CYPRESS FINANCIAL REVIEW

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Cypress Financial Planning, LLC

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How Secure is Social Security?

Imagine your employer is introducing a new retirement plan for all employees. You are initially apprehensive because you will be required to contribute 6.2% of your salary, but ecstatic when you learn that your employer will match dollar-for-dollar the entire amount. You are even more pleased to learn that this is a very robust savings program, providing a guaranteed monthly benefit for life that increases with inflation, as well as benefits for your spouse and dependent children should they outlive you. After you have been participating in the program for a few months, you are interested to see how your account is growing. That is when you find out some disturbing news. Your contributions are not going into an account for your future; instead they are paying the benefits of another employee who has just retired! This imaginary employer retirement plan may sound like the Ponzi-scheme operated by Bernie Madoff. However, this is exactly how the United States Social Security System works. And just like Madoff, our national Ponzi scheme only functions while the money is flowing in. What is going to happen when the music stops?

History of Social Security

Social Security was developed in 1935 as a U.S. Federal program of social insurance and benefits. At that time, there were already 34 other nations operating some form of social insurance program. The philosophy driving its creation was one in which the government would assist in providing economic security to its citizens during phases of their lives when it was needed, including disability, death, and old age. On January 31, 1940, the first monthly retirement check was issued to Ida May Fuller. The accumulated taxes on her salary totaled $24.75. As she lived to be 100 years old, she eventually collected a total of $22,889 in benefits! Since then, Social Security has grown into the nation's largest Federal program, while also deemed the most effective antipoverty program in US history. Recent data from the Social Security Administration shows that over the years, more than $8.7 trillion has been paid into the Trust Fund and more than $7.4 trillion has been paid out in benefits. Factoring in the interest earned, the Social Security Trust Fund had a balance of about $2.6 trillion as of the end of 2010.

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Current Concerns

The White House's 2012 budget proposal reported that Social Security faces a "long-term financing shortfall". Social Security paid out more than it received in payroll taxes in 2010, marking the first time the program was in the red since it was overhauled in 1983. This annual deficit is set to worsen. As the baby boomer generation begins to retire, Social Security enrollees will increase while the pool of workers contributing to the program will decline. According to estimates compiled by the president's non-partisan fiscal commission, there were 16 workers per beneficiary in 1950. That ratio decreased to five workers per beneficiary in 1960, three in 2010 and an estimated 2.3 in 2025. As Figure 1 shows, the years of building reserves are basically over. Unless reforms are made now, outlays will consistently and significantly outweigh inflows. The Social Security Trustees project that in 2037, the trust fund will be completely expended. Prompt action must be taken in order to sustain Social Security.

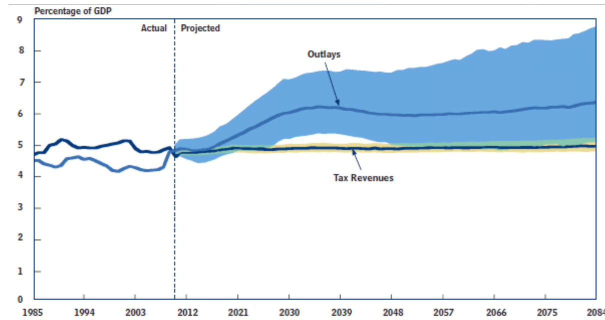


Figure 1: Long Term Projections for Social Security Cash Flow (Source: Congressional Budget Office)

Proposals to Fix the Shortfall

Lawmakers continue to debate a variety of proposals to improve the long term health of the Social Security System. When faced with similar long-term funding issues back in 1983, Congress approved a major overhaul that included raising the normal retirement age from 65 to 67. Here are some of the more popular strategies being floated around Washington:

- Similar to the 1983 reform, raising the age at which Americans can receive retirement benefits is one recommendation of the president's high-level deficit commission. As the nation's life expectancy increases, it makes logical sense to push back this level concurrently. This modification would eliminate a third of the projected deficit.
- Currently, surplus money from taxpayers is put into trust funds that are used to pay for other projects. Instead of investing these assets into higher yielding securities, they are instead placed into federal IOUs earning low interest rates. Investing 40% of the trust fund in the stock market would also reduce the projected deficit by a third. However, it would expose the fund to increased risk and liability in the event of market downturns.
- It was also suggested that Social Security payouts be reduced by 3% for new beneficiaries, eliminating about 18% of the funding shortfall. A 30% deficit reduction would result if a 5% cut was initiated.
- A fourth idea to tackling the shortfall is to increase worker and employer contributions. At present, workers and employers pay 6.2% of earnings up to $106,800 into Social Security. Increasing this percentage to 7.3% would completely eliminate the projected deficit. Additionally, if all income above $106,800 were still taxed but did not count toward benefits, the projected deficit would also be completely eliminated.

Conclusion

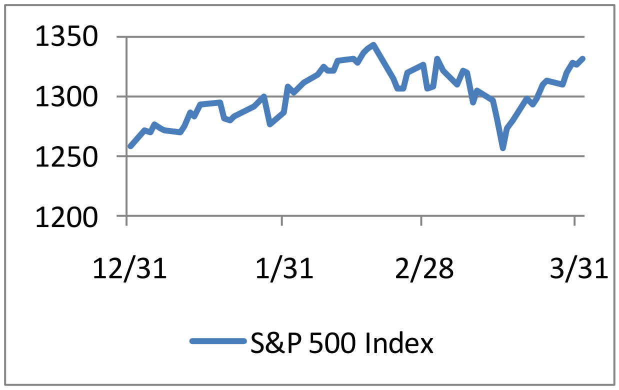
The complexity of the Social Security reform debate is inarguable. However, the problems and potential solutions are no different from those that every household faces with their family finances. How do we increase income and reduce expenses? How do we prepare for a future with less income? How do we invest prudently to achieve a high level of return without unmanageable risk? Implementing some of the proposed changes above may be a bitter pill to swallow for many Americans, but the pain pales in comparison to what is in store for the Social Security System if we allow it to continue on its current destructive course. Thoughtful action is imperative for both the nation's short-term economic recovery and the long-term security of America's families and communities.

First Quarter Economic Review

Although it was a wild ride, stocks actually logged their best first quarter in more than a decade. The Dow Jones Industrial Average rose more than 6% in a highly volatile period marked by a severe earthquake in Japan and political turmoil in the Middle East. Ultimately, these international concerns were outweighed by the continuing strength and improvement of our domestic economy.

First Quarter Market Performance

Most investors did not realize it at the time, but February 16 was a fairly monumental day for the stock market. Closing at a level of 1336, the S&P 500 doubled from a recession low of 667 it had touched less than two years before. Individuals can take from this experience the importance of not acting on your fears and selling after a rout. These have proven time and again to be the most advantageous opportunities to profit. Immediately after this milestone, the market began to turn south, ultimately falling almost 7% before finally stabilizing in the middle of March.



With the improving economy, interest rates are starting to creep slowly upward as well. The yield on the 10-yr treasury now stands at 3.45%, significantly higher than the 2.38% level we hit as recently as last October. This rate rise causes the prices of bonds to decrease, dampening the total return for bond investors to just 0.41% as measured by the Barclays Capital US Aggregate Index.

International stock performance was not quite as strong as the US, which is to be expected with Japan constituting a significant share of the global market. Hindered by a 21% drop in the Japanese Nikkei index following the earthquake, international stocks were still able to manage a 3.2% gain during the quarter.

US Economy

The government's broadest snapshot of the labor market showed March job creation of 216,000 as the private sector grows healthily, offset by continued cuts by local governments. The jobless rate, edged down slightly to 8.8%, its fourth consecutive monthly decline. Encouraging signs on the job front are contrasted with continued weakness in our housing market. A report last week found the S&P/Case-Shiller index of property values fell 3.1% from January 2010, the biggest year-over-year decrease since December 2009. Experts attribute this decline to rising foreclosures as well as potential buyers sitting on the sidelines expecting further decreases, creating a self-fulfilling prophecy.

Disaster in Japan

On March 11th the strongest earthquake (9.0) to hit Japan in at least 300 years claimed the lives of over 10,000 people, left 13,000 missing and nearly a half million individuals and families homeless. Equally concerning is the crisis triggered at the country's Fukushima-Daiichi nuclear power plant. Emergency crews are working tirelessly to restore cooling and stabilize pressure. Other countries are blocking the import of food products from the affected regions as the Japanese government found radioactive materials in food and drinking water. Japan is already weighed down with massive public debt of 200% of GDP and damage from this disaster could end up reaching $300 billion.

Turmoil in Middle East

High unemployment, food inflation, government corruption, a lack of political freedom and poor living conditions caused a young Tunisian man to protest by lighting himself on fire on December 17th, 2010. This single act sparked a series of protests and uprisings that eventually led to the ousting of longtime President Zine El Abidine Ben Ali in January of 2011. Watching the success of the citizens of this neighboring country, protests and demonstrations quickly spread across Northern Africa and the Middle East. On February 11th, following weeks of determined popular protest and pressure, Egyptian President Hosni Mubarak relinquished control of the country to the military until elections could be held. Immediately after, protestors in Libya began calling for an end to Muammar Gaddafi's 42-year rule. He has responded with substantial military force against the rebels, leading NATO to enforce a no-fly zone over the country with the intention of preventing genocide. Protests are also ongoing in Yemen, Bahrain and Syria.

Government Budget Debate

In February, President Obama released a widely criticized 2012 budget proposal that would reduce the federal deficit over time, but still leave spending at historically high levels. In response, a group of US senators, known as the Gang of Six, is working on a plan to cut the deficit by $4 trillion over 10 years by overhauling the tax code, reworking entitlement programs such as Medicare and Social Security, and trimming spending throughout the government. A total of 32 senators from each party sent a letter to President Obama urging him to "engage" on long-term deficit reduction. Similarly, governors around the US propose to balance their states' budgets with a long list of cuts—from public-employee pensions to education to Medicaid reimbursement—and almost no new taxes, reflecting a goal by politicians of both parties to erase deficits mainly by shrinking government. In one of the most extreme examples, Republican senators in Wisconsin passed legislation stripping public employees' unions of collective bargaining rights, only to have a circuit court judge block the law from being implemented.

European Union bailout

The European sovereign debt crisis that started last spring in Greece and spread to Ireland in the fall looks poised to capture its third victim. Portugal's premier resigned after opposition parties voted down an austerity package, pushing borrowing costs to unaffordable levels and threatening to force the country to seek a bailout. Portugal's plight now puts Spain into the bailout spotlight, as it has long believed to be the crucial battlefield in the euro zone's struggle to prevent a collapse of creditors' trust in its weaker nations. The worst-case scenario is that Spain's property market falls so hard that the country's struggling regional savings banks need more money to cover their losses than the state can raise. To help ease fears, the European Union is conducting a second round of "stress tests" on its banks, utilizing scenarios that are more severe than last year's highly criticized version.