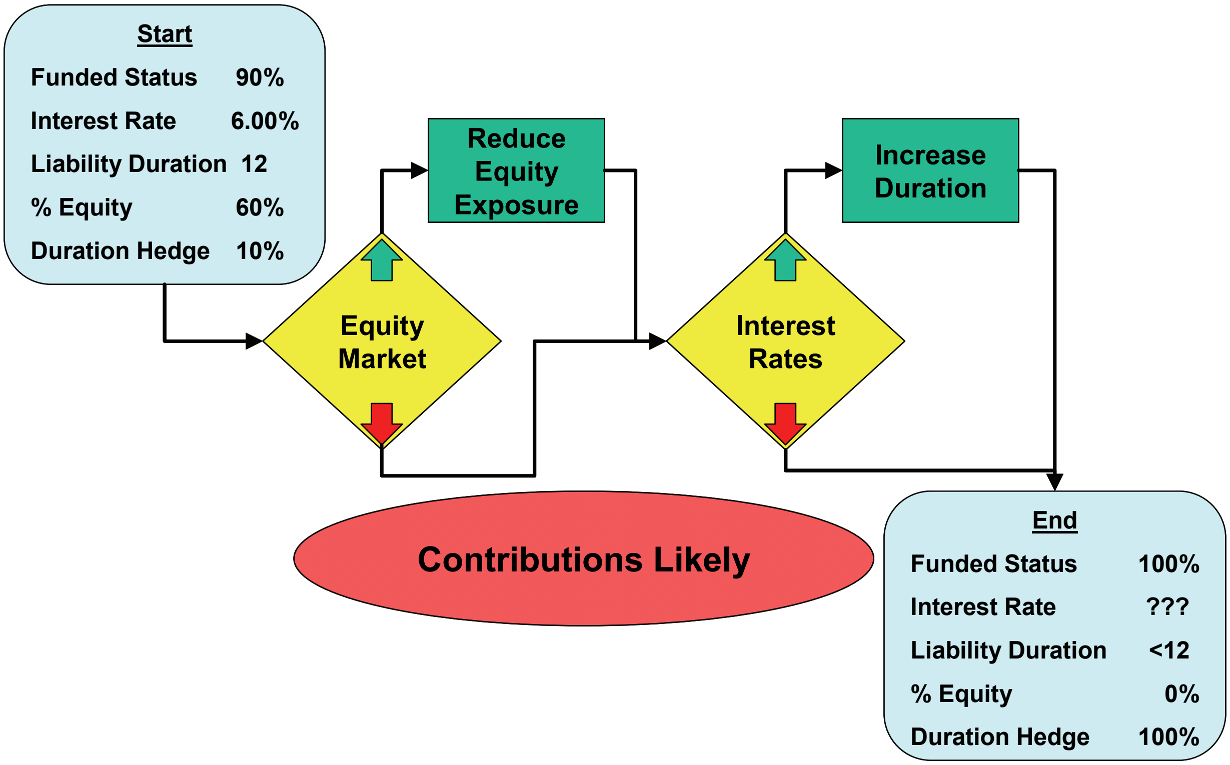
Systematic Reallocation

Looking forward, each frozen plan should have defined risk positions with regard to interest rates, equity exposure, and manager tracking error. These risk positions should decrease as the plan approaches termination, gradually migrating toward a 100% immunized bond portfolio. We believe the best way to get from beginning to end is through a disciplined strategy of capturing gains, both in interest rates and equity. For example, when rates increase, say 25 basis points, the asset duration is increased. When equities rally, the target equity allocation is reduced. While such a strategy does not guarantee full funding, it allows volatility to benefit the plan over time, and helps protect against the downside scenarios that would trigger much larger contributions.

Concept #5: Gains captured over time.

Other Considerations

Given the focus of this paper, we have not addressed important features of ongoing defined benefit (DB) plans. We believe they remain an important tool for attracting and retaining em-



ployees, and provide strong incentive and rewards for long-service employees. For our clients sponsoring ongoing plans, we partner with them to reduce the volatility that has contributed to the increase in plan freezes, using the risk management tools addressed above. We also recognize that many plan sponsors are replacing their DB plans with defined contribution (DC) programs. Our DC consulting practice seeks to work with plan sponsors to help retain many of the investment benefits of a DB plan within a DC structure, using diversified lifecycle structures.

Conclusions

Freezing a plan is an important step for reducing future benefit risks. Financial risks, however, remain virtually unchanged. Investment decisions increase in importance and should be reassessed. Our frozen plan framework seeks to define existing risks, determine ultimate goals, and develop an investment program to meet objectives over time. We have significant experience helping our clients with frozen plans and our consultants are ready to assist you with these important issues.

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