



**First Financial Group**

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## THE SOCIAL SECURITY DIVIDE:

### Are You Last-Generation or Next-Generation?



Since its implementation in the 1930s, Social Security has been a financial constant in the lives of Americans, first as taxes assessed against earnings to fund the program, later as a monthly retirement income. Except for some limited exemptions (most of which came at Social Security's beginning), all Americans participate in Social Security; everyone pays into the program, and everyone qualifies to receive a monthly retirement income.

Social Security is a group plan in which current taxes fund current benefits; even though taxes and benefits are calculated based on individual incomes, Social Security does not keep separate accounts for each future recipient. Although previous tax collections built significant reserves, since 2010 Social Security has run an annual deficit, and the shortfall between the taxes and benefits is increasing. According to its most recent annual report, current tax and benefit rates are projected to exhaust the plan's assets by 2033.

One of the reasons for the funding gap is the demographic anomaly of the Baby Boom generation, which has distorted the proportional relationship of taxes

collected and the number of retirees receiving benefits. Consequently, even though it was intended to be a plan for all Americans, the economic benefits from Social Security project to be sharply divided along generational lines – with some modest winners and big losers.

Stanley Druckenmiller, a retired investment fund manager, is touring college campuses with a presentation titled "Generational Theft." Druckenmiller's main premise: Individuals entering the workforce today are participants in a plan that projects to deliver negative benefits in the future while continuing to provide overly-generous benefits to today's retirees. Putting this idea into numbers, Druckenmiller compares the total payments made into Social Security during one's working lifetime and contrasts it against benefits received, then makes comparisons for different age groups. In summary,

**"(W)hile today's 65-year-olds will receive on average net lifetime benefits of \$327,400, children born now will suffer net lifetime losses of \$420,600 as they struggle to pay the bills of aging Americans."**

This means if you're currently receiving Social Security or soon will be eligible, it's a good deal – i.e., benefits received will most likely exceed the taxes paid. But the younger you are, the less attractive Social Security gets, and the Baby Boomers look like the last generation that will truly benefit from a Social Security retirement. For the generations that follow, the program projects to deliver negative value, as least in regard to retirement income.

Is there a fix for this dilemma? Yes...but not really. Druckenmiller says the Baby Boom generation is so large and the benefits they are due to receive will last so long that it is not financially possible to borrow to cover the annual deficits until the population stabilizes. According to Druckenmiller, this leaves two options: "Either tax rates rise, or generosity falls. There is no alternative." Unfortunately, the unusual funding structure of Social Security makes either option problematic, because workers from different generations have different self-interests.

For example, Druckenmiller proposes a possible fix by subjecting eligibility to means-testing; the more you have in assets and income, the less you receive in Social Security benefits. But 65-year-olds on the cusp of retirement with 40 years of payments to Social Security aren't likely to see this as a "good deal" or even "fair." They paid for others' benefits

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and were told younger generations would be doing the same for them. Changing the terms of agreement for a large group of Americans just before retirement seems like bad policy – and bad politics. What politician would risk the wrath of a large voting bloc by decreasing benefits?

On the other hand, once they understand the math, it's tough to imagine most young workers continuing to support the current arrangement. Where's the value in paying to sustain someone else's benefits while losing money yourself? And if the proportion of benefits received to taxes paid is already bad, convincing the public that the problem can be solved by increasing taxes will require serious spin, since an increase in Social Security taxes would affect everyone, not just "the rich."

A means-testing qualification also changes a fundamental assumption of Social Security. Instead of a program in which *all* Americans participate and *all* receive benefits, means-testing will result in some participants paying into the system, yet receiving nothing. This is a circumstance with great potential for antagonism and division between generations and income brackets. Further, means-testing, creates a moral hazard for personal saving. If every dollar saved reduces one's future benefits, saving becomes counter-productive.

In considering these issues, no silver-bullet solutions are readily apparent. In fact, given the understandable tendency of politicians to avoid or delay changes to Social Security that might be unpopular with voters, there is perhaps a greater potential for bad endings: an eventual collapse of the Social Security system and loss of benefits, along with an economically stratified and divided country.

### Pragmatic Responses to Inevitable Changes

Twentieth-century economist Herbert Stein's most famous pronouncement was "If something cannot go on forever, it will stop." Social Security, as presently configured, will not go on forever, which means eventually it will stop. When this happens, commentators will dissect the reasons, and assign blame. But knowing how it happened and who is responsible will not change the outcome, or the financial impact it will have on individuals. Better to honestly assess one's options, find opportunities, and attempt to select the best of what may be tough alternatives. Two broad considerations:

**Identify your generational position.** The cut-off line is fuzzy because everyone's situation is unique, but in general: The older you are, the more value you can expect from Social Security. As Druckenmiller notes, today's 65-year-olds are receiving significant value from Social Security retirement checks; workers in their 20s cannot have similar expectations. When it comes to crafting a response to the uncertainties of Social Security, there is truly a generational divide. First-generation recipients of Social Security and the Baby Boomers are on one side. Young people just entering the workforce are on the other. Those between 40 and 60 are on the fence, wondering how things will fall out for them.

**Adopt "generationally appropriate" financial strategies.**  
**Currently receiving benefits?** Gratefully accept every check, and hope the projections for 2033 are wrong – in a good way. Prudence might suggest keeping a reserve accumulation

(especially if you are a younger retiree), just in case Social Security ends before you do.

**About to retire?** The window for determining Social Security retirement benefits opens at age 62 and extends to age 70; the longer you wait, the higher the monthly payment. A number of sophisticated calculators exist to help retirees determine the optimum age at which they should begin drawing benefits. But

since the Baby Boomer cohort now moving through this window may be the last to truly benefit from Social Security, there is also an argument for receiving benefits as early as possible, even if the monthly payment is diminished. If government projections are correct, what's more valuable: receiving a smaller check for 20 years, or waiting for a larger check, but only receiving it for 10?

**Between 50 and 62?** These are particularly vexing issues, because while Social Security has not yet

changed/diminished/ended, the day when it inevitably does is growing closer. Retirement is on the near-horizon, but some oncesure resources may not be available. The potential for means-tested benefits also comes into play. How will this uncertainty affect you? Should you save more? Work longer? Or perhaps retire sooner? These are tough questions, the kind that should prompt serious discussions with your financial professionals.

**Below 50?** The choices may be clearer, yet more challenging. If nothing changes, you'll pay more in taxes than the benefits you'll receive. If a means-test is instituted, those who save will receive even less. The pragmatic but aggravating response is to take Social Security out of your retirement plans. If this is your assumption, the most likely replacement is increased personal saving. Making this happen typically involves forgoing some present enjoyments, i.e., no big vacations, no new cars, not eating out as often, etc. A diminished standard of living is not a psychological positive; at some point, delayed gratification gives diminishing returns.

Relying on one-size-fits-all financial maxims (i.e. save 10%, max your 401(k), etc.) has never been an ideal approach to securing a prosperous future. The demographic realities behind Social Security's funding issues exaggerate this point: How you plan and save for your financial future is very much impacted by your generational position. Your situation is not the same as that of your parents, or your children. The national challenge of Social Security is unlikely to be addressed proactively because politicians often have strong incentive to "kick the can" to the next generation. But individuals would be well-served to act now, because history shows that demographics can create economic consequences for which there are no quick fixes. ❖



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A January 4, 2014, headline from a national financial publication read:

### “How to Invest as Rates Rise”

The article begins with a rationale on why interest rates are likely to rise, proceeds to predict the impact of rising rates on stocks and bonds, and follows with recommendations under the heading “**What to Do Now.**”

The author of these recommendations? According to his online bio, the writer is a Yale graduate with a background in reporting on financial topics. An accompanying photo suggests he is perhaps in his mid-thirties. **There are no indications of extensive experience in the financial industry except as a reporter.**

This apparent lack of experience does not preclude the author from offering an opinion, nor does it imply his recommendations are wrong. He faces almost no restrictions on his commentary (other than those imposed by his editor), and under most circumstances, will not be held liable if readers suffer financial loss by acting on his inaccurate recommendations.

In contrast, many well-trained (and presumably more knowledgeable) individuals working in the financial services industry are significantly restricted from offering similar opinions, particularly in writing. Further, if their recommendations proved to be in error, these financial service professionals could be subject to legal and civil action by customers who relied on their advice – even when the recommendations included disclaimers.

Why can those with minimal financial credentials often be the freest and most pointed in their commentaries?

### Understanding Conflict of Interest – “How do you get paid?”

A business dictionary defines conflict of interest as “a set of circumstances where one’s judgment or actions in a primary interest may be unduly influenced by a secondary interest.” In many instances involving financial services, the secondary interest is compensation – i.e., “How does the person providing the information get paid?”

### Information from brokers, agents and advisors

Brokers and insurance agents are primarily compensated by financial institutions for connecting customers with products and services. Because brokers and agents usually have greater knowledge of the products or services than their prospective clients, they operate under suitability or fiduciary standards established by national and state organizations. Their recommendations should be appropriate for the individual’s unique circumstances, and/or in the prospective customer’s best interest.

People licensed in the financial services industry must limit their commentary to their credentialed practice. Insurance agents

may not comment on stocks and bonds unless they are also licensed as securities representatives, and vice versa. Unless they are specifically certified, they are even enjoined from critiquing a competitor’s products and services.

Financial professionals who receive fees for their expert counsel operate under similar constraints. Advice or information should relate to one’s licensed areas of expertise. In the event a fee-based advisor also receives compensation as the result of a sale of product or service, this arrangement must be disclosed.

Firms or individuals may disseminate information on their products and services, which may include discussions of ideas or strategies, third-party commentary, and even personal opinions on why customers may find these items valuable. But suitability concerns and the limitations of one’s scope of practice will usually preclude specific recommendations.

Because it directly or indirectly promotes the firm’s products or services, these communications are often classified as “sales material” even if the content is purely informational. Consequently, most broker/agent/adviser publications (including this one), will undergo internal legal review to ensure the content is accurate, falls within the limits of licensed activities, and does not present (or even imply) specific recommendations or guarantees – i.e., you won’t see “what to do now” in print.



### Information from the financial media

Writers for news publications or stock pickers on television shows are paid by their employers. Like anyone else who makes public comments, they are subject to libel and slander standards, but free to have opinions and make recommendations, often without disclaimer. Instead of suitability or fiduciary standards, the operative phrase regarding their advice is “caveat emptor” – let the buyer beware. Because of this distinction, **journalists and financial “entertainers” are the least regulated in what they say or do.**

However, commentators who also work in the business or engage in financial service-related transactions are subject to disclosure and conflict of interest regulations not imposed on commentators with no industry affiliation. Recently, several prominent financial “gurus” have run into trouble over perceived conflicts of interest. In one instance, a seminar speaker and syndicated columnist promoted a credit card issued by a company in which the author had an endorsement agreement. In another, a broad-topic newsletter recommended specific investments through a broker-dealer in which the writer had an ownership interest.

### Who Can You Trust?

As “outsiders” in the financial services arena, financial news outlets and personalities may claim to be independent sources of financial information. Good journalists and reporters can certainly be valuable watchdogs, uncovering bad behavior and alerting consumers. And since their primary product is information, there is strong incentive to get the facts, present them accurately, and offer good advice.

**But this information is not “spin-free.”** Success in the financial media requires attracting and retaining an audience – and advertisers. And while conflicts of interest may not be readily apparent, editorial slant may be tilted to satisfy an audience or appeal to potential advertisers. Tabloid journalism has its audience, even for finances. And people usually advertise in

media outlets where their product or service is well-thought-of. In addition, many media information businesses are seeking the largest audience possible. When casting a wide net, it's sometimes easier (and more profitable) to write "life insurance is a rip-off" than discuss why consumers have continued to purchase the product for the past century.

Competent brokers and agents have in-depth knowledge of their products, services and potential applications that exceeds that of people outside the financial services industry; they can legitimately be called experts. Some people are of the opinion that when an expert's compensation comes from products or services, the information is somehow tainted. Actually, considering the stringent compliance oversight and the legal, financial, and professional sanctions that could result from misinformation, there's a good chance it's quite the opposite. The challenge for consumers is not so much trusting the information, but determining if they agree with the underlying philosophies used to interpret the facts.

The reality: all information sources have biases, and potential conflicts of interest. In a sea of financial data and commentary, understanding the different constraints financial information providers operate under should help you evaluate the trustworthiness of the source, and whether the information is not only accurate, but in line with your perspectives on financial success. ❖



One of the vignettes in "Fantasia," Walt Disney's groundbreaking animated film from 1940, is "The Sorcerer's Apprentice." The story, adapted from a poem by Goethe, begins with an old sorcerer assigning a young apprentice (Mickey Mouse) the task of carrying water from a well to the workshop. It is exhausting work...until, in a moment of inspiration, the apprentice casts a spell to make a broom do the work for him. At first, things are wonderful. But because the apprentice has used magic he has not yet fully mastered, the broom is soon out of control. The workshop floods, and the apprentice is drowning. Desperate, he axes the broom in two, only to see each piece become a new broom that fetches water even faster. Just when all seems lost, the sorcerer returns, and averts disaster by breaking the spell.

The "Sorcerer's Apprentice" is an apt analogy for many of the issues we face with technology. The new capabilities are magnificent, but there is a growing sense that we may not have

these wonderful innovations under control. But unlike the story, there doesn't seem to be a wise old sorcerer to rescue us, which means we are awash in a flood of circumstances, hoping to avoid disaster.

### The Hackers

One of the problems in this new, digitally-dominated world is the concurrent rise of hackers or information thieves who, to quote Farhad Manjoo, "for reasons both noble and savage, are systematically breaking into every valuable cache of information stored in any digital format anywhere."

The research firm Risk Based Security reports that security intrusions more than doubled between 2011 and 2012, and the 2013 numbers look even higher. News events confirm this trend: It seems like every day another business or governmental organization has been hacked, and the magnitude of some of these data thefts is staggering. One month after a December 2013 hacking of its customer database, Target stores estimates that as many as **110 million customers** may have been victims of identity theft, exposing their names, addresses, phone numbers and e-mail addresses.

Some of the blame for these data thefts can be placed on lax or inadequate cyber security protocols by the businesses or institutions holding the data. But the other side of the coin is that people keep developing and using new data applications without considering how to protect them.

### Social Media

Prime examples of this "innovation gap" in data security can be found in social media. We may have an awareness that party photos posted on Facebook could wreck a job interview, or that a hasty, thoughtless comment on Twitter might irreparably damage friendships. But how many users are aware of the potential **financial data** risks from using social media?

For example, Snapchat is a smartphone application that allows users to take photos, record videos, add text and drawings, and send these "snaps" to a controlled list of recipients. Users set a time limit, between 1 and 10 seconds, on how long the snap can be viewed, after which they are hidden from view (but kept on Snapchat's servers forever).

Hackers have limited interest in stealing a photo of you sleeping with your dog, or recording the somersault your kid just did from the couch to the floor. But Snapchat contains one valuable piece of information: your phone number, which is an essential piece of data for identity theft. At the end of December 2013, approximately 4.6 million Snapchat users had their phone numbers leaked.

### Your Credit Score

Illegal access to your personal data is a disturbing violation of your privacy. But some new wrinkles in legitimate data mining may also be troubling as well. A January 9, 2014, *Wall Street Journal* article noted that a growing trend among private lending institutions is to sift through social media data to "help determine a borrower's creditworthiness..." How could your social media information be used by lenders? To see if...

- job information posted on LinkedIn matches your loan application
- career changes reported on Facebook coincide with your employment history.
- customer comments on eBay confirm positive statements about your business.

Some of this seems like amateur, computer-nerd, detective work. But when Fair Isaac Corporation, the company that provides credit scores for more than 90% of lender decisions (your “FICO score”), says “we’re looking at” social media as another assessment tool, you realize every bit of exposed personal data is subject to examination – and interpretation.

### Limiting Your Exposure

This information has to make you cautious about how and where you hold personal financial data. Some arrangements, such as credit-card purchases, are almost unavoidable. But others, like social media sites, should give you pause. Any digital storage via an Internet connection should be assessed for its security measures. And as the IT veterans will tell you, having one hard copy is always recommended. ❖

The owner does not have to decide in advance how the policy will be used; its purpose can be adapted to meet the challenges of future events.

equivalent to paying lower premiums for a longer period. And anecdotal evidence from life insurance professionals suggests that a significant percentage of whole life insurance purchases occur later in life by individuals who have not only the resources, but also a clear understanding of the value, and can readily afford the premiums. So is it better to wait before committing to a whole life insurance program? Here’s a Person A vs. Person B hypothetical comparison to ponder.

## The Cost of Waiting

to buy  
Whole Life  
Insurance



There are compelling reasons for whole life insurance<sup>1</sup> to be included in your long-term financial program. Because a whole life insurance contract delivers a guaranteed financial benefit at a specific moment in time, it may be used to:

- address estate concerns
- fund an inheritance
- act as a permission slip to spend other assets
- provide additional income in retirement
- or assist in paying long-term expenses.

Equally important, the owner of the contract does not have to decide in advance how the policy will be used; its purpose can be adapted to meet the challenges of future events.

From a purely hypothetical perspective, most people can see the value in whole life insurance. The real-world problem many have is paying for it. For them, the life-long benefits of whole life insurance are diminished by the obligation of life-long premiums. With so many other financial unknowns that will arise between now and the end of life, can they really afford to commit a portion of their savings to such a long-term financial instrument?

In addition, those with a better understanding of basic life insurance concepts might say, “Why not wait until later in life to secure whole life insurance? The older you are, the more likely that you will know how the policy will fit your financial plans. Sure, the annual premiums might be higher, but you won’t have to pay them for such a long time!”

Does this perspective have merit? Since the pricing of life insurance is based on actuarial calculations of life expectancy, the true cost of paying higher premiums later may be financially

### Person A

A 35-year-old male decides to commit \$3,000 in annual premiums to a whole life insurance program with a highly-rated mutual life insurance company. The company approves his application, and issues a policy at a “Preferred, Non-tobacco” rating -- the middle of its three standard ratings for non-tobacco users. The \$3,000 premium purchases a \$239,000 insurance death benefit, but no additional riders or benefits.

The contract entitles the policy owner to dividends<sup>2</sup>, should the insurance company pay them, and specifies that these dividend payments should be used to purchase additional paid-up life insurance. While dividends are not guaranteed, the long history of regular dividend distributions by insurance companies permits them to be projected in a policy illustration. After 25 years, at age 60, the projected details for Person A’s policy are as follows:

Total Premiums:	\$75,000
Cash Value:	\$128,697
Death Benefit:	\$329,253

The Social Security Administration’s Life Expectancy Calculator says a 35-year-old male who is alive today has a life expectancy of 82. If he is still alive at 62, it increases to 85. If Person A’s life ends at age 85, this will require another 25 years of premium payments beyond age 60. Here are the projected results:

Total Premiums:	\$150,000
Cash Value:	\$470,400
Death Benefit:	\$585,380

### Person B

Person B, another 35-year-old male, decides to defer a decision about whole life insurance until a later date. In fact, he waits until age 60. At that time, to stay in step with Person A, he applies for a policy with a \$329,253 death benefit. He is approved, with the same Preferred, Non-tobacco rating as Person A. The annual premium is \$13,122. Like Person A, Person B lives to age 85. Here are the projected results:

Total Premiums:	\$328,050
Cash Value:	\$448,000
Death Benefit:	\$611,468

<sup>1</sup>All whole life insurance guarantees are subject to the timely payment of all required premiums and the claims paying ability of the issuing insurance company.

<sup>2</sup>Dividends are not guaranteed and are declared annually by the insurance company’s board of directors.

At Age 85	Total Premiums	Projected Cash Value	Proj. IRR	Projected Death Benefit	Proj. IRR
<b>PERSON A</b>	\$150,000	\$470,400	3.95%	\$585,380	4.65%
<b>PERSON B</b>	\$328,050	\$448,400	2.32%	\$611,468	4.50%

**Observations**

Understanding that the age 85 calculations are only projections and not guarantees, they still provide some interesting side-by-side insights.

- Person A’s cash value is slightly higher, while Person B’s death benefit is larger. But in each case, the difference is less than 5 percent.
- The Internal Rate of Return (IRR) for premiums deposited vs. the death benefit received is very close.
- The Internal Rate of Return (IRR) for premiums deposited vs. the cash value accumulation is substantially greater for Person A.
- An additional item of note: In a future value calculation, a \$3,000 premium grows to \$13,122 in 25 years using an annual rate of 6.05%. This is greater than the historical annual rate of inflation which has been 2.75% for the past 25 years.

**In these projections, the cost of waiting is greater than the past rate of inflation.**

The information above is a very narrow assessment of specific components of a whole life insurance policy, and does not account for many other issues that must be considered when deciding how and when to buy life insurance. It uses the company’s projections to produce calculations at arbitrarily selected ages. Different companies and different ages will certainly generate different numbers. Yet given these limitations, some conclusions are possible.

- Projected out to life expectancy, the older purchaser of whole life insurance is projected to accrue nearly the same financial benefits as one who secured coverage earlier. Since individuals will most likely pass away before or after life expectancy, real returns will be different. However, the age 85 projections **tend to support the actuarial assumption that the costs of insurance are similar, whether paid as smaller premiums over a longer time, or higher premiums for a shorter period.**
- Some of the “**living benefits**” of whole life insurance that **involve access to cash values are significantly reduced by waiting.** The projections reward those who start early.
- Future health is a real-world variable with the potential to completely invalidate this simplistic comparison. Over 25 years, **the likelihood of declining health and the risk of not being insurable at age 60 makes waiting problematic.**

Even if you are older, it still may be possible to add whole life insurance to your financial program. And if you’re young, now might be the best time to guarantee your insurability (even with convertible term insurance) so that these long-term financial benefits can be part of your future. You might be able to wait, but there are advantages to starting now. ❖

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