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## PAGE ONE

# Pension-Plan 'Crisis' May Be False Alarm

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Staff Reporters of THE WALL STREET JOURNAL

Investors have been flinching at bleak disclosures about the failing health of pension plans this fall. But the supposed pension crisis isn't something most shareholders need to be concerned about.

There certainly have been some scary announcements:

**International Business Machines Corp.** said it might need to pump \$1.5 billion into its pension plan. **Boeing Co.**, too, said it could take a hit in the fourth quarter to its shareholder equity of as much as \$4 billion. And **General Motors Corp.**'s announcement that its U.S. pension plans could be short \$23 billion triggered a debt-rating downgrade.

Sure, pension plans have lost billions of dollars this year, and a group of chronically deficit-ridden pension plans -- mostly auto makers, airlines and steel companies -- are in worse shape than ever, which will likely sap cash flow and in some cases raise their cost of borrowing.

Still, most large company pension plans aren't even close to being in peril. "The sky isn't falling," says Jack Ciesielski, who publishes the Analyst's Accounting Observer, and who has been analyzing pension expenses since the early 1990s.

For one thing, merely being underfunded doesn't automatically mean that companies must dump money into their pension plans. "People jump out of their skin when they hear that a pension plan is X-billion underfunded," says Jeffrey Applegate, former U.S. market strategist at Lehman Brothers. "There's this notion that the

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## COMPANIES

Dow Jones, [Reuters](#)


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[International Business Machines Corp. \(IBM\)](#)


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PRICE	86.20
CHANGE	1.77
U.S. dollars	11/25

company is going to have to write a check in the next nanosecond." Companies, following a web of complex government and accounting rules, typically have years in which to make the required contributions.

During that time, the underfunding can vanish. Back in 1993, companies in the Standard & Poor's 500 stock index collectively posted a shortfall in their pension plans. Then came the bull market and year after year of strong investment returns, leading to vast overfunding just two years ago.

Then, the continued market decline shrank the assets in pension plans, while declining interest rates boosted the plans' liabilities (lower interest rates increase the plans' liabilities, because if one assumes the assets have a lower return, more money must be set aside to meet future obligations). This one-two punch melted the surplus for companies in the S&P 500 to \$4 billion in 2001 from \$235 billion in 2000, according to a July report by Morgan Stanley.

Boeing's surplus, for example, shriveled to \$1.1 billion in 2001 from almost \$14 billion in 2000, and the company expects the plan to end the year with a deficit. "The absolutely dismal performance of the stock market, combined with interest rates coming down very significantly, makes the situation a 'perfect storm,'" says Walt Skowronski, Boeing's treasurer. "But like any storm, it can clear very quickly."

While many don't believe that interest rates and the stock market will rise soon, a Merrill Lynch report this month found that companies in the S&P 500 won't exhaust their pension assets for another 12 years, and that is with no further asset appreciation or company contributions.

Why the sudden pension obsession? For one thing, although most analysts ignored pension plans when they were pumping billions into earnings in the 1990s, now that the situation has reversed, they have gone to the other extreme. A bumper crop of pension reports in the last six months dissected the ways pension-plan losses can hurt balance sheets and earnings.

For the most part, the media focused on scary paragraphs about the most severely underfunded plans, so unless shareholders scrutinize the actual reports -- many of which are actually very helpful -- they might easily conclude pension plans as a group are going over a cliff. And they overreact to pension news they don't understand.

Jittery investors, in fact, sent **Lockheed Martin Corp.** shares tumbling when the company, in its third-quarter earnings announcement, mentioned that the pension plan would probably generate an expense of \$50 million to \$100 million this year, instead of contributing \$150 million to the bottom line, as it did last year.

Company officials and industry analysts expressed surprise with the 4% decline in shares of the

#### Boeing Co. (BA)

PRICE	33.49
CHANGE	-0.51
U.S. dollars	11/25

#### General Motors Corp. (GM)

PRICE	38.70
CHANGE	1.12
U.S. dollars	11/25

\* At Market Close

## PENSION SCORECARD

Some large U.S. companies' pension plans in 2001, in billions.

Company	Assets	Liabilities	Percent Funded
IBM	\$61.1	\$60.4	101.1%
Boeing	33.8	32.7	103.4
AMR	5.5	7.4	73.9
GM	73.7	86.3	85.3
Lockheed	20.3	19.7	103.0
Verizon	48.6	36.4	133.4
Qwest	11.1	9.6	115.5

Note: Includes U.S. and foreign plans

Source: Morgan Stanley

nation's largest defense contractor, saying investors largely ignored that quarterly earnings rose 36% and instead focused on increased pension costs that the industry can pass on to the government in its contracts.

Companies themselves may have contributed to the scare. In the wake of recent corporate accounting scandals, companies are more eager to warn shareholders of potential problems, says Mr. Ciesielski, the accounting specialist. He adds, however, that some companies could be using the pension losses as a negotiating tool with their

unions. And many companies that are cutting retiree medical benefits and reducing pensions may hope that the cuts will appear necessary and prudent, given the losses in their pension plans.

Contributing to the climate of doubt is that analysts can't say for sure what is going on this year, since companies are required only once a year to publicly disclose most details about their pension plans, including asset levels. For the majority with a Dec. 31 year end, shareholders won't know the actual health of the plan until annual reports come out next spring, although some companies have said they will provide updates with fourth-quarter earnings.

Investor expectations also play a role in pension panic attacks. During the 1990s, many pension plans were so overfunded that companies didn't have to contribute to them for years. Investors got used to this anomaly -- and forgot that companies used to make frequent contributions to pension funds.

Now, some shareholders wonder whether a company's cash flow will be harmed if the pension plan is underfunded. In most cases, the answer is no. Federal pension law requires companies to contribute additional assets if the plan's funding status falls below an average of 90% over three consecutive years, or 80% in any one year. What's more, companies have three to five years to make up the shortfall and can often contribute stock instead of cash. Merrill Lynch concludes: Only a handful of companies are likely to have liquidity problems despite growing liabilities.

Nor is the fact that a company is contributing cash to its pension plan an automatic red flag. Some companies with strong cash flow are contributing more than they need to. For example, 3M Co. recently contributed \$789 million to its underfunded pension plan -- a big increase from the \$104 million it contributed in 2001. "We're not required to put in any money this year," a company spokesman acknowledges. "But we had such significant cash flow that we wanted to put in a

significant contribution," which will reduce contributions it may need to make in subsequent years.

Of course, financially distressed companies with chronically underfunded plans are another story. For the most part, these are older, industrialized giants, which typically have long-established "defined benefit" pension plans for mainly unionized work forces. In contrast, roughly 30% of companies in the S&P 500 don't have pension plans, and instead contribute to retirement-savings plans such as 401(k)s, which shift investment risk and contributions responsibility to employees.

But even at beleaguered companies, shareholders need to put information in perspective. **AMR Corp.**, parent of American Airlines, said recently that it contributed \$250 million to its pension plan this year. But that is a relatively small portion of the \$2.8 billion in cash the company generated this year. "So as we think of all the challenges facing AMR ... we don't see cash-funding needs in our pension plans as a significant issue for AMR between now and the end of 2003," Jeffrey Campbell, the chief financial officer, told investors recently.

Likewise, announcements of pension-related charges to shareholders' equity in many cases aren't cause for alarm. If a pension plan's deficit is especially steep, the company must record some of the underfunded amount on its balance sheet.

For the smaller group of very underfunded plans, a reduction in shareholder equity could put the company out of compliance with debt covenants, forcing negotiations with lenders. GM's estimated \$23 billion shortfall in its U.S. plan, up from \$9.1 billion in 2001, was a factor in Standard & Poor's Corp. Oct. 15 decision to cut GM's debt rating to two levels above junk status.

GM officials say that being underfunded is hardly new. "Back in the early 1990s, we had a \$20 billion underfunded pension liability, and in the course of that decade we became fully funded" thanks to hefty contributions -- much of it company stock -- aided by the 1990s bull market, a GM spokeswoman says. The auto maker says that a percentage-point rise in interest rates could erase \$7 billion in underfunded pension liabilities.

A more immediate concern for shareholders is whether pension-plan losses this year will hurt company earnings. The short answer is yes -- indirectly -- but the impact is an accounting phenomenon that analysts largely discount. Here's why:

To keep pension-plan returns from whipsawing earnings each year, accounting rules allow companies to use a hypothetical, or "expected," return when calculating annual pension expense, not the actual return. In short, pension expense is the cost of benefits earned by employees during the 12-month period and some other expenses, offset by the "expected" investment return.

Since 1995, companies have used an expected return of 9%, on average, according to Lehman Brothers. These expected returns were lower than what the pension assets were actually returning during the roaring bull market, so the excess gains -- the amounts that exceeded the expected returns -- was set aside. Companies then dribble some of these excess gains into future years' earnings calculations, a process called "amortizing," which boosts pension income.

Many companies have benefited from these amortized gains in recent years. At IBM, for instance, pension "income" -- a figure that includes the expected returns, plus amortized gains -- grew from \$285 million in 1996 to \$1.03 billion in 2001 in its U.S. plan.

Now that the bull-market party is over, and the stockpile of gains is getting smaller, many companies will have lower pension income. Morgan Stanley estimates that net pension income at **Verizon Communications Inc.** might decline 4.9% this year; such income at **Qwest Communications International Inc.** could decline 28.6% and, at Boeing, 5.7%.

IBM's pension income could drop by \$700 million next year for another reason: a reduction in the company's expected rate of return, to between 8% and 8.5% from 9.5%, IBM said in its October conference call to investors and analysts. It isn't clear if many companies will follow IBM's lead, but some, including Warren Buffett, chairman of **Berkshire Hathaway Inc.**, have criticized companies for propping up earnings by continuing to use expected rates of return that he sees as unrealistically high. Berkshire-Hathaway's expected return figure: 6.5%.

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