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Bear Markets Do Not Hurt the Case for Social Security Retirement Accounts

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Critics of Social Security reform claim that the stock market's recent poor performance shows that introducing personal retirement accounts into the Social Security system would be unwise. They are wrong. Even with recent market losses, such accounts over time would vastly outperform Social Security. Moreover, because investment portfolios tend to become more diversified with higher proportions of less volatile instruments as retirement nears, such accounts would be less sensitive to market changes than a portfolio that is composed solely of stocks.

Morningstar, Inc., an independent market data and analysis firm, estimates that the value of mutual funds invested in diversified U.S. stocks declined 12.3 percent during the first quarter of 2001. However, not all investments went down. Mutual funds containing the lower-risk instruments routinely held by those nearing retirement, such as taxable bonds, *rose* an average of 2.3 percent over that same period, while funds investing in tax-exempt bonds rose 1.9 percent. Moreover, Series I U.S. Savings Bonds (I Bonds) saw positive results and through May 1 will pay 6.49 percent annually (3.4 percent after inflation). Thus, even with recent stock fluctuations, the long-term prospects for earnings in personal retirement accounts remain strong.

The recent poor performance of stocks must be balanced against the high earnings of 1997–1999 and expected future positive returns. The return on a prudently mixed portfolio of 50 percent stock index funds and 50 percent government bonds could average 5 percent annually. In contrast, a 35-year-old man with average earnings for his age group can expect to "earn" a *minus* 0.3 percent return on his Social Security retirement taxes. Thus, after paying about $282,000 in taxes over his career, he can expect only $262,000 in benefits. His 32-year-old wife would see a positive rate of return of 1.9 percent annually—still far below even what I Bonds would pay.

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Lessons from the Bear Market. In the real world, retirement investments have risk-limiting features to reduce losses from market fluctuations. Such features could be part of Social Security personal retirement accounts as well.

- **Different portfolios for older and younger investors.** Funds managers should structure personal retirement accounts so that older workers could shift more funds into fixed-income investments. As investors age, they tend to lock in earnings by decreasing the proportion of investment in stocks. A recent survey of 401(k) plans shows that investors in their sixties invest less of their portfolios in equity funds (44 percent vs. 63 percent for investors in their twenties) and much more (23 percent vs. 8 percent) in guaranteed investment contracts and similar instruments that pay a fixed interest rate.

This is significant because decreasing the proportion in stocks reduces the potential for short-term loss. Younger investors need to invest most of their assets in stocks to get higher returns, but those closer to retirement need to reduce the chance that a sudden market shift will affect them. In the first quarter of 2001, older investors nearing retirement whose money was invested 40 percent in stocks and 60 percent in taxable bonds would have seen their assets decline only by about 3.5 percent.

- **Index-type funds rather than individual stocks.** Stock index funds that track the entire market are much less volatile than individual stocks and funds that track only one economic sector. On March 22, 2001, Standard & Poor's 500 index declined by 0.4 percent, but that one day saw Intel stock increase by 12.2 percent and Honeywell stock decline by 4.9 percent. While individual stocks come and go and individual companies that make up an index change frequently, the index continues.
- **Long-term investments in stocks.** Retirement investors should be encouraged to buy and hold stocks for long periods; thus, legislation creating personal retirement accounts should discourage short-term trading. Though stock returns fluctuate widely from year to year, earnings on stocks held for 20 years or more have always gone up. This is significant because retirement assets are usually held for 20 to 40 years. The investment analysis firm of Ibbottson & Associates has found that, since 1926, large company stocks have had returns that varied from +53 percent in 1954 to –43 percent in 1931; when the same stocks were held for 20 consecutive years, they had positive average annual returns, even during the Great Depression. Longer is even better. Jeremy Siegel of the Wharton School at the University of Pennsylvania found that, since 1871, stocks held for 30 years have *always* outperformed bonds and Treasury bills.
- **Blended portfolios to smooth out risk and returns.** Funds managers should allow workers to invest retirement account funds in mixed portfolios of stocks and other investments. Such portfolios would ease concerns about market fluctuation, since some money would be invested in safer income instruments. As the demand for retirement investment and annuity products grows, new instruments that combine reduced risk with higher returns are being developed. One securities firm has developed an inflation-indexed annuity with a survivor's benefit. Insurance companies are developing packages that include both investments and life insurance. Any of these products would be suitable for personal retirement accounts.
- **Series I Bonds or similar investments.** Legislation creating personal retirement accounts also should allow workers who wish to avoid any risk to invest in U.S. Treasury I Bonds, which currently pay 3.4 percent plus inflation and have no administrative charges.

Conclusion. Retirement investing is not day trading. It should consist of long-term investments that allow relatively brief downturns to be balanced by more frequent positive returns. Stock investments held for 20 years or longer always have positive average annual returns. Nothing about the recent stock market losses changes this fact. Because Social Security still pays extremely low rates of return and faces significant financial problems, workers—even with the recent market fluctuations—could expect to earn significantly more from personal retirement accounts than they could expect from Social Security, accumulating a nest egg for retirement or to pass on to their families. Some say that choosing between higher risk and higher returns is like choosing between eating better or sleeping better. Allowing workers to invest some of their existing Social Security taxes in their own personal retirement accounts would enable them to do both.

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NOTE: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.