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Armco hedges to hold market gains

Derivatives guard $1.52 billion

By Barry B. Burr

PITTSBURGH — Armco Inc. is hedging its $1.9 billion pension fund to preserve big gains it made this year in stocks and bonds.

Using caps, collars and other derivative strategies, the hedge against a fallback in the markets is being put on through the last trading day of the year, said Dennis F. Furey, director-investment management.

The hedge covers $1.52 billion, all of the fund's 40% allocation to domestic equities and 40% allocation to domestic fixed income. (Armco also has 15% of its pension assets in international equities in 5% in cash equivalents.)

He said the fund wants to protect the 23% or 24% gain in equities and 13.5% gain in fixed income it earned this year through July.

Armco is putting on its hedges as an overlay, so the move won't affect the equity and fixed-income portfolios of its money managers.

Mellon Capital Management Corp., San Francisco, executed the hedges for the fund. Thomas B. Hazuka, Mellon Capital's executive vice president, said only one other client is hedging its gains as Armco is doing. He wouldn't name the client, but did say it's a billion-dollar-plus pension fund.

"We did this not because of any view of how the market may be moving," said Mr. Furey, "but based on the risk tolerance of our plan."

The fund normally takes a long-term, unprotected investment horizon, Mr. Furey added.

"What brought this to a head in 1995 is the rather significant (pension) contribution we have to make in 1996 and the risk that those contributions would have to be increased if the market fell."

Armco "expects to contribute $70 million a year for the next three years," Mr. Furey said.

"We're hedging to protect our year-end return, recognizing the year-end market value is very important in determining pension contributions in subsequent years," he said.

At the end of 1994, the company's pension plan had an accumulated benefit obligation of $1.868 billion, meaning the present value of its accrued pension liabilities was fully funded on a termination basis, Mr. Furey said.

Its projected benefit obligation, or the present value of the plan on an ongoing basis, was just slightly higher, at $1.89 billion, he added, the similarity of liability values indicating "we've a very mature pension plan.

"But that was based on an 8.5% discount rate" for calculating the present value of the pension liabilities, Mr. Furey said. "The plan is probably underfunded now due to the decline in interest rates."

The company's next financial report on its pension plan won't be available until after the end of this year.

Mellon Capital, despite its involvement with the hedge, isn't taking a pessimistic view of the markets for its other clients.

In late May, in its tactical allocation accounts, unrelated to

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Armco, Mellon Capital moved its allocation to 80% equities from 60%.

"It's our highest equity allocation since 1986," said Mr. Hazuka, "which paid off handsomely."

"Since then we have cut back somewhat toward 60%." He declined to give a specific percentage, although the equity allocation is still above its mix in May.

As for hedging, "neither Dennis Furey nor the other client made their hedging decision because the market was overvalued, but because of balance-sheet issues," Mr. Hazuka said.

For these companies, doing the hedges for this kind of reason makes sense, Mr. Hazuka added.

"Other clients have asked if they should get out of the market," Mr. Hazuka said. "Based on valuation, we don't think so."

Mr. Furey agreed: "Our circumstances are different than other pension funds, which are much better funded than ours and don't have to be sensitive to short-term volatility" in the investment markets.

The fund is using several different hedging strategies to protect both its equity and fixed-income portfolios.

In some cases, its upside potential on some of the assets is capped to help pay for the cost of the downside protection, Mr. Furey said. In other cases, the fund took on the cost of the floor protection, allowing it to keep the unlimited potential for gains.

In a way, Armco is hedging its hedge by doing some collars and straight puts, said Mr. Hazuka.

In hedging its equities, Mr. Furey said, "We have a floor around the 15% level."

As a result, the fund would preserve a market return of 15% for the entire year, regardless of how much the market fell before the end of the year.

"So we'd absorb some of the decline in the market," from the approximate 23% level of gain it has earned this year through July, he said.

"So a 1987-type event would not evaporate our gains," he said, referring to the Oct. 19, 1987, stock market meltdown, after which the market finished with only about a 5% gain for the entire year.

In fixed income, the hedge protects its return at around 13%, or close to the gain the fund earned for the year through July.

In its equity hedging strategy, Mr. Furey said, "the basic risk is if our actively managed equity portfolios were to act differently than the S&P 500."

Armco has its equity hedge based on the Standard & Poor's 500 stock index.

For fixed income, its hedging instrument is based on Treasury securities, divided into five-, 10- and 30-year exposures.

"That avoids any yield curve whips," he said. That is, the chance the shape of the yield curve would change and the interest rates on all maturities not move proportionately with each other.

The fund executed the hedges mostly through over-the-counter options, Mr. Furey said.

The OTC market offered more flexibility in setting the expiration date at the end of the year, when Armco wanted it, rather than exchange-traded derivatives, he added.

"It's a perfect fit," he said of the OTC expiration date. "We wanted a custom-trading date of the last business date of the year."

Armco is using European-style settlement for its options, which allows execution only at the expiration date, rather than American-style settlement, which allows execution on any date until the contract expires.

"We didn't need to pay for American settlement, because we didn't need it," Mr. Furey said. American settlement costs more because it allows greater trading liquidity. ■

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