



KAMP INSITE



Fireside Chat

Your Monthly Update from KCS

March 2013

Time for a New Game Plan?

As we touched upon in our January, 2013 *Fireside Chat*, the Private, Public and Union pension deficit in America exceeds \$4 trillion. Since 1999, pension asset growth has significantly underperformed liability growth and the return on assets (ROA), causing increased contribution costs and a national pension crisis. The true objective of any pension plan is to fund their liabilities (benefit payments) at *low* and *stable* contribution costs - with *reduced risk* through time.

Do you need a new game plan? We'll explore the asset allocation issues sponsors face and offer solutions for underfunded plans.

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Rethinking Your Strategy

First and foremost, a plan sponsor must determine or reconsider the appropriate objective for both their constituents and the assets they represent, as the pension "game" has changed over the years.

We believe the only reason a defined benefit (DB) plan exists is to fund a promise that organizations have made to the employee / beneficiary. Historically, the primary objective for DB plans has been to achieve the return on assets assumption (ROA). As market conditions have continued to fluctuate, the industry's focus on the ROA has not served plan sponsors well. It's the primary reason our DB system is in its current state - where most plans, private or public, are underfunded based on any metric - but especially so when both assets and liabilities are valued at market.

As such, the pension liability has to become a focus for sponsors to achieve the goal of providing plan participants' benefits they were promised. The growth in liabilities quickly becomes disconnected from the ROA once the plan is up and running. Given that economic reality, targeting an annual static positive ROA of 8% when liability growth is volatile and interest rate sensitive is just

Rethinking Your Strategy (con't)

not sound practice. Asset growth versus liability growth is a relative return comparison and not an absolute return (ROA) objective.

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Consider a New Playbook

When working with our client’s DB plans, we encourage them to develop a Custom Liability Index (CLI). This is the objective index that enables all plan parties to understand the present value size and interest rate sensitivity of the liabilities on a current basis. Traditionally, most DB plans receive annual actuarial reports three to six months after the end of the fiscal year which provides stale data. Such reports tend to focus on actuarial valuations of assets and liabilities and not market or economic valuations, rendering the output confusing and sometimes erroneous. The projected benefit payment schedule needed to construct the CLI is provided by actuaries; however, it may be an additional service request.

Once the CLI is constructed, we can begin to evaluate how well the plan’s assets need to perform relative to the liabilities, and over what timeframe (usually the modified duration of the liabilities) to begin to chip away at the plan’s underfunding. As the determination is made as to how hard the assets must work relative to the liabilities, we can then begin the process of allocating the assets.

Selecting the Players

“KCS is a proponent of establishing two portfolios...the Beta portfolio, whose job is to match and fund liabilities, and the Alpha portfolio, whose job is to outperform liability growth...”

KCS is a proponent of establishing two portfolios. One is called the Beta portfolio, whose job is to match and fund liabilities, and the other the Alpha portfolio, whose job is to outperform liability growth as measured by the CLI and to erase any deficits.

With regard to the Beta portfolio, we suggest purchasing short maturity U.S. Treasury STRIP securities to match precisely the monthly benefit payments chronologically. STRIP is an acronym for separate trading of registered interest and principal securities. By allocating a portion (not determinable until we create a CLI) to this Beta immunization portfolio, we are securing the benefit payments for your beneficiaries chronologically, buying time for the Alpha portfolio to “win”. This also extends the investment horizon for the alpha portfolio assets, enabling them to capture the liquidity premium that exists. Between 2007 and 2009, many plan sponsors were forced to sell illiquid assets to meet benefit payments that were due, creating exacerbated losses due to these “fire sales”.

Selecting the Players (con't)

Using Beta assets to meet benefit payments chronologically dramatically reduces the potential for this unfortunate event.

“By extending the time horizon for the Alpha portfolio, we are building positions that don’t necessarily have to work immediately, thus reducing the need to have perfect forethought with regard to their short-term returns.”

The Alpha portfolio(s) will be invested in a variety of assets and asset classes that will benefit from economic activity, higher inflation and rising interest rates. In addition, the performance of these assets has historically shown a negative to low correlation relative to liabilities. By extending the time horizon for the Alpha portfolio, we are building positions that don’t necessarily have to work immediately, thus reducing the need to have perfect forethought with regard to their short-term future returns. Examples of assets that we would consider for this economically sensitive portfolio might include real estate, commodities, emerging market debt and equity, timber, agriculture, absolute / alternatives, private equity, Treasury Inflation-Protected Securities (TIPS), etc.

Aren’t Bonds Expensive?

Yes! The U.S. fixed income markets have enjoyed an historic bull market dating back to early in President Reagan’s first term. Long rates, as measured by the 30-year U.S. Treasury, are at roughly 3.2% today, and 10-year Treasury notes are at 2%. It is quite appropriate to ask just how much further these rates can fall. We think the next cycle for rates is clearly higher, but when that starts to happen is not a bet that we are willing to make today. As such, we would recommend using a portion of your existing fixed income assets to create the U.S. Treasury STRIP Beta portfolio, thus reducing the need to “bet” on a direction of interest rates in the near term.

We would suggest that the balance of the fixed income exposure be used to restructure the Alpha portfolio assets to more appropriately anticipate economic growth, inflation and rising interest rates.

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Implement the New Game Plan

Asset allocation decisions have historically accounted for 80% to 90% of a plan’s total return. We anticipate a similar contribution as we move through the next decade. However, the easy money that was made in following the trend of falling interest rates is behind us.

Implement the New Game Plan (con't)

We feel that plan sponsors need to be more tactical in their asset allocations, departing from long-term strategic allocations when it makes sense to do so. However, most committee structures make it difficult to implement these tactical moves in a timely manner.

A plan can overcome this implementation short-fall through one of three ways:

- 1) Have the committee meet more frequently with an agenda that focuses on short-term asset class opportunities;
- 2) Use a tactical allocation manager in the portfolio, either with a portion of the assets or as an overlay manager, and / or;
- 3) Outsource to a third party the asset allocation process, such as an outsourced Chief Investment Officer (CIO) to handle asset allocation as their primary responsibility.

“Plan sponsors need to be more tactical in their asset allocations, departing from the long-term strategic allocations when it makes sense to do so.”

These are difficult economic times. Employees are being asked to contribute more to fund their future benefits in an environment in which jobs are scarce and in the case of union plans, membership is declining. The need to have employees contribute more is a function of the volatility in the performance of assets versus liabilities. Subjecting retirement plans to the additional risks of fluctuating economic conditions can be mitigated by sponsors becoming more liability aware, which will drive asset allocation decisions, and hopefully improve funded ratios and stabilize annual contribution costs. We suggest that you act now.



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