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PBGC's New Diversified Investment Policy

The Pension Benefit Guaranty Corporation announced a change in how the agency invested its assets to provide future benefits (33 PBD, 2/20/08; 35 BPR 447, 2/26/08). In response to reported comments related to this action, PBGC's director has provided a comprehensive explanation of the agency's new investment policy.

PBGC's New Diversified Investment Policy

By Charles E. F. Millard

Charles E. F. Millard is the director of the Pension Benefit Guaranty Corporation.

Introduction

On Feb. 12, 2008, the Board of Directors of the Pension Benefit Guaranty Corporation (PBGC) unanimously adopted a new diversified investment policy to increase the likelihood that the Corporation will be able to meet its long-term obligations. The PBGC currently has a shortfall of $14 billion, and faces the possibility that someday it will run out of money. The overarching goal of the new policy is to help ensure that the PBGC will be able to meet its obligations to the 1.3 million Americans who depend on it for their pension benefits.

The new policy is designed to take advantage of the PBGC's long-term investment horizon, and will allocate 45 percent of Corporation assets to equity investments, 45 percent to fixed income, and 10 percent to alternative investments such as private equity. This strategy of increased diversification aims at generating better returns, while providing superior protection against ultimate downside risks over time. The previous policy was not diversified, and therefore carried greater risk.

The new policy was adopted after an extensive review process that began in mid-2007. The review showed the new diversified portfolio would have yielded better results than the old investment policy 98 percent of the time over rolling 20-year periods. Most telling, stochastic scenario analysis performed as part of the review demonstrates that the new policy will give the PBGC a 57 percent likelihood of achieving full funding within ten years, compared to 19 percent under the previous policy.

The PBGC's new investment policy has generated lively interest among policy makers, academics and investment professionals. The PBGC is committed to transparency, and wishes to answer any and all questions about its investment diversification. In that spirit, the PBGC offers to the readers of BNA's *Pension & Benefits Daily* and *BNA Pension & Benefits Reporter* the following account of the review process and the analysis that led to the decision to adopt the new policy.

Summary of the New Investment Policy Statement (IPS)

ERISA explicitly states that the United States government does not stand behind the PBGC's obligations; therefore, it is the Corporation's responsibility to ensure that it can carry out its mission of paying guaranteed pension benefits. The primary objective of the PBGC's new investment policy is to prudently maximize investment returns in order to meet the Corporation's current and future obligations.

The new strategy offers four principal advantages over the previous approach. The new PBGC investment policy:

(1) Takes better advantage of PBGC's long-term investment horizon;
(2) Utilizes greater diversification to decrease risk and generate returns;

› Department of Labor

› Internal Revenue Service

› Thomas

› White House

(3) Better enables the Corporation to meet its obligations over all time periods; and
(4) Provides superior downside risk protection.

The Corporation's former investment policy stated that its long-term objective was "to maintain sufficient assets to meet liabilities and to produce sufficient revenue, in the form of investment income and insurance premiums to meet expected future claims." However, with its recommended asset allocation of 75-85 percent to fixed-income investments, the policy offered little likelihood of meeting that objective.

The previous investment policy was based on a desire to match closely the short-term performance and dollar duration of PBGC's assets and liabilities, but that effort has resulted in large and repeated tracking error. It has also resulted in significant opportunity costs.

For example, the Pension Protection Act requires that each year the PBGC calculate and publish a comparison of its actual investment returns with the hypothetical returns of a portfolio invested 60 percent in equities and 40 percent in fixed income. The comparison for 2007, published in the PBGC's Annual Management Report, shows that a 60/40 portfolio would have generated substantial incremental gains: $2.3 billion over one year and $7.3 billion over five years. This 5-year result would have cut the PBGC's 2007 shortfall by approximately one half.

The two most important facts about the new investment policy are that it significantly improves the probability the PBGC will be able to meet its obligations, and that it does so while taking less short-term and long-term risk. The new policy increases from 19 percent to 57 percent the likelihood that the PBGC will be able to achieve full funding over the next ten years, and increases that likelihood from 37 percent to 76 percent over the next 20 years. And it decreases standard deviation from 9.9 percent to 8.2 percent.

It may seem counterintuitive that an allocation focused on fixed-income assets would carry greater risk, but that is precisely the point. Diversification mitigates risk. Concentration increases it.

In the months leading up to the adoption of the new investment policy, the Corporation's independent consultant, Rocaton Investment Advisors, conducted a comprehensive review of the old investment policy and numerous alternative policies. The review included all aspects of PBGC's assets, liabilities, constraints, contingent liabilities, and premium structures, and evaluated PBGC's current and alternative investment policies over 5-, 10- and 20-year periods.

The new policy is expected to improve PBGC's financial position significantly and provide greater downside protection. Rocaton's review showed that the diversified portfolio adopted by the Board would have outperformed the current asset mix 98 percent of the time over rolling 20-year periods since 1927. Likewise, for rolling 10-year periods the new policy would have outperformed the current asset mix 87 percent of the time. In the worst-case scenario (*i.e.*, the 99th percentile scenario, which models a severe economic downturn and large new terminations), PBGC's financial position was forecasted to be better off under the new investment policy than under the old investment policy over 5-, 10- or 20-year periods.

Objectives and Guidelines of the New Investment Policy

In implementing the Investment Policy, the Corporation is guided by the following principles:
(1) ERISA explicitly states that the U.S. Government does not stand behind the obligations of PBGC. Therefore, it is the Corporation's responsibility to meet its obligations.
(2) The Investment Policy is premised upon current law. As changes are made in law to PBGC's premium structure or other related matters, the Corporation may review the Investment Policy and make the necessary adjustments.
(3) The PBGC has a long-term investment horizon, and it may incur short-term volatility to improve its long-term risk/return profile, thereby increasing the likelihood that the Corporation will meet its future obligations.
(4) This Investment Policy contemplates and accepts the possibility that the financial markets' and the Corporation's investment performance will underperform long-term expectations over shorter time periods.
(5) This Investment Policy considers the nature of PBGC's current and contingent liabilities including, but not limited to, the sensitivity of those liabilities to interest rates (*e.g.*, duration).
(6) The PBGC will take reasonable steps to avoid investments in companies representing highly likely and significant contingent liabilities.
(7) The chief risk that the PBGC must attempt to avoid is the risk that it will be unable to meet its obligations in the future.
(8) The Corporation will invest in a broadly diversified portfolio of asset classes, strategies, and managers, as one of the principal means of reducing risk, and exercising prudence, and meeting long-term objectives.
(9) The Corporation will strive to maintain premiums at the lowest level consistent with ERISA.

Responsibility

The Director is responsible to the Board of Directors for the overall management of the PBGC and its investment program. The Chief Financial Officer and the financial operations staff have the day-to-day responsibility for implementing, managing and monitoring the investment program. The Board recognizes that the PBGC Director, the CFO, and financial operations staff require reasonable flexibility in the implementation and operation of this new Investment Policy.

Cash Flow and Liquidity

The assets subject to the Investment Policy are the assets the PBGC uses to meet its current and future obligations. Asset allocation targets will be designed to achieve that objective, and must always reflect PBGC's unique operational cash flow needs. Sufficient liquidity will be maintained at all times.

Asset Allocation

Assets will be invested in a manner consistent with all legal restrictions. In selecting investments, the PBGC will seek to earn a competitive return consistent with appropriate levels of risk, and PBGC's investment managers will be directed to avoid purchasing the securities of an issuer that is likely to terminate an underfunded pension plan insured by the PBGC. For asset allocation purposes, the single-employer and multiemployer funds are treated as one fund. Revolving Fund assets will be invested only in U.S. Treasury securities. Trust Fund assets will be invested within the parameters established by the Board of Directors in this Investment Policy Statement. Trust fund investments may include public and private, domestic and international fixed income, equities, real estate, and derivative products.

PBGC's asset allocation targets and ranges for the investment program (Revolving Fund and Trust Fund combined) are as follows:

- **Asset Class: Target**;
- Equity: 45 percent;
- Fixed Income: 45 percent;
- Alternative Assets: 10 percent.
- Total: 100 percent

It is understood that events beyond the control of the Investment Program or the PBGC will sometimes cause changes in the asset allocation or cash flow of the Corporation. For example, when a pension plan terminates, the PBGC inherits the plan's assets as they have been allocated by the terminating plan. These allocations can differ significantly from PBGC's, causing the PBGC to be outside its allowed asset allocation ranges for some period of time. In such instances, the PBGC will prudently and cost-effectively transition the portfolio back to PBGC's established asset allocation.

Investment Portfolio Rebalancing

The PBGC will seek to rebalance the investment portfolio at least semi-annually in order to keep its asset allocation consistent with this Investment Policy. The specific timing and size of the rebalancing process will depend upon the liquidity needs of the Corporation, the cost of the rebalancing, anticipated receipt of assets from newly trusteed plans and projected premiums.

Investment Manager Selection

Short-term cash holdings in the Revolving Fund may be managed internally by the PBGC. All other discretionary investments will be managed by external professional money management organizations. Managers will be selected based upon demonstrated performance, expertise, and expense so that their investment strategies collectively implement PBGC's investment strategy. The PBGC will typically utilize the services of an investment consultant when selecting these managers. The PBGC will hold the investment management firms accountable for implementation of their investment strategy within the guidelines as defined and periodically refined by the PBGC. The PBGC will evaluate the performance of investment managers against specified performance benchmarks selected by the PBGC and the manager. As appropriate, PBGC will remove assets from underperforming managers once managers have had sufficient time to meet their performance objectives, typically as demonstrated over a full market cycle. The PBGC will also remove assets from managers when the PBGC no longer believes they will be able to meet their investment objectives (*e.g.*, due to loss of key investment professionals, significant change in ownership or organizational structure with potential negative consequences). Investment management fees should be designed to compensate managers for their services as well as to minimize the cost to the PBGC. Fee arrangements may be flat, asset-based and/or performance based. The PBGC will seek to control costs without sacrificing quality and/or superior performance, and whenever appropriate, the PBGC should seek to use lower-cost investment strategies such as index funds to achieve its investment objectives.

Proxy Voting

The PBGC will delegate the authority to vote proxies to external investment managers and will require that such managers meet fiduciary standards. Proxy voting rights must be exercised in accordance with the fiduciary duties of loyalty and prudence. At least annually, managers will report their voting record to PBGC.

Trading and Brokerage Practices

The PBGC delegates the responsibility of selecting brokerage firms to its investment managers, provided that the investment managers select and utilize brokers in a manner designed to achieve best execution.

Allowed Programs

1. Securities lending is allowed.

2. PBGC may purchase annuities with Trust and Revolving Funds to pay benefits if supported by a cost/benefit analysis.

Advisory Committee

PBGC's Advisory Committee advises the Director on investment activities. Periodically the Advisory Committee will meet with PBGC's investment managers, and may advise in the selection of new managers and changes to investment policies.

Reporting Requirements

Monthly investment reports will be prepared by the PBGC and will be submitted by the Director to the Board of Directors. Investment performance reports will also be prepared for each Advisory Committee meeting. PBGC's Annual Report will include fiscal year investment results.

Exempt Investment Assets

The plan assets received from the TWA pension plans are held in a separate account managed by an independent third-party investment manager as a result of a settlement agreement with the former plan sponsor. These assets are invested according to guidelines established by that agreement and cannot be changed or modified by the PBGC.

Process Overview

The process that the PBGC conducted to arrive at the conclusion to alter the Corporation's investment policy involved a thorough assessment of PBGC's long-term obligations to plan participants and beneficiaries, exhaustive debate and discussion among numerous constituents, and in-depth analysis by leading industry experts.

At the inception of the process, the Corporation's long-term objective and guiding principles were agreed to and documented by several key constituents including Representatives of the Board. This was followed by a close examination of the characteristics of the Corporation's obligations, including duration and key risk factors. A thorough review of the capital market opportunities then explored a wide range of investment policy alternatives. The potential performance of these alternatives and the Corporation's obligations were analyzed in the context of 5,000 economic scenarios over 20-year periods for each portfolio considered. Results across the full range of scenarios were analyzed to identify both expected and worst case environments to gain a thorough understanding of the range of outcomes for the various policy alternatives. The new investment policy was determined to offer the most appropriate balance of liquidity, downside protection, and long-term return potential relative to the Corporation's obligations.

Outside Consultant Review and Analysis

Rocaton worked closely with various PBGC departments to understand the underlying nature of PBGC's current and contingent liabilities, cash flow requirements, investment time horizon and investable universe. Specifically, Rocaton met with the Financial Operations Department to understand the current investment program and operating environment. The Actuarial Services Division provided Rocaton with an understanding of the current liability distribution as well as the liability valuation process. Rocaton also met with the Policy, Research and Analysis Department to understand the Pension Insurance Modeling System (PIMS) model that the PBGC uses for forecasting contingent liabilities and premiums. The PBGC's liability discount rate-

setting methodology was explained, and historical results were used in Rocaton's modeling process.

Rocaton's asset/liability model quantifies the relative merits and risks associated with different asset mixes, utilizing the following metrics: 1) investment returns, 2) volatility of investment returns, 3) funded position over various periods, and 4) volatility of the funded position. These metrics were evaluated over short, intermediate, and long-term time frames. This analysis recognizes that the PBGC is faced with significant uncertainty and, therefore, considers a wide range of possible outcomes for each of these metrics. By considering these metrics under the "expected" (50th percentile) and "worst case" (99th percentile) environments, the PBGC was able to evaluate the risk/return tradeoffs associated with different asset mixes and, therefore, determine an appropriate investment policy.

Rocaton's approach fully considered the unique characteristics of PBGC's liabilities, including the particular risks associated with the contingent liabilities, which are the most significant and uncertain the PBGC faces. Rocaton utilized PBGC's benefit payment liability distribution (provided by PBGC's Actuarial Services Division), and contingent liability and premium projections from the PIMS model in order to develop a detailed projection of PBGC's contingent and trusteed liabilities and benefit payments. Furthermore, the PIMS model also includes projections of contingent liabilities, benefit payments and assets that utilize Rocaton's capital market assumptions, including long-term inflation, real interest rates, and market returns. These assumptions (long-term return, risk and correlations for all asset classes) were used to run thousands of simulations quantifying their impact on PBGC's assets, liabilities, funded status, risk and return under a variety of economic and market conditions. The model calculated the range of possible outcomes for each portfolio measured against PBGC's known and contingent liabilities.

Rocaton's key findings were:

- The current investment policy's focus on limiting the financial risk exposure arising from a mismatch of assets against liabilities has had a very high opportunity cost, while not adequately protecting the PBGC from downside risk.
- The PBGC's current investment strategy is relatively undiversified and has a low likelihood of meeting PBGC's financial obligations over the long-term.
- The PBGC would increase the likelihood of meeting its financial obligations with a more diversified asset allocation strategy expected to deliver higher returns and better downside protection over the long-term.
- Shifting some of PBGC's allocation from fixed income to equities and/or alternative asset classes will significantly improve PBGC's ability to strengthen its financial position and significantly improve PBGC's downside protection.
- No asset mix can guard against the possibility of PBGC's deficit growing significantly due to large claims in the future. However, the recommended asset allocation can materially reduce the size of the deficit even in worst-case scenarios.

Rocaton recognized that the PBGC also faces short-term risks due to the possibility of increased terminations during periods when equity markets are underperforming. However, the scenario analyses that Rocaton performed determined that even if the worst-case economic scenarios did occur, the PBGC would still be in a better long-term financial position by investing in a mixture of less correlated and higher returning assets. The additional returns gained over the long-term from equity and other assets overcome even the most drastic short-term declines in PBGC's funded status.

PBGC's Advisory Committee Review

Throughout the fall of 2007, Rocaton met with PBGC's presidentially appointed Advisory Committee. In total, the Committee met seven times from March to December 2007 to discuss PBGC's investment program and alternative investment structures and policies. Rocaton presented at three of those meetings. PBGC staff and Board Representatives and/or their staffs attended and participated in these discussions as well. PBGC's Advisory Committee also met with a variety of outside investment advisory firms in its review of asset/liability management.

PBGC Board's Review and Oversight

The PBGC is governed by a three-member Board of Directors composed of Secretary of Labor Elaine L. Chao (chairman), Secretary of Commerce Carlos Gutierrez and Secretary of the Treasury Henry Paulson. Throughout the review process, the PBGC consulted with the Board's designated representatives and their staffs, beginning with the decision on engaging an independent investment consultant to conduct an asset/liability study. Once selected, Rocaton met with the Board Representatives, briefed them on the asset/liability review process, responded to questions, and obtained concurrence on Rocaton's general approach.

The PBGC also solicited feedback from the Board Representatives when developing the recommended investment policy objective and guiding principles, which are a key part of the proposed Investment Policy Statement. On December 10, 2007, Rocaton made a comprehensive presentation of its findings and recommendation to the Board Representatives and their staffs.

PBGC Staff Evaluation and Review

Over the course of the review process, the PBGC consulted with numerous investment, pension, and insurance industry experts concerning PBGC's investment policy, asset allocation structures, risk management policies, and best practices. The PBGC also met with insurance companies in order to understand their liability and premium structures and how each compared to those of the PBGC.

These industry experts consistently advised the PBGC that the Corporation has a long-term investment horizon and can weather short-term market volatility associated with risk assets. In addition, they advised that the Corporation would be much more likely to meets its obligations over all time periods by decreasing the amount of its fixed-income assets, and by increasing portfolio diversification through greater allocations to other strategic asset classes. These experts believed that a well-diversified portfolio would reduce the overall risk and increase the expected return of the investment program and lead either to reduced risk without sacrificing returns or to increased return at the same level of risk.

Process Conclusion

The investment policy review process concluded with a formal presentation by Rocaton to PBGC's Board on Feb. 12, 2008. The Board unanimously approved the recommendation that resulted from the process described above at this meeting.

Questions and Answers

1. Is this new investment policy riskier than the old one? Are you taking more risk by increasing your allocation to additional equities?

No, the new investment policy is not riskier than the old one. Our study of alternative investment policies demonstrated that by allocating to a diversified mix of asset classes including equities, the PBGC expects to realize higher investment returns over the long-term and provide greater downside protection than the former policy. Long duration bonds, which dominated the former policy, can be quite volatile. By diversifying into other asset classes, the PBGC is actually reducing the risk in its portfolio.

2. Why did you change the goal of matching returns to liabilities under the old policy that de-emphasized equities?

PBGC's ability to limit the volatility of its assets versus its liabilities is significantly affected by fundamental differences between (1) the liability-valuation interest factors derived from annuity prices on which PBGC's liabilities are valued, and (2) the interest rates reflected in the fixed income market, which determine the value of PBGC's fixed income assets. In contrast with fixed income prices, annuity prices also reflect the costs of mortality guarantees, administrative and marketing expenses, statutory reserves and surplus requirements, and other expense and profit items. These differences have had a material impact on the Corporation's ability to approximately match the interest rate risk of its assets and liabilities, despite high levels of dollar duration matching of its assets to its liabilities.

Given PBGC's current financial position, any investment policy would result in some possibility that PBGC's assets would prove to be insufficient to meet the Corporation's future obligations. Our analysis demonstrated that the previous policy has a more significant probability of this occurring than the new policy.

In addition, the PBGC has calculated the opportunity cost of the previous policy. A portfolio invested 60 percent in equities and 40 percent in fixed income would have generated substantial incremental gains: $2.3 billion over one year and $7.3 billion over five years for the periods ending Sept. 30, 2007. The incremental gain over five years would have cut the PBGC's 2007 shortfall by approximately one half and would have placed the PBGC on significantly better financial footing. The analysis Rocaton conducted in order to evaluate different investment policies shows that the new policy is expected to deliver superior results--significantly better returns that are expected to put the PBGC in a much stronger financial position, while also lowering the downside risk.

3. Considering that stock market returns have been relatively anemic in this country lately, what will be PBGC's allocation to foreign stocks, and will you use an index technique? Is it appropriate for an agency that insures American pensions to have significant investments outside the U.S.?

The PBGC plans to invest across a wide array of markets, including non-U.S. markets, in order to diversify its equity portfolio holdings. Index strategies will be considered among all the alternatives in every market the PBGC invests in. Consistent with ERISA's standards for prudence, the new policy plans to have the PBGC avail itself of opportunities to prudently diversify its investments across the global capital markets. More than half of global market opportunities lie outside the U.S.

4. The new policy has only slightly better than a break-even chance of achieving fully-funded benefit liabilities for the agency. Couldn't you do better?

The probability of the PBGC achieving full funding in ten years is 57 percent with the new policy versus only 19 percent under the old one. More so, the probability of reaching full funding improves to 76 percent over 20 years with the new investment policy. The PBGC evaluated policy alternatives that might have improved the chances of achieving full funding over time; however, the Board ultimately determined that the new policy offered the most appropriate balance between improving the Corporation's financial position over time and limiting the downside outcomes.

This policy is not designed to "pull out all the stops" or "shoot the moon" for greater returns. Its target return over time is 7.7 percent. The goal is to increase the likelihood of meeting PBGC's obligations without taking undue risk.

5. How does the new policy better enable the Corporation to withstand a one-two punch: increasing episodes of acute corporate financial distress and plan terminations, and overall weakening of business earnings and share prices?

No investment policy immunizes the PBGC from the risk that corporate bankruptcies and plan terminations may increase. The new policy does assume an appropriate level of market risk to generate investment returns over the long-term, given the long-term nature of PBGC's obligations. We expect this strategy will improve the financial position of the PBGC over time and as a result better enable the PBGC to withstand economic and corporate downturns when they occur.

It is true that the PBGC has at times experienced a higher level of plan terminations following periods of U.S. economic weakness. However, plans generally terminate after a lengthy bankruptcy process. By the time the PBGC actually trustees the plan's assets, the equity markets have often stabilized and started to experience significant positive returns. Assuming the plan has maintained its equity allocation, the PBGC, in reality, has not experienced additional losses due to equity exposure.

6. Does this investment policy change reflect a strategy to avoid more premium hikes and thus encourage employers to continue sponsoring DB plans?

The new investment policy is expected to enable the PBGC to maintain premiums at reasonable levels by providing a higher long-term rate of return, while also providing enhanced downside protection.

Premiums should be appropriately priced and the PBGC should have the authority to impose risk-based premiums similar to a life insurance company, which charges lower premiums to good risks and higher premiums to poor ones. If Congress provides this authority in the future, it would reduce premium costs accordingly and bring added balance and fairness to the system.

7. Given a history of government insurance programs charging inadequate premiums relative to risk of loss and cost to taxpayers, how do you plan to avoid this scenario if your investment policy has only a 57 percent chance of success? Isn't this just gambling to try to invest your way out of the deficit?

This policy is not taking on inappropriate amounts of risk. In fact, the Corporation did not attempt to guarantee that it will eliminate the deficit. Rather we seek to increase the likelihood that we will be able to prudently do so over time. The PBGC evaluated policy alternatives that might have improved the chances of achieving full funding over time; however, the Board ultimately determined that the new policy offered the most appropriate balance between improving the Corporation's financial position and limiting the chance that PBGC's deficit would grow significantly over time. In fact, despite the conservative appearance of the 75 percent allocation to bonds in the former policy, the potential for PBGC's funded status to worsen significantly is expected to be less severe under the new policy than under the former policy.

8. Have you considered a possible stock market stagnation as Japan has experienced? What would be the appropriate strategy then?

The new policy is intended for the long-term and is based on a thorough analysis of a wide range of market environments, including those where stock markets severely underperform long-term expectations. The possibility of any single stock market stagnating is the very reason the new policy includes a diversified allocation to various types of global stock and bond markets.

9. Given that the PBGC insures pension plans that invest in equities, doesn't the PBGC's new 45 percent equity allocation represent a doubling down of risk? Isn't as if a property/casualty insurer that is vulnerable to hurricane loss were investing in Florida beachfront real estate?

It is true that typically pension plans invest in equities and funding levels generally drop when equity markets underperform. It is also the case that funding levels can drop when interest rates fall causing liability values to increase. When plans terminate during or subsequent to an environment of falling equity markets or declining interest rates, those plans are likely to be worse funded than they would have been otherwise.

Remember, however, that the PBGC assumes control of the assets only after plans terminate. Maintaining a policy that is dominated by long duration fixed income securities may force PBGC to sell much of the equities held by terminated plans at relatively lower prices and buy bonds at relatively higher prices. And while the assets in PBGC's investment program might have also declined in value during this period, it would still be many years, on average, before the PBGC would have to sell these assets to pay benefits to beneficiaries. This leaves many years for asset values to recover. In addition, PBGC's 45 percent allocation to equities will be more diversified than the typical pension plan it insures, taking advantage of the benefits of diversification and PBGC's long time horizon.

10. With the market in turmoil, isn't this the wrong time to be making a bet on equities?

This is not a bet for the short-term based on current market conditions. It is a long-term investment strategy designed to take advantage of the Corporation's long-term investment horizon and the benefits of diversification. As a prudent long-term investor, the PBGC should never be in the business of trying to time the markets.

11. Why are you moving away from asset-liability matching at a time when others are moving towards it? Aren't you moving in the wrong direction?

There is no one-size-fits-all approach for the institutional investor community.

Among corporate defined benefit plans, whose liability characteristics are arguably most similar to PBGC's, the allocations to equities and alternative assets remain well above PBGC's new policy. While there has been movement among some plan sponsors toward liability-matching, this is most prevalent for plan sponsors who need to manage the short-term impact of volatility on corporate balance sheets and earnings. This concept of short-term balance sheet and earnings volatility does not apply to the PBGC.

Among public defined benefit plans there has not been any perceptible movement toward liability-matching strategies, presumably for the same reason it does not makes sense for the PBGC.

Both corporate and public plan sponsors have been embracing alternative asset classes in recent years in an effort to dampen portfolio volatility and take advantage of market opportunities and their long investment horizon.

Corporate defined benefit plan sponsors are either able to or required to better fund their plans. Once they are at or near full funding, liability-matching strategies have a greater ability to track the actual movements of liabilities. The PBGC does not make profits and has no ability to better fund itself. Even if the PBGC were able to achieve full funding, the Corporation would still face the risk of taking in large new underfunded plans, pushing the Corporation back into a large deficit.

12. The prior investment policy recognized that the PBGC is an insurance company. Why do you now want to move away from the investment model used by insurers?

It is an oversimplification to say the PBGC operates like an insurance company. Although the PBGC does share some of the same attributes of commercial insurance companies, there are also many significant differences. For instance, private-sector insurers have the ability to set appropriate risk-based premiums and select their customers through underwriting. Perhaps most important is the fact that the PBGC runs with a $14 billion shortfall, which would not be tolerated by insurance regulators; if the PBGC were a private-sector insurer, it would be shut down. These differences, among others, mean that a direct comparison of PBGC's investment practices to those of commercial insurers is inappropriate.

The PBGC has a unique set of attributes that correspond in varying degrees to the characteristics of insurance companies, corporate pension plans, public pension plans, and other types of institutional investors. These attributes were taken into consideration when arriving at the new investment policy, but none of these models address the unique characteristics.

13. Some investors say that the risk premium is a slippery concept. The concept of risk premium says that investors will require a higher return to compensate for higher risk. But if that return is correctly judged, the result should be neutral --the risk-adjusted risk premium should be zero. How do you respond to that?

It is true that investors should expect to take additional risk to achieve return premiums. This concept was incorporated into PBGC's analysis, as all asset classes were assumed to have roughly the same risk-adjusted return at different return and risk levels. This does not reflect, however, the expected benefits of diversification that can improve risk-adjusted returns.

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