

Sound Financial Management through Asset Liability Solutions

Retirement plan sponsors are responsible for the ongoing financial management of their pension plans, which requires them to establish, monitor, and periodically reconfirm investment, funding, and benefit strategies. These strategies need to address not only adequate plan funding but also another, conflicting pressure: cash flow and expense management for the rest of the organization. Moreover, plan sponsors must carry out their responsibilities against a backdrop of evolving regulatory and financial constraints, which have forced them to adopt additional planning horizons.

Sound financial management can be complex, but in these challenging economic times the task may become daunting. Plan sponsors need to manage pension plans as effectively as possible through the short-term volatility with an eye toward a long-term strategy that balances benefit security with desired cost levels and risk.

Asset liability management (ALM) is a powerful framework for understanding the financial dynamics of a pension plan and evaluating the impact of alternative investment, funding, and/or benefit strategies in a variety of economic and investment environments over various planning horizons.

Buck Consultants' team of seasoned actuaries and investment consultants applies experience, knowledge, and an array of the most sophisticated financial models available to help plan sponsors engineer a pension plan strategy that is tailored to the organization's risk/reward profile.

NEW FUNDING AND ACCOUNTING RULES CREATE NEW CHALLENGES

The regulatory environment is continually evolving, with new rules for funding and financial reporting continuously being introduced, and new paradigms for funding and investing are emerging.

For example:

- The Pension Protection Act of 2006 (PPA) requires that plan sponsors fund current obligations much more rapidly and provides incentives for sponsors to keep funding levels above certain thresholds to avoid benefit restrictions and notice requirements. Under PPA, liabilities are valued under one actuarial method using market interest rates, and smoothing of asset gains/losses is limited, resulting in increased short-term volatility.
- Statement of Financial Accounting Standards No. 158 (FAS 158) requires plan sponsors to recognize unfunded benefit obligations in their entirety on the balance sheet.
- While pension obligations are intended to be long term in nature, publicly traded companies are subject to the risks of mergers and acquisitions, bankruptcy, and other potential business disruptions. Those plan sponsors are also subject to scrutiny by shareholders with shorter-term investment horizons. As a result, focus on a longer funding horizon becomes even more challenging.

Buck's ALM professionals are experienced in assisting clients reassess their strategies in response to change. We can help plan sponsors understand and quantify risks over different time horizons and incorporate those risks into the broader risk management of the organization.

ALM: INTEGRATED ANALYSIS OF FINANCIAL DRIVERS

Buck's approach to ALM provides an integrated analysis of financial drivers, enabling us to evaluate one or more interrelated actuarial and investment drivers of a pension plan's costs.

Investment Strategy: Linking Assets and Liabilities.

Managing a plan's surplus/deficit (assets minus liabilities) is more important than managing either assets or liabilities alone. Certain financial variables — such as inflation and interest rate levels — that impact investment performance also directly impact liability behavior. A properly constructed portfolio will anticipate these economic relationships, and will promote the desired level of surplus/deficit volatility, cash contribution and expense levels and volatility, balance sheet impact, etc. Liability-driven investment strategies are one approach to managing surplus/deficit.

Funding Strategy: Balancing Investment Risk with Plan and Enterprise Cash Flows. Under PPA, plans have a 100 percent funding target, and benefit restrictions and reporting requirements are triggered if the funding percentage is below specific thresholds. Plan sponsors may wish to fund a pension plan to levels that avoid these various benefit and reporting requirements. Riskier investments can lead to higher investment returns thereby accelerating progress to funding targets, but such investments may also result in lower returns, requiring greater contributions to achieve PPA funding targets.

Benefit Strategy: New Benefit Strategies Require New Investment and Funding Strategies. Plan sponsors who are considering a plan design change, such as a plan freeze or conversion to a hybrid benefit formula, should confirm that the investment and funding strategy are appropriate under the new liability structure.

Demographics: Understanding the Financial Impact of a Dynamic Workforce. Workforce changes lead to shifts in pension liabilities and costs. Organizations considering a workforce event — such as a window or a reduction in force — need to know the potential impact on the pension plan's liability structure and in turn the impact on financial management strategy.

ASSET LIABILITY MODELING — POWERFUL, FLEXIBLE, AND FAST

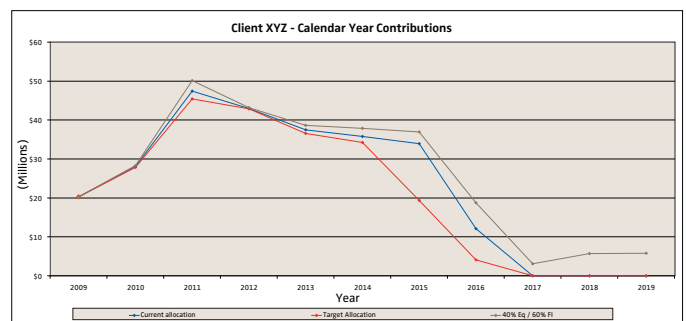
Asset liability modeling is an invaluable tool for delivering ALM services. In asset liability modeling, future actuarial valuations are performed under a variety of potential economic and capital market environments to identify organizational risks.

Buck offers a variety of modeling solutions to meet each client's ALM needs and budgets, from streamlined analyses to fully customized and comprehensive studies.

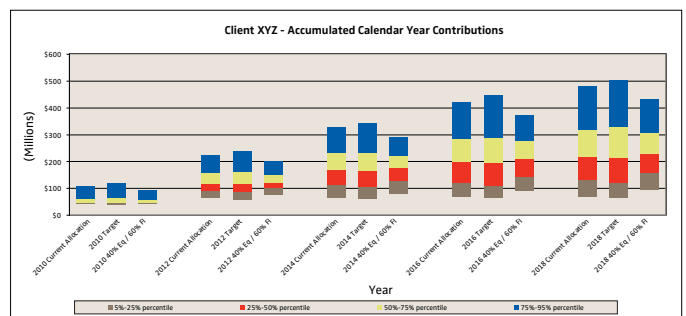
Deterministic vs. Stochastic ALM Analysis

There are two basic types of modeling: deterministic and stochastic. The deterministic approach evaluates the financial impact of specific predefined economic scenarios. The stochastic approach evaluates the financial impact of thousands of scenarios to determine the likelihood that actual results will fall into various ranges. Buck works with each client to decide which type of analysis is most appropriate for its individualized needs.

Deterministic



Stochastic



Comprehensive Risk Analysis

Risk factors are typically influenced by items such as cash flow or income levels, earnings per share, loan covenants, and the role of pension financials within the overall context of the organization's financials. Buck works with each plan sponsor to define the appropriate risk factors for analysis. We offer more than 70 standard risk metrics and can customize risk metrics to each organization's specifications. The standard risk measures most frequently requested by our clients include:

- Expense or cash contribution magnitude and volatility
- GAAP balance sheet liability
- PPA funded status and the likelihood of benefit restrictions

ALM EXPRESS™

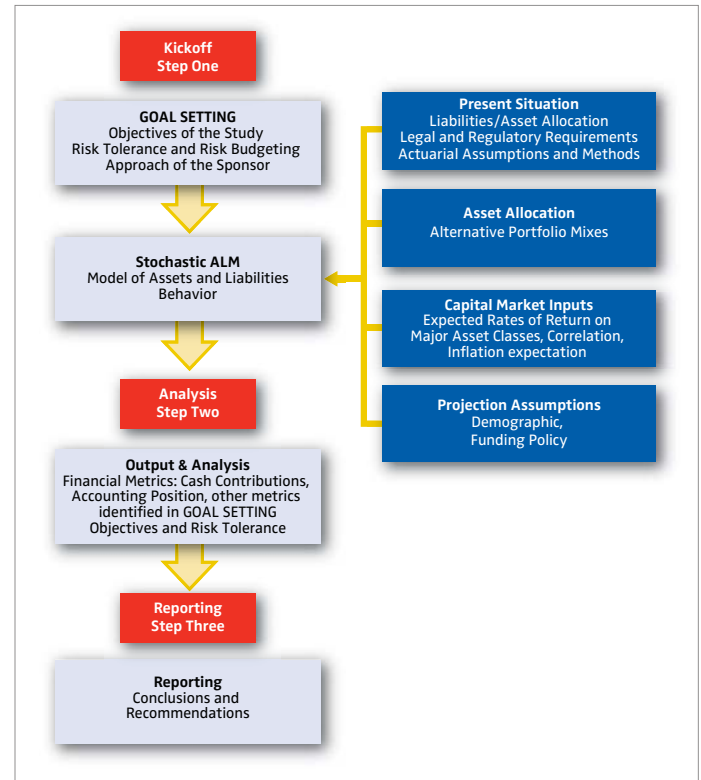
ALM Express is a scalable, interactive ALM approach that utilizes a highly efficient modeling tool that can perform both stochastic and deterministic modeling. ALM Express can be used:

- To augment annual actuarial valuations by providing basic forecasts of the financial position of a plan in the future using information developed the standard valuation process — at a low incremental cost
- For ongoing monitoring of a plan's emerging financial condition in the years between full studies, providing up-to-date information on the client's asset liability positions
- For full asset liability modeling studies to periodically assess the client's long-term strategic asset allocation and funding policy

ALM Express is an *interactive solution*. We can meet with a plan sponsor and perform a real-time analysis of investment strategies and funding policies in a live setting. Our software can model dynamically, and immediately display changes in investment and/or funding strategy as the plan's financial situation changes over time.

OUR CLIENT-FOCUSED PROJECT APPROACH

Buck views asset liability modeling projects as a collaborative effort between the client, the Buck ALM team, and, for existing actuarial clients, the Buck actuarial team. Buck works with the client at the onset of the project to establish the goals of the study and the actuarial and capital market framework for the analysis. We keep the client informed of project progress and provide customized reporting that incorporates the client's specifications. Once a final report is delivered, Buck also can provide implementation support for our recommendations.



BUCK'S TAILORED SOLUTIONS: EXAMPLES OF OUR WORK WITH CLIENTS

Liability-Driven Investment Solutions: We have assisted in evaluating the effectiveness of a derivative overlay interest rate hedging strategy designed to enable the plan sponsor to maintain its current asset allocation and manage its liability interest rate risk.

Reducing Equity Exposure and Increasing Fixed Income Exposure: Some clients have decreased their equity exposure and increased their fixed income exposure and duration to better match the liability structure of their closed or frozen plan. We have modeled the impact of changing the asset allocation and then assisted them with the ongoing implementation.

Portfolio Diversification: We have assisted organizations with evaluating the impact of adding alternative assets such as real estate (public and private), private equity, hedge funds, and commodities.

Funding Policy Design: We have helped clients evaluate their financial, HR, and regulatory risks associated with falling below PPA Funding Target Attainment Percentage thresholds and worked with them to develop a funding strategy to meet their needs.

CONTACT US

For more information about Buck's ALM solutions, email us at ALMGroup@buckconsultants.com.

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