

MARKET NEWS

Keeping our Clients Informed

First Quarter 2005



April 14, 2005

Cash is King

Cash (including short-term bonds) was the only major asset class that had a positive return in the first quarter. Medium and long-term bonds were off between 1% and 2% for the quarter. The S&P 500 and Dow Jones Industrial averages were down 2.6% and the NASDAQ composite declined 8.5%.

Many of the problems that faced us last year continued to plague the equity and bond market this quarter. These were primarily persistently high energy costs and rising interest rates. To date, the economy has shown itself to be surprisingly resilient to \$50+ per barrel oil. However, no one is sure where the top is in oil nor are they sure when the consumer will be impacted by these higher costs. It is felt that most households will respond to higher gas prices by reducing their discretionary spending in other places. The question then becomes how this potential slowdown would affect GDP, inflation and earnings. Wal-Mart has already indicated that they are beginning to see some signs of changes in customer spending.

Going forward we feel that equities will finish the year with a modest positive return. Add that to the advance necessary to get back to breakeven, and equities would provide a solid return from their current lows. Long bonds will most likely be hurt by an expected rise in long-term interest rates. One positive to the Fed tightening is that money market yields have nearly doubled since last year.

Social Security Reform (again)

Since our last newsletter, the debate over social security reform has hit its full stride. It seems that every group with a microphone has now chimed in on the subject. And while there has been no

surprise which side of the fence each political party has taken, we are surprised to see staunch resistance to reform come from organizations such as the AARP.

In our marketplace the AARP has even started running a major television campaign comparing the problems facing social security with a clogged drain. The spot then shows the house being torn down in response to the problem. I think the more accurate analogy would be to show a house with a crumbling foundation falling in on itself as more and more people move in.

What has not surprised us are the claims being made by those opposing the reforms. In our last newsletter we laid out what we felt would be the 7 major talking points of the objectors. Senator Ted Kennedy appeared on Meet the Press a few weeks ago, and you would have thought we'd had an advance copy of his comments back in January. It is for this reason that we felt that it would be a good idea to revisit Social Security reform in this newsletter.

Talking Points – a refresher

Because of the relationship of taxes paid verses benefit received, if you have been on social security for the past 10 years this program has been a legitimate supplemental pension for you. If you are just now retiring or are nearing retirement, the program hasn't hurt you and may have been a good thing, depending on your age and lifetime earnings. If you're younger than 45 this program is a financial anchor around you and your family's necks.

Based on the annual salary limits and tax rate, young to middle-aged workers are faced with the prospect of receiving retirement benefits that represent between 0-1.5% return on their lifetime

contributions. Combine this with the fact that retirement benefits are now subject to income tax and, other than your spouse, the government keeps everything upon your death, there can be only one conclusion; in the current form, this system is indefensible.

As best we can tell, the opponents to any reform can be divided into three categories:

1. Those who have something to lose - i.e. the government spenders that need the cash flow for their political survival.
2. Those who hate Republicans and President Bush and anything they propose.
3. Those who really don't understand the math.

To add a little clarity to the debate, we are going to address some of the main concerns and objections that have been put forth thus far.

Private accounts are too risky – This is one of the most prevalent and intellectually dishonest arguments. Let's be clear about one thing; accounts are not risky. It's the investments in the accounts that are risky. To that end, beating the current 1% you're getting from Social Security doesn't require taking on any risk. This myth is spawned from the belief that Social Security is currently investing in Treasury Bonds that are yielding bond market based returns. Accepting this at face value, which in and of itself is hard to do, then why are we only offered retirement payments that equate to an average annual return of 1%? Those supposed long-term bonds should be yielding around 6%. Does this imply that the government is charging a 5% management fee on their bond fund or are they investing in some sort of special 1% Treasury bond that is sold only to the Social Security Administration? The reality is that there is no relationship between what you've paid in and what you get out. If you had a private account there would be a relationship between contributions and benefits. If every bit of Social Security tax you and your employer paid went into a private account and was invested in Treasury bonds (the very same bonds the "trust fund" claims to own), we estimate that most would retire with 3-times the amount of income currently offered. Although we don't think they should be excluded, the argument that private accounts are too risky is

easily defused by removing equity securities as an option for private account investment.

The tripod theory of financial safety – Opponents to reform like to remind us that Social Security was never meant to be a retirement plan. Instead, it was meant to be the safest of the 3 pillars of retirement income – private savings, company pension and Social Security. This is actually a very reasonable premise. The problem is that these 3 sources of income do not contribute evenly in retirement. Typically, someone who has lived a fiscally responsible life will have most of their income provided by their private savings, then by an employer pension plan and lastly by Social Security. The problem becomes clearer when you realize that Social Security (the smallest contributor) has consumed 12% (probably the greatest amount) of every dollar you have ever made. Thus, this "3 pillars" argument fails to address that enormous imbalance.

Robbing the Social Security trust fund – It's hard to steal from something that's not really there. The fact is that there is no trust fund. The argument that is really being made here is that the benefits that have already been guaranteed (i.e. remaining life of current and soon-to-be retirees) are relying on the current tax dollars for solvency. If this sounds like a ponzi scheme that's because it is. If anyone other than the Federal government were selling this plan, they'd be convicted and thrown in jail. This is really more of a scare tactic than an argument. Of course, the Federal government's plan B would be to borrow more money to fulfill its obligations to retirees, which leads us to the next point.

Too expensive – As noted above, if the Feds were to get out of the retirement planning business, the cost would be enormous. The process would require weaning the government off the Social Security tax revenue over many years. This is precisely why the current reform proposals only involve redirecting a small portion of the tax dollars into private accounts – they have to start small. Be assured that the long-term goal of the reform movement is to eventually have all withholdings directed into private accounts. To help fund this transition younger Americans would have to be willing to forego any benefits that they

have accrued so far. This is why the superior long-term prospects of stock-based returns are being discussed so much. It is hoped that the chances of higher returns will be enough to entice young Americans to opt-out of the current system. This is where the real success in transitioning will occur. It is the future liabilities of these young people that add the highest costs.

Another point to keep in mind about some of the cost figures being tossed around is that none of this is going to occur overnight. The alarmist will loosely throw around trillion dollar figures without providing the framework by which that will come about. These costs that the government will have to expend will take generations to be fully realized. The burden of the federal deficit is only significant when compared to the size of our economy. How big will our economy be in 30 years? Will the increased debt resulting from privatizing Social Security be overwhelming at that time? It's doubtful. Worst case, this would only mean the transition would have to take place over a longer period of time. The really frightening figures become evident when you look at waiting to fix the system when it is near collapse. If people are truly afraid of the costs of reform, they should be pushing for a faster overhaul of the system rather than none at all.

Social Security is the only income for many seniors – Under no circumstances is anyone even remotely contemplating changing anything about the system that would affect current retirees. To imply otherwise is nothing less than dishonest. Paying for the current retiree obligations are the least expensive liabilities that the program faces. As previously mentioned, it is the youngest participants (individuals in their 20's and 30's) that pose the greatest risk to solvency. One point of irony here is that a system designed as a safety net for seniors has become so burdensome that it will most certainly be the major cause of poverty among retirees in the future due to its mismanagement.

Social Security offers disability and dependent benefits – This is true. It is also true that life and disability insurance policies are available at a fraction of the costs of what you currently spend via your Social Security tax dollars. How much

does this cost via Social Security? Fortunately, SSA breaks down the total tax into the various benefit components. 1.8% of the total 12.4% Social Security tax goes towards the insurance benefit. The remaining 10.6% goes toward the monthly retirement payout. If you apply the salary cap to the 1.8% tax you will see that you are paying as much as \$135 per month for this coverage. Not only could you get this coverage for less, but the level of coverage would be much higher from the private sector (insurance companies). Opponents that argue this point are apparently under the false impression that insurance is only available via the Federal government.

This will only enrich the financial services industry – This argument appeals to the conspiracy theorist. Although it might seem a little self-serving because our firm falls into this category, this argument is just plain silly. It's a little like saying we shouldn't have electricity because the power company may make money on it. While it is true that privatization would be a huge boost to the financial services industry, that doesn't mean that anyone would be forced to use their services. As we've discussed earlier, simply buying Treasury bonds (a totally free transaction available at www.savingsbonds.gov) would provide you with higher returns than you're currently getting from your Social Security contributions.

People can't be trusted to make wise investment decisions – This comes from the big government camp. These are the people who think that every problem, real or imaginary, can be fixed with a government program. This is mostly a philosophical argument. We would respond by saying that this government program has had 70 years to get it right, and has yet to do so. Let's try something different.

All kidding aside, it is true that there are a great many poor decision makers out there. By definition, that's why we need some form of forced savings program. The objections to the current system arise from the mismanagement of those funds and not by its existence. Any program that would involve private accounts would be tightly controlled and would have limited investment choices for those funds.