RETIREMENT INVESTING: A BIG PICTURE LOOK AT WHAT LIES AHEAD

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PRESENTATION OVERVIEW

• Pension trends.
• Savings trends.
• The composition of government spending.
• Demographics in the U.S. and around the world.
• The importance of globalization.
• A global investment world.
PENSION TRENDS

• ERISA was signed in 1974.
• DB pensions were dominant and DC pensions were mostly supplemental.
  – Changes in industrial structure partially explain differences.
• DC now clearly dominant and DB holding steady only in state and local government sector.
  – Pension Protection Act of 2006 will hasten demise of DB.
• Pension coverage and participation rates roughly constant.
SAVINGS TRENDS

- Household savings rate has been in decline since 1980.
- From approx. 10% of income then to approx. 0% today.
  - Actual savings trend the last couple of years is slightly negative.
- Saving via pension plans is the only saving done by most American households.
  - Only half of all workers participate in a pension plan.
- Average contribution to 401(k) plans is approx. $3,500.
GOVERNMENT SPENDING AND REVENUES

- Federal government spending has remained fairly steady over time as a percentage of GDP.
  - Approximately 20%.
- Federal government revenues have remained fairly steady over time as a percentage of GDP.
- State and local spending rose sharply in the 1960s and then leveled off as a percentage of GDP.
- General government spending has remained fairly steady since about 1970.
  - Between 30 and 33%.
THE COMPOSITION OF FEDERAL SPENDING

- The relative size of the federal government has remained relatively constant but the composition has changed greatly.
- Over time the share of defense has declined.
- Over time the share of non-defense discretionary spending has declined.
  - EPA, FBI, FDA, etc.
- Social Security is the same in relative terms as in 1980.
- Medicare and Medicaid have grown tremendously.
FEDERAL SPENDING: WHERE WE STAND

- Non-defense discretionary spending at relative low share of federal budget.
- Social Security spending will soon begin to grow.
- Medicare and Medicaid already growing.
  - Exacerbated by prescription drug benefit.
- Interest payments a growing share.
- Defense spending: What to do?
STATE AND LOCAL FINANCES

- Medicaid is already a budget problem.
  - Half of total state expenditures in some states.
- State and local government pension under funding: America’s next fiscal crisis.
  - State and local government plans not subject to ERISA.
  - Pension plan under funding at least $500 billion.
- Retiree health benefits for public sector workers.
Right now the U.S. is experiencing a demographic golden age.

- Partly because the cohort born during the Great Depression was unusually small.

This starts to change in just two years. Beginning in 2008 the first of the baby boomers becomes eligible for Social Security.

The U.S. will undergo a relatively rapid demographic transition and also a relatively early transition.

- The number of Americans over the age of 65 will triple between 2010 and 2020.
GLOBAL DEMOGRAPHICS

- Within the EU the Nordics generally have the best demographics and the Southern and Central European nations have the worst.
  - Hungary was the first nation to experience population decline.
- Europe could do a lot to help itself by implementing parametric pension reforms.
- Japan’s population began to decline in 2004.
- China will get old before it gets rich.
GLOBALIZATION: THE FACILITATORS

• The World Trade Organization (WTO).
  – Who says economists can’t agree on anything?
• Relative decline in transportation costs.
  – The incredible importance of the humble shipping container.
• Relative decline in the cost of telecommunications.
• Improvements in policy.
  – Central Banking is almost uniformly excellent now around the world.
GLOBALIZATION: STILL THE EARLY INNINGS

• Despite well-known problems the 21st century started out better than one could have expected.
• The peaceful end to the Cold War.
• China begins opening to the world in 1979.
• India begins reforms in the early 1990s.
• These are not unrelated events.
GLOBALIZATION AND U.S. MARKETS

• Impact of increased national and international competition evident.
  – Corporate restructurings.
  – Better capital allocation.

• Globalization’s impact felt across sectors and in firms of varying size.

• Significant causal factor of Pension Benefit Guaranty Corporation (PBGC) deficit.
A GLOBAL INVESTMENT WORLD

- The U.S. market is 46% of the total global stock market.
- EAFE + Canada is 47% of the total global stock market.
- Emerging markets are 7% of the total.
- U.S. investors tend to exhibit a pronounced home bias.
  - Why?
- European investors (especially U.K. pension plans) tend to be much more global in their investment outlook.
EAFE + CANADA

- Total equity market capitalization approximately equal to the U.S. market.
- Exposure to certain sectors is available entirely or primarily outside the U.S.
- How much of the global equity market share of the auto sector is accounted for by non-U.S. names?
- In many if not most sectors portfolios are only completed with inclusion of names in this benchmark.
  - Analyst teams now organized in terms of global, not national, sectors.
EMERGING MARKETS

- Now account for half of global economic growth.
- Fully 5/6 of global population and virtually all global population growth.
- Widespread policy improvements.
- Still less than 10% of global equity and less than 10% of global bond market capitalizations.
- Potential for portfolio diversification and high returns.
THE KNOWN FUTURE

• After remaining roughly the same size as a share of GDP for many decades the federal government is beginning to grow.
• We don’t know what future tax rates will be. We do know the future tax burden will be higher.
• The current household savings rate and long-time trends in household savings are a sign that Americans are not saving enough for retirement.
PREPARING FOR THE FUTURE

• Whether you are 25 or 75 keep inflation in mind.
  – Remember the rule of 72.

• Trend is for risks to be shifted to individuals and households. People will have to assume greater responsibility for their retirement income security.
  – Including health care security.

• Address longevity risk.
  – Wide variety of annuity options available.
A FEW PRINCIPLES

• The simplest way to reduce risk is to invest in safe assets.
• Diversification among a portfolio of risky assets reduces risk compared to investing in a single risky asset but does not eliminate risk.
• Equities are not a “safe” asset or a less risky asset in the long run. The risk of investing in the stock market does not decline with the time horizon.
• Human capital is an important component of the present value of lifetime wealth.