

THOUGHT CONTAGIONS

## Penron? Truth and Hype about "The Pension Bomb"

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We have already highlighted to clients the risks to earnings and balance sheets for companies that operate defined benefit pension plans (see ["The Deflation Investor's Checklist"](#) November 21, 2001). Now with many large companies having revealed pension-related losses in their year-end quarterly reports and with annual reports on the way with lots of pension footnotes sure to be lurking in the dark corners, these risks have begun to come home to roost.

[A sensationalistic article](#) in the February 18, 2002 *Business Week*, "The Pension Bomb," picks up on these concerns, calling pension problems "another big earnings booby trap out there." And it invokes the name of **Enron** to try to inflame readers about the "looking glass world of pension accounting," which it calls "a chief financial officer's dream -- and an investor's nightmare." It congratulates those companies that have lowered the assumed returns on their pension plan assets as having "come clean about the widening gap between pension projections and reality."

Let's get our feet on the ground here. There is nothing to "come clean" about. Yes, an earnings booby-trap it surely is, as we have already pointed out -- although *Business Week* is largely concerned with purely optical effects on GAAP reported earnings, while the more dangerous effects are elsewhere. I will discuss more important concerns in a follow-up report. But today, I want to make the case that this is no "Penron."

*Business Week* focuses on the estimate for assumed returns on plan assets that companies set each year. This is an important number, because under [Statement 87](#) of the **Financial Accounting Standards Board** issued in December, 1985, a company's pension expense for GAAP reporting purposes is calculated as *though* plan assets earned the assumed return, regardless of how much or how little they *actually* earned. The difference between assumed return and actual return is feathered into pension expense a little at a time over five years. You might well ask, why bother to estimate an assumed return at all -- why not just report the actual performance? If you did that, you'd give up in volatility every thing you'd gain in clarity. For example, consider **General Motors** with defined benefit plan assets at \$82.2 billion (as of September 30), more than twice its market cap. Typical swings in returns from asset markets year-to-year would swamp GM's earnings.

Even small changes in the assumed returns number can cause big changes in pre-tax earnings. For example, if General Motors lowered its assumed return from the current level of 10% down to 9%, that would mean an earnings hit equal to 1% of value of plan assets -- call it \$800 million -- every year. No wonder **Warren Buffett** despairs in a [recent Fortune article](#), "Unfortunately, the subject of pension assumptions, critically important though it is, almost never comes up in corporate board meetings. (I myself have been on 19 boards, and I've never heard of a serious discussion of the subject.)"

From what I can see there's not a lot to discuss. Most companies seem to be clustered in a pretty tight pack, with numbers in the 8% to 10% range. And they don't seem to change them very often. Sure, in an Enron-sensitized world we can imagine corrupt actuaries endorsing a

slightly higher assumed return estimate to help boost reported earnings. But these numbers are disclosed each year in a company's annual report -- so a real outlier would stand out like a sore thumb. And in any particular case, if an investor doesn't like the number a particular company has chosen, just do the simple mental arithmetic required to adjust the reported earnings -- or he could always just sell the stock.

But it seems to me that these numbers are perfectly sensible, or at least as sensible as any numbers I'd be likely to come up with if someone asked me for a guess as to average asset returns over the next, say, 10 years -- assuming some reasonable mix of stocks and bonds, domestic and foreign. According to **Ibbotson Associates'** data, the average arithmetic return for the S&P 500 since 1926 has been 12.8%, and on long-term Treasury bonds it has been 5.6%. Starting with numbers like that -- and considering that you could add small-cap stocks, corporate bonds, and other asset classes with higher assumed returns (the inclusion of which would also lower overall portfolio risk) -- you'd hardly need **Arthur Andersen's** help to get to an assumed return number even at the high end of today's typical range.

But because stock returns have been negative these last two years (though bond returns have *not* been), *Business Week* thinks it's a matter of "coming clean" for companies to lower their assumed return estimates. And Buffett complains that today's assumed returns are "extreme," and are being set by "looking backward at the glories of the 1990s." Wait a second -- during the 1990s, the S&P 500 returned on average 19.3% and long-term Treasuries returned 9.15%. I don't know of any companies who are putting up earnings based on those kind of assumed returns. So are today's numbers really so "extreme"? I think they are not. Buffett may be right that they will not be met over the next couple of years -- and he may be wrong. But such market timing speculations are not properly included in an estimate of long-term assumed returns under an accounting doctrine designed to smooth out volatile results.

*Business Week* and Buffett both focus on the gains in reported earnings attributable to pension credits. **Morgan Stanley** estimates that S&P 500 operating earnings were enhanced by at least 5% in 2000 thanks to such credits. But while it's true that assumed returns estimates have gradually crept up over the last decade (although they have significantly trailed actual market results), these credits are not just the result of arbitrary numbers determined by CFOs or their actuaries -- they are just as much or more the result of very real market performance in excess of the assumed return estimates, which traipse into results gradually thanks to FAS 87.

The longer we stay in a deflationary world of lower nominal asset returns, the more the true, investment results-driven component of those credits will evaporate as the "glories" gradually roll off the books. And when the CFOs and their actuaries decide that such conditions should be reflected in their assumed returns, the process will be accelerated. Indeed, **General Electric** has already lowered its assumed return number, from 9.5% to 8.5%. More might follow the lead of this bellwether company. I think that's enough to worry about without positing self-dealing and corruption in the pension accounting process.

But unfortunately, there is even more to worry about. Beyond the largely optical GAAP world of reported earnings there's the *real* world of balance sheet damage, increased financing needs, and distorted employee behavior that result from dimensions of the pension issue not addressed by *Business Week*. More on *that* to come. **TM**