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Capital Blueprints for the Future

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Social Security Myths

A real privatization debate should start with facts.

When President Bush made Social Security reform a focal point of his second term, the ideological battle lines began to form. Knowing the facts may help you better judge the models to be proposed in 2005. Let's correct a few myths about Social Security:

• **"Social Security is not facing a crisis."** Social Security operates on a pay-as-you-go basis, collecting payroll taxes from current workers and immediately paying the cash to beneficiaries. The demographics have been changing over the years as lower birthrates and rising longevity have reduced the worker-to-retiree ratio.[1] Although the program now collects more than it pays out each year, the surplus will disappear by 2018.

In addition, excessively high future benefits will worsen the funding gap over time. This is because Social Security payments are indexed to wage growth, not inflation. In 2005, an average worker's retirement benefit is $14,854. But in 2050, the average benefit is projected to grow 60%, to $23,811 (in 2004 dollars).[2]

• **"The trust fund surplus will cover the funding gap well into the future."** Social Security now collects more than it pays out, with the surplus money credited to its trust fund, which was valued at $1.5 trillion in 2004. But this fund is only an accounting entry and holds no tangible assets.[3] The government borrows this money to spend on other programs and issues special interest-bearing bonds (or IOUs).

The fiscal squeeze begins in 2018 when Social Security's collections fall below payout obligations. The program will then start redeeming the IOUs—and in growing annual amounts. Between 2018 and 2042, the federal government will have to pay back over $5 trillion to the trust fund. This is an off-budget item that has no dedicated funding source. The °government will have to raise the money through tax increases, higher borrowing, spending cuts in other areas, or benefit reductions. Beginning in 2042, the trust fund will have no more bonds to redeem and will be technically insolvent. To cover the growing deficit, the federal government will have to provide additional funding and make more spending/benefit cuts.

• **"The current model will work—with minor adjustments."** Proponents claim that minor tweaking will keep the program on solid fiscal ground. Actions include hiking the payroll tax by 2%, lowering future benefits by 1% to 6% (according to worker age), and raising the income level subject to payroll tax (now at $87,900 per worker).

But adjustments only delay the projected deficit for a few years—and the math doesn't recognize that the system only has enough cash to pay benefits through 2018. The tax hikes and spending cuts necessary to cover the bonds and meet the funding gap will likely have negative downstream effects on the budget, worker incentives, personal consumption, economic growth and payroll collections.

Measured in 2004 dollars, Social Security's cumulative projected deficit from 2018 to 2080 is more than $27 trillion—or about $100,000 per working household. Funding that larger burden today would require an immediate infusion of somewhere between $5.2 trillion and $11.2 trillion, depending on future worker participation assumptions.[4] This is far above the often-quoted $3.7 trillion figure.[5] And even if such funding were possible (which it is not), there's no mechanism to hold and invest the money.

• **"Privatization will inflict a net cost on the system."** This myth argues that transition costs will range from $1 trillion to $2 trillion while contributing nothing to the long-term funding shortfall. In reality, private accounts will not require benefit reductions for either current retirees or those nearing retirement. When money is needed to fund the accounts, the government can take the same action as it will in 2018, when the trust fund bond redemptions begin.

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(1) In 1950, there were 16 workers per retiree; today there are three workers per one Social Security recipient; in 2030, the ratio will drop to two workers per retiree. In 1935, the average retiree lived to be 77 years old. Today, the average retiree lives to 82; by 2040, to age 84.

(2) "An Idea Whose Time Has Come", National Review, 31 Jan. 2005, p 32.

(3) In the private sector, trust fund assets can be used only for specifically designated purposes and the managers are held to a strict standard. In a federal trust, however, the government can raise, lower or redirect both the collection and payments of the credits. The assets are not real assets to be drawn down, but are claims against the Treasury. ("Analytic Perspectives", Office of Management and Budget, p 337.)

Social Security doesn't maintain or invest money for workers, and has no legal obligation to pay benefits.

(4) Social Security Administration, <u>2004 Social Security Trustees Report</u>, Table IV.B8, 23 March 2004.

(5) The $3.7 trillion present value is misleading because it's a rolling total that rises each year as the system's fiscal condition worsens. Moreover, it only covers the next 75 years, while the largest deficits occur even farther out. The $5.2 to $11.2 trillion present value range is the lump sum amount necessary to make the system self-sustaining forever.

(6) For decades, state pension funds and private investment companies have managed portfolios for public employees. The Thrift Savings Plan is offered to employees of the executive and legislative branches of the federal government. It takes the place of Social Security.

(7) U.S. obligations are backed by the faith and credit of the federal government, while corporate stocks and bonds are considered higher risk because they may lose part or all of their value. Past performance does not guarantee future results.

(8) State Street Corporation, "Administrative Challenges Confronting Social Security Reform", 22 March 1999.

Factoring Doubt

The 2004 stock market endured many unknowns.

For most of 2004, the broad U.S. stock market fluctuated within a narrow price range, reflecting the high degree of doubt over the economy, foreign affairs and the presidential election. Major factors shaping market sentiment included:

• **Rising interest rates.** The Federal Reserve raised its federal funds target rate five times in the second half of 2004, resulting in a 1.25% climb in short-term rates. Rate increases early in a rebound often don't affect corporate performance. But over time, the rising cost of borrowing is expected to temper business activity and cool consumer demand, in accordance with the Fed's intent to curb inflationary growth.

• **Climbing energy costs.** The price of crude oil climbed through much of the year and exceeded record highs as it traded in the mid-$50 per barrel range before retreating to the mid-$40s by year-end. Investors were anxious that higher prices would worsen inflation, hinder consumer demand and stunt economic growth.[1]

• **Sluggish job growth.** Until the fourth quarter, job growth had not matched the broad recovery. The publicized loss of technical and professional jobs to offshoring has raised questions about the New Economy infrastructure. Specifically, can Americans maintain a high living standard when capital, trade and skilled jobs are flowing freely across national borders and between economic regions of the world?

• **Iraq war and terrorism.** Fighting in Iraq throughout 2004 brought a cloud of speculation regarding the likelihood of democratization and the implications of further conflict on the broader terrorist war effort. The markets also were assessing how an extended occupation may affect federal spending, industry performance, energy prices, inflation and economic growth.

• **The 2004 election.** The presidential candidates' agendas revealed sharply contrasting views on tax reform, economic policy, federal spending, regulation, health care and other issues impacting personal wealth. Many investors were waiting to see which policies would prevail before interpreting the likely effects on economic growth and corporate earnings in 2005.[2]

A strong finish

Amidst the uncertainty, the U.S. stock market recovered by year end. The major market indicators increased for the second straight year, which is the first back-to-back advance since 1998-99.[3] GDP grew in the estimated range of 3.5% to 4% during the year. Since its 6.3% peak in June 2003, the unemployment rate has declined to 5.4% with the help of 2.2 million net jobs added in 2004. U.S. corporate profits hit a record $1.1 trillion in late December—25% above peak earnings in the last recovery.[4] The manufacturing sector also had good news. U.S. industrial production showed its strongest growth in five years and capacity utilization neared 80%—the highest since 2000.[5]

Looking ahead, Wall Street is optimistic that a voter mandate and Congressional majority may produce favorable economic policy in 2005. Making the 2003 tax cuts permanent and privatizing part of Social Security are expected to be top legislative items.[6]

One market concern is the dollar's weakness against major world currencies. The widening current account (trade) deficit indicates that the U.S. economy is growing much faster than those of its primary trading partners. A gradually declining dollar should make U.S. goods and services increasingly competitive overseas. But sluggish growth in Europe and Japan—combined with Asia's aggressive support of the dollar—have kept the greenback from losing enough value to increase U.S. exports and reduce domestic consumption of foreign goods.

Rising inflation is another concern. In 2004, the Consumer Price Index (CPI) rose 3.3%—the largest gain since 2000. Core inflation, which excludes food and energy costs, measured 2.2%. Although these rates are moderate by historical standards, they are well above 2003 increases. With Fed policy now reversed, the consensus view expects more quarter-point hikes in 2005 as the central bank tries to prevent economic overheating while curbing inflation and stabilizing the dollar.

Reports of sustained GDP growth, job creation, corporate profitability and war progress—combined with Federal Reserve monetary policy—will ultimately drive the stock market in the coming months. While these and other events may shape investment sentiment, keep in mind that markets are unpredictable, often volatile and best approached through a diversified, risk-appropriate portfolio strategy. ■

(1) Shrinking excess capacity among Mideast suppliers, rising global demand (especially in China), and damaged infrastructure from the U.S. hurricanes contributed to the market imbalance. Prices also reflected premiums for the Iraq conflict, speculator activity and the inventory buildup in the U.S. Strategic Petroleum Reserve.

(2) The stock market may affect elections to the extent that many of the same forces are generally working in the economic, investment and public opinion arenas. ("Stocks Vote Independent", The Wall Street Journal, 1 Nov. 2004, C1)

According to one study of market performance and election outcome (1927 to 2003), a post-election stock market typically shows strong returns for the first three months, but the 12-month results are much closer to historical norms. (Booth, David. "Presidential Elections and Market Returns", White Paper, Sept. 2004)

(3) The Dow Jones Industrial Average gained 3.1%; the S&P 500 Index climbed 8.9%; the Nasdaq Composite Index rose 8.6%; the Dow Jones Wilshire 5000 Composite Index gained 10.8%. You cannot invest directly in any market index. Past performance does not guarantee future results.

(4) "Barreling Ahead Into 2005", National Review Online, 30 Dec. 2004.

(5) "2004, By the Numbers", National Review Online, 7 Jan. 2005.

(6) Making the tax cuts permanent could raise the after-tax returns on stocks; tort reform could improve corporate profits and motivate companies to take more risks; allowing a portion of Social Security to be maintained through private investment accounts would send a flood of new money into the stock and bond markets.

MONEY • MYTHS • messages

It is important to keep in mind that cultural messages have a profound influence on our money beliefs. Intellectually we can disagree, but subconsciously these messages can effect how we feel about money. Therefore, true financial freedom is more than having a lot of money; it is being free of money myths and notions that influence our money attitudes and behaviors.

For example, there is a lot of truth to the old adage, "Money can't buy happiness." However, what money can "buy" is options—more alternatives to choose from as you design the life you want to live—now and in the future.

The authors of Invest in Yourself: Six Secrets to a Rich Life say it simply and directly: "Wealth is having more than you need, and poverty is having less." Now and in the future, "poverty" will limit the number of choices you have regarding housing and location. Poverty will narrow your health insurance and health care options. Poverty will also limit the ways in which you can assist your children and aging parents when they have needs. The examples are endless.

On the other hand, "wealth"—having more than you need—puts you in the driver's seat of your own life. You get to pick the lifestyle YOU want—whether your choice is a luxury apartment in the city and all the excitement that metropolitan life can offer, or a modest farm house in rural America where you practice "simple" living and explore the art and science of organic gardening.

Wealth will also give you more options in the way that you respond to the "bumps" in the road of life including health problems, disability of a loved one, or a catastrophic event such as flood or fire.

And last, but certainly not least, wealth will offer you more freedom to explore your potential. Are you still longing to earn that degree, live in a foreign country, or take art classes from a master?

How about the unfulfilled dream of an idealistic 20-year old to join the Peace Corps? Idealism can burn just as bright at 50, 60, 70, and beyond. What are the causes that resonate with you? The possibilities are endless—child safety, the environment, literacy, the arts, animal welfare, equality, homelessness, medical research, and so on.

True financial freedom is more than having a lot of money. It is being free of money myths and notions that influence money attitudes and behaviors.

You know what you really care about. The bottom line is this: Wealth will give you more opportunity in your retirement years to invest your time, energy, and money in the ways that matter most to YOU.

To get the most from what you earn, spend, give, save, and invest, it is important to view money for what it is—a tool. Think of money as a tool for:

(1) helping you to achieve your goals in all areas of life, and

(2) meeting the challenges and grabbing hold of the opportunities that lie ahead. ■

Social Security Myths
(Continued)

More importantly, private accounts can help move younger workers out of the program while preserving most of their payroll taxes to meet obligations. Although the private accounts would receive a much smaller share of the total payroll tax—such as 2% of the 12.4% rate—their investment in the capital markets may produce a higher long-term return. This might replace the future benefits young workers would give up. Social Security's transition estimate is in the $500 billion range. If private accounts are implemented soon, the system's shortfall could be reduced from $27 trillion to about $8 trillion.

• **"Investing in the capital markets is gambling with the future."** Privatization foes claim that the capital markets are too volatile for Social Security money. This argument ignores financial truths and investment fundamentals. It also discounts the track record of public pensions and private-account retirement models, such as the 401(k) plan for corporate employees and the Thrift Savings Plan for federal workers.(6) Of course, short-term volatility is higher in the capital markets, which is why investors expect a higher return over the long term.

Proponents of the old Social Security model regard the system as risk free. It is estimated that Social Security has provided annual investment returns between –3% and +2%, depending on marital status, lifespan and contributions. Compare this to the long-term average rates historically earned in the private capital markets.(7) How much better off would Social Security recipients be today if their earnings had been invested more responsibly over the years?

Moreover, the system carries political risk that may increase over time as bankruptcy draws near. Future workers may be unwilling to reduce their lifestyles to fund ever-increasing payroll and income tax rates. And if benefit cuts are made to maintain the program's solvency, future retirees may earn a low or negative return on their contributions.

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Social Security Myths
(Continued)

• **"Workers cannot manage their accounts."** Account owners would have the freedom and responsibility to diversify according to their time horizon and risk tolerance. It's only common sense that a young worker would have a much different asset allocation than someone who is about to retire. Privatization would require citizens to gain a higher knowledge of financial principles—including asset group characteristics, market behavior, diversification, risk management and portfolio structure—and select investments or investment managers that can implement these principles in a cost efficient and prudent manner.

• **"Private accounts would be too expensive and impractical to administer."** This claim assumes that high administrative fees and other inefficiencies would eliminate the potential benefits of privatized accounts, while the arrangement would benefit investment firms.

History shows that administrative costs are highest when a program is first set up, then drop as economies of scale improve. This has been the case with 401(k) accounts, the Thrift Savings Plan, and Social Security itself. According to one projection, annual fees for private retirement accounts would range from 0.19% to 0.35%, assuming a contribution equal to 2% of gross earnings. In dollar terms, that's $3.55 to $6.91 per person.[8]

Time to act

Three actions can help delay the funding shortfall and reduce its impact. First, the government can cover the system's growing deficit by raising taxes, piling on more debt and/or implementing major spending cuts in other programs. Second, the program can significantly reduce the benefits promised to workers in the future. Third, the system can let younger workers' payroll taxes work harder by allowing a portion of their contributions to flow into the private capital markets.

The time has come to include privatization in the long-term solution. The alternative is to place faith in an accounting illusion and hope that the next generation of workers will pay the mounting retirement bill. ■

In My Opinion. . .

Robert J. Cole, Jr., CLU, ChFC, CFP®

If I Only Had the Time…

Every time I hear someone lament over their lack of chronological resources, I cringe. Those of us who are fortunate enough to live a full week will live *exactly* one hundred sixty eight hours—no more, no less. Still, our culture seems obsessed with the concept that outside forces have conspired to shrink those hours. Much has been said about how new technologies, which are supposed to "free up" more time, have actually placed additional demands on us to the extent that we have become "slaves" to them. If you don't believe it, just walk through any airport and observe the myriad of cell phone conversations going on.

It seems to be a rare experience to sit and visit with someone who isn't "on their way" to their next stop - rushed to the point of missing where they are right now. The environment bombards us with information, all competing for our attention. We are absolutely convinced that if we don't absorb each piece of this data, we will somehow fall even further "behind". In fact, we have become a society obsessed with staying busy. Kids don't play in the neighborhood, they participate in organized leagues and activities designed to take up their idle moments. Adults run between jobs and social commitments with hardly an opportunity to catch a breath, all the while lamenting that they "wish they had the time to _________ " (you fill in the blank).

Of all the resources that a person has in his or her store of wealth, time is the most difficult to deal with. This is because no one really knows how much of it they have. It is precisely for this reason that one must take personal responsibility for how it is spent. Steven Covey, in his book Seven Habits of Highly Effective People, says that it is in the moment between stimulus and response that one can best execute this complex task. He says that we all are responsABLE, which means that we can **choose** how we respond to the environment, rather than seeing ourselves as a victim of it.

This past year I had the opportunity to spend a number of days without anything to do. At first it seemed luxurious and indulgent. After a while however, I became fidgety. I was like a junkie on withdrawal. I had to train myself (mostly in the woods) to find my quiet center, so I could hear my inklings. Two things occurred to me. First, the cultural concept of retirement as a time where you cease activity is ridiculous. There is no way that the human mind is made to be put on full idle and keep working. Second, it is up to each individual to determine what the proper balance between action and non-action is. A healthy lifestyle requires both.

All of this will require that you give careful thought to your personal life goals and keep your activities in that framework. You should also be respectful of other's time choices as well. Be clear to others about your choices, so they can recognize when there is a compatibility problem. Use the technologies, don't let them use you! (Yes, those cell phones do have voice mail!)

Finally, we need to watch our self talk. I suggest that the next time you find yourself starting a statement with "If I only had the time . . . ," stop and remind yourself that it is you who choose how you spend your time and those decisions determine much of where you are in your life at the present. Take the opportunity to affirm your choices and say "I choose to spend my time this way . . . ". It will transform the way that you manage the wealth in your life.

Until next time, that's my opinion…

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