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HEARD ON THE STREET

Gloom Lifting for Pension Plans

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A \$220-billion-plus weight could be lifting -- at least a bit -- off the stock market.

Thanks to a drastic turnaround in interest rates and improved stock-market returns, the prognosis for the health of corporate pension plans isn't quite as gloomy as many investors feared just weeks ago.

In recent months, many analysts and investors have focused on the combination of falling interest rates, which had sharply boosted the present value of what companies owe current and future pensioners, and three years of miserable stock-market performance, which had sharply depressed the assets in the plans.

"Everybody talked about the perfect storm," says Jack Ciesielski, editor of Analyst's Accounting Observer newsletter in Baltimore.

And the storm seemed poised only to worsen. As recently as mid-June, Standard & Poor's cautioned that the underfunding of pensions in its S&P-500 stock index had jumped, in less than six months, an additional 7% -- to \$226 billion from \$212 billion at year end. That year-end figure represented a big reversal from the year before (2001), when there was a \$5 billion surplus.

To be sure, the woes of many of the 322 companies in the S&P-500 index with underfunded pensions are far from over, particularly the most deficit-ridden ones in the auto-making, airline and steel industries. And the improvement so far has been moderate. But the sudden summer upturn in interest rates, combined with the improving stock market, can "have powerful effects on pension-plan funding" says Mr. Ciesielski. Indeed, a one percentage-point change in long-term yields easily can shrink or inflate a company's pension liability by 10% or more. And the yield on the bellwether 10-year Treasury note has soared nearly 1.5 percentage points since June, when recession fears abounded (to stand at 4.531% Thursday).

Overall, pension plans should be "better off than they were a year ago," Mr. Ciesielski says.

S&P now expects its 500-company universe to end the year with an aggregate shortfall of \$182 billion, assuming a broader stock-market increase of about 5% between now and the end of the year with interest rates holding steady. The Dow Jones Industrial Average is up 11% since the year began.

Some savvy investors already have figured out that the abrupt rise in interest rates is a boost to those companies with large pension liabilities, many of which had been beaten down over the past year over investors' concerns.

Bridgewater Associates, a Westport, Conn., institutional-money manager, says companies with the largest pension liabilities relative to their market capitalizations have been outperforming the overall market of late. Those were the companies that "really got whacked when stocks were collapsing and bonds were rallying," says Greg Jensen, senior research associate at Bridgewater. While Bridgewater terms the recent relief "only modest to this point," Mr. Jensen says it "has had a leveraged effect on these companies."

Companies topping Bridgewater's "pension-heavy index" are **General Motors Corp.**, **Lucent Technologies Inc.**, and **Ford Motor Co.** Gains of the companies with the heaviest pension loads have come as riskier stocks, including Internet shares, generally have outperformed.

Exactly how much better off are these plans? That is among the most closely guarded secrets that investors face. Companies are required to disclose details of their pension funds only to the Internal Revenue Service, and information from these filings is generally available to the public only with a two-year lag. Publicly traded companies do provide once-a-year snapshots of their pension obligations and the assets set aside to cover them. This information, which S&P and Wall Street analysts rely upon to assess pension health, is in the annual reports generally filed each spring for the preceding calendar year. So investors won't know until next spring how pension funds have fared this year.

While investors' perceptions are shaped by these snapshots, they have one notable shortcoming: Pension obligations are calculated differently in these snapshots than at the IRS, and it is the government that has final say over when companies must top up underfunded pension plans. For investors, the concern is the extent to which pension contributions will divert dollars that otherwise could be used for capital investments, dividends or share buybacks.

This is where interest rates come in. A company calculates its pension obligations by estimating what it ultimately will have to pay current and future retirees. Then it discounts this amount back to today's dollars. A lower discount rate leads to a higher net present value, while a higher one leads to a smaller present value. (Lower interest rates boost the plans' present-day liability, because if one assumes the assets have a lower return, more money must be set aside to meet future obligations.)

For snapshot purposes, a company's discount rate should reflect the interest rate of a portfolio of high-quality corporate bonds with maturities matching the expected payments to pensioners. The average discount rate used as of Dec. 31 by S&P-500 companies: 6.64%, down from 7.31% the year before, according to S&P. Rates vary wildly. **ConAgra Foods Inc.**, for instance, used a 7.5% rate last year, while Bermuda insurer **Ace Ltd.** opted for 5.06%.

Meanwhile, the discount rate mandated by the government is a four-year weighted average of the 30-year Treasury bond. Under a "relief" measure in effect since the beginning of 2002, companies can use 120% of the average. At the end of last year, the discount rate stood at 6.65%, which is 120% of the 5.54% weighted average. As of the end of July, the adjusted discount rate was 6.38%.

Whatever the benchmark, small changes in a discount rate can make huge differences in the funding status of pension plans. At General Motors, for instance, a quarter-of-a-percentage point increase reduces the company's obligation to its tens of thousands of current and future pensioners by \$1.8 billion, or 2.25%, all else being equal, according to the annual report of the Detroit auto maker filed in March. At last year's end, GM calculated its U.S. pension obligations at \$80.1 billion, based on a 6.75% discount rate.

"The [recent] increase in rates looks favorable" for the funding status of GM's pension plans, says Toni Simonetti, a GM spokeswoman. But, she cautions, it is difficult to predict where rates will be at year end when the next snapshot will be taken.

Great Atlantic & Pacific Tea Co. calculates that a discount-rate increase of one percentage point would reduce its pension obligation by \$9.3 million, or 6.37%, its financial filings show. The Montvale, N.J., supermarket chain reported U.S. pension obligations of \$145.9 million at the end of 2002, based on a 6.5% discount rate.

In general, federal pension law requires companies to contribute additional assets if the plan's funding status falls below an average of 90% over three consecutive years, or 80% in any one year. Companies

generally have three to five years to make up the shortfall.

Last year, companies in the S&P-500 universe contributed \$46 billion to their pension funds, triple the year-earlier level, according to company disclosures reviewed by Credit Suisse First Boston analyst David Zion. He attributes a lot of the jump to voluntary contributions, which are attractive to companies because they can deduct the contributions for tax purposes, reduce the insurance premiums required for significantly underfunded pension funds, and, through quirks of pension accounting, use the increase in assets to boost earnings.

To bridge the current information gap, the private-sector Financial Accounting Standards Board is working on new pension-disclosure rules. The current thinking is that companies should tell investors how much they expect to contribute to their pension funds in the coming year; now, they disclose just the past year's contribution. The rule-setters also are leaning toward requiring companies to reveal more about the type of investments in their pension plans, including estimated returns for each asset group. A proposal is due out next month, with the goal of a final rule by year end.

Some investors would like to see quarterly snapshots. "Quarterly reporting of such a large and important number is exceedingly important to us," says Rebecca McEnally, vice president of global advocacy at the Association for Investment Management and Research, a group representing money managers and analysts.

FASB has shied away from requiring such disclosures, saying it places too big a burden on companies. But the board is expected to require quarterly disclosure of any significant changes in estimated plan contributions.

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