

# INVESTMENT PERSPECTIVES

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Opportunities to manage risks in today's market:

- Consider investment strategy alternatives.
- Harvest gains from long-duration portfolios.
- Consider investment-grade corporate bonds.
- Reduce small-cap exposure.
- Know where you stand: Conduct a pension cost analysis.

## Priming Pension Plans for Today's Market

Despite the impact of the current financial crisis on pension plans, there are tactics that can help you succeed over the next 12 months and the long term. This issue of *Investment Perspectives* focuses on investment strategies that can help pension plan clients reap gains from long-duration portfolios and investment-grade corporate bonds, and reduce small-cap exposure. While each client's specific investment strategy will differ, there are clearly opportunities to manage risks and even realize gains in today's market.

## OVERVIEW

### TIME TO PRESS THE RESET BUTTON ON INVESTMENT STRATEGIES?

Senior financial executives across a range of industries are grappling with a common challenge: managing the financial risks of their retirement plans. In the current economic environment, fewer liquid fixed-income products, almost unprecedented equity market contraction and a significant shift in capital toward high-quality bonds are creating a unique opportunity to reassess pension plan allocations and explore investment alternatives. Here is a quick look at several investment strategies you may want to consider:

### Harvest Gains From Long-Duration Portfolios

As a result of the flight to quality government bonds and the material decline in long-term interest rates, long-duration portfolios appreciated considerably in 2008. By reducing the size of your long-duration portfolio, you can move fully hedged strategies back to better liability matching. Or, in the case of

partial hedges, you can harvest gains and move your pension plan back to its original risk-reduction targets.

### Consider Investment-Grade Corporate Bonds

As climbing corporate bond yields move closer to targeted pension plan return objectives, you may want to consider a dedicated allocation to investment-grade corporate bonds with Triple B ratings or better. With their higher yields, investment-grade corporate bonds support a total return strategy by addressing the inherent interest-rate mismatch between plan liabilities and traditional "total return" strategies. As a hedge against liability, longer-duration portfolios are an attractive vehicle for funding investment-grade credit positions.

The increased level of systemic risk in the current market further supports investment-grade corporate bond allocations. As shown in the exhibit, bonds fared comparatively well during the Great Depression and 2008.

## EXHIBIT

### Performance Comparisons: The 1929–1937 Experience Adjusted for 2008 Actual Results

Historical Period	1929–1932		1933	1934	1935	1936	1937	Annualized Full Period 7-Yr. Return
	Actual 2008	2009*	Actual Post-Depression Annual Returns					
Large U.S. Stocks	-37%	-43%	54%	-1%	48%	34%	-35%	-5.0%
Small U.S. Stocks	-37%	-77%	143%	24%	40%	65%	-58%	-11.7%
International Government Bonds	13%	20%	2%	9%	7%	3%	2%	7.8%
Long Government Bonds	26%	20%	0%	10%	5%	8%	0%	9.4%
U.S. T-Bills	2%	9%	0%	0%	0%	0%	0%	1.7%

\*2009 incorporates the residual depression experience not captured by actual 2008 returns.

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### **Reduce Small-Cap Exposure**

Pension plans typically use small-cap equity to improve absolute returns over volatility reduction. But, in today's market, this approach may be undermined by limited access to capital, tighter lending standards and a smaller starting capital base for many small-cap companies. In fact, a comparison of performance during the Great Depression to today's results indicates there is still considerable potential market downside risk for both large- and small-cap stocks if the economy continues to decline.

To take a closer look, we isolated the 1929–1932 performance period, adjusted it for the 2008 actual experience and projected 2009 returns (see exhibit). Based on these calculations, under an identical Great Depression scenario, small cap could decline by more than 70% from year-end 2008 prices.

In other words, assuming Great Depression-era equivalent performance, with even modest small-cap allocations of 5% to 10%, organizations with underfunded plans and tight cost constraints are exposed to material business risk.

### **KNOW WHERE YOU STAND: CONDUCT A PENSION COST ANALYSIS**

As you know, as a result of the dramatic decline in equity markets and interest rates, pension plan costs and the implications of pension asset allocations have changed. That's why a clear understanding of current and projected plan costs using the current asset allocation will help you identify the most optimal investment approach. As part of this process, it's critical to assess projected performance during different scenarios. For example:

- if markets gradually improve
- if interest rates fluctuate
- if market conditions reflect 1929-1932 performance
- if previous market levels (dating back to October 2007) are achieved over the next five to 10 years.

### **LOOKING AHEAD**

Making gradual adjustments to strategic investments provides an opportunity to address the current market environment without jeopardizing the benefits of long-term investing. While each organization's circumstance must be carefully evaluated to determine the best path forward, the strategies discussed above — harvesting gains from long-duration portfolios and investment-grade corporate bonds, and reducing exposure to small-cap exposures — when properly implemented, can help balance return objectives with current and future costs, whether capital markets deteriorate or improve.

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Our Investment Consulting practice helps organizations develop and implement investment strategies. Whether the asset pool is a retirement plan, endowment, foundation, operating reserves or other, we focus on designing the appropriate strategy based on risk tolerances, business objectives, and internal and external governance standards.

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