Dear Director,

I am writing to you to comment on your Exposure Draft “Financial Reporting for Pension Plans - An Amendment of GASB Statement No. 25”. I am aware that my letter will arrive after the comment and testimony periods have passed. I had not monitored GASB statement No. 25 and therefore was not aware of your proposal to require the reporting of money-weighted rates of return on the plan level. Nonetheless, I believe that your current deliberations might still benefit from my remarks concerning the calculation of money-weighted rates of return.

Perhaps my previous comments and public testimony on the Preliminary Views as well as my presentation in your office have contributed to your conclusion that money-weighted returns provide valuable information to the users of plan financial statements. I commend you for striving to better measure pension plan success through money-weighted returns, even though I have not achieved my primary goal of convincing you to abandon the use of expected returns as discount rates.

Not all Money-Weighted Returns are Created Equal

In paragraph 86 of your Exposure Draft, you state the following:

“In contrast, a money-weighted rate of return provides information about the actual performance of the plan’s investment portfolio because it takes into account the effects of transactions that increase the amount of plan investments, such as employer and employee contributions, and those that decrease the amount of plan investments, such as benefit payments. Additionally, the money-weighted rate of return provides information that is comparable with the long-term expected rate of return of plan investments, which is used in calculating information presented in other disclosures. The Board concluded that information about both aspects of performance is essential to users of plan financial statements.”

In Appendix C of your Exposure Draft, you illustrate the calculation of time- and money-weighted returns. Assuming that you and the final users of plan financial statements are primarily interested in a measure of total pension plan success, I suggest a slight modification to improve the calculation of money-weighted returns. Without this modification, a money-weighted return calculated as in Appendix C would fall short of your stated goal of being a return measure that is comparable to the long-term expected rate of return on which funding cost expectations are based.
Pension Plans are Different than Mutual Funds

Appendix C adopts a mutual funds methodology for calculating money-weighted returns. DB pension plans, however, are materially different from mutual funds since the latter have no meaningfully defined funded status. The funding levels of pension plans contain a great deal of information about their financial health and overall success. The money-weighted return that you are suggesting, however, does not take funding status information into account and is thus an incomplete measure of overall pension plan success. A more appropriate measure of total pension success – one that could then be compared to the long-term expected rate of return – considers changes in funding status due to non-investment related influences by treating them as a (hypothetical) final cash flow from (or to) the plan sponsor. In order to avoid a terminological confusion with the money-weighted returns from the mutual funds world, I now believe that this new return measure needs to be labeled differently. I suggest calling it the Pension Plan Internal Rate of Return (PenPIRR). This return measure uses a money-weighted return methodology, but considers one additional cash flow that traditional money-weighted returns ignore.

I apologize for any confusion that my previous testimony may have caused. I used the term “money-weighted returns”, not realizing that I was indeed referring to a different return measure that deserves its own name.

Examples of Differences Between Standard Money-Weighted Rates of Return and PenPIRR

Your sample calculation of money-weighted returns on page 39 could indeed be the result of very different funding cost scenarios for DB pension plans:

- **Scenario I – Fully Funded at the Beginning and at the End of the Investment Period**

  When pension plans start and end the performance evaluation period fully funded, no further modification to the cash flow structure is necessary. Traditional money-weighted returns and the Pension Plan Internal Rate of Return coincide.

- **Scenario II – Benefit Increase at the End of the Investment Horizon**

  For scenario II let us assume that everything unfolds identically to scenario one – except for a benefit increase at the end of the investment period. All cash flows during the performance evaluation period remained identical; therefore, the standard money-weighted return measure would not be affected by the final increase in the present value of liabilities. However, everybody would agree that the financial health of the now underfunded pension plan of Scenario II is worse than that of a scenario I pension plan.

  The PenPIRR accounts for that by considering a final cash flow from the plan sponsor to the fund to bring the fund back to full funding. That hypothetical cash flow transforms the increase in the present value of liabilities into a corresponding decline in the PenPIRR. Conversely, if a reduction in pension benefits results in a funding surplus, that surplus could be returned to the plan sponsor, thus increasing the PenPIRR.

- **Scenario III – Initially Fully Funded, but Insufficient Contributions to Fund Benefit Accruals**

  Net cash flows are generally the result of contribution and benefit payments. However, the standard money-weighted return methodology does not relate the actual contributions to the required contributions (normal cost). If new benefit accruals are not or only insufficiently funded, then plan funding levels will decline over time. Again, standard money-weighted returns fail to differentiate between pension plans that have different actual contributions to
required contributions ratios. The PenPIRR, on the other hand, takes the aggregate effect of insufficient contributions – the final funding deficit – into account.

• *Scenario IV – Same Present Value of Liabilities, Initial Underfunding, No Loss Amortization*

Similarly, if a different plan has an initial funding deficit, an identical net cash flow sequence implies that the plan is further and further falling behind in funding status (remember that in scenario I, the plan started and ended fully funded). The initial funding deficit grows with a rate equal to the discount rate. That information should be used to gauge a pension plan's overall success.

All of the four scenarios from above would yield the same standard money-weighted return measure as they have not (yet) affected cash flows. Each of these scenarios, however, depicts a different pension success story. I believe that we should provide the users of plan financial statements with a performance metric that is able to differentiate between these different scenarios. That performance measure would not focus on the investment decisions alone. It would not even stop at considering the timing and the amount of funding contributions. It would set the funding amounts in relation to the required contributions. And finally, it would quantify the performance impact of all other plan sponsor decisions, especially those on the benefit side.

**Conclusion**

I hope to have illustrated that the standard money-weighted rate of return remains an inappropriate success measure if we are interested in total plan sponsor success. With only a slight modification to the existing methodology, that return measure can be turned into a really powerful total performance metric, the Pension Plan Internal Rate of Return.

The PenPIRR methodology translates all factors on plan sponsor success into an equivalent PenPIRR contribution. Investment manager decisions, plan sponsor decisions, and market influences all become comparable to each other and to our ultimate return expectation. As long as we are basing our funding cost expectations on the expected return of plan investments, it is the PenPIRR that will provide the ultimate information whether our expectations have been met or not.

Sincerely,

Dr. Norman Ehrentreich

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