

## ► Customized Pension Portfolio Supports Corporate IPO Strategy

### Company Profile:

- A leading supplier of metal products and services
- Formed in the early 2000s as a result of a merger among several metal manufacturers
- Planning to go public in the next three to five years

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**SEI Solution:** Integrated pension advice including a customized asset allocation scenario analysis and recommendation

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### Key Benefits:

- Implement a portfolio that matches the plan's risk/return profile while decreasing the volatility of expected contributions
- Minimize interest rate sensitivity
- Support company's strategy to go public by controlling financial impact of pension plan

### BACKGROUND

The primary near-term strategy of the metal supply company, launched in the early 2000s, is to take the company public. With an initial public offering (IPO) planned for the next three to five years, it is critical that the company maintain healthy financials and achieve targeted earnings levels.

One threat to accomplishing the desired results is the financial impact of the company's pension plan. Specifically, the volatility of pension contributions is of significant concern. The company operates in a market that provides countercyclical cash flows. Therefore, managing required pension contributions, in concert with ensuring that the company has the free cash flow to make them, is also a high priority. The company's plan will continue to be sensitive to the unpredictable interest rate environment. Managing the volatility of these contributions appropriately is critical to both the health of the plan and the company.

### SEI ADVICE SOLUTION

Given the metal manufacturer's plan needs, near term sensitivity to contributions and interest rates, coupled with a foreseeable IPO, SEI has partnered with the organization to develop an alternative to offerings typically found in the marketplace.

### Asset Allocation

As of the end of plan year 2003, the metal manufacturer maintained a 60/40 equity to fixed income mix. This Traditional Portfolio allocation decision was based on an asset only portfolio framework. Under this framework, the fixed income portion of the portfolio was invested in products that were meant to closely track the Lehman Aggregate Bond Index, which has a significantly shorter duration than the plan's liabilities. As a result, during the interest rate declines and poor market returns of the early 2000s, the company, like many other plan sponsors, saw their liabilities grow much faster than their assets, and therefore found itself needing to make unanticipated contributions.

With this in mind, SEI has developed an alternative investment strategy to address the company's need to stabilize the funded status of the plan and reduce the volatility of future pension contributions. The new strategy (Portfolio 2) accomplishes this through the use of targeted duration bonds that are customized

to fit the sensitivity of pension liabilities. The resulting portfolio has a 52/48 equity to fixed income mix that will provide comparable levels of risk and return for the plan and substantially reduce the volatility of contributions.

Besides using a different equity to fixed income mix, Portfolio 2 is composed of different asset classes than those found in the Traditional Portfolio. In the Traditional Portfolio, allocations to US Equity are achieved through active Large Cap and Small Cap Equity strategies. By contrast, Portfolio 2 allocates this portion of the portfolio to Large Cap Disciplined Equity and Small/Mid Cap strategies. The Large Cap Disciplined Equity strategy is designed to provide more consistent alpha than traditionally achieved within a Large Cap strategy. The Small/Mid Cap strategy serves as the complement to the Large Cap Disciplined Equity strategy to achieve a US equity component benchmarked to the Russell 3000 Index.

While Portfolio 2 does provide reduced exposure to equities, it actually increases the range of potential investment returns while reducing the volatility of contributions.

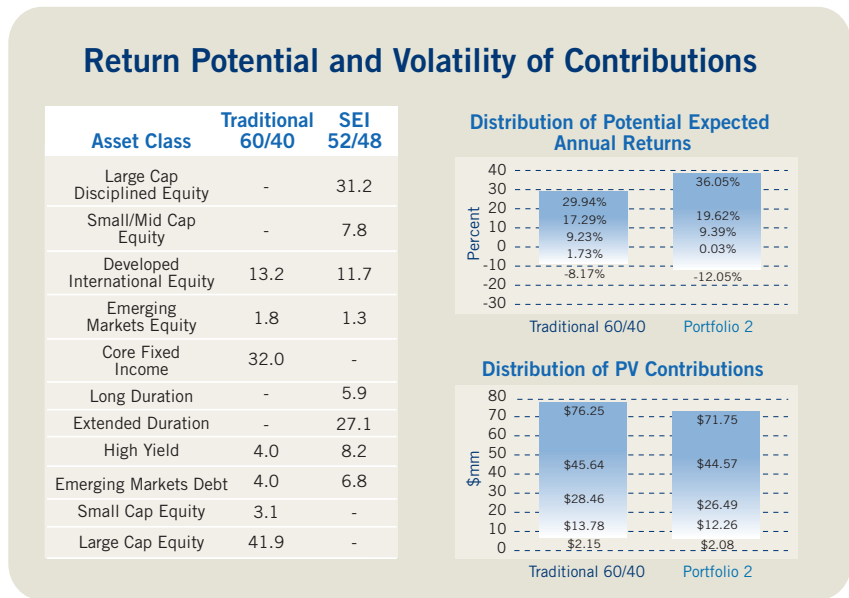


FIGURE 1

Additionally, the fixed income portion of the portfolio has been adjusted to include Long Duration and Extended Duration products and excludes the shorter duration Core Fixed Income asset class. Again, by combining the longer duration strategies, Portfolio 2 includes an allocation to bonds with a duration (23), which is more in line with the duration of their liabilities (15). The duration of the Core Fixed piece of the Traditional Portfolio is approximately five.

A major concern of the company was that the new portfolio would not be able to provide sufficient returns to meet the plan's needs. While Portfolio 2 does provide reduced exposure to equities, it actually increases the range of potential investment returns while reducing the volatility of contributions. *Figure 1* compares the two portfolios. The potential expected return of the Traditional Portfolio is 9.23% while the portfolio's return in a poor market scenario is a potential loss of -8.17%. These returns are magnified slightly with Portfolio 2 where the potential expected return is 9.39% and the potential return in a poor

market scenario is -12.05%. During good times, the magnification persists as the Traditional Portfolio is charted to return a potential 29.94% versus Portfolio 2's expected potential return of 36.05%.

### Interest Rate Scenario Analysis

The alternative to the Traditional Portfolio is designed to provide appropriate risk/return for the plan and address the company's desire to reduce the volatility of its contributions. Because the key driver of volatility is the level of interest rates, SEI completed a scenario analysis to understand the sensitivity of contributions to interest rates. The study forecasted the contributions necessary with the traditional 60/40 portfolio versus those necessary with Portfolio 2 given various interest rate scenarios. *Figure 2* summarizes the results of the scenario analysis. *Figure 3* (on page 4) provides the details around two of the scenarios considered.

The contribution differential between Portfolio 2 and the Traditional Portfolio in these three scenarios ranges from \$1 million to \$16 million.

100 bps Rate Change in Year 1	Traditional 60/40 Portfolio (\$mm)	Portfolio 2 (\$mm)	Differential (\$mm)
Rise and Stay	5.59	6.13	-0.54
Fall and Stay	19.79	9.06	10.73
Fall-Rise	4.72	3.61	1.11
Rise-Fall	20.29	4.27	16.02

200 bps Rate Change in Year 1	Traditional 60/40 Portfolio (\$mm)	Portfolio 2 (\$mm)	Differential (\$mm)
Rise and Stay	6.28	12.16	-5.88
Fall and Stay	39.92	20.54	19.38
Fall-Rise	6.36	5.80	0.56
Rise-Fall	42.67	8.61	34.06

Source: SEI research

FIGURE 2

The first set of scenarios illustrates how contributions are affected given a 100 basis point change following year one of a ten year time period. In three of the four scenarios, Portfolio 2 results in lower cumulative contributions over the ten year time period. Further, the contribution differential between Portfolio 2 and the Traditional Portfolio in these three scenarios ranges from \$1 million to \$16 million. By contrast, in the one scenario that resulted in the Traditional Portfolio providing a lower cumulative contribution than Portfolio 2, the differential was approximately \$0.5 million.

This exercise indicates that given a moderate (100 basis point) change in interest rates, the range in contribution levels would be significantly less under Portfolio 2 than under the Traditional Portfolio, specifically \$5.45 million compared to \$15.57 million. Further, in the instance where there existed an opportunity cost to the plan for choosing Portfolio 2, this cost, \$540,000, was very small compared to the potential benefit, as much as \$16.02 million, in the scenarios modeled.

The second set of scenarios is identical to the first set but instead model the effect of a more extreme move in interest rates—200 bps following year one. Again, in three of the four scenarios, Portfolio 2 results in lower cumulative contributions over the ten year time period. As expected, both the values of the cumulative contributions and the range of the differentials are magnified.

### Summary

To address the immediate and on-going goal of taking the company public, SEI offers the company an alternative (Portfolio 2) to its Traditional Portfolio:

- An asset allocation decision that includes Disciplined Equity, Small/Mid Cap Equity and Long and Extended Duration strategies, as well as larger allocations to the High Yield and Emerging Markets Debt asset classes.
- A lower equity to fixed income ratio that decreases the volatility of expected contributions.

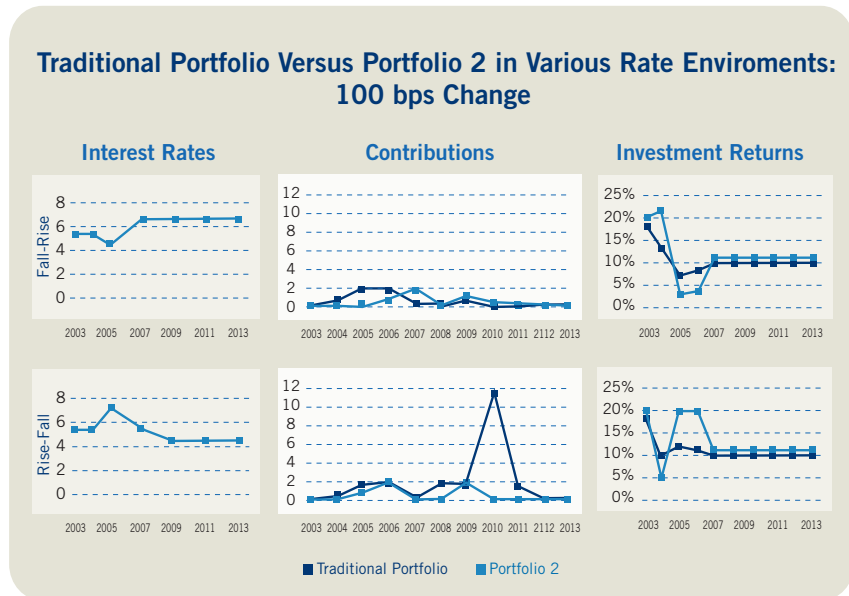


FIGURE 3

Portfolio 2's benefit was tested by completing a scenario analysis that illustrates the performance (as measured by level of portfolio contributions) of the two portfolio options under different interest rate environments.

Based on the analysis, the metal supply company adopted SEI's allocation recommendation. SEI will continue to work with the client to ensure that the pension solution is adequately designed to manage the intermediate goal of controlling pension expense to help best position the company for an IPO.

This time, the exercise indicates that given a large (200 basis point) change in interest rates, the range in contributions would be significantly less under Portfolio 2 than under the traditional portfolio, specifically \$14.74 million compared to \$36.39 million. Further, in the case where there existed an opportunity cost to the plan for choosing Portfolio 2, this cost, \$5.8 million, was small compared to the potential benefit, as much as \$34.06 million in the scenarios modeled.

*Interest rate scenario analysis is hypothetical and provided for illustrative purposes only. Projections and calculations shown in this report should be provided for informational purposes only and are subject to change.*

*Plan sponsors should make investment decisions solely in the interest of plan participants and for the main purpose of providing benefits. So long as interests of the plan are considered first, the interests of the plan sponsor can and should be considered. This case study focused on just such an "incidental" or "secondary" benefit to plan sponsors, and did not focus on any primary benefits to plans.*