In Focus
Your Retirement and Financial Management Newsletter
Hewitt Consulting
Hewitt
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This update summarizes recent trends and developments in U.S. retirement benefits.

In Today's Markets, You Can Be Rewarded.

2008 has been a true test of risk management practices for pension plans. Equities and corporate bonds have declined sharply, and credit spreads have increased. Both trends have recently emerged at alarming rates. As of the beginning of the year, the pension plans of the S&P 500 had a cumulative deficit of $49 billion, which had ballooned to a deficit of $340 billion by mid-October.

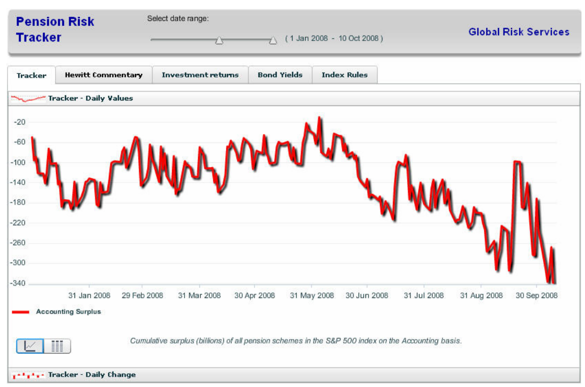
Often there are steps the plan sponsor can take so that, in times like these, risks can be avoided or rewarded. There are two key components to managing this pension risk and volatility:

■ Understanding the structure of your pension plan and your risk tolerance as a plan sponsor; and
■ Developing the tools to quantify and assess the risks that are relevant to your pension plan.

2008 pension plan experience will provide opportunities for all plan sponsors to rethink the best approach to investments and risks after an unprecedented change of direction in our economy. As such, all plan sponsors need to be sure they have the tools to make and monitor their decisions.

Pension Risk Tracker

Hewitt's Pension Risk Tracker monitors the aggregate funded status of the S&P 500's pension plans. Based on this group, the first half of 2008 was characterized by volatility and downward trends; however, the second half shows a sharp decline. As mentioned above, the year began 97.7 percent funded, which corresponds to a deficit position of $49 billion, and declined to 80.9 percent by mid-October, which corresponds to the $340 billion deficit mentioned above. As the chart to the right shows, this decline has generally taken place since mid-June—in the span of just four months!



Measurement and Monitoring: The Only Way to Know

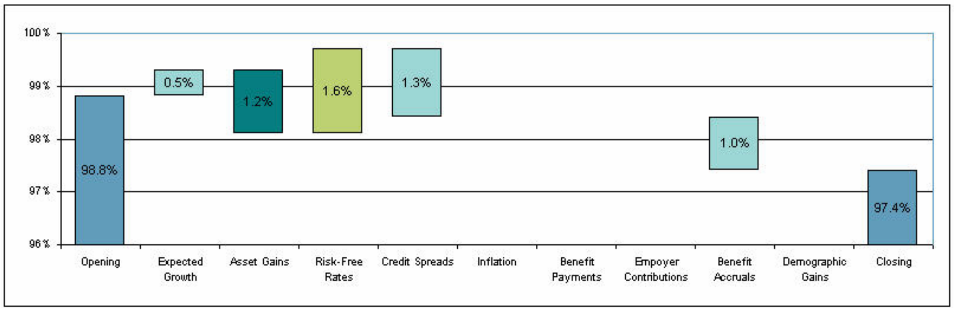
A pension plan is a complicated combination of assets and liabilities. As such, plan management tools and procedures must be carefully designed for specific situations. Effective plan management should consider:

■ ***Performance monitoring*** – to ensure decisions have their intended effect;
■ ***Scenario testing*** – for evaluation of alternative future economic environments; and
■ ***Demographic analysis*** – to better understand the impact of demographic changes.

Performance Monitoring

Pension plan performance should be monitored at a high level to provide the "big picture" but detailed enough to answer difficult questions from leadership. More importantly, today, reporting must be timely. Plan sponsors can no longer rely on quarterly reporting or the reporting of results that are even a couple months old. In some cases, analysis as frequently as daily may be necessary. Effective reporting should break down the impact on funded status of all measurable external forces as shown in the table below:

Performance—Funded Ratio



- Assets contained only about 25% as much exposure to credit as the liabilities, resulting in a 1.3% decrease in funded status.
- Negative active manager experience resulted in a 1.2% decrease in funded status.
- Benefit accruals without offsetting employer contributions resulted in a decline of 1% in funded status.

Scenario Testing

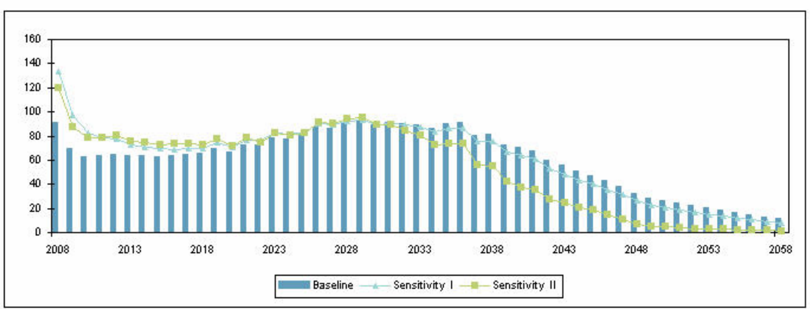
Secondly, effective management understands the various risks of different economic changes in the future. This enables the plan sponsor to recognize unwanted risks and volatility and take mitigating action proactively. This type of scenario testing provides snapshots of different types of exposure (e.g., high inflation) by showing the impact on the plan's funded status. In a sense, it's stress testing for certain basic shocks to the economic system.

As a practical matter, these changes are rarely isolated occurrences and may not be clearly defined. However, the sensitivities do provide a plan sponsor with proper detail about the significance of potential events and the ability to research alternatives to consider in the event.

Demographic Analysis

The third consideration is the impact of demographic changes. While economic risks receive the most attention, demographic changes can present a meaningful and predictive risk over a longer time horizon. A valuable way to look at demographic risk is to review future payments under different demographic scenarios. Changes in the timing for the payments impact cash needs and ultimately the liquidity of the plan.

Demographic Analysis



- Baseline assumes all actuarial assumptions are exactly realized.
- Sensitivity I assumes 50% increase in turnover/retirement rates.
- Sensitivity II assumes 25% increase in lump sum elections.

Payment Over Next 10 Years ($millions)

	2008-2012	2013-2017	Total
Baseline	348	314	661
Sensitivity I	470	351	821
Sensitivity II	444	370	814

Impact of Benefit Obligation ($millions)

	PBO	Change in PBO
Baseline	1,114	
Sensitivity I	1,195	81
Sensitivity II	1,314	201

A Way Going Forward

Many plan sponsors are now managing their pension plans through the lens of risk management. They're less focused on maximum expected returns and instead seek out strategies that balance the risks and the rewards. The intended result is overall solid returns with better predictability and less volatility.

Those plan sponsors who may be at early stages of these practices or who have not developed the types of processes and procedures outlined here should consider doing so. We believe this is the most effective and comprehensive way to manage the pension obligation. Doing so will:

- Create a framework for future discussions and decision making;
- Provide a comprehensive understanding of both the investment potential and risks; and
- Help make the attainment of future budgets a managed process as opposed to a "best guess."

To view Pension Risk Tracker, click here.