

May 15, 2002

Selection of Asset Valuation Methods
Actuarial Standards Board
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By e-mail: comments@actuary.org

ASB Board and Committee Members:

We are writing to comment on the Proposed Actuarial Standard of Practice – Selection of Asset Valuation Methods for Pension Valuations.

The proposed ASOP gives the ASB an opportunity to make a positive professional statement by endorsing the use of market value (or fair value, for non-traded assets) as the single best measure of pension assets.

We encourage this definition of a **best practice** standard within a range of acceptable but notably less scientific measures. We recognize that existing codifications (principally, ERISA, FASB, and GASB) and sponsor expectations and preferences demand a wider range of allowable practices. Fortunately, each of these codifications will permit our recommended best practice.

It is useful to review the origins of the actuarial asset valuation methods. The Jackson-Hamilton (1968)¹ paper (and its excellent discussions) is a superb starting place, not only for what it includes, but for a sense of its era implicit in its omissions and its unstated presumptions.

We learn from the Jackson-Hamilton paper that:

- The significant and growing allocation of assets to the equity markets had exposed some of the frailties of earlier book value methods:
 - Book and market values necessarily converge for bonds held to maturity, but not for equities.
 - There is no economic reason to distinguish among dividends and realized and unrealized gains. Differentiation among these may lead to manipulative trading strategies.
 - Equities, valued at market, transmitted volatility to plan contributions. Many actuaries deemed much of this volatility to be specious. Virtually all actuaries and sponsors found such volatility unattractive.
- The prime function of pension actuaries was to create a sponsor contribution budget. Secondary objectives included compliance with accounting and tax regulations and actuarial soundness. Sponsors wanted smoothness on the one hand and sufficient recognition of expected and achieved equity returns to keep costs low. Jackson-Hamilton framed the entire process as a balance of these objectives in classical

¹ Jackson, Paul H. and Hamilton, James A., “*The Valuation of Pension Fund Assets*”, Transactions of Society of Actuaries 1968, Vol. 20, Pt. 1, No. 58, pp 386-436.

actuarial fashion: “[T]he choice [of method] will depend on the relative weight assigned to the criterion of smoothness of contribution as compared with fit of value to market.”²

- Conflicts of interest, real or potential, among shareholders, participants, government agencies and other regulators were not yet a significant issue.
- ERISA still lay in the future and APB³ was brand new: “Current legislative proposals (e.g., Senate bills introduced by Senator Yarborough and Senator Javits) to impose stricter minimum funding standards on private pension plans and the rigidity in pension costs resulting from a strict application of the rules in Opinion No. 8 by practicing accountants may force employers to explore the possibility of changing some of the actuarial assumptions, the method of funding, and the method of valuing pension fund assets in order to minimize the impact of any required changes.”⁴
- Modern financial and investment principles were in their infancy and beyond the scope of the day’s typical pension actuary: “[A]ctuaries in America have usually disclaimed investment expertise and have been prone to leave asset valuation problems to the employer, trustee, or insurance company.”⁵
- Nonetheless, Jackson-Hamilton recognized that: “From an investment standpoint at least, it appears that current market value has been fairly well accepted as **the only true measure of asset value.**”⁶ [Emphasis added] This suggests that the actuarial view of specious volatility (hinted at even in today’s proposed ASOP by the phrase “short-term volatility in market value”⁷) was not a dominant view.

Three decades later, we have acquired some greater insights and encumbrances:

- Volatility is a property of markets; it is not a disease for which actuarial methodology is the cure.
- ERISA, SFAS 87, and GASB 25 permit actuarial asset valuation methods to smooth asset values and ultimately to smooth sponsor contributions and reported expenses.
- Sponsors still desire smoothness of expenses and contributions. Although many know that hedging (asset-liability matching) may be used to reduce volatility, they do not wish to reduce expected returns. They generally prefer to take advantage of the permitted actuarial/accounting smoothings.

We may not be unilaterally able to move client sponsors toward a choice between lower expected returns and volatility, but we have sister professions who may be our allies in such a transition. These include MBAs, CFAs, financial engineers, securities analysts and, trailing slightly behind these others, CPAs. Our own well-trained recent Investment FSAs share the skills and disciplines of many of these professions.

² Op. cit. p. 386.

³ Opinion No. 8 of the Accounting Principles Board (1966).

⁴ Jackson-Hamilton, p. 389.

⁵ Op. cit. p. 387.

⁶ Op. cit. p. 388.

⁷ Paragraph 3.2.1.

These professions have preceded us in accepting the teachings of financial economics. They may fully repudiate off-market asset values before we even begin. We are in no small danger of being left behind, with a concomitant loss of credibility and stature among policymakers, regulators and investors.

The proposed ASOP has the potential to be a watershed. We can use it as an opportunity to define market value as our best practice and take a leadership position in encouraging legislative and regulatory reform. Alternatively, we can continue to endorse practices that have lost relevance in a financial world sensitized by episodes of opaque and misleading financial disclosure.

We will forward shortly a paper by Lawrence N. Bader and Jeremy Gold.⁸ It outlines some greater challenges to pension actuarial technology and to the remaining pieces of ASOP 4, Measuring Pension Obligations. In doing so, it lays out some of the lessons of financial economics that the authors have learned and applies them to our science. ASB members may wish to review the article for a sense of the world from which the specifics of this commentary letter are drawn.

Finally we outline our recommendations specific to the proposed ASOP:

- Define a **best practice** – using market value for liquid assets and fair value for other assets. Identify acceptable departures from this best practice. We note, however, that until the ASB also identifies as a best practice a market-type valuation of liabilities, the use of market value for assets will not necessarily improve the measurement of funding status.
- Remove references to short-term volatility of assets as a motivation for smoothing and acknowledge that the sole reason for non-market asset valuations is to meet sponsor desires for smoothing contributions and expenses. It does not serve pension actuaries well to suggest that a "true" value of assets lies hidden within volatile markets and that actuaries are especially well prepared to find it.
- Remove paragraph 3.2.2 as presently written. Acknowledge sponsor prerogatives under certain regulations and statutes. Further acknowledge the interests of other constituents, including participants, shareholders, lenders, taxpayers, the Pension Benefit Guaranty Corporation, and others who rely upon our professional representations.
- State in the preamble that we would welcome a legislative and regulatory requirement to use market value for pension assets.
- Make a more explicit statement on the use of market value restarts (for example, in paragraph 3.6). It is not uncommon, particularly in the public plan sector with plans subject to GASB, for actuaries to be whipsawed between requests to raise investment return assumptions when interest rates rise (and market value is likely to be below the actuarial asset value) and requests to restart the actuarial asset value at market when market value exceeds the actuarial value (and interest rates are likely to have fallen). Because ASOPs give both latitude and protection to practicing

⁸ The paper speaks for its authors and does not necessarily represent the views of the undersigned.

actuaries, we must recognize that excessive latitude may limit the actuary's ability to resist this kind of double bind.

We hope that the evolving Actuarial Standards of Practice will serve to bring about change sooner rather than later. We would very much like to see the actuarial profession lead the reformation of pension finance, rather than be towed in its wake.

SIGNED