Too Scared of Stocks

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MarketWatch Blog by Alicia H. Munnell

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Last month, I got out of equities. I would write a paragraph and then look at the market. Write another paragraph and look again. No way to live. But in this new 401(k) world, avoiding equities entirely means very high contribution rates. So the question is "What is the best way to take advantage of the equity premium in a retirement income system?"

One answer is that we should capture equity returns in the Social Security System. Theory says that the ability to spread risk over a number of generations improves the expected outcome. And indeed, proposals to invest a portion of Social Security trust fund assets in equities have been part of the debate since the 1994-96 Advisory Council on Social Security.

Such a shift would improve the distribution of risk. Generally, it makes sense for individuals to bear more risk when young and less when old. However, the young often hold no risky, high-yielding assets, and their implicit asset – Social Security – is invested in bonds. Introducing equities into the Social Security system has the potential to shift risk from the old to the young and could make all generations better off.

But most importantly, equity investment could make Social Security less expensive. To the extent that the realized return on Social Security assets turned out to be higher, participants would be required to contribute less to

Social Security than they would have otherwise, thereby freeing them to invest their 401(k) balances in a way that generated less heartburn.

The major concern about investing Social Security trust fund assets in equities is the power it potentially puts in the hands of government. Using trust fund assets for “socially desirable” purposes would clearly undermine retirement income security. It would also open the door to government interference in the economy – often without public oversight – and this, in turn, could undermine the democratic process.

But other countries invest a portion of their national pension assets in equities. Take Canada, for example. To guard against such threats, the Canadian structure calls for an independent Investment Board, selected through a laborious political process that involves a wide array of provincial and federal officials. The Board must periodically review its own performance and make frequent and extensive reports to the public. But within this governance framework, the Board is free to invest trust fund assets in the full gamut of opportunities available to employer defined benefit pension fund managers. To date, no problems have arisen in terms of the pension plan interfering in private sector activity.

Moreover, in the United States, most proposals for investing Social Security trust fund assets in equities reject such an active investment policy and call for investing in a broad market index, such as the Russell 3000 or the Wilshire 5000. An expert investment board would select the index, choose portfolio managers for the accounts, and monitor the performance of the managers. To ensure that government ownership does not disrupt corporate governance, most proposals require that voting rights be given to the asset managers, not voted at all, or voted in the same fashion as the other shareholders.

Everyone saving for retirement knows that a portfolio should include some equities. The more that equity investing can be done through Social Security as opposed to individual 401(k) plans, the better everybody might sleep at night.