

MACROCOSM

## Up Against the Pension Headwind

Wednesday, March 27, 2002

Donald Luskin

With only three companies having not yet filed their 2001 10-K's from among the 25 in the Dow Jones Industrials that sponsor defined benefit plans, we can make very accurate predictions about how pension problems will affect 2002 sequential earnings growth. It turns out we were right when we warned last November that the corrosive effects of monetary deflation on asset returns and discount rates would sharply reduce pension plan asset values and damage funded status (see ["The Deflation Investor's Checklist"](#) November 21, 2001).

Lower returns from plan assets that will be reported in 2002 under GAAP will be a \$5.8 billion penalty against sequential earnings in the aggregate, for the 22 DJI companies that have reported. Based on their aggregate reported earning of \$84.6 billion for 2001, this means that the first 6.8% of earnings growth in 2002 will be consumed by overcoming this headwind.

For some companies, the headwind is more like a brick wall. For **Eastman Kodak**, **General Motors**, and **Honeywell**, the year-over-year drop in pension asset returns that will occur in 2002 represents more than 100% of 2001 earnings. Please see the table below for a stock-by-stock analysis.

However daunting the pension headwind for a particular company, at this point it's completely locked in, no matter how the market performs this year. Here's why.

In 2001 the value of invested assets of the defined benefit pension plans of the 22 DJI companies that have reported fell by 13.6% in the aggregate. Somewhat less than half of that -- 6.2% -- came from actual market losses; the rest came from benefits payments. Don't forget, a pension plan has to make money every year just to keep up with its benefits payments, or it starts falling behind. That is, unless the plan sponsor kicks in a contribution -- and there wasn't much of that last year, considering that all but three plans started the year over-funded.

Pension expenses and credits under GAAP are calculated (to simplify only slightly) by taking the market value of plan assets at the beginning of the year, and applying an expected long-term rate of return. Because that rate of return will be applied to an asset base that is 13.6% lower than it was a year earlier, the resulting gains will be commensurately lower. Making matters slightly worse, three companies in this universe have announced that they will be using lower expected rates of return for this calculation next year -- including **IBM** and **General Electric**, which have two of the largest pension funds. No company has announced it intends to use a *higher* assumption in 2002 than it did in 2001 (see ["Penron? Truth and Hype about 'The Pension Bomb'"](#) February 19, 2002). In aggregate, it appears that the weighted-average expected return for 2002 will be 9.41%, down from 9.62% last year.

### RELATED REPORTS

[Penron II: More Pension Tension](#)

February 27, 2002

[Penron? Truth and Hype about "The Pension Bomb"](#)

February 19, 2002

[The Deflation Investor's Checklist](#)

November 21, 2001

*Actual* market returns don't matter much to this calculation. Even if the markets turn in a banner year in 2002 -- as unlikely as that is, in our view -- GAAP still requires companies to use the *expected* return, not the *actual* return to compute pension expenses and credits. Any difference between the two returns is amortized over years -- and either way, *both* are calculated off a base that will be 13.6% lower than it was last year.

Beyond this totally unavoidable headwind facing GAAP earnings, companies with defined benefit plans are faced by entirely different challenge, as well -- the cost of keeping their plans fully funded. Last year's drop in asset values took down the aggregate over-funded status of these plans from \$79.2 billion to \$13.6 billion. But the aggregate measurement of funded status masks great differences among these companies. General Electric's over-funding -- at \$14.6 billion -- alone more than explains the entire aggregate over-funded status of all 22 companies. Nine of the companies are now under-funded, up from only three last year. The median company is only \$91 million overfunded. Please see the table below for a stock-by-stock analysis.

That means that several companies will have to make contributions to their pension funds, some for the first time in years. General Motors, which swung year-on-year from being \$1.7 billion over-funded to \$9.0 billion under-funded, has already announced that it would use most of the proceeds from its recent convertible offering to feed its hungry fund. GAAP earnings aside, that consumes cash, leverages the balance sheet, and reduces strategic optionality (see ["Penron II: More Pension Tension"](#) February 27, 2002).

Of course, factoring in the dynamics of post-retirement health care funds only makes this picture darker. Most of these plans were deeply underfunded coming into last year, and now they are even more so.

With gold hovering between \$290 and \$300, and other indicators of deflation relief at hand, it's easy to imagine that prosperity is just around the corner. But the pension headwind is one of many ways that deflation's legacy will still be with us for quite a while. Remember, though -- some companies don't sponsor defined benefit pension plans, and they are not all technology companies. Among the DJI, pension-free companies include **Home Depot**, **Intel**, **McDonalds**, **Microsoft** and **Wal-Mart**. They will have their own problems to face in what will probably be a challenging year -- but the pension headwind won't be one of them. **IM**

---

On the following page are tables that track many of these factors. They will be updated as the last three companies in the DJI that sponsor defined benefit pension plan file their 10-k's over the coming week. Soon we will also produce companion tables that analyze post-retirement health care plans.

## Defined Benefit Plan Impact on Reported Net Earnings

Source: Company 10-k's, TrendMacro analysis

	ASSUMED RETURN			PLAN ASSETS			P/L	HIT TO NET	
	2002	2001	2000	2001	2000	Y/O/Y	2001	2002est	01 Net %
AA	9.50%	9.50%	9.00%	8,434	9,790	-13.9%	0.7%	(129)	14.2%
AXP	NOT REPORTED		9.00%						
BA	9.25%	9.25%	9.25%	33,810	42,856	-21.1%	-16.7%	(837)	29.6%
C	9.50%	9.50%	9.25%	8,224	8,478	-3.0%	-2.8%	(24)	0.2%
CAT	9.70%	9.70%	9.70%	8,481	9,490	-10.6%	-4.7%	(98)	12.2%
DD	9.50%	9.50%	9.50%	17,923	20,314	-11.8%	-3.0%	(227)	5.2%
DIS	9.50%	9.50%	10.00%	2,450	2,773	-11.6%	-8.3%	(31)	19.4%
EK	9.50%	9.50%	9.50%	6,317	7,290	-13.3%	-5.7%	(92)	121.6%
GE	8.50%	9.50%	9.50%	45,006	49,757	-9.5%	-5.8%	(901)	6.6%
GM	10.00%	10.00%	10.00%	67,322	77,866	-13.5%	-5.7%	(1,054)	210.0%
HD	NO DB PLAN								
HON	10.00%	10.00%	10.00%	11,051	12,264	-9.9%	-3.1%	(121)	122.5%
HWP	9.00%	9.00%	9.00%	881	1,200	-26.6%	-25.6%	(29)	7.0%
IBM	9.50%	10.00%	10.00%	39,565	44,594	-11.3%	-5.4%	(701)	9.1%
INTC	NO DB PLAN								
IP	9.25%	10.00%	10.00%	6,502	7,253	-10.4%	-3.2%	(124)	10.3%
JNJ	9.00%	9.00%	9.00%	4,345	4,857	-10.5%	-5.7%	(46)	0.8%
JPM	9.25%	9.25%	9.25%	4,048	4,314	-6.2%	2.0%	(25)	1.5%
KO	8.50%	8.50%	8.50%	1,492	1,555	-4.1%	-6.2%	(5)	0.1%
MCD	NO DB PLAN								
MMM	9.00%	9.00%	9.00%	6,053	6,954	-13.0%	-10.4%	(81)	5.7%
MO	9.00%	9.00%	9.00%	9,448	10,322	-8.5%	-5.7%	(79)	0.9%
MRK	10.00%	10.00%	10.00%	2,864	3,121	-8.2%	-8.3%	(26)	0.4%
MSFT	NO DB PLAN								
PG	9.00%	9.00%	9.00%	9,448	10,342	-8.6%	-0.9%	(80)	2.8%
SBC	9.50%	9.50%	8.50%	32,715	40,814	-19.8%	-1.6%	(769)	10.6%
T	NOT REPORTED		9.50%						
UTX	9.60%	9.60%	9.70%	10,025	13,119	-23.6%	-17.8%	(297)	15.3%
WMT	NO DB PLAN								
XOM	NOT REPORTED		9.50%						
AVG	9.41%	9.62%	9.50%	15,291	17,697	-12.23%	-6.54%	-263	
TOTAL				336,404	389,323	-13.59%	-6.32%	(5,777)	-6.83%

## Defined Benefit Plan Funded Status

Source: Company 10-k's, TrendMacro analysis

	FUNDED STATUS		
	2002	2001	Y/O/Y
AA	(54)	1,520	(1,574)
AXP	NOT REPORTED		
BA	1,117	13,754	(12,637)
C	401	1,096	(695)
CAT	(129)	1,401	(1,530)
DD	525	3,521	(2,996)
DIS	948	319	629
EK	660	1,760	(1,100)
GE	14,583	21,222	(6,639)
GM	(9,061)	1,735	(10,796)
HD	NO DB PLAN		
HON	99	2,132	(2,033)
HWP	(769)	(221)	(548)
IBM	956	7,055	(6,099)
INTC	NO DB PLAN		
IP	83	934	(851)
JNJ	(671)	292	(963)
JPM	41	416	(375)
KO	(414)	(264)	(150)
MCD	NO DB PLAN		
MMM	(500)	1,049	(1,549)
MO	630	2,740	(2,110)
MRK	(747)	(45)	(702)
MSFT	NO DB PLAN		
PG	630	2,740	(2,110)
SBC	7,655	15,237	(7,582)
T	NOT REPORTED		
UTX	(2,329)	887	(3,216)
WMT	NO DB PLAN		
XOM	NOT REPORTED		
AVG	621	3,604	(2,983)
TOTAL	13,654	79,280	(65,626)