

In Search of Safe Harbor

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Managing Pension Assets in a Volatile Market

On the heels of a tumultuous year, plan sponsors enter 2009 facing tremendous headwinds. Unlike prior economic downturns, today's environment is so volatile and unpredictable that investors are finding that a mere adjustment of the sails is not sufficient enough to stabilize the ship.

The decline of stock market valuations in conjunction with an increase in the liabilities of pension plans has created a perfect storm for plan sponsors. In 2008, the funded status of typical U.S. corporate pensions dropped more than 30%. For companies already reeling from weak demand and income, this decline could have a profound effect. Many will feel it in a number of ways, including having to make higher cash contributions or reflecting deficits on their balance sheet, which could reduce corporate earnings, profits, or even the firm's credit ratings.

Like their private sector counterparts, public funds have also been hit hard by the financial downturn. Before the crisis, most public plans were on a path to full funding as recommended by GASB, but the market tsunami has thrown them off course too. This, coupled with a decrease in tax collections, threatens to hobble many public systems and is forcing many to take a new approach to managing liquidity in an illiquid market.

Security of Pensions

While the turbulence of 2008 has shown that many pension funds' risk strategies have been focused on the short-term volatility of the financial markets, economic pressures elsewhere could present bigger questions about the strength of the pension promise or a sponsor's financial backing for that matter.

With employers eliminating millions of jobs already, and no relief in sight, 2009 may go down in history as the Year of the Pink Slip Parade. It seems virtually no industry is immune, and it is highly likely that companies will continue to take bold steps in order to cut costs. Closing DB plans to new entrants is the tames of those actions in an environment where converting to cash balance plans is becoming commonplace, and many firms are suspending their 401(k) matching programs and pension plans.

Asset Allocation and Reporting

As the decrease in global equity markets take effect, the value of diversification has never been stronger. In recent years, most pension funds have embraced more complex financial instruments, while expanding their range of asset classes to include alternatives such as hedge funds, private equity, commodities and real estate. At the same time, many managers have cast their nets geographically further for investment opportunities, and adopted different types of products and

strategies including liability driven investing.

With this altered landscape, come new requirements for not only managing assets, but also monitoring the management of those assets. In difficult market conditions, every basis point counts and sponsors are becoming more keenly aware of how money is made and lost and where it is being spent. As a result, they are looking to their custodians to help fill the gaps in new ways. This includes support for regulatory reporting and associated audits, investment guideline monitoring and exception reporting, and manager transitions when shifting strategies.

Flight to Strength

In the wake of the current market turmoil, we have seen increased emphasis on the safety of assets. Some sponsors are opting for more conservative investment strategies and prioritizing greater risk control as areas for improvement in fund governance.

While funding deficits are most assuredly back on the agenda, as volatile markets wiped out billions in value - another issue that sponsors are monitoring is liquidity risk. For funds with large monthly payroll commitments, the concern is two-fold: currency positions and cash flows from portfolio assets.

The downstream effect of these liquidity constraints is an environment where some plans are finding that certain assets have quickly become too illiquid to sell, or, conversely, that their strategic asset allocation is too out of balance in order to take advantage of opportunities now arising in the market.

As sponsors focus on efforts to meet their pension liabilities, without stretching their balance sheet, they are increasingly looking toward their custodians and asking two very important questions:

1. Are you stable and well capitalized?
2. What more can you do to help me meet the demands of my various stakeholders?

The challenge of answering to multiple stakeholders is nothing new to plan sponsors. They are accustomed to answering to many masters - CFO's, regulators, and pensioners themselves. Prudently managing fiduciary requirements in that context can seem like a delicate balancing act. Fiduciaries are responsible for providing accurate and transparent information to these stakeholders, but they also must ensure compliance with new accounting and financial regulatory rules and standards.

While many would argue that US plans are mature, those not on the front lines might be surprised at how dynamic and numerous the changes (outside of the market) are that impact these funds.

The impact that stricter regulatory reporting has had on pension funds and their stakeholders is widespread. As sponsors continue to digest recent changes such as the PPA, FAS157, and

GASB40, there are additional reporting changes on the horizon including FAS 132R, and new disclosure requirements for 5500 reporting. Sponsors who have not typically tracked these items, may find themselves in quandary when preparing Form 5500 Schedule R which now includes the presentation of total portfolio duration, and a stratification of Debt instruments between:

- > Government Debt
- > Investment Grade Corporate Debt, and
- > High-Yield Corporate Debt

As regulation has begun to tighten its grip and pension funds have forayed into asset classes across the spectrum, sponsors are more conscious of the fact that they rarely have enough hands on deck to satisfy the needs of all stakeholders. This has new meaning in the post-credit crunch world, where every basis point of return counts and few sponsors can add staff. In the way that investment managers earlier embraced the concept of outsourcing, many plan sponsors have begun to embrace the concept of "co-sourcing." While no one would advocate outsourcing one's fiduciary requirements, many are eager to work with custodians to co-source certain aspects of their job. This increasingly entails taking a more active role in fulfilling reporting requirements, such as FAS 157 reporting and related support for audits and governance.

The never-ending pursuit for the Holy Grail—Transparency!

Institutional investors are increasingly concerned with transparency and current market conditions have only further intensified that scrutiny. In today's transparency-obsessed market, sponsors want to operate in an environment where all the elements of control, compliance and risk management are brought together under one umbrella.

Clients aren't willing to merely accept information; they also want an independent check wherever possible. Several years ago, on the heels of Sarbanes/Oxley we witnessed a similar trend, but in hindsight that was more a blip on the radar compared to the rigorous reviews that sponsors and their auditors are undertaking today in response to FAS 157.

While private equity and hedge funds have become the belle of the pension fund ball in recent years, most plan sponsors are unwilling to grant free reign to these fund managers without a fair amount of due diligence. Plan sponsors now recognize that performing such due diligence is not a one time event. This is particularly true in the hedge fund arena, where nearly 70% of the assets invested belong to institutional investors, who tend to be demanding.

Likewise, the risk stemming from lack of transparency may expose plans to millions of dollars in potential losses due to inaccurate valuations, unknown risk exposure to entities and counterparties, and failed trades. Institutional investors are more likely to invest funds with firms that can both demonstrate a transparent formula for managing and valuing assets and that have a strong operational infrastructure.

Today, plan sponsors are imposing a structured methodology for assessing and managing risk and, consequently, demanding tools

that allow them to dissect their portfolios into more granular pieces. Technology facilitates the process and adds transparency and although sometimes there is a cost involved, sponsors have realized that good governance can have a positive impact on their portfolios. Pension funds are also leveraging technology to scrutinize more closely their fund managers as well as third party administrators, such as prime brokers and alternative asset managers.

Performance and Risk Management

At a time when pension funds were tested as never before by a deep and broad-based economic downturn, valuation risk is a key concern, but so too is reputational risk. If pension funds do not value their holdings, particularly the more complex instruments, accurately and fairly, then their reputations could suffer and they could be the next major headline.

Tools such as performance measurement and attribution, as well as Value at Risk (VAR) models, have become important. Sponsors not only want to drill down into individual portfolio performance, but also want technology that will look at the potential VAR scenarios to see what could go wrong. Increasingly, our mission is to assist clients in managing the down-side with an in-depth view of all of their assets, as well as actionable information about those assets.

While, historically, only the most sophisticated sponsors utilized Value at Risk, we are seeing the plan sponsor community begin to integrate a VAR mindset as part of a comprehensive risk measurement program. The continuing fallout from the credit crunch has only heightened the demand for these types of tools, and, in fact, may lead to regulatory agencies requiring the calculation.

Conclusion

The turbulence of 2008 has heightened pension funds' concerns regarding risk. Valuation risk has given way to reputational risk in a world where even those with a sterling reputation have been stung by high-profile bankruptcies, defaults and fraud. There is renewed focus on how sponsors can generate alpha through better risk management and rigorous due diligence. In 2009, we expect additional commentary around valuations and transparency as sponsors seek ways of improving returns at a time when both insecurity and volatility are often driving the markets.

Transparency, accountability and security are the watch words of the day in servicing plan sponsor assets. As institutional investors grapple with the challenges of how to operate effectively in a strained credit environment amid complex new accounting regulations, they often turn to their custodians for assistance. Providing our clients with meaningful data that allows them to look at their exposures, yields, durations and other measures of risk—plus multiple ways to analyze that data—helps to demystify the process.



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