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.
  - A shock arrives in 2007.

U.S. DEMOGRAPHICS

- 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.