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Beware the pension monster

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Abstract (Summary)

The pension monster has been hidden in the shadows. Now it is stepping out into the light. And it is ever one mammoth ugly creature: Big corporate pension plans in America owe some $1.2 trillion to their current and future retirees, and for the first time in years companies do not have enough money stashed away to pay for those benefits. At the root of today's problem was a historic advance for American workers: the widespread adoption of so-called defined-benefit pension plans. Why are the funds in such distress? The same reason, no doubt, that your own 401(k) is: the punishing stock market. Now, as once over-funded plans become underfunded, pension income is being replaced by pension expense. Many analysts are forecasting that big companies will reduce their expected rates of return by an average of about one percentage point. Even that tiny change will have a big impact. One thing is clear: Investors would be well advised to acquaint themselves with the annual reports of the companies in which they own shares.

Full Text (3446 words)

[Headnote]
It lurks behind funny accounting, ready to pounce on unsuspecting investors.

Of all the things that could keep investors up at night-chief executives being hauled away in hand-- cuffs, the possibility of a double-dip recession, the threat of a war in Iraq-the state of corporate pension plans hasn't done much to move the needle on the fright meter.

Until recently, that is.

Like the unseen menace that stalked Elm Street, the pension monster has been hidden in the shadows. Now it's stepping out into the light. And is it ever one mammoth ugly creature: Big corporate pension plans in America owe some $1.2 trillion to their current and future retirees, and for the first time in years companies don't have enough money stashed away to pay for those benefits. The size of the current shortfall? $240 billion. To put that in perspective, that's more than half of what they're expected to earn this year.

It's the day of reckoning in corporate America. You've probably read that companies are restating their pension assumptions and will take a hit to earnings as a result. You've no doubt seen how the stocks of some huge, widely held companies like General Motors, Ford, Delta, and American Airlines' parent, AMR, have been pummeled, in no small part because of concerns about their underfunded pension plans. But what you may not realize is the extent of the havoc this monster can wreak. The debit is not just an accounting mirage; companies will have to start pumping cash-some $29 billion next year alone-- into pension funds. That's real money. Money that won't be going to dividends or research or new plants. In other words, the monster is going to suck the blood out of those corporations.

That loss of blood could be enough to push ailing companies over the edge into bankruptcy. Exhibits A and B: Bethlehem Steel and TWA. It's quite possible that more companies will follow. Even the most optimistic scenario assumes dozens will be forced to redirect billions in cash from shareholders to retirees. And as in any edge-- of-the-seat horror flick, you can expect more hair-raising scenes before the final credits.

How did we get to this point? At the root of today's problem was a historic advance for American workers: the widespread adoption of so-called defined-benefit pension plans. First flourishing in the industrial boom of the 1950s, when corporations were flush with cash but short on workers, defined-benefit plans give employees a guaranteed annual payment upon retirement-- $2,000 a month, say, for an employee with 25 years of service. The company put up all the money, and workers gained real retirement security.

Today, with many companies opting for much cheaper pension alternatives, such as 401(k) plans, in which employees themselves put up cash, many people think of defined-benefit plans as a quaint relic of a more paternalistic era. But in fact the plans are still a huge presence in publicly traded companies. According to a recent study conducted by Credit Suisse First Boston, 360 of the companies that make up the S&P 500-more than 70%-offer defined-- benefit pension plans or are obligated to pay retirees the proceeds of legacy plans. While that's great for employees, it's becoming an increasingly risky financial proposition for corporations.

Here's why: Companies are required by law to set aside money for pensioners. If a pension plan's assets don't generate enough income on an annual basis to pay for those retirement benefits, the company must make up the shortfall. Thanks to the double whammy brought about by the unrelenting bear market and falling interest rates, much of corporate America is now faced with the prospect of doing just that-- in a big way. An estimated 90% of those pension-paying corporations in the CSFB study now have underfunded plans (that is, the value of the assets has sunk below the estimated cost of the pension obligations). That's 325 big American companies, four times the number in 1999.

Why are the funds in such distress? The same reason, no doubt, that your own 401(k) is: the punishing stock market. Most plans hold about two-thirds of their assets in stocks, and they have been no more successful than individual investors in avoiding the carnage of the past three years. Even factoring in the plans' bond holdings, most analysts estimate that pension-plan assets have lost, on average, about 10% of their value in 2002 alone. In total, some $300 billion of pension assets have been wiped away since the bull market ended in 2000, according to David Zion, a research analyst who co-wrote the CSFB report. Those companies with the largest plans, including GM, IBM, and Verizon, have been hit the hardest-each has lost an estimated $15 billion or more since the end of 2000.

As if the hit to assets weren't bad enough, falling interest rates have also hammered companies on the liability side of the pension equation-that is, the money they owe to current and future retirees. To figure out how much money needs to be in the pension plan, a company's financial officers must calculate the present value of its obligations, or what it would cost in today's dollars to make good on its promises to workers when they retire. To determine this minimum funding level, companies factor backward using a so-called discount rate. In other words, if you know you'll owe $1,000 in 20 years and you assume you'll get interest of x% on the money you salt away each year, x is the discount rate. For pensions, companies generally use a rate that tracks the yield on high-quality corporate bonds.

Simply put, the lower the discount rate, the more a company must set aside today. Trouble is, as interest rates have plunged, so too has the discount rate. The current yield on investment-grade corporate bonds, for example, has dropped to 6.5%, down roughly half a percentage point since the end of 2001. If you're drifting off right about now, lulled to sleep by all the math, this number may wake you up: $80 billion. That's the extra "balance due" that S&P 500 companies inherited merely from that half-point decline in the discount rate, says Ron Ryan, president of New York-based asset management firm Ryan Labs.

Interest rates may have neared a bottom, but most observers aren't expecting a sharp rebound anytime soon. And Ryan, for one, doesn't mince words about this massive stealth liability: "I think we're faced with the worst financial situation since the Depression," he says.

At this point it's important to note that the pensioners won't get the shaft in the mess. Corporations are required by federal law to fund their defined-benefit pension plans and pay premiums to the Pension Benefit Guaranty Corp., the government agency that steps in to provide some of the promised benefits to the employees of bankrupt companies. So even in a worst-case scenario, pensioners would likely emerge in fair shape.

No, the folks who really stand to lose are shareholders. The first attack of the pension monster is about to occur, stomping on the reported earnings of a number of widely held companies. And like it or not, reported earnings drive stock prices.

To understand where the danger lies, we'll have to take a brief trip through the accounting looking glass. Don't worry: We'll spare you the mind-- numbing details. In fact, there are only a couple of key points you need to understand about the impact of pension plans on earnings.

The first is that even though pension plan assets do not belong to shareholders (they are the legal entitlement of a company's current and future retirees), accounting rules nonetheless require companies to book the gains and losses on those pension assets in reported earnings. Up until recently, not too many companies were complaining about that quirk in the rules. Back in the heady days of the stock market bubble, pension surpluses bolstered many a bottom line. In 2000, for example, pension gains accounted for $1.74 billion, or 9%, of GE's pretax earnings. IBM's pension plan contributed $1.2 billion-- more than 10% of its earnings.

But now, as once-- overfunded plans become underfunded, pension income is being replaced by pension expense. CSFB estimates that pension losses will subtract $1 billion in net earnings from the S&P 500 in 2002.

If you are thinking $1 billion isn't so frightful considering the size of the pension shortfall, you're right. That's because until now accounting rules have allowed companies to mask their losses. That mask is about to come off, and what's underneath ... well, remember Freddy Krueger? Next year that drop is expected to grow a monstrous $25 billion-and that's assuming a sharp market upturn.

That brings us to a second key point about pension accounting: how the losses were disguised in the first place. For accounting purposes it's not the actual return on plan assets that counts most. What really matters is the expected (read: "imaginary") return that management assumes it can generate. As CSFB's Zion puts it, the process is akin to "replacing actual revenues on the income statement with budgeted revenues."

Here's a quick, albeit highly simplified, example of how this magic works: Say a company's employees accrue $50 of pension benefits this year. That's a pension expense. Now assume that the company's pension plan begins the year with $1,000 in assets, which then decline by 10% over the next 12 months. The management of our little company, however, had "expected" those assets to generate a positive return of 10%. For accounting purposes, that expected return of $100 offsets the pension expense of $50, and the company shows pension income of $50. The difference between the actual and expected return-in this case $200-might eventually hit the income statement as an expense, but only if the accumulated deficit over the years were to become really big. Even then the company would have a number of years over which to expense it. Got that?

In the meantime, the higher the expected rate of return a company uses, the better its reported earnings will hold up. How much better? Consider this: In 2001, pension plan assets for the S&P 500 actually declined by an average of 7.5%. Meanwhile, the median expected rate of return was a positive 9.2%. Those rosy assumptions transformed an actual $90 billion pension loss into $104 billion of income, according to the CSFB report. Had they not been able to rely on purely fictional expected returns, 30 companies-including Boeing, Verizon, and Lucent-- would have seen their reported earnings drop by more than $1 billion apiece.

No surprise, this kind of profit pumping, while entirely permissible under accounting rules, has generated a firestorm of criticism and a cry for greater realism in pension accounting. "There's phenomenal pressure on companies to lower their expected returns," says Chris Struve, an analyst with credit ratings agency Fitch. Stuart Schweitzer, a global investment strategist with J.P. Morgan Fleming Asset Management, believes that a far more reasonable assumption for growth is between 6.5% and 7%, given the widely held expectations for stock and bond performance over the next 20 years. And yet the following craw-- sticking fact will show you how much impact the criticism and expert testimony has had: The median expected annual rate of return among S&P 500 companies has remained unchanged at 9.2% since 1997. Okay, now check your 401(k) balance and scream.

If all that is making you think, "Here's another example of corporate America gaming the numbers," you're right. And while the wink-and-nod pension accounting may not lead to an SEC investigation, it is sure to have far more impact on investors than the Enron and WorldCom blowups did. Legendary investor Warren Buffett went so far as to argue in FORTUNE last year that companies with overly optimistic return assumptions were risking litigation for misleading investors. (Buffett, by the way, eats his own cooking: Berkshire Hathaway, the company he controls, lowered its expected return from 8.3% to 6.5% in 2001.)

Said Buffett in FORTUNE: "I invite you to ask the CFO of a company having a large defined-benefit pension fund what adjustment would need to be made to the company's earnings if its pension assumptions were lowered to 6.5%." CSFB has since run those calculations, in fact. The answer is that bottom lines would get shellacked: Profits for the S&P 500 would plummet by $44 billion in 2003 alone. Companies taking the biggest hits would include GM, Northrop Grumman, U.S. Steel, and Boeing-all of which would see earnings drop by 35% or more from the consensus outlook. For that reason most observers don't expect companies to follow Buffett's lead.

The movement for greater realism is having some impact, however, be it ever so modest. Many analysts are forecasting that big companies will reduce their expected rates of return by an average of about one percentage point. Even that tiny change will have a big impact. Remember Freddy unmasked? This measly one percentage point reduction is what will cause S&P 500 earnings to drop by about $25 billion in 2003.

Early hints of that profit plunge are already showing up. IBM said recently that it is planning to reduce its assumed return from 9.5% in 2002 to between 8% and 8.5% for 2003-a move that would wipe out nearly $700 million from pretax earnings. Other companies, including Whirlpool, Dow Chemical, and General Electric, have likewise ratcheted down their assumptions. Which is not to say there aren't holdouts. Delta Air Lines, for example, told FORTUNE that the company has no plans to lower its expected return of 10%. "We've had returns of 10% to 12% in the past, sometimes higher," says Delta spokesperson Kristi Tucker.

But even if corporations persist in using fantasy returns in estimating pension gains, earnings will still take a hit. With the stock market's slide over the past three years, the expected rate of return is now being applied to a shrinking asset base. Moreover, the difference between actual returns and those expected returns has grown so large that companies must now start expensing the actual losses on their income statements. If S&P 500 companies were to resist the pressure and leave their assumptions unchanged, the hit to earnings next year would still be about $15 billion, Zion says. And that, trust us, is going to have an impact on stock prices.

That's one way investors get stomped, but it's not the only way. When it comes to actually funding those malnourished pension plans, companies can't depend on quirky accounting rules to get them off the hook. The folks who regulate the nation's pension plans don't give a hoot about expected returns-they monitor a plan's actual assets and liabilities. Generally, if a pension plan is underfunded by more than 10%, it must kick in additional funds, usually over a period of three to five years. And guess where that money often comes from? That's right. The company's already squeezed cash flow.

As Trevor Harris, an analyst with Morgan Stanley's accounting research group, puts it, "The more you get into a hole, the harder it is to dig out of it." And corporate America will have no choice now but to bring out the shovels. In fact, a rash of companies-from Honeywell to J.C. Penney to Hewlett-Packard-have recently announced that they have been, or will soon be, plowing hundreds of millions of dollars into their underfunded pension plans. Cash contributions to S&P 500 pension plans are expected to jump from $15 billion in 2001 to $29 billion in 2003 and $44 billion in 2004, according to CSFB. Remember, that's real money-not manufactured earnings. "Of all the things to worry about, potential cash contributions are probably the most important," notes analyst Zion. "It's cash that's coming out of the pockets of shareholders and going into the pension plan."

At the extreme, unmanageable pension payments can propel a company into bankruptcy. Right now, hard-hit airlines, including Delta, AMR, and Northwest are facing onerous contributions. They couldn't be coming at a worse time. Their cash flows have been hammered, and their ability to borrow is both limited and prohibitively expensive. "It could be the straw that breaks the camel's back in the case of the airlines," says Fitch's Struve.

Even for companies that aren't in such a precarious position, pension contributions can spell bad news for investors, since that money won't be available for other purposes such as building new factories, retiring debt, or paying shareholder dividends. GM, for example, has already infused its fund with $2.2 billion in 2002, and some analysts, including UBS Warburg's Saul Rubin, believe that additional contributions over the next few years could jeopardize the company's dividend payment to shareholders. Rival Ford, meanwhile, said recently that it will contribute $1 billion to its pension plan over the next two years. While the company has a large amount of cash on hand, it's eroding quickly as Ford's borrowing costs have sky-- rocketed. Indeed, most analysts expect Ford's free cash flow to be negative in 2003.

Companies do have the option of contributing their own stock to their pension plans as long as the total doesn't exceed 10% of plan assets. But such stock contributions dilute the holdings of existing shareholders. IBM, for instance, recently announced that it may be issuing up to $1.5 billion in stock to meet its pension shortfall, a move that at its current share price would represent about 1% of shares outstanding. Surely, though, that kind of quick fix would not be welcomed by shareholders of beaten-down companies like Delphi or Goodyear Tire, whose estimated pension contributions for 2003 would cause dilution of about 10% and 30%, respectively, were they to be made in the form of company stock.

Just how severe the cash squeeze becomes will depend, of course, on the returns pension plan assets actually generate in 2003 and beyond. For many companies to avoid staggering contributions in future years, the stock market would have to rebound sharply-and keep going. Given the rate at which pension liabilities are growing, Morgan Stanley's Harris estimates that in order to simply tread water at their current funding levels, most plans would have to generate, at a bare minimum, an annual return of 10% next year. Given the average asset allocation of pension plans, that means that stocks will have to return more than 12%.

Regardless of how pension assets perform, the problem isn't going to just disappear anytime soon. That's because pension liabilities will only get bigger. With average life expectancies increasing, companies will have to pay out more money over a longer period of time. Today the average 65-year-- old can expect to live another 15 years. Longevity experts say that span is likely to increase to at least 20 years by 2050.

That happy increase in life span, coupled with the fact that legions of baby-- boomers are nearing retirement age, means that companies are going to be supporting proportionally more retirees in relation to their active workers. Today the ratio of active workers to retirees is three to one. By 2030, assuming an average retirement age of 65, that ratio will be 1.5 to 1. (Some companies have already flipped the ratio: GM, for example, currently counts about 2.5 retirees for every active worker-a key reason its pension plan is so troubled from a cash-flow perspective.)

In the worst-case scenario-one in which the stock market continues to decline and interest rates remain low-the situation could become downright nightmarish. "If we get a negative 10% return next year, this pension issue will be on the cover of your magazine every couple of weeks," predicts Fitch's Struve, "because somebody will be blowing up."

Whether that dark scenario will ultimately play out isn't yet certain. In the meantime, however, one thing is clear: Investors would be well advised to acquaint themselves with the annual reports of the companies in which they own shares. You'll find the most frightening stuff about the pension monster in the footnotes-in fine print, of course. But then, sometimes it's better to be scared than to be surprised.

[Sidebar]
Hit from all sides: The pension burden means companies are ...

[Sidebar]
OWING MORE

[Sidebar]
$80 billion
Estimated increase in total pension liabilities of S&P 500 by 2003

[Sidebar]
Declining interest rates mean companies have to set aside more money now to pay for future pension liabilities.

[Sidebar]
MAKING LESS

[Sidebar]
$25 billion
Estimated hit to EPS of S&P 500 in 2003

[Sidebar]
A swooning stock market has reduced pension plan assets-- a blow that will be felt on corporate earnings.

[Sidebar]
PAYING OUT

[Sidebar]
$29 billion
Estimated hit to cash flow of S&P 500 in 2003

[Sidebar]
Companies must start sharing up pension plans with big infusions of cash.

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