

FOCUS

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***Social Security:
You do the math***

[We recently read a very interesting article about Social Security benefits. Unfortunately, we did not make note of the author or the source, but we did check the facts at the Social Security Administration's web site (at least with respect to Ms. Fuller, who is mentioned in the article). Our apologies to the author for the lack of attribution. –*ed.*]

Perhaps the trouble with the current debate about Social Security is more elementary than we care to admit: while our esteemed representatives are good with words and sound bites, when it comes to basic arithmetic they struggle. So, they tend to focus on the words and the hyperbole (which they enjoy) and ignore the math (which, seemingly, they don't). And, so, they've created a lot of "good" phrases to describe Social Security, like "trust fund," "pension system," and "retirement plan." The problem with these words is that none of them have a shred of truth. The sad fact is Social Security has essentially been a welfare-type system from the outset. It was never "funded," and "contributions" were really just taxes that were taken from one generation and redistributed to an older one, based on a formula.

Consider the case of the first recipient of a monthly Social Security check, Ida May Fuller. On January 1, 1940, Ida May received her first check for \$22.54. Before retirement, Ida May had paid a total of \$24.75 into the system. Unfortunately for the system (but, no doubt, happily for Ida May), she lived to be 100 years old. In total, she collected \$22,888.92 from the government. That's an annual return of 2,642 percent. Of course, in order for Ida May to have gotten a 2,642 percent return, it means that a whole lot of other people must get seriously negative returns.

Ironically, those negative returns were also by design. When the system was established, the retirement age was set at 103 percent of life expectancy—which in 1935 was 62.8 years. The government expected most people who paid into the system to die before they collected their first dollar. Since everyone was forced to pay (and they would hopefully die young), there was no worry about the Ida May Fullers of this world taking a disproportionate share of the money. Similarly, if the current retirement age were 103 percent of life expectancy (78.7 years), the system could probably go on forever—baby boomers or no...

If you want to find out if you are on a winning level of this pyramid, it's easy to do so. The Social Security Administration habitually sends out statements to contributors. My recently-arrived analysis states that by the time I retire, I will probably have amassed contributions of \$285,425. This, presumably, will allow me to receive payments of \$1,499 per month at age 62. If I live until 78 (my life expectancy), I will receive \$287,808 in checks. In case you're wondering, the imputed annual return on this amount for my 16 years of retirement is **0.1 percent per year**. Yes, that is *not* a typo—one tenth of a percent per year. The investment returns on the accumulated contributions prior to retirement are exactly zero. Ida May, my hat is off to you!

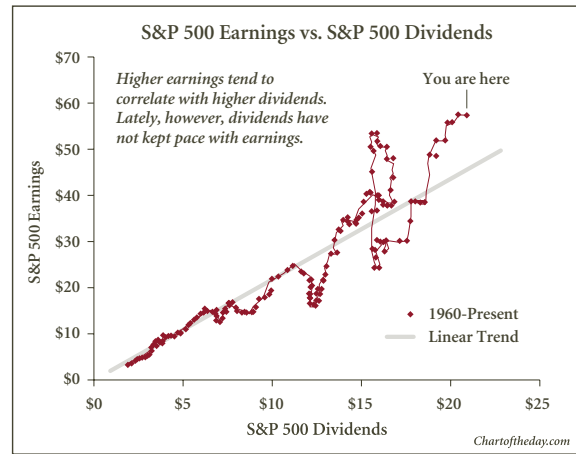
[For those readers interested in a more in-depth discussion of Social Security reform, we encourage you to read Don Luskin's article entitled "You Say You Want a Revolution" at www.trendmacro.com.]

Whither dividends

Data shown on the chart at the top of the next page suggests that we should expect both an increase in dividends from companies currently paying them as well as an increase in the number of companies initiating dividend payouts.

For many companies, there are simply no new, attractive investment opportunities that exceed their cost of

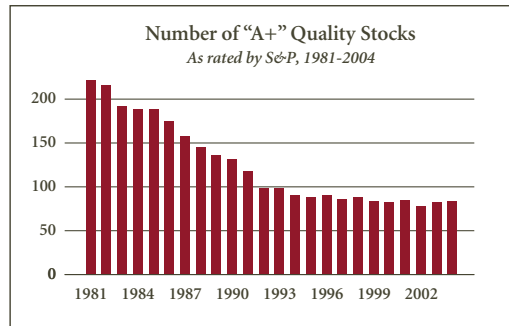
capital. Therefore, rather than let cash languish on the books, they better serve their shareholders by paying it out.



The decline of corporate quality

Standard & Poors recently published in its *Outlook* newsletter the rather startling chart that appears below.

The quality rating is in large part a function of earnings growth and stability. What this chart suggests is that the market is significantly overvalued and has been for



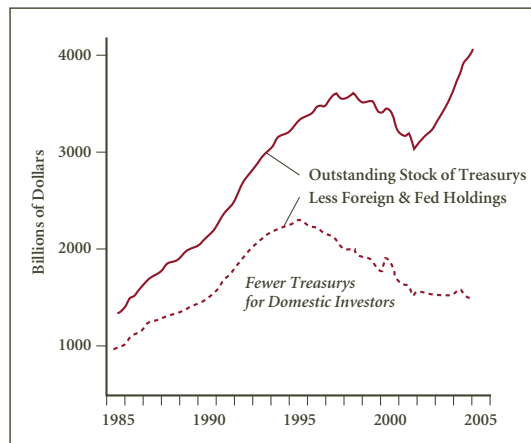
some time. Another interpretation is that with the advent of global competition, it has become increasingly difficult for companies to sustain both growing earnings and stability

in that growth. What is surprising is that in the face of declining quality, price/earnings multiples have risen and remained well above historic norms, suggesting that investors are ignoring this decline in "quality."

As interest rates continue to rise, increasing stress will be applied to the entire financial system. Therefore, at some point, the "quality" chickens may come home to roost. In other words, we will not be surprised if at some point in the foreseeable future, the stock market will encounter some very rough going as valuations adjust to levels consistent with the quality of the underlying earnings streams. ☒

And as for the bond market...

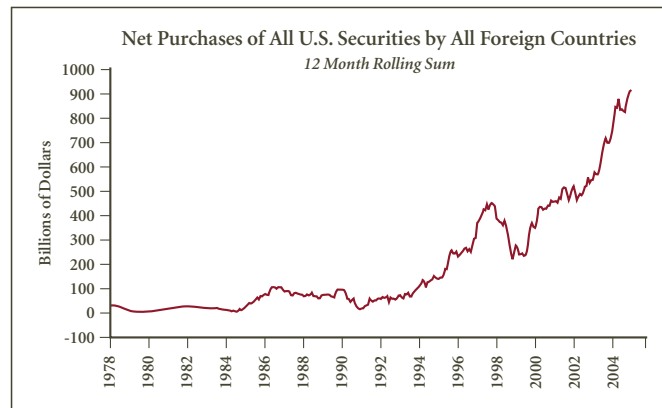
As the Fed has raised rates over the last 9 months, the consensus among bond market analysts has been that bond yields must rise, ending the bull market in bonds that began in the early 1980s and driving bond prices down. Yet, so far, not much has happened. The reason is that in spite of a declining dollar, foreign central banks, esp. the Chinese, have continued to sop up the seemingly endless outpouring of bond offerings from the Treasury as it finances our growing deficit. As shown in the first chart accompanying this article, this has resulted in fewer Treasury bonds being



available for domestic investors. When the supply of anything is constrained, it usually results in higher prices. In the case of bonds, this translates to lower yields than would otherwise be expected.

The second chart shows the dollar volume of foreign central banks' purchases. You would think that with the dollar dropping to near record lows against most major currencies, central bankers would want to cut their losses, stop buying, and maybe even sell.

One theory for the lack of selling pressure (so far, at least) is that they are all afraid to do so because as



soon as there is a whiff of selling pressure, all holders would run for the exits, resulting in a bond market crash the likes of which has never been seen. After all, who except other central bankers (and the U.S. government) could absorb that quantity of bonds?

Other explanations abound. Our take is that most holders expect that the Federal Reserve will continue to raise rates. While this should shore up the dollar, reducing the holders' currency losses, it will also cause the value of their bonds to decline—that's what happens when rates go up. Sooner or later, the pain may just become too great. With no sign that there will be any serious attempt to reduce the budget deficit anytime soon, and with the funding requirements for Social Security and Medicare/Medicaid reform on the horizon, someone is likely to flinch.

***From the
technology
corner***

Those of us who are regular users of email periodically receive correspondence from friends and colleagues purporting to expose some sinister plot, warn about an imminent health threat, or reveal some sort of previously unknown juicy factoid. Examples include one about Hilary Clinton having defended a Black Panther, another about Bill Gates paying you for every visit to a particular website, a very recent one about how coughing may help you survive a heart attack if you experience one while alone, and so on. Because we like to gossip, or like to be helpful, or for some other reason, our tendency is to forward these on to others we think (hope?) may find them interesting/cute/hysterically funny without thinking too much about it.

Some of these tidbits turn out to be true. However, the vast majority are fabrications. One way we can all reduce email clutter is to check out anything that sounds even the slightest bit odd, or too good to be true, or just too good not to pass on. The easiest way to do this is to go to either <http://www.snopes.com> or to <http://urbanlegends.about.com>. Both

sites are easy to navigate and often have lots of interesting background on a particular hoax/legend/myth.

Another thing you can do if you receive an email you discover to be a hoax is let the sender know by providing him/her with a link to the site you used to debunk it and then encourage the sender to use that site to vet any future such emails. We may not be able to do much about spam, but we can certainly all work towards making the Internet a more trustworthy and less junk-littered place.

Fun with words

The Washington Post's Style Invitational once again asked readers to take any word from the dictionary, alter it by adding, subtracting, or changing one letter, and supply a new definition. Here are this year's winners:

Bozone (n.): The substance surrounding a stupid person that stops bright ideas from penetrating.

Foreploy (v): Any misrepresentation about yourself for the purpose of, well, you know.

Cashtration (n.): The act of buying a house, which renders the subject financially impotent for an indefinite period.

Sarchasm (n): The gulf between the author of sarcastic wit and the person who doesn't get it.

Inoculatte (v): To take coffee intravenously when you are running late.

Hipatitis (n): Terminal coolness.

Osteopornosis (n): A degenerate disease.

Karmageddon (n): It's like, when everybody is sending off all these really bad vibes, right? And then, like, the Earth explodes and it's like, a serious bummer.

Decafalon (n.): The grueling event of getting through the day consuming only things that are good for you.

Glibido (v): All talk and no action.

Dopeler effect (n): The tendency of stupid ideas to seem smarter when they come very quickly.

Arachnoleptic fit (n.): The frantic dance performed just after you've accidentally walked through a spider web.

Beelzebug (n.): Satan in the form of a mosquito that gets into your bedroom at three in the morning and cannot be cast out.

Caterpallor (n.): The color you turn after finding half a grub in the fruit you're eating.


Inside Woodside

Our new website is up and running. However, there are several new features in the client area that have not yet been implemented. One of these is a service called account aggregation. Account aggregation allows a client to see every account they have that offers online access—brokerage, bank, credit card, affinity card (hotel, airline, etc.), retirement, and the like—in one place on one display with one login. Moreover, access can be granted to some or all of that information to others, such as trustees, CPAs, attorneys, etc.—anyone the client wants to authorize. Your editor has been using this service (through its originator, Yodlee.com) for several years and has found it very convenient.

Another feature is the ability to store important documents online. For example, for about the last year, we have been scanning and storing most client documents—tax returns, wills and trusts, etc.—on our server. We will now be able to post these scanned documents to each client's personal storage area so that they will be archived for easy retrieval.

We will announce the availability of these features as we enable them. 

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