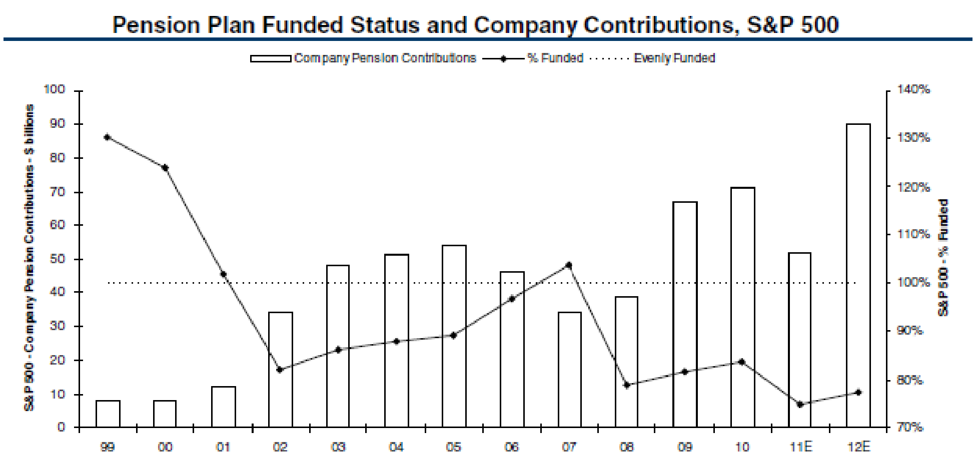
February 2, 2012

Dear clients and colleagues,

The 4Q2011 earnings season rolled out a shocking array of problems of underfunded pension plans. Many S&P 500 companies reported higher-than-expected pension expenses which negatively impacted their bottom lines. They also announced more pension contributions in the coming years. For instance:

- ✓ Boeing expects 2012 pension expense to be $2.6B, an increase of $1B
- ✓ Verizon expects pension contributions to triple from $400M in 2011 to $1.26B in 2012
- ✓ AT&T made $1B pension contributions in 2011
- ✓ Lockheed Martin made $1B discretionary pension contributions in 2011
- ✓ Honeywell had $1.8B pension related charges in 2011
- ✓ Ford made $1.1B pension contributions in 2011

Big US pension plans have long been burdened with huge pension obligations. Back in 2002, aggregate pension underfunding for the S&P 500 hit $164B (82% funded), then jumped to $274B (79% funded) in 2008, and now is expected to reach a new high of $458B (74% funded). See the chart below.



Note: The 2011 company contribution and funded status include actual amounts for companies with January to June fiscal year ends and estimates for July to December fiscal year ends.
Source: Company data, Credit Suisse estimates

The main reason behind the uptrend in the past few years is that defined benefit pension plans have experienced a “double whammy”. On one hand, dropping equity prices reduced pension assets. On the other hand, declining long-term interest rates drove up the pension obligations.

We found that the estimated pension contribution in 2012 from 114 companies in the S&P 500 is more than 10% of trailing cash flow from operations. In addition to higher contributions this year, it seems like pension funding may become more of an ongoing drain on cash than it has been in the past. A lack of information leads us to believe that it may not be well factored into the market’s expectation for future cash flows.

Pension plan analysis is part of our fundamental research. Recently we conducted a complete review on the funded status of our Global Small Cap portfolio and did not detect high-risk signals. 20 out of the total 54 companies have defined benefit pension plans. Three companies are overfunded. The most underfunded is Autogrill with a net underfunded amount of about EUR 87 million, small compared to the company’s operating cash flow of EUR 450 million in 2011.

As the review demonstrates, most small cap companies do not have defined benefit pension plans. In cases where they do, their relatively short corporate histories often imply a young working force where contributions exceed pension obligations.

Have a good weekend.

The Global Alpha Team