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PBGC Announces New Investment Policy In What Practitioner Calls a 'Dramatic' Shift

Pension Benefits Guaranty Corporation Director Charles E. F. Millard told BNA in a telephone interview Feb. 19 that the new investment policy announced by the agency addresses the agency's long-term time horizon and diversifies the asset mix.

"Those two things give us a potential for higher returns with less risk than we are currently taking," Millard added.

The new policy allocates 45 percent of PBGC assets to a diversified set of fixed-income investments, 45 percent to diversified equity investments, and 10 percent to alternative investment classes, a Feb. 18 agency news release said.

"This is a dramatic policy shift after decades of following a policy aimed at limiting the probability of losses," Dallas Salisbury, president of the Employee Benefit Research Institute, told BNA Feb. 19.

Notable is the allocation to private equity, a sector that has chosen to terminate defined benefit plans and pass liabilities to PBGC in the past when they have taken companies private, Salisbury said. "This will lead PBGC to be invested more like a pension fund and less like an insurance company," he said.

Salisbury had told BNA on Dec. 26, 2007, that the central point of debate at PBGC on investment policy has always been whether the agency should invest more like a pension fund, with heavy equity exposure, or like an insurance company, with a reliance on fixed income portfolios (6 PBD, 1/10/07; 35 BPR 161, 1/15/07). Past reviews have always ended at the insurance company fixed income model, he said.

Enhancing Assets to Pay Benefits. PBGC has the ability to accept some degree of short-term volatility to achieve its goal of enhancing assets to pay benefits, Millard said in the news release. However, the policy is carefully structured to balance risk and returns, and to improve PBGC's chances of reaching full funding over the long term, while maintaining the agency's ability to meet its obligations to retirees, he said.

PBGC's previous policy set an equity investment target of 15 percent to 25 percent, although the actual level of equity investment was 28 percent at the end of fiscal 2007, the news release said.

PBGC currently has approximately $55 billion to invest under the new investment policy, the agency said. It noted that it had an accumulated deficit of $14 billion as of the end of fiscal 2007.

PBGC also emphasized that it is not funded by tax dollars and does not enjoy the full faith and credit of the United States government. The agency is financed by premiums paid by employers, assets from failed pension plans, recoveries from bankruptcies, and invested assets, it noted.

Key Issue at Senate Hearing. PBGC's investment policy was the key issue raised at a Sept. 6 Senate Health, Education, Labor, and Pensions Committee hearing on the nomination of Millard to be director of the agency (173 PBD, 9/7/07; 34 BPR 2089, 9/11/07). Sen. Barbara A. Mikulski (D-Md.) chaired the nomination hearing on behalf of the committee chairman, Sen. Edward M. Kennedy (D-Mass.). Mikulski chairs the committee's Subcommittee on Retirement and Aging.

The Senate on Dec. 14 approved Millard's nomination to be PBGC director (241 PBD, 12/18/07; 35 BPR 24, 1/1/08). President Bush had appointed Millard to work as interim director of the agency on May 23 pending his confirmation by the Senate as director.

At the Sept. 6 hearing, Mikulski said she wanted Congress "actively involved" in any investment policy decisions made by the agency. Any change of investment policy by PBGC is "a major policy issue," she said.

"Before the asset allocation is changed, share [what you are doing] with Congress," Mikulski told Millard, adding that she "gets the sense ... you will really work with Congress."

Millard told BNA, ''We have made sure that people on the Hill are aware of what is going on. We have a cooperative relationship with all the appropriate Hill committees.''

Better Management of Invested Assets. The new investment policy adopted by the PBGC board of directors will better manage our invested assets, Millard said in the news release.

Although it should generate higher returns, it also offers lower risk through broader diversification, Millard said. This strategy gives PBGC a 57 percent likelihood of full funding within 10 years, compared to 19 percent under the previous policy, he added.

Because the PBGC's obligations are paid over many years, the new investment policy is designed to take advantage of a long-term investment horizon, PBGC said. The strategy of increased diversification, including use of alternative investments, aims at generating returns while providing superior protection against ultimate downside risks over time, it said.

The policy was adopted after an extensive review process that began in mid-2007, PBGC said. The review evaluated current and alternative investment policies over periods of five, 10, and 20 years, it said.

The review showed that the diversified portfolio adopted by the board of directors would have outperformed the current asset mix 98 percent of the time over rolling 20-year periods, PBGC said. The board of directors reviews the investment policy every two years, it said.

PBGC does not select individual stocks or bonds or actively manage its portfolio, the news release said. Its invested assets are managed by professional money management firms or invested in various market indexes, it added.

Good or Bad Decision? ''Only time will tell whether this is a good or bad decision,'' Salisbury said.

If the current credit crunch leads to the United States following the path of Japan, it will have been unwise. If past returns prove instead to be predictive of the future it will prove wise, he said.

Salisbury said his reference to Japan was in the context of ''decades of disaster experienced by the Japanese stock market.''

'Lame Duck' Decision. ''It is likely that a new administration will review this decision in 2009 as it is a decision by three lame duck cabinet members'' at the departments of Labor, Treasury, and Commerce, who compose the agency's board of directors, and marks a radical shift for PBGC, Salisbury said.

''It is interesting that this change comes on the heels of the Pension Protection Act of 2006, which is structured to encourage plans to move away from equities,'' Jim Keightley, a partner with Keightley & Ashner LLP and PBGC's former General Counsel, told BNA Feb. 19. ''Presumably, the PBGC's board now recognizes that the goal of reducing the deficit requires a less conservative investment strategy,'' he added.

What is not clear from PBGC's announcement is the extent, if any, to which it will invest in foreign equity markets as part of its portfolio of diversified equity investments, Keightley said. Nor is it clear the extent to which its alternative investment classes will include hedge funds, he said.

Millard told BNA the investment policy's alternative investments classes will not include hedge funds. Alternative investments will include private equity and real estate only, he said.

''Given the significant discretion the PBGC board has in this area, the PBGC's just-announced long-term investment strategy may not last for the long term,'' Keightley said.

''PBGC's earlier switch from equities to bonds very much reflected the personal views of PBGC's board members from Treasury, and the PBGC executive director, that PBGC should try to immunize its portfolio from interest rate changes by investing in bonds that would match its pension payouts,'' Stuart Sirkin, executive director for Compensation and Benefits Group with National Tax, Ernst & Young LLP, and former director, Corporate Policy and Research Department for PBGC, told BNA Feb. 19. ''They were willing to sacrifice return to minimize risk and volatility,'' he said.

''I expect the switch back is a result of the personal investment views of the new people high up at Treasury, and the new PBGC director, as much any new analytical conclusions,'' Sirkin said.

''It is good that PBGC has decided to change its strategy,'' Lynn D. Dudley, vice president for retirement policy at the American Benefits Council, told BNA Feb. 19. ''In the long run it is better for their return, better for the participants they protect,'' she said.

By Michael W. Wyand

Text of the announcement is at http://www.pbgc.gov/media/news-archive/news-releases/2008/pr08-19.html.

