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Asset Rebalancing Strategies During Periods of Market Uncertainty

Extreme market losses in pension funds and the associated volatility have many plan sponsors looking at their asset allocations and questioning the rebalancing policies for their plans. During such turbulent market conditions, rebalancing back to strategic asset allocation targets represents a remarkable act of coolheaded and pragmatic resolve. However, countless studies indicate that over time, rebalancing serves as a valuable tool in improving long-term asset returns and reducing risk for plans.

Traditionally, it has been advocated that plan fiduciaries periodically review their strategic asset allocation and implement a systematic rebalancing program. Unfortunately, recent market volatility and lack of liquidity has resulted in sharp declines in asset returns as well as dislocation in asset prices relative to long-term historical averages. In this highly unusual environment, plan fiduciaries may want to consider several rebalancing approaches depending on their specific circumstances and liquidity needs. As long as there is not an immediate cash need to meet benefit payments, plan fiduciaries may want to consider using an averaging strategy to reach the target allocations over an extended period or adopt a "wait and see" stance until signs of more normal market pricing and trading patterns emerge. The essential issue is to find the best way to rebalance in order to generate the best potential return while minimizing the risk to the plan portfolio.
Several key points to consider about different rebalancing strategies are outlined below:

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Strategy A - Total Rebalance Immediately

- Rebalance to target allocations with additional attention to liquidity needs.
- This rebalance strategy dominates from a return and risk (standard deviation) perspective if equities continually trend upward with low volatility.

Strategy B – Partial Rebalance Immediately, Reach Target Allocations over Extended Period

- Make investment changes using a percentage (i.e. 50%, 33%, etc.) of Strategy A "rebalance" totals over a period of time. Again, pay close attention to liquidity needs for plan benefit payments and expenses.
- This rebalancing strategy dominates if equities are trending downward. This tactic also works particularly well when heightened volatility is pervasive. The downside would be if the markets experienced a sharp and sustained rebound, although risk would still be lessened.
- In this dislocated market environment, bond managers may have atypical opportunities to capitalize through multiple strategies.
- Rebalance again in pre-determined period. Revisit strategy and market conditions.

Strategy C – Maintain Current Allocation "Wait and See" Approach

- Do nothing. If there is no immediate liquidity need, allow markets to "normalize" before making any investment changes.
- This rebalancing strategy could be considered "buy and hold". This strategy will outperform if equities continue to trend downward over an extended period of time with low volatility. As with Strategy B, the negative consequence would be if the markets experienced a sharp and sustained rebound.

Since the duration of the current market turbulence is unknown, consider revisiting the preferred strategy at each rebalance period to determine if expectations have materially changed and if the markets are entering a period of greater stability. The goal of each approach is not to time market movements, but rather to modify and implement fundamental investing principles to achieve long-term goals.

In all cases, the plan fiduciaries should document these decisions and ideally, the investment policy should contain language that provides latitude in times of extreme market volatility.

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Additional Easing of Defined Benefit Funding Rules

In light of the recent financial market downturns and the resulting downturn in pension plan assets, the IRS has recently eased the rules for calculating a defined benefit plans' funded status or "Funding Target Attainment Percentage" (FTAP).

In *IRS Notice 2009-22*, the IRS ruled that pension plans will now be allowed to change the asset valuation methods they will use in 2009 without seeking IRS approval. Previously, plans were required to receive IRS approval to change the asset valuation method used for their plans each year. This change will allow plans to take advantage of the new rules set forth in the Worker, Retiree and Employer Recovery Act of 2008. Most importantly, plans can smooth asset valuations, looking back up to 24 months prior to the beginning of the plan year, as opposed to using a plan's current market value or average asset value. The smoothing method allows a plan to use an expected rate of return on assets when determining the plan's actuarial asset value. The expected rate of return cannot exceed the third segment rate, which is a long-term, high-quality corporate bond rate. This holds special significance now, due to the fact that the recent market downturn had a major effect on many plans' assets and utilizing the smoothing valuation method may mitigate the impact of the dramatic market losses seen in 2008 on a plan's valuation.

In addition to the relief in calculating a plan's assets, defined benefit plan sponsors will also benefit from new changes in calculating plan liabilities. Now, plans will also be able to use a spot-rate yield curve from as early as four months before their plan year begins to calculate their plan funding requirements for 2009, regardless of how the plan calculated liabilities in previous years. So, for a calendar year plan with a January 1, 2009 valuation date, the plans can use the monthly yield curve data for January, 2009, or the yield rate for one of the four months immediately preceding. Prior to this ruling, the IRS proposed that plans would be required to use the spot rate based on the effective interest rate for the month preceding the beginning of the plan year to calculate a plan's liabilities. In the aforementioned scenario, the plan would have been required to use the December, 2008 spot rate, as opposed to the higher interest rates that were in effect in October or November of that year, which would increase the plans calculated liabilities and result in a lower funding target attainment percentage.

The Benefits of Asset Allocation & Continual Retirement Plan Contributions

With the current economic and market conditions, it is easy to understand how a participant might feel more comfortable being out of equities until most of the fear and panic in the market subsides. However, the question arises if they are doing more harm to their portfolios over the long-term than they realize.

An individual who starts regularly contributing to their 401k at the age of 25 will experience many market cycles during the course of their career. The primary focus of the participant should be placed on maintaining the proper asset allocation based on their specific objectives, such as their

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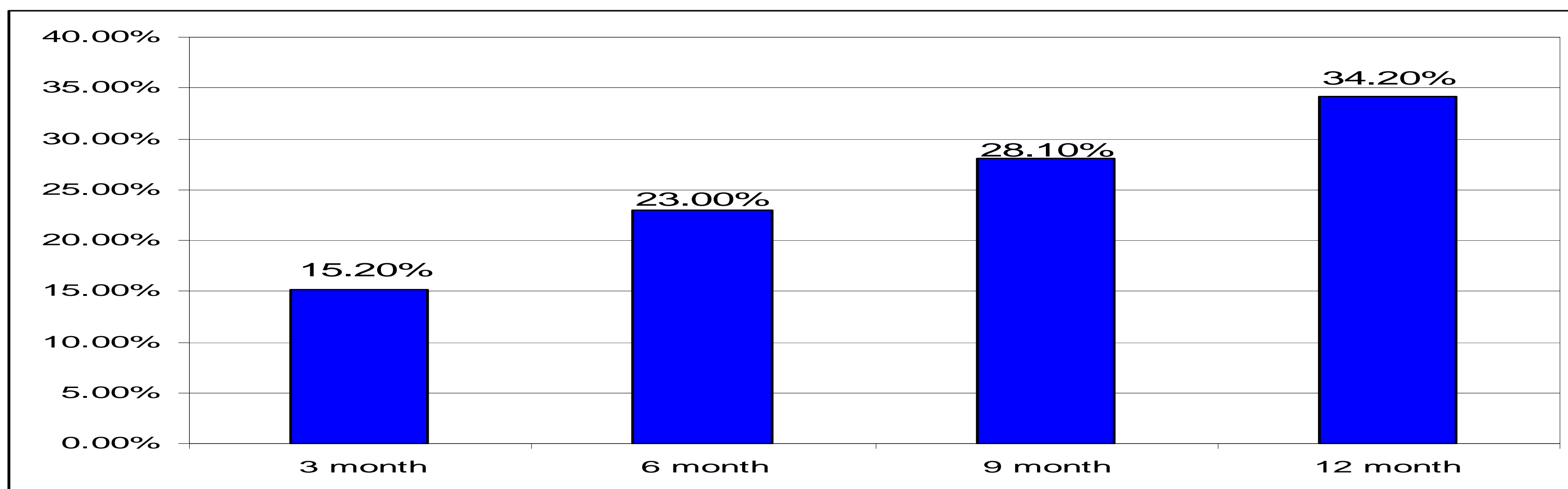
time horizon and risk tolerance. Assuming that the investor's asset allocation was appropriate to begin with, market turbulence does not equate to an automatic reason to dramatically shift their portfolios. William Sharpe wrote about this subject in his 1975 paper titled *"Likely Gains From Market Timing"*. Sharpe used statistical analysis to show that an individual would have to correctly predict up and down markets at a rate of 74% in order for market timing to be beneficial. It would be hard to imagine many plan participants being able to achieve these kinds of results, especially since even many professional money managers have trouble reaching this level of outperformance.

By shifting their portfolios based on where they feel the market will be over the next several weeks, participants may forgo many of the benefits of dollar cost averaging, which in part removes emotion from the investment process. Systematic purchases are made whether the market is in the middle of a bull market or stuck in the depths of a downturn. It is during these downturns that the long-term investor has the ability to purchase shares at a discounted price. While no one can predict exactly when the market will bottom, history has shown that recoveries can occur quite quickly. In fact, Ned Davis Research conducted a study examining the performance of the S&P 500 after the market bottomed during the last 10 recessions. The median returns for the S&P 500 after bottoming are as follows:



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Median Periodic Return Following the Most Recent 10 U.S. Recessions

While past performance cannot predict future results, it does indicate that investors who have stayed the course over the long-term have been able to both purchase shares at discounted prices and experience all of the gains of the subsequent rebound.

U.S. Senate Special Committee on Aging Holds Hearing "Targeting" Target Date Funds

In February of 2009, the U.S. Senate Special Committee on Aging held a hearing regarding the economic downturn and its effect on retirement security, notably upon those close to retirement. Focus was directed towards target date funds due to their growing popularity and their designation under the Pension Protection Act of 2006 as QDIAs. Committee Chairman Senator Herb Kohl of Wisconsin took aim at examining target date funds with particular emphasis on funds designed for investors expecting to retire in 2010.

Notable testimony on this topic was provided to the committee by Dallas Salisbury, the President and CEO of the Employee Benefits Research Institute (EBRI). He highlighted the findings in the EBRI's March 2009 Issue Brief [1], which analyzed target date fund activity of nearly 22 million participants through 2007. One of the findings showed that among 2010 target date funds the equity allocations averaged 45%, but varied significantly, ranging from 26% to 66% among participants within three years of the retirement date at the time of data collection. Per PEI's proprietary universe, the median 2010 Fund lost 26.09% in 2008.

The usage of target date funds in retirement plans has also increased dramatically the past several years. A Fidelity Survey presented before the committee showed that in September of 2005, 4% of their plans offered these funds, while in December 2008 this figure grew to 60%. Although in many cases target date funds had negative returns in 2008, EBRI research found that, as of year-end 2007, nearly 1 in 4 participants between the ages of 56-65 had more than 90% of their account balances in equities, and more than 2 in 5 had more than 70%.

Senator Kohl concluded the hearing by stating his intention to send letters to the new Secretary of Labor and SEC Chairwoman urging for a full review of target date funds and the consideration of additional oversight and regulations for these funds in order to protect plan participants and their retirement security.

[1] Craig Copeland, "The Use of Target-Date Funds in 401(k) Plans, 2007," *EBRI Issue Brief,* no. 327, March 2009.

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Money Market Liquidity Programs

During the last few months of 2008, the U.S. Federal Reserve and Treasury Department implemented a number of facilities to protect money market funds. These initiatives were established to help enhance liquidity and restore the stability of the market, and as importantly, bolster investor confidence. A brief summary of several of these programs is outlined in the ensuing paragraphs:

The **Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF)** seeks to help money funds that hold high-quality asset-backed commercial paper (ABCP) meet redemption demands and restore liquidity by offering loans to banks and bank holding companies to purchase eligible ABCP. This has boosted the comfort level of holding ABCP for many money fund managers who originally cut holdings, but in 2009 are back to targeted levels. The facility has been extended until October 30, 2009.

The **U.S. Treasury Temporary Guarantee Program** has helped stabilize the market conditions over the past months by guaranteeing participating money market mutual fund shareholders based on the number of shares invested in the fund at the close of business on September 19, 2008. However, any additional purchase of shares by an existing or new investor after the close of business on September 19, 2008, will not be guaranteed. Unless further extended by the U.S. Treasury, the program is currently set to expire on September 18, 2009.

To provide liquidity and help ensure timely payment of principal and interest, a limited liability company called the CPFF LLC was created under the **Commercial Paper Funding Facility** (CPFF). To meet this objective, the CPFF LLC purchases eligible three-month unsecured and asset-backed commercial paper from eligible issuers and holds the paper until maturity. The Federal Reserve Bank of New York finances the purchases and PIMCO serves as the asset manager. This program has also been extended through October 30, 2009.

The **Money Market Investor Funding Facility** (MMIFF) also improves market liquidity by increasing the ability of banks and other financial institutions to meet redemption requests. Under this program, the Federal Reserve Bank of New York provides senior secured funding to a series of limited liability companies that were initiated by the private sector. The limited liability company purchases U.S. Dollar denominated certificates of deposit and commercial paper of highly noted financial institutions with maturities of 90 days or less. JPMorgan Chase is the sponsor and the manager of the conduits. This program is currently set to expire on October 30, 2009.

The U.S. Treasury Department issued the **Temporary Liquidity Guarantee Program** (TLGP) via the FDIC in mid-October of 2008. This program allows the FDIC to guarantee newly-issued senior unsecured debt that is issued by FDIC insured institutions and their holding companies on or before June 30, 2009. If needed, the FDIC will continue to make scheduled interest and principal payments under the terms of the debt instrument through June 30, 2012. In addition, the FDIC provides full coverage for non-interest bearing deposit accounts held at FDIC insured

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institutions and will protect payment-processing, payroll and working capital accounts of small to medium-sized businesses. This deposit guarantee program is scheduled to expire on December 31, 2009.

PEI has spoken with a number of money market fund managers, strategists, and credit analysts in 2009. All have clearly indicated that they have observed a definite improvement in credit conditions in money markets as a result of these programs. Portfolio managers remain cautiously optimistic, but do continue to hold higher than typical levels of short and overnight liquidity. They are also cautiously optimistic that these programs will most likely be extended through the end of 2009 to avoid market dislocations.

Key Criteria in Evaluating a Money Market or Stable Value Fund

Plan fiduciaries can take some solace in the governmental programs now supporting money market funds, but must also be diligent in monitoring these investments. A number of key criteria that need to be considered are outlined below:

Performance: How has the fund performed relative to its benchmark and its peer group? Is the risk-adjusted performance in line with the investment strategy?

Transparency: Does the fund publish holdings on at least a monthly basis? Does the fund address the liquidity issues associated with their holdings?

Liquidity: Is there a diversified mix of short and longer dated holdings, and overnight liquidity to meet changes in cash flows? Is the average maturity or duration in line with the fund's investment strategy? For stable value funds; the fund should have appropriate liquidity tiers. Also, the fund should fully disclose its holdings in asset-backed and mortgage-backed securities.

Credit quality and the fund's credit evaluation process: Is there a dedicated team assigned to understanding the risks associated with holdings? For money market funds, what due diligence does the fund management perform on asset-backed holdings with regard to the vehicle collateral, and support agreements? Is the credit support relationship of the conduit sponsor well understood? For stable value funds; what is the nature and diversification of the wrap contracts, and the credit quality of the wrap contract issuers? Are contracts designed to weather a wrap provider leaving the market? Also, has the fund increased their exposure to general account GICs?

Portfolio valuation: How is the fund evaluating the holdings, especially less liquid asset-backed and variable rate securities? For stable value funds; is the fund disclosing the market-to-book value and is it in line with similar funds?

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Changes in asset base: What is the cash flow history in and out of the fund over the last year? How has this impacted the yield of the fund?

Repurchase agreements: What type and what level of collateralization?

Securities lending: What is the percent of fund that participates in securities lending, along with the nature of the collateral?

Fees: Are they in line with the industry, given the investment strategy? For stable value funds; has there been an increase in wrap contract fees?

What's New at PEI

As part of our national growth plans, PEI recently hired Fred Stewart as an investment consultant in our Atlanta office. This is the second of our four regional offices to now have a permanent local presence. Fred has over 20 years of industry experience and is a member of the Southern Employee Benefits Conference (SEBC). He has a wealth of experience working with pension, 401(k), 457, and 403(b) plans in a number of industries and we are excited about our increased exposure in the Southeast.

Underpinning our success has been our core philosophy – do everything in the best interest of the client. By being true to this tenet, we hope to continue to grow as a firm and to develop our regional offices.

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