First, the headline:

Before this decade ends, there will be a Massive shift of pension assets from Equities to Bonds.

It will not be driven by accounting changes.

It will be driven by common sense.

BUT, that common sense will be made possible by accounting changes.

We three are going to outline coming changes in Pensions.

These changes are inter-related.

The proof of the pudding will be seen in investing. I believe that Carl and I do not agree about how massive the changes will be nor about how sensible.

Accounting and actuarial changes will lead. Any major statutory changes that we see will come later. If the statutes change as I hope, they will carry the same implications for investing.

On the statutory front, 2003 defined a future battle over funding rules – strong standards that may hasten the demise of SOME DB pension plans -

versus

weak standards that will prolong and worsen the damage that weak companies do to the system – analogy is the savings and loan debacle.

Hawks, such as I, want full funding at all times

Investing battle lines are drawn between two models:

The traditional model is based on the portfolio selection theory that derives from Markowitz and Sharpe – and which should apply to the portfolios chosen by INDIVIDUALS.

The corporate finance model, which should apply to corporate pension plans, is based on Modigliani, Miller, Treynor, Tepper and Black. For those of you who attended last year, Zvi Bodie explained why this model leads to bonds, bonds, bonds.

The accounting changes that will lead us to apply the proper finance model may be summarized as FAIR VALUE.

The Fair Value paradigm replaces historic cost with an effort to mark assets and liabilities to market.

Fair value will apply first to those assets and liabilities that may be called “financial instruments”.

Aimed at 2005, this application has been slowed somewhat by a parallel effort to internationalize corporate accounting standards.

The remainder of my talk consists of outlining:

the implications of fair value for pension accounting, and

the implications of pension accounting for investing

On the following slides I will highlight elements of the current standard, FAS 87, in red and the likely changes, under fair value, in green.

FAS 87 allows actuaries and accountants to make several smoothings. The first of these is the value of assets which is often a five-year trailing average of market values.

The only FAIR VALUE for assets is MARKET

FAS 87 discounts future benefit payouts using double-A rates, usually an index such as Moody’s. FASB wants us to use a yield curve and may have something to say about this within a year.

FAIR VALUE requires the use of a yield curve that properly reflects the fact that pension plan promises are collateralized by the funded assets

and

that the strength of the promise depends on these assets and upon the strength of the plan sponsor.

FAS 87 pension expenses have four components. I will outline changes for each.

The first component is the value of benefits newly earned by plan members. FAIR VALUE does not change this in concept, but may do so in details.

The second component of pension expense is the time value increase in liability value. Under FAS 87 this is computed as the discount rate times the beginning of year liability value.

FAIR VALUE will call for the total return on liabilities including the liability price change.

FAS 87 pension expenses are reduced by the EXPECTED return on plan assets which is applied to smoothed asset value.

FAIR VALUE accounting will replace this with the total return on the market value of assets.

Under FAS 87, all the mismeasures of prior years (for example, the change in liability prices and the difference between actual and expected asset returns) are deferred and then dripped into the expenses or income of future years.

FAIR VALUE requires immediate recognition and thus there are no deferred items to amortize.

Under FAS 87, all four elements of pension expense are treated as operating expenses (income when negative).

A study by two Federal reserve economists, Julia Coronado and Steven Sharpe shows that analysts and investors do not distinguish these highly artificial earnings from more genuine operating earnings.

Under FAIR VALUE only the first expense element is an operating expense.

Asset and liability returns are treated as “financing” – much like a mutual fund, the value is the net of assets minus liabilities with NO MULTIPLE.

What are the implications of fair value accounting for investors?

The first order effect should be indifference. A dollar's worth of stocks equals a dollar's worth of bonds. Shareholders don't need their operating companies to make asset allocation decisions for them.

The second order effect is that pensions invested in stocks are tax inefficient and unnecessarily risky. Companies will invest in bonds and let their shareholders buy stocks on their own.

This brilliant UBS cartoon pretty well sums up the impact that bad accounting has on pension asset allocation decisions made by corporations.

Credit where credit is due:

The cartoon appears in a UBS Pension paper issued in September, jointly written by Steve Cooper in the U.K. and David Bianco in the U.S.

I have predicted a massive move to bonds in this decade.

Those who move create tax arbitrage gains for their shareholders.

Those who move FIRST also get a one time gain based on the price pressures that these massive changes will cause.

Thank you.