Article from:

Risks and Rewards Newsletter

March 1999 – Issue No. 32

Commentary-Social Security: Go Refigure

by Aaron Bernstein

Editor's note: This article first appeared on the Business Week Website. It is reprinted with permission.

Democrats and Republicans disagree sharply on how to save Social Security. But they agree on two things: the system faces a funding crunch some 30 years hence and investing in the stock market can help fill the gap. Problem is, both of these views can't be correct. The fear of a gigantic shortfall in funds rests on the Social Security Administration's (SSA) projection of an economy growing at just 1.4% over the next 75 years. But the stock market solution depends upon equities producing inflation-adjusted returns of some 7% a year, which is what has happened over the past three-quarters of a century, when the economy averaged 3% annual growth.

"If you believe the Social Security projections, the rate of return on capital will be less,'' says Jeremy J. Seigel, an expert on long-term stock trends at the University of Pennsylvania's Wharton School.

DEEP GLOOM

The politicians can't have it both ways. Either the economy will grow at far below the historic rates, and there will be a Social Security crisis that the stock market will not be able to rectify. Or the economy will grow at a faster rate, the stock market will continue to rise at a healthy pace, and Social Security will have the funds it needs to keep operating throughout the retirement of the baby boom generation.

What makes SSA take a view that's so pessimistic? The agency doesn't believe that productivity will continue to grow as rapidly as it has since 1995. Agency economists say they are simply being prudent by projecting a future annual rate of 1.26% for productivity. To arrive at this number, the agency focuses on the 1% average annual increase set between 1973 and 1995 and ignores the more recent spikes that have put productivity gains closer to the historic 2%-a-year average. The SSA views population growth in much the same fashion. It focuses on the trend toward smaller families that began in the 1970s and dismisses the rise in birth rates that has occurred in this decade as a possible aberration.

If the SSA is right, the stock market can't be the savior of Social Security. With subpar productivity gains and slower growth in the labor force and the ranks of consumers, corporate profits are unlikely to expand rapidly. And without higher profits, it's hard to see how equities will continue to rise 7% annually over future decades. Stephen C. Goss, Social Security's deputy chief actuary, argues that stock gains are linked to economic growth only in the short term. But over time, capital has a fixed rate of return. As a result, stocks can still deliver the returns even if gross domestic product slows. Experts such as Seigel disagree. And so, no doubt, would Wall Street pros and corporate executives who still think that slow growth means market doldrums.

ALTERNATE MODEL

The SSA isn't totally wedded to its gloomy projections, however. It has an alternate model, in which gross domestic product growth averages 2.14% a year over the next 75 years. At that rate, Social Security is likely to show a slight surplus through 2072, largely because the population grows faster and there are more workers paying taxes for every retiree drawing a government retiree check.

Clearly, no one can predict what will happen over such a long period of time. But if you think that the markets will match their historic performance, you shouldn't be worrying so much about Social Security. And if you buy the notion that we're in for 75 years of 1.4% growth, you have a lot more to worry about than just Social Security.

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Dr. Thaler was a supporter of 401(k) plans. He felt it was the only way most employees would save enough for retirement since the money was automatically deducted from their paychecks. One phenomenon in these plans that explains the decline in stable value funds is the 1/n rule. Given n funds, the most common election is 1/n to each fund. If more funds are bond funds, employees chose a higher allocation to bonds than in those plans that have more stock funds. Thus the decline in stable value is due to the proliferation of investment alternatives and not to stock market performance. Since employees rarely change their investment election, the movement from stable value has been slow, but may not reverse if the stock market drops.

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