

BOND THEORY GRABS NOTICE AS PENSION DEBATE SWELLS

By Kaja Whitehouse.

An investment idea once chided by the defined-benefit pension world may be gaining a little more respect. The idea calls for traditional pension funds to scrap their equity holdings for fixed-income assets, not as a defensive move against falling stocks, but as a permanent investment strategy.

Pension funds, the theory argues, are essentially another form of corporate debt because they owe money to retirees. For that reason, bonds can more easily match liabilities. Stocks, it says, aren't predictable enough.

This relatively simple concept once triggered some furious reactions, said Zvi Bodie, a professor of finance at Boston University who wrote in 1995 that the Pension Benefits Guaranty Corporation, or PBGC, should adopt such a strategy. But today, it seems to be gaining more positive reception from companies, pension consultants, fund managers and even the PBGC, the government agency that acts as the pension insurance company. The last few years of stock-market tumbles have severely dented pension funds, many of which had moved more heavily toward equities in the past decade. Now, companies are finding themselves having to cough up the cash to fund the gaps. The average pension of S&P 500 companies could be underfunded by about \$323 billion, or 69% of total assets, by the end of this year, according to a recent study by Merrill Lynch & Co. (MER). That compares with an overfunded position of about \$500 million at the end of 2001, and a surplus of \$215 billion the year before, the report said.

Received At The PBGC

Critics argue that companies should be wary of rushing to bonds simply based on recent performance. But proponents say they advocate no such thing. It's all about matching liabilities, Bodie said. When stocks tumble, as they have in the past few years, pension funds risk falling short of the cash they need to pay their workers, he said.

The PBGC has invited Bodie to talk about the topic next Tuesday. The agency is exploring altering its investment policy for the first time since 1994, when it moved more aggressively into equity investing, said Jeffrey Speicher, a spokesman. Bodie will be one of three speakers, with one advocating active management and the other supporting equity-index fund investing, Speicher said. Bodie said he plans to tell the government agency that it has no business investing in stocks. He also plans to advise it that it should charge a premium to funds that are overexposed to the stock market.

Debate Continues

British drugstore chain Boots Co. PLC was in the pension spotlight last year when it dumped its pension fund of stocks and turned to bonds in an effort to better match the fund's liabilities. But some doubt that many companies will follow Boot's lead. "I've read it (the theory), but I don't buy it," said Karl L. Polen, member of the board of directors of the Arizona State Retirement System in Phoenix. "What it ignores is that a lowering in the cost of funds associated with fixed-income should in theory raise the value of equities."

"There's no better way for assets to match liabilities" than fixed-income, said Albert Petruzzi, the retirement-plan administrator for the San Luis Obispo Country Pension Trust in Central California, which based its pension on a 100% fixed-income portfolio until the early 1990s. Despite Petruzzi's confidence in the effectiveness of the strategy, the California fund plans to stick with its current asset allocation of 44% fixed-income, 41% domestic stocks, 5% international and about 10% real estate. "There're improvements that occur, like salary increases, and you need something to go along with that," which is where stocks come in, he said. But some pension

consultants and fund managers have been exploring and even promoting the fixed-income idea. "Borrowing long and investing in the stock market is not a sound long-term strategy," said David Hershey, a fixed-income portfolio manager with Lotsoff Capital Management in Chicago.

Hershey has written a paper on the subject titled, "Are Pension Funds Sailing into a Storm?," which he posted on the company's Web site. In it, he makes the case that "the essential issue is to recast the pension strategy as an asset versus liability decision, not asset versus asset decision." Response to the article "has been gratifying," and has generated e-mails and calls from clients and others who support the idea, Hershey said.

That's a dramatically different reception from the one that Bodie received in 1995, when he suggested the PBGC ban stock investing. "I could show you a collection of letters" denouncing the editor of a publication that ran the story, Bodie said. They told the publication's editor not to run stories "by a kook like me."

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