

The Coming Generational Storm

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Bull's Eye Update

By John Mauldin

Today, we are going to look at a very important study by the always insightful James Montier on the Echo Bubble? Can we look at past bubbles and see a pattern? But first, we are going to look at a (frankly disturbing) new book, which I am going to encourage you to get and read.

“In 2030, as 77 million baby boomers hobble into old age, walkers will outnumber strollers; there will be twice as many retirees as there are today but only 18 percent more workers. How will America handle this demographic overload? How will Social Security and Medicare function with fewer working taxpayers to support these programs?”

While some boomers are hopeful we will not hobble into old age, these are the very reasonable questions asked by Larry Kotlikoff and Scott Burns in their guaranteed to be controversial new book, hot off the press, called “*The Coming Generational Storm.*”

I have often written about the coming demographic problems facing our nation. This is a topic I have researched at length, and have a few chapters on the subject in my book. Yet reading this book, I was constantly confronted with new facts and analysis. Some of the facts amazed me. Some of it was disturbing. Kotlikoff and Burns not only offer solutions to the coming problems, but personal financial advice to deal with the implications of their conclusions.

Before my European readers skip to the next section, let me say that the problems I discuss now, while they may be those of the US, are the very ones also facing you. In fact, with the exception of Britain, your demographically caused pension problems are far worse than that of the US. For instance, Germany “is still looking at a 60 percent long-run payroll tax rate to fund the combination of old age pensions, health care, long-term care, accident insurance and disability” promised by the current government rules. This is before any other government spending. No matter what reforms are enacted, there are going to be some unhappy campers in Germany in the coming decades. Either benefits will be cut, or taxes doubled. Many of the solutions Kotlikoff and Burns suggest will work for you, although few politicians are going to like them.

We are going to look at some aspects of this book at length, but before we do, let me strongly suggest that this is a book you should buy. In fact, some of you should buy two. Those who have a relationship with their Congressman or Senator should put the second copy in their hand. If you have adult children, you should buy them a copy as well. Links to Amazon.com are at the end of this section.

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(For the record, Laurence J. Kotlikoff is Professor of Economics at Boston University and a Research Associate of the National Bureau of Economic Research. Scott Burns, and an acquaintance of long standing (given the nature of this book, I am now sensitive to the word old), is a nationally syndicated financial columnist with the Dallas Morning News.)

Let's briefly review the problem. If one calculates the cost of all the future promises of Social Security and Medicare/Medicaid, the number runs to somewhere around \$45 trillion. Without any reform that number grows to \$54 billion by 2008. Future generations of tax-payers (read the young) are going to be left with this debt.

Of course, they are things we could do to solve the problem. In order to achieve current solvency, the government could simply raise payroll taxes by 69%, beginning today. Alternatively the government could cut Social Security and non-Medicare outlays by 45% immediately and forever. (How do you think either policy would go over at the polls? Not to mention how quickly could you spell recession?)

Of course, when that study was done, the recently passed Medicare Drug Benefit program had not been passed. That merely raises the future deficits by \$6 trillion to \$51 trillion.

At some point in the future, either social safety net benefits are going to have to be cut or taxes raised, or both. And the changes will be significant. Rob Arnott (correctly, I think) points out in studies that I have written about elsewhere that long before we get to the crisis predicted by these numbers, the market will have forced a solution. The trends are unsustainable. The system is going to have to be restructured. The question is when and how, and at what price?

Try telling some future retiree who has been paying into Social Security for 40 years that his benefits are going to get cut. Social Security is one of the lousiest "investments" of all time, because it is not an investment. Apart from pandering politicians, everyone knows there is no Social Security Trust Fund Lock-box. The program is just a huge transfer of tax money from workers to retirees, with very serious government management costs draining resources.

Of course, as Kotlikoff and Burns point out, to not change the benefit structure means an eventual almost doubling of the payroll tax. Try telling future young workers they should pay 30% on payroll tax, plus a huge hike in income taxes to pay for Medicare and Medicaid.

There are no easy solutions or pain free way out. Part of the problem keeping us from reform is that the distance between the two political parties is so vast, and neither party wants to talk about the very real economic pain a true solution would create. Privatizing Social Security might sound nice to Republicans, but is anathema to Democrats. And frankly, allowing Mom and Pop investor to "time" the market in their

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accounts means some are going to not end up with a reasonable retirement. Control has its benefits and its very real costs. Are we going to have the government come in and pick up the costs for those who invested unwisely?

Letting people opt out of Social Security and going private (I would do so in a nano-second) means that someone through some other tax would have to finance the pay as you go system we now have. Even if we were to gradually do it, it would mean gradual tax increases or more government debt.

But taking the Al Gore approach (do nothing) means that future generations are going to have to cough up a lot of money. We merely postpone the crisis and payments to our kids, or they vote to stiff us.

I can give you the logic of privatizing Social Security. But it is not politically possible, and perhaps not even wise. So what might be? Kotlikoff and Burns offer the following novel suggestions.

Personal Security Accounts

1. Basically, stop accruing any more social security benefits to anyone. Simply stop the current system.
2. Any benefits already accumulated will be paid, but eliminate the Social Security tax. Anyone promised any benefit will get everything they have been promised, and in full.
3. Social Security's Old Age Insurance payroll tax is eliminated and replaced with equivalent compulsory contributions to something they call a Personal Security System (PSS) account. The account is invested in a weighted world index of stocks, bonds and real estate from every major stock market.
4. A new federal retail sales tax is used to pay off the accrued retirement benefits owed under the old system.
5. To eliminate the dramatic unfairness in the current system, worker contributions are shared 50-50 with their spouses.
6. The government contributes to PSS accounts on behalf of disables and unemployed.
7. The government matches PSS contributions on a progressive basis.
8. All PSS accounts are invested in a single market-weighted global index fund of stocks, bonds and real estate.
9. The government guarantees the real principle that workers contribute to their accounts.
10. Between age 57 and 67, workers PSS accounts are gradually sold off and transformed into inflation-protected pensions.
11. If a worker dies prior to age 67, any remaining PSS balances would be transferred to PSS accounts of the worker's heirs.

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Young workers are guaranteed a far better retirement than current Social Security benefits. Depending upon contributions, it could be many times better. Everyone gets their benefits. The system they propose is clearly fairer. What's not to like?

The Devil is in the details. I preface the details with this note. For those who do not know of Scott Burns, he is no liberal. He helped found the National Taxpayers Union and is no proponent of big government or taxes.

The national sales tax they propose to deal with the accumulated benefits already due to future retirees would start at 12%. Over time (many decades) it would decrease to about 3%, as with each passing year, those who die would stop receiving benefits.

They then follow this up with reasons why the sales tax is not really all that regressive, is certainly better than the current situation and so on. They explain why they use a world investment index. All nice arguments and reasonably set forth.

Is this realistic? Do you really want to invest in a world index with all the currency problems and other issues? As bad as the US debt may look, do we want to invest in a Europe where it is at least twice as bad? Are there better ways to solve the problem? Maybe, but it misses the point. And here we go from their analysis to mine.

Without any fanfare, they give us the real cost, in a very understandable way, of the current Social Security dilemma. It is 12% of our national sales for a very long time and only slowly decreasing to 3% in 4-5 decades. Yes, it creates a forced saving pool and it makes retirement fairer and more certain. It puts the burden of paying for their retirement on the boomer generation. Again, the burden falls onto a generation who believe they have already paid for their benefits. Politicians have told them this lie for years.

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But solving the crisis today using this model costs 12% of national sales. That means a 12% reduction in funds available for consumer spending. And in an economy that is two-thirds powered by consumer spending that means, at least to me, an immediate and guaranteed deep recession. When I asked Kotlikoff about this, he responded that economies with much larger savings ratios (as this plan would force upon the nation) do just fine. Further, he quite correctly pointed out, it is immoral to obligate future generations – our children - to pay for our debts.

Of course, putting off the solution simply guarantees the problem to be worse in the future, and more expensive and a bigger drag on the economy.

Scott was a little bit more up front. He agreed with me that it would likely create a recession. But it is the right thing to do. Further in our discussion we asked ourselves what politician is going to vote for a plan that forces current generations and voters to suffer when we can put off suffering until they are out of office? If Kerry is elected, there

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is a snowball's chance in hell that any agreement can be reached to restructure Social Security. If Bush is re-elected with a large majority, do you think they will willingly sacrifice today's economy? They can't even hold down spending.

But even if the entire plan, or some form of it, were adopted, that only solves about 20% of the long term debt problem. The real and massive problem is Medicare and Medicaid. Without going into great detail, they propose a New Medical Security System (MSS). Basically, it is universal insurance vouchers that tailored to your individual health and circumstances. If you are sick or have cancer, your voucher might be as much as \$100,000. If you are healthy, it might only be a few thousand. Their math shows this would save another \$27 trillion. They would balance the rest of the future debt by a combination of tax increases and limits on federal spending.

Social Security and health care commitments are not problems that we can simply grow ourselves out of. Yes, the study which shows the \$45 trillion debt assumes over time that we will be spending up to 30% of our GDP on health care, which I seriously doubt is possible. There are other flaws in the study. There are no assumptions that future entrepreneurs will find ways to meet future needs in a more cost-efficient manner, or that new technologies will change the cost equation of goods and services.

We could always quadruple immigration, but Kotlikoff and Burns show that only partially solves the problem. And can you think of a politician who would run on such a platform?

We can quibble with a lot of things, but the fact remains that, give or take a few ten trillion dollars, under the current plan future generations are going to have to come up with the resources to pay for a burgeoning cohort of retirees. Under their plan, taxes and government debt do not rise nearly as much as if we do nothing, but it is not without pain, as the transition to massive forced savings will disrupt the economy for at least several years.

Whether that is done within this decade or put off into the future, when that time comes, it is going to mean a decrease in the available funds for consumer spending, whether one time or gradual. Doing nothing is going to mean a significant rise in taxes in the future. It will mean a doubling of the payroll tax, at the very least.

It is like the old Fram oil filter commercial, "Pay me now (for a new oil filter) or pay me later (for a new engine)." (Yes, I just really dated myself.)

The last few chapters of the book basically assume that Congress will do nothing in the short or medium term, and offers some very concrete suggestions for protecting your own retirement.

"Unfortunately," they note, "knowing our political system there is every reason to believe that our politicians are going to miss this opportunity to save our ship of state. In

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this case, it's critical that we look out for ourselves and our own families. So don your life jacket and follow us to Chapter 7.”

The next few chapters are full of practical advice. TIPS, alternative portfolios and other creative solutions are part of their recommendations, some as simple as owning your own home free of debt.

Frankly, the point of the book is NOT their proposed solutions, but their very convincing presentation of the magnitude of the problem and a step-by-step plan for protecting your own retirement funds. It helps that Scott is a very, very good writer who can make the complex very simple. It helps that he has a sense of humor and quick wit.

Unless you are well-off or plan to die within 10 years, this “Coming Generational Storm” is going to affect your retirement plans and ability to fund a reasonable retirement.

You can get the book by going to <http://www.amazon.com/exec/obidos/ASIN/0262112868/frontlinethou-20>. You may not like all of what you read, but you need to know what we are facing. Avoiding learning about a problem will not make it go away.

The Echo Bubble

As I wrote last week, I want to look at James Montier's work on what he calls an “Echo Bubble.” James is the Global Equity Strategy for Dresdner Kleinwort Wasserstein in London. (Quotes are from his work with my comments interspersed.) An echo bubble is a mini-bubble, if you will, which echoes a previously burst bubble.

“Bubbles appear to share common features during both the inflation stage and the de-bubbling phase. Most of the bubbles we have found exhibit a bubble echo - a relatively short lived rebound in markets. This seems to be driven by conservatism bias. Only when the bubble echo finally fails, do investors lose their illusions.

“This very limited ability to recognize and deal with change leads to anchoring and slow adjustment. Once a position has been stated most people find it very hard to move away from that view. When movement does occur it does so only very slowly. That is to say, people hold on to their prior beliefs too long and only change their views when there is irrefutable proof that they were wrong. During the last market rally, investors have been effectively anchored in the bubble environment, still applying bubble standards to valuations and behavior. It is likely to take more than one downturn to shake the faith that investors have built up over the long bull market.”

“Bubble echoes appear to be commonplace in the range of historical experiences ranging from the South Sea Bubble to the UK railroads of the 1840s, right through to Japan in the 1990s.”

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They looked for bubbles in the past that had two characteristics: they were liquid and there was available data. They found nine previous bubbles which met that criteria. Basically, doing some fancy math, they found the average curve of the bubble and its aftermath.

When you overlay that pattern with the S&P 500, you find a rather remarkable correlation with the “average” bubble right up until today. Visually, it could hardly be more closely correlated. If it remains true to form, we are due for a rather bearish market for the next two years (which is as far as the graph goes). Interestingly, the “average” bubble does not go back to previous lows.

“We believe these patterns are driven by the immutable nature of human psychology. Investors suffer ‘conservatism bias’: an unwillingness to give up previous beliefs. Psychologists have found that it takes anywhere between two and five observations to do one observation’s worth of work in inducing a subject to change his opinion. Examining the relationship between the current US experience and that from past bubbles reveals that this is almost exactly the right time for the bubble echo to start to deflate.”

“We are not alone in finding a commonality within the bubbles and busts of history. Experimental economics also shows that bubble echoes are commonplace, as investors take time to learn the errors of their ways. Technical analysis such as Dow theory and Elliot Wave theory also identify the bubble echo scenario, and the mistake investors make of confusing a bull rally in bear market with the hope of a new bull market.”

They cite the work of several economists who develop experiments with investors and create a bubble within their experiments. The research shows that inexperienced traders are very likely to participate in a second bubble before they revert to value investing.

Interestingly, in experiments that grouped experienced traders with novices “... shows that even twice experienced players [who knew a bubble was developing] can’t quite manage to hold fundamental value lines when there are novices involved in the market as well.”

They cite work by both Dow and Elliott Wave theorists which shows the likelihood of an echo bubble. Then they conclude:

“The simple truth is that new bull markets are usually born from exceptionally cheap valuations, not the excessively expensive ones which we see now. When the psychology of the long bull market finally breaks, the resulting reality check will be all the more painful for investors. The loss of illusion is a necessary step on the road to revulsion.”

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The lesson from today's message is simple, gentle reader. It is quite possible this market has begun a renewed bear phase. Proceed with extreme caution. Then again, as I read this study, I was reminded of Boss Gettys' line about Citizen Kane: "He's going to need more than one lesson, and he's going to get more than one lesson."

Bull's Eye Update and an Opportunity

Bull's Eye Investing is going on the press in just a few days and is scheduled to ship from the warehouses to bookstores April 15. I hope to get a copy in my hands and then on to yours SOON!

Thanks for those of you who are helping us find those in the media and newspapers who are willing to review the book or arrange for an interview. We are starting to put together a list of radio and TV appearances. I need all the help I can get.

I was very gratified to get this quote from Neil Howe, who was the co-author of "*Generations*" and "*The Fourth Turning*," two books which I think are seminal reading. Howe is one of my favorite thinkers and intellectuals.

"Bull's Eye Investing is a scintillating tour of the art and science of long-range forecasting. With his eye fixed as it should be in the great sweep of history, John throws a much-needed splash of realism onto the wishful thinking of recent years."

A friend of mine asked me to mention that he is looking for a very experienced alternative investments retail broker for his boutique firm. It would be a good position, but the emphasis is upon experience. I will forward your resumes.

I am going to have to learn to delegate, as there is just too much going on, therefore I am also looking for a free lance copy writer to help me with some of the book promotional copy and marketing. Send samples of your work and resumes to me, along with some idea of your fees.

Spring is in the air, and that means it is time to plant flowers. I get a great deal of enjoyment from putting in the spring flowers, although this year I think #2 son is going to do more than usual. He needs the money, and I need the time. But I do love flowers.

My bride and I are off to Puerto Vallarta next Thursday for some much-needed R&R and time alone, where I intend to read sci-fi and other literature with no socially redeeming value, other than for my enjoyment.

Your starting to think of margaritas and beaches,

John Mauldin