



Wealth Architecture™ Digest

Often people do not plan because they see only what is, and they do not have a vision of what can be. Something is always possible. We believe that, with vision, the possibilities are almost unlimited.

New Math and Old Vows

Most Americans who marry repeat vows that commit the bride and groom to one another "... for richer or poorer, in sickness and in health, until death..." We have always believed that a promise is a promise, and it should not be broken. But over the decades the sacred vows of marriage have become simply words to be spoken without being taken seriously.

Over the past sixty years there were also some vows made, contracts between employers and employees, union as well as non-union; private and public sectors. The commitments made were that those employees who worked long-term for the employer would receive a pension at retirement. The employer agreed, as a part of a compensation package, to *guarantee* an income stream for retirement so the employee could worry less about the vagaries of the market. Because the pension was frequently based on years of service, and did not vest for many years, the benefit also served the employer as a form of "golden handcuffs." An employee would have to think twice before moving to another company because he would lose much of his pension.

A pension is meant to provide an income after retirement beginning at a certain age (much like Social Security), which in the 1950s and 1960s was 65 years of age. Back then it was fairly common for those who retired at 65 to live only 7-10 more years. The cost to fund a pension income for life was modest by today's standards. The "lump sum value" of \$1,000 per month for a 65-year-old male retiring in 1960 might have been \$125,000, based on a life expectancy of 13 years (source: National Vital Statistics System). Actuaries worked on the basis of tables that were developed from the experience of millions of lives covered by the country's life insurance companies over more than 100 years.

Life expectancy is not an indication of when one would expect to die, but rather the median age for expected death. Half of the group is still alive at that time. Over the past 50 years life expectancies have greatly increased, to where by 2006 the 65-year-old men had an expectancy of 17 years, while same-age women could expect to live 19 more years. Participants living longer means more money is required to fully fund the same benefits.

The funding of pension benefits is simple in concept, but can be extremely difficult in practice. It is replete with actuarial *assumptions*, each of which impacts the overall calculation and results. When a new 25-year-old employee is hired and joins a plan with "promised" benefits at age 65 of two percent of covered compensation for each year of service, it seems straightforward. However, the compensation used in the formula is usually based on anything from the highest compensation over the past x years (often one to three). So, for this 25-year-old, the plan has to assume – essentially guess – what that final compensation will be. Will the employee stay in the same job and have pay that goes up with inflation? Will she be promoted to a manager with significantly higher pay? These plans do not take into account the actual pay until the very end, although the calculations change along the way as the employee's pay changes. With each year's change in pay a new assumption of final pay is made, and funding is adjusted accordingly.

Another factor in funding for these future benefits is investment return on the plan assets. The higher the assumed return, the lower the amount needed to fund benefits. When I recently spoke to a Calpers representative¹ he told me that they had been using

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an investment total return assumption of over 7%. That meant that less would be needed at age 65 to be fully funded for the retiring participant. If the needed reserve at age 65 were to be \$1,000,000, the annual payment needed, assuming a 7% return, would be \$5,009; if the return assumption were reduced to 4%, the required payment will be \$10,523. Many public sector plans allow full retirement earlier than age 65, meaning a higher funding level (it costs more to pay a benefit for life starting at a younger age) must be met over a shorter accumulation period.

Calpers' public disclosures indicate that over the ten years ending 9/30/10, the fund's returns have averaged only 3.65% after losing 27.8% in 2008. This has led to significant underfunding *and* a proposed reduction of the forward-looking return assumptions. The bottom line – significantly higher payments needed to meet promised benefits.

A third assumption that actuaries make in determining funding levels of a pension plan is mortality, and this works in a few ways. For a given person living longer it is obvious that if she lives longer than assumed, it will cost more for her benefits. But it is more complicated than that. In a very large group assumptions of earlier than expected death of pre and post retirees provides a positive financial benefit to the total plan. However, if they don't die according to assumptions, even more money is needed to fully fund for all participants. The actual mortality experience is regularly reviewed and funding adjusted, but the decrease in early deaths has also driven up the costs for government meeting its commitments to its long term employees.

Now, with some local, state, and federal budgets bleeding red ink and revenue enhancements unlikely, the accrued liability is going to be very difficult to overcome. With the major underfunding caused by the investment losses of the past decade, I feel either future investment returns would have to be well above past results, **or** there will need to be

significant increases in current and future contributions to the plans. The only other alternative will be to reduce benefits – even for current employees.

I have gone to great lengths to provide a reasonably cogent explanation of the problems facing organizations offering defined benefit (DB) pensions. Most corporations terminated their DB plans long ago, opting for 401(k) plans that contain no guarantees in the future. However, I believe that most government and many union employees are covered by DB plans. This is a very serious problem given the “new math” to which I've alluded.

Finally, without going into great detail, there is one other problem that I believe is becoming more intractable than the underfunded pension liabilities: post-retirement health care benefits. The same life expectancy and investment return issues that face the pension plans also confront the reserve requirements for retiree health benefits. In addition, the actual cost of medical cost has increased significantly above the rate of inflation and the rates assumed when the benefits were granted. Retirees are living longer, partly because of the new (and expensive) procedures and drugs recently developed. I feel higher projected costs, lower investment returns, and money available to fund all of this have all converged to create a real crisis.

On December 15, 2010 the Controller of the City and County of San Francisco issued a report stating in part, “*The City's unfunded liability for other post-employment health benefits (OPEB) reported in the July 1, 2008 valuation report is \$4.36 billion. This number represents the future cost of providing retiree health benefits earned by employees and retirees as of that date.*” Note that this is currently **unfunded**, and for benefits earned (vows made) as of 2008. The report went on to point out that in order to pre-fund the liability, the city would have to immediately begin to put away 15.4% of employee compensation, which could be impossible in today's cost-cutting environment.

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So where does that leave us? Private and government employers made contracts – vows – with their employees over the past several decades. Now they face the desire to break the vows, saying “we can’t afford it...” and the new math supports their view. It may be like a spouse of a terminally ill patient, who really wants to keep paying to keep him alive just a little longer, but is running out of money, vows made have to be broken.

The Economy, Politics, and the Market

The year just ending has been one of very mixed signals. It is just over two years since the world economy was on the brink of total financial collapse. In mid-September, 2008 when Lehman Brothers went into liquidation and AIG was given a huge lifeline (bailout) from the government, capital markets around the world went into a tailspin. Trillions of dollars of government support were injected into the economies in the US, the United Kingdom, Europe, China, and other countries.

With a rush to perceived safety, many investors dumped stocks as well as corporate and municipal bonds, putting most proceeds into shorter-term U.S. Treasury obligations. During that timeframe, the lower risk investments, 3-6 month treasury bills, saw yields drop to incredibly low levels. The six-month treasury bill that at the beginning of the year had an annualized yield of 3.32%, dropped to 0.27% by the end of the year (source for treasury yields: www.treasury.gov). On December 20, 2010, with the economy officially out of recession for six months, the yield was still stuck at 0.20%.

In 2010 the US stock market, as measured by the S&P500 Index, provided an interesting rollercoaster ride for investors. After starting fairly flat for the first couple of weeks, the index dropped 8% by February 8th, only to jump 14.75% by April 23rd. It then fell 15.6% by July 2nd, even though there were a couple of 5%-plus rallies in between. The next five weeks were

up 10.66%, then down for the next three weeks. By the end of August the S&P500 Index was down almost 6% year-to-date. Then, with little significant economic news, the index soared 18.25% by December 17th, up 9.91% for the year and 89% above the March, 2009 low. (source: bloomberg.com)

It has often been said that the stock market is a leading economic indicator, and employment (or the lack thereof) is a lagging one. That might be true, but the results of the last 21 months cause me to ask how long the lead and lag may be. The American Recovery and Reinvestment Act of 2009, known as the “stimulus” package was signed into law on February 14, 2009. The Democrats thought it too little, and the Republicans derided it as a worthless, pork-laden law. *But*, three weeks later the S&P500 Index bottomed out, and rocketed northward to finish the year 63% above its March low. Now, almost two years later the economy is growing, but very slowly. The Bureau of Labor Statistics reports that there are 1.8 million *more* unemployed today than there were in March, 2009.

I believe we have a major structural problem that we have yet to face. Many consumers (likely most) want the lowest cost they can get, regardless of where their products or services come from. When you make a call with a question on almost any service or product, you are likely to be talking with someone in India or the Philippines. Somehow \$12/hour can’t compete with 50 cents an hour, and with new technology the phone call itself is virtually without cost. Toll takers on bridges and parking lots have been replaced by credit card machines. The novice accountants who once input data and then compiled simple tax returns have been replaced by competent employees in India who work for 1/3 or less the cost of a local employee. However, without adequate jobs for entry level or unskilled labor, how will overall employment pick up? If it doesn’t, how will the US economy grow at the 3-4% minimum needed if consumers here don’t have money to spend?

That brings me to my final point: Politics. I feel the reality of politics in America is that it has become

more Partisan than at any time in recent history. Whether we agree with the reasoning behind it or not, the filibuster was used a record number of times over the past couple of years. Conservatives feel that's fine, as they wanted to stop the Democratic agenda. Looking forward, I think it is likely that the Democrats will use the Senate and the presidency to stop what they see as Republican overreach.

Come March we hit a crisis point for the US economy. I believe the debt ceiling needs to be raised or the US goes into default on its debt. That would undoubtedly cause another global crisis. There are a few newly elected members of both houses of congress that have threatened to block the extension if they don't get the spending cuts they want. There are Democrats who believe that to be an idle threat. The American economy, and the people – We the People – are the pawns in their chess game.

Everyone prefers some level of certainty, and right now this can be hard to come by. I feel the government is operating on a continuing resolution, not appropriation bills. It would be like saying that we've removed your name plaque from the door of your office, and replaced it with your name written in chalk on the door. Be good, or else. Do it my way, or you'll disappear. Both parties are in a struggle for power. The country is split, and volatile. Politicians are focused on November, 2012 and not the unemployed of January, 2011.

The market has had an amazing recovery (although still not to the levels of 2007), and it could be easily spooked. The economy has been called "in recovery, but fragile." I feel the legislatures at every level have become battlegrounds for the extremes, barely able to function. While I never predict the unpredictable – where are the markets going – I still believe there is enough uncertainty that your plans should be no more aggressive. At least no change should be made unless your circumstances demand it.

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¹Calpers, the California Employees' Retirement System, invests the assets for 1.6 million active and retired California State and municipal employees. At October 31, 2010 it had over \$218 million in assets. (source: calpers.ca.gov)

Gross Domestic Product (GDP) measures the total market value of all final goods and services produced in a country in a given year. Unless otherwise noted, market statistics and data used in this newsletter were obtained from finance.google.com, and interest rate information was derived from www.treasurydirect.gov.

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