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Client Newsletter

"Those who have knowledge don't predict. Those who predict don't have knowledge."
Lao Tzu, Chinese philosopher, 6th century BC

Latest Social Security Trustees Report For 2013 Confirms Most Benefits Will Still Be Paid

Article Courtesy of Michael Kitces

A few weeks ago, the 2013 Trustees Report on Social Security was released, confirming once again that the Social Security system continues to pay out more than it takes in, remaining on a path that is ultimately unsustainable. Yet the details underlying the report reveal a more profound reality: that while Social Security as it is currently constituted is not viable in the long run, the downside of depleting Social Security is far less severe than we often make it out to be.

The reality of the Trustees Report is actually that, even if we do nothing to resolve Social Security in the coming decades, that the system will still be able to pay out 77% of its projected benefits in 2033 when the trust fund is depleted, and continue to pay out more than 70% of its projected benefits for the remainder of the century. In other words, even if we do nothing to fix the system at all, today's Generation X and Y young adults would still be anticipated to receive about 3/4ths of their anticipated benefits for their entire retirement.

And that's if nothing is done. If instead the woes of Social Security ultimately are addressed, through some combination of current and/or future benefit adjustments, and increases in the Social Security payroll tax rate, wage base, or the taxation of benefits, the shortfalls decline further and the ability to pay future benefits rises. Which means that ultimately, the most likely future outcome is a haircut of less than 23% of benefits for today's young adults, and that most future benefits will in fact still be funded. As a result, it's important to recognize the real state of the Social Security system, to ensure that clients receive appropriate advice in light of what isn't, and is, likely to be there when the time comes.

The Current State Of Social Security

The latest Trustees Report on Social Security shows that last year in 2012, Social Security paid out benefits to approximately 57 million people, including 40 million retirees and their dependents, 6 million widows and widowers, and 11 million disabled individuals and their dependents. The total payments to these individuals amounted to $775 billion (and total outflows were $786 billion, including a small amount of Railroad Retirement benefits and the administrative expenses of the Social Security system).

To fund these costs, approximately 161 million workers in the US paid at least some payroll taxes last year, adding up to a total of nearly $704 billion (including about $114B that was actually paid from the General Fund of the Treasury to cover the 2% payroll tax "holiday" in place for 2012). In addition, another $27B of revenue was collected from the taxation of Social Security benefits, bringing the total up to nearly $731B, and leaving a shortfall of almost $55B of expenditures paid in excess of the revenue collected.

However, the balance of the Social Security trust fund entering 2012 was $2,677.9 billion - the accumulation of several decades' worth of years where the Social Security tax revenue was in excess of the costs - and its investment in US government bonds yielded a total return of about $109B in interest. This more than made up the remaining shortfall, and in fact left more than $54B of excess remaining, which was re-invested into government bonds, bringing the Social Security Trust Fund up to $2,732.3 billion at the end of the year.

Or stated more simply - this year, the total revenue from ongoing Social Security taxes on workers, plus interest on prior reserves, was enough to fully cover all payments for Social Security, with a small excess left over that was invested for future needs.

Getting A Real Handle On Social Security's Future

Of course, as we've all long since heard, the balance of the current Social Security system's flow of payments are not going to remain where they are; going forward, the number of people eligible to claim benefits will continue to rise as more and more of the baby boomers reach their 60s, and their ongoing retirements will simultaneously reduce the number of workers paying into the system. As a result, while the ratio of workers to retirees had remained remarkably stable at about 3.2 to 3.4 from 1974 to 2008, it has begun to decline, falling to 2.9 by 2012, and is projected to decline as low as 2.1 workers per retiree by 2035. Anticipated increases in longevity impact the numbers slightly further, as the ratio is further anticipated to fall to about 1.9 workers per retiree by the end of the 21st century.

As the numbers shift, Social Security will soon reach the point where current tax revenues, plus interest payments on the Social Security Trust Fund's government bond investments, will be insufficient to fund the ongoing benefits payments (currently projected to be the year 2021). This will force the trust fund to begin to liquidate some of its principal - redeeming an increasing chunk of its government bond holdings - until eventually, 20 years from now, all of the prior savings will have been depleted. At that point, there will be nothing remaining to cover the shortfall.

However, the key is that when that date arrives - currently projected to be the year 2033 - it's only the shortfall that will no longer be covered by liquidating Social Security trust fund assets. The bulk of Social Security funding - which comes in the form of our ongoing Social Security payroll taxes levied on current workers - will continue to come in, as there will still be more than 2 workers paying the tax for every baby boomer retired and claiming benefits from it. Given that balance of workers to retirees, the Social Security system will still be able to pay 77% of its promised benefits, just from then-current tax revenue alone. As the worker/retiree ratio declines slightly further through the end of the century, the ability to pay annual benefits will slip slightly further, from 77% of benefits down to 72% by the 2080s.

Keeping Social Security Planning In Proper Context

Ultimately, the point of this discussion is to recognize that when doing Social Security projections - and especially, when making adjustments to anticipated future benefits for now-retiring clients or especially young clients who won't retire for decades to come - that suggesting Social Security will be "broke" or "insolvent" or "gone" in the future is to grossly overstate the actual situation, which can potentially result in a drastically inaccurate series of financial planning recommendations to clients.

Instead, the reality, as noted above, is that clients 20 years from now will begin to take a 23% haircut on their benefit payments. That's it. Today's young people in Generations X and Y, who won't reach retirement until well past the point that the Social Security trust fund is depleted, aren't on a path to lose all their Social Security benefits, or even most of them. They might find that about a quarter of their original benefits can't be paid when the time comes to retire.

And of course, that assumes we do nothing at all to fix the problem, at any point for the remainder of the century, even for a problem that has been communicated well in advance. On the other hand, if we simply enacted benefit cuts today to address the problem, rather than waiting until the situation gets worse, the reduction wouldn't even be 23% of benefits; instead, cuts of only be 16.5% of benefits would be necessary to get the system back on track. Alternatively, we might split the difference, such as cutting for future benefits for those starting in 2013 or beyond, a less severe outcome than cutting for everyone including current retirees, or just waiting and cutting future retirees more severely in 2033. These scenarios that shift the distribution of cuts somewhere between the extremes would result in benefit reductions somewhere between 16.5% and 23%.

In addition, all of these shortfalls assume that we do nothing to address the revenues side of the equation - the Social Security payroll tax - in the next century either. As the Trustees Report reveals, though, it would take a payroll tax increase of "only" 2.66% (increasing it from today's 12.4% for Social Security, up to 15.06%) to render the system fully funded for the next 75 years. While that's not a trivial amount, and would have some noticeable impact on the economy, it's also not exactly a catastrophe, either; ultimately, funding the entirety of Social Security's projected deficits actuarially amounts to less than 1%/year of GDP for the rest of the century.

Realistically, the most likely outcome will include some combination of benefits adjustments and a Social Security payroll tax increase (either by increasing the rate, adjusting the Social Security wage base, or both), which further mitigates the magnitude of benefit reductions. For instance, the adoption of chained CPI would reduce the Social Security shortfall by 21% over the next 75 years, and the projected impact is that Social Security benefits would grow by about 0.25% - 0.3% per year slower than they would under the current system; while this impact is not trivial, it's still far less of a benefit reduction than a 23% haircut starting in 2033. If you'd like to check out the impact of other proposed reforms and the extent to which they resolve the Social Security system's projected shortfalls, here's a good summary of proposed changes from the Social Security Administration, or you can check out this tool from the Committee For A Responsible Federal Budget.

The bottom line, though, is simply this: even if you believe that we will come to no resolution to adjust benefits or Social Security taxes at any point in the future, the "downside" to Social Security in this relatively "worst case do nothing and run off the cliff" scenario for clients is still only a 23% reduction in benefits, starting 20 years from now. To the extent that we intervene in the coming decades, through some combination of changes to benefits and tax rates, the impact on a client's future retirement benefits would be even less. While these potential consequences are not insignificant, they are all scenarios where clients are still projected to have 77% of their benefits - or more - ready and waiting for them when the time comes to retire. So be cautious that, when planning for a client's Social Security future, you're not overstating the true consequences of Social Security's so-called "insolvency" in the decades to come.

Teaching Your Kids About Money – A Childhood Money Mastery Curriculum

Article Courtesy of Bob Veres

Chances are, there was a lot you didn't know about finances when you reached adulthood. Your ignorance may have cost you money in the form of an overdrawn checking account where the bank gleefully heaped on additional fees, or credit card debt at interest rates that would have qualified as criminal usury in the Middle Ages. You may have overextended yourself when buying a car, been mystified by the APR on your home mortgage, or you may be one of those unfortunate people who ran into a financial predator who sells high-commission investments, annuities or unnecessary life insurance coverage.

You don't want your children to learn these lessons the hard way. What can you do to help them master the complexities of this mysterious thing we call "money?"

The bad news is that you'll have to home-school this curriculum, since primary and secondary schools inexplicably don't teach basic money skills, and the only way your children will be taught about money in college is if they decide to take financial planning courses that are taught at a fraction of all the colleges and universities in the U.S.

Just like any other subject, a money curriculum provides information and teaching that is appropriate to the age. You're not going to be able to teach a seven-year-old about graduated income tax rates or the wonders of compound interest, and she'll have no idea what you mean if you tell her that your home cost $200,000. So consider this as an age-appropriate guideline for developing money mastery in your children.

Ages 6-10

Some experts say that your child's financial education should begin as soon as he or she is old enough not to eat the money. But money is fundamentally about mathematics; when your children can add and subtract, they can start the money learning process.

Step one: Introduce your children to coins first. Explain the value of coins in terms they can understand--how many are required to buy gum, a candy bar or something else they ask you for as you shepherd them past that dreaded candy display at the checkout counter. Help them learn to make change and convert one kind of coins into others. Later, you can do the same for bills.

Step two: Begin giving your children an allowance, and as time goes on, draw an ever-clearer link between chores and allowance. When children make their beds, put their clothes in the laundry and take their dishes off the table, they recognize that their weekly stipend is earned rather than doled out. (This is an area where experts disagree, because of the possibility that a child will decide not to make her bed and then challenge you to dock some hard-to-calculate percent of her allowance. But a compromise is to require that the chores be done.) Pay extra for additional jobs your children perform.

Step three: Encourage your children to save some or all of their allowance in a piggy bank. They'll begin to see how the coins accumulate, and how that process can eventually deliver enough of them to buy something they might desire. This is the fundamental essence of saving. Interestingly, research has shown that some children are distrustful of a piggy bank if they can't see where the money went. The state-of-the-art in piggy banks is the Money Savvy Pig, a see-through piggy bank with four slots: save, spend, donate, and invest. The goal is to help kids learn that money isn't just accumulated to buy things.

Step four: Empower your children to manage their own money. Let them decide how their allowance will be used, and let them make mistakes. If they make impulse purchases, and later want something that costs more than they currently have, that becomes a teachable moment.

Step five: Incorporate your money mastery teaching into your everyday activities. In the early years, use your trips to the grocery store to explain prices. When you go to the ATM, you can explain that money doesn't actually come from a machine. Later, when you open bills, you can talk about payment for services like the phone and cable TV.

Step six: Use the power of online gaming for good rather than time-wasting evil. There are online websites and even games that families can use to get the conversation going such as Thegreatpiggybankadventure. Other examples include Feedthepig.org, kids.gov, www.doughmain.com and TheMint.org/kids. PNC Bank and Sesame Street teamed up to create fun videos and games that teach kids about money: http://www.sesamestreet.org/parents/topicsandactivities/toolkits/save. MassMutual, meanwhile, has developed Save! The Game, an app for the ipad and iPhone that teaches kids the difference between wants and needs.

Ages 11-13

As your children reach middle school age, you should start to increase their responsibilities--to help them learn by doing.

Step one: Start to make your children responsible for paying, out of their allowance, more of their daily expenses--school clothes, school lunches, birthday presents--and help them create a budget that allows them to save if they buy wisely. How much money should you give them? Keep track of what you've been spending on their needs and desires over several weeks, and arrive at a reasonable figure that exceeds their weekly or monthly costs by the amount of allowance you intend them to have.

Step two: Have your children set up a savings account, and tell them you'll match every dollar they put in there. The only stipulation is that they can't take out the money you put in. That's earmarked for long-term savings and/or college expenses.

Step three: As you shop for groceries or head to the mall, help your children comparison shop, so they can eventually go out on their own and shop for value. Show them similar items that might have very different price tags. You might also consider using cash for your purchases when you go out with your children. They aren't going to learn very much about money if they see you paying for everything with that magic piece of plastic.

Age 14-17

Your high school-age (pre-college-age) children will soon need to function on their own financially, so consider these finishing touches.

Step one: Help your children set up a checking account, so they can get familiar with staying on top of their account balance and pay their expenses by check.

Step two: Explain how debt works, and show your children a credit card statement (if you have one) that includes finance charges. A surprising percentage of teenagers didn't understand that banks charge interest on the loans they make. Many teens don't even realize that credit cards are a form of borrowing. Consider giving them additional money each week or month for gas purchases, and get them a gas station credit card that they can pay off each month.

Step three: Let your children invest. Your child may not yet have the money to buy a Treasury bill or 100 shares of Apple, but you can buy mutual fund shares at very low initial payments, and many fund companies have programs especially set up for teens. Look together at the fund's most recent holdings report and see how many companies you recognize--and help your children monitor the performance of the investment. Show them on a simple spreadsheet how a regular monthly investment compounds over 10, 20 and 30 years. Chances are you, yourself, will be astonished at the accumulation opportunities of the very young.

Step four: Your children have entered the summer job years, which gives them an opportunity to learn about taxes. Children who have never held a job before and thought that taxes didn't need to be paid until April 15 (or not at all) will learn a quick lesson from their first paycheck statement. Most employers will be withholding far more tax than your children will end up owing, and the FICA withholdings provide another teachable moment. (You can, of course, file a W-4 claiming exemption from withholding, but appropriate payroll taxes will still be withheld.)

There's more, of course, such as sitting down with your children and discussing charitable donations (some parents save all their charity solicitations for six months and then sit down to go over which look most appealing) and the need to save receipts if your children go into business for themselves (such as mowing lawns or housesitting animals). Consider those optional elective courses in the overall curriculum.

If your children manage to graduate from this money mastery home-school program, they'll be far better prepared for the real world of money than you probably were. And they'll be far more likely to succeed financially than 95% of their peers, who will enter college with only a dim idea of what a checkbook or budget is.

First-Half Report Card: Mixed Gains

Dear Clients,

The recent turmoil in the investment markets might cause one to think that people have lost money this year in U.S. stocks. But in fact, most of the U.S. indices are sitting on double-digit gains, and the second quarter actually added to those gains.

Despite a rocky last month, the Wilshire 5000--the broadest measure of U.S. stocks and bonds--rose 2.77% for the second quarter--and now stands at a 13.97% gain for the first half of the year. The comparable Russell 3000 index gained 2.69% in the second three months of the year, posting a 14.06% gain in the first half of 2013.

The other U.S. market sectors experienced comparable gains. Large cap stocks, represented by the Wilshire U.S. Large Cap index, gained 2.74% in the second quarter, and is now up 13.68% so far for the year. The Russell 1000 large-cap index returned 2.65% for the quarter, up 13.91% for the year, while the widely-quoted S&P 500 index of large company stocks gained 2.36% for the quarter and is up 12.63% since January 1.

The Wilshire U.S. Mid-Cap index index rose 1.97% in the second three months of the year, and is up 15.75% at the year's midway point. The Russell midcap index was up 2.21% for the quarter, and now stands at a 15.45% gain so far this year.

Small company stocks, as measured by the Wilshire U.S. Small-Cap, gained 2.80% in the second quarter; with the first quarter gains, the index is up 16.28% so far this year. The comparable Russell 2000 small-cap index was up 3.08% in the second three months of the year, posting a 15.86% gain in the year's first half. The technology-heavy Nasdaq Composite Index was up 4.15% for the quarter, and has gained 12.71% for its investors so far this year.

The rest of the world is not doing as well. The broad-based EAFE index of larger foreign companies in developed economies fell 2.11% in dollar terms during the second quarter of the year, and is up just 2.18% so far this year. The stocks across the Eurozone economies fell 0.20%, and are now down 1.48% for the first half of the year.

The news was much worse for emerging markets stocks, which have been touted as the world's engine of growth. The EAFE Emerging Markets index of lesser-developed economies plunged 9.14% for the quarter, and are now down 10.89% for the year.

Looking over the other investment categories, real estate investments, as measured by the Wilshire REIT index, fell 1.39% for the quarter, though it is still standing at a 5.94% gain for the year. Commodities, as measured by the S&P GSCI index, fell 5.93% this past quarter, taking them down 5.41% for the year. Gold recently hit its lowest settlement price since August of 2010.

Bonds experienced a very difficult first half of the year, with much of the damage coming in the past 30 days. The Barclay's Global Aggregate bond index is down 4.83% so far this year, and the U.S. Aggregate index has lost 2.44% of its value in the same time period.

Many investors have lost money in seemingly-safe Treasury bonds in the past month, but the damage was limited to bonds with longer maturities. 30-year Treasuries have seen their yields rise .75% in the past 12 months, to 2.875%, and 10-year Treasuries have actually gained more yield, 0.84%, including .37% in the past month alone, to stand at 1.75%.

Higher yields, of course, means a decline in value for those holding the bonds; in aggregate, government bonds with maturities of 10 years or longer lost an average of 10.8% of their value since the beginning of May. This was a shock for investors who saw Treasury market gains of 32.9% in 2011 and 11.7% in 2010. The decline in bond values has caused investors to sell a record $76.5 billion worth of bond funds during the month of June.

Meanwhile, 3-month Treasuries have held their value, and have actually seen their yield go down, resting at 0.03%. But rates are still remarkably low. Lending the government a hundred dollars for a year (buying 12-month Treasuries) will now yield you a princely sum of 14 cents in returns. Muni bonds are sporting aggregate yields of 0.19% (1-year), 0.50% (2-year), 1.40% (5-year) and 1.68% (10-year).

The economic news has been mixed; Europe, particularly Southern Europe, is still mired in recession, and there has been turmoil in China as the country's leaders try to rein in the so-called "shadow banking system"--meaning lenders who are not officially sanctioned banks. In the U.S., home prices experienced the largest price rise in the history of the S&P/Case-Shiller price index in April, and over the past year, the index tells us that home prices have risen 12.1%.

This is the kind of market environment that many professional advisors least enjoy--for a variety of reasons. First, the turmoil over the past month makes it clear that investors are making investment decisions--and moving market prices--based on emotions rather than logic. The initial panic following Fed Chairman Ben Bernanke's comments about ending its QE3 stimulus program seems to have subsided. But when market values drop precipitously based on a single speech about a hypothetical Fed action that would only be taken due to improved fundamentals, you know that investors are not thinking rationally.

The other reason professional advisors dislike the current state of the markets is the way diversification looks right now. Whenever U.S. stocks are delivering positive returns while everything else--international stocks, bonds, real estate, commodities and all the other pieces of a prudently constructed portfolio--are going in the tank, investors will ask questions like: "The S&P 500 is up 14% so far this year, but my portfolio is only up 6%. What are you doing wrong?"

The truth is, no professional can pick the one winning asset out of the myriad of options every year (or half year), and no prudent professional would ever try. There will always be one asset that returns more than the others, and that winning asset will always be different. Yet American investors hear about the S&P 500 (and the Dow, and other U.S. large stock indices) on the nightly news, so they are most likely to question the competence (or sanity) of their advisor when the U.S. stock markets are booming and everything else is lagging--exactly the situation we have today.

Eventually, some other investment will take the lead, diversified portfolios will look better relative to the U.S. stock indices, and professional advisors will look like geniuses. That, too, will be a naive view of the situation, but it will be a more pleasant one for those of us who believe in the long-term value of diversification.

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• Income;
• Account balances and positions;
• Investment activity;
• Accounts at other institutions; and
• Personal and/or family situations and objectives.

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Some Interesting Factoids...

- **UP AND DOWN DAYS** - The percentage split between **up and down trading days** on the S&P 500 over the last 50 years (1963-2012) is **53/47**. The YTD split (through Friday 6/21/13) is **60/40** and the YTD total return is +12.8%. The S&P 500 consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market value weighted index with each stock's weight in the index proportionate to its market value.

- **BAD DAY OF TRADING** – On 06/20/13 **loss of 2.5%** (total return) was the S&P 500's **worst single day of trading** since 11/09/11 or **19 ½ months ago**.

- **TEN OR MORE** - In the last 87 calendar years (1926-2012), the S&P 500 has experienced **double-digit total return percentage losses** 11 times. Three of the 11 have occurred in the **last 12 years.**

Source: BTN Research