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Homeland Security

There are 60,000 employees in the Department of Homeland Security. They're responsible for protecting you from threats - both foreign and domestic.

Since 2002 Congress has appropriated $210 billion to operate the Department. Their mission is to protect our ports, airports, borders, railroads and the seas from both natural and man made threats. The department is also supposed to help fix stuff. You know - like they did in New Orleans and along the Gulf Coast.

American troops were deployed to Iraq in 2003. Since then 2,450 soldiers have been killed and 17,000 wounded in the name of Homeland Security.

As of March 2006 we have spent $260 billion on the war. The Congressional Budget Office projects that we will spend $9 billion a month this year. The cost beyond 2006 is harder to predict. Some think the long tail economic impact could exceed a trillion dollars.

The Administration tells us that the lives lost and the money spent is an investment in freedom, an investment in democracy. Reasonable people will debate this for awhile.

But Iraq is not what I want to talk to you about …

We have heard Kit Kat essays that could be placed in the category of Homeland Security. For example, George Paulson's reflections on the 1918 flu pandemic.

His description of the death of millions of people in the US and around the globe - gives us a perspective on the potential of today's bird flu.

So far there are 101 confirmed human deaths as a result of bird flu. The World Bank predicts that it will take a billion dollars to control the virus and avoid a pandemic. The Food and Agriculture Organization estimates that the economic impact of bird flu in China is, already, more than $10 billion.

It's difficult to predict the cost of the next flu pandemic. Some estimates suggest that the economic impact could exceed $800 billion.

Governor Taft hosted a bird flu summit in Ohio in February. At the conference, the Secretary of Health and Human Services reported that we were budgeting $350 million, nationally, for bird flu planning.

Is the Homeland secure from the next flu pandemic? Reasonable people now debate if we're doing all we can.

But bird flu not what I want to talk to you about…

Don Shackelford's essay - As Thy Purse Can Bear - discussed the possible effects and costs associated with global warming. America declined to sign the Kyoto protocol which set benchmarks for the reduction of greenhouse gasses around the world.

The US position is that:

a. Environmental activists have exaggerated the effects of global warming and that the science does not support national action and
b. That signing on to the protocol would render American business less competitive in the global economy.

As a developed economy, are we doing what we can to ensure that we can sustain our way of life for ourselves and our children? Global warming is, as the name suggests, global. The US cannot stand alone. Is global warming a homeland security issue? Some think yes, others think no. As a refugee from environmental regulation - I think yes.

But global warming is not what I want to talk to you about …

The abuse of alcohol and prescription drugs in **suburban households** by women and teens has reached epidemic proportions. The National Institute of Drug and Alcohol Abuse estimates that 32 million Americans abuse drugs, including prescription drugs, and alcohol daily. Of that number half are teens under the age of 18.

Some researchers think there is a correlation between the increased abuse of controlled substances in the suburbs and the increase in our suicide rate. Suicide in America declined for six consecutive years until 2001. You remember 2001… that was a bad year.

Since 2001 160,000 Americans have reportedly killed themselves. That's 87 people a day. More alarming is that 15% of suicides are in the 15 to 24 year old age group.

What are the costs associated with …

The loss of life to war;
Drug and alcohol abuse in cities and suburbs
Of a bird flu pandemic; or
Global warming?

Who knows? What we do know is that it will cost a lot. But not as much as what I want to talk to you about tonight.

The public discourse on these subjects and others will soon yield the lectern to the 75 million baby boomers that will begin retiring this year. More than 50% of whom do not have enough savings or prospective pension income to maintain their current lifestyle – and neither do many of their parents.

That's what I want to talk to you about. Will older and aging Americans have enough money to take care

of themselves after they leave the workforce – the answer is No. Homeland Security.

46% of working Americans aged 25 to 64 participate in some kind of retirement plan other than Social Security. This means that 54% do not.

For boomers who contribute to a 401(k) account, which have been around for 25 years, the median account balance for people age 50 to 59 is $54,000. The average 401(k) for all age groups is $39,600. Not enough.

25% of all Americans between the age of 65 and 74, who are able to, hold jobs – not because they want to - but because they have to.

The average Social Security payment is about $900. The poverty line for a single person over 65 is $9,000 a year – **before tax.** The federal minimum wage is about the same annual income.

Six million people over 65 are poor and living on Social Security. Their health care is provided by Medicare and Medicaid.

My mom's her sole source of income – other than help from my brother and me – is Social Security. After working for 50 years she gets $680.00.

My step father worked for a ship building company for 27 years, he got sick and died. The company went out of business 3 years later; just before my Mom became eligible for retirement benefits. She did not benefit from the government provided pension safety net. She is not alone.

The Social Security surplus will end by 2012, unless we do something - which appears unlikely. The projected shortfall in the Social Security trust fund is expected to be $4 trillion in 75 years in today's dollars.

Meanwhile, the **seldom** discussed gorilla sitting in the basement is Medicare and Medicaid. The Medicare shortfall is projected to be $30 trillion in 75 years, in today's dollars.

Medicaid has cost us $320 billion so far. Medicaid has 50 million health care customers and pays for two thirds of all nursing home care in America.

The Administration proposes to cut the Medicaid appropriation.

So what's your point Warren?

The point is that your children and your children's' children can't count on Social Security, Medicaid or Medicare.

But, that's not the bad news. The bad news is that your children and your children's children can't count on many state and local pension plans or their private sector brethren either.

Like global warming and bird flu, industrialized economies are grappling with how to care for their aging and retired workers and how to deal with under funded pension schemes.

So – who cares? The notion that I got mine; or it's not my ox...Won't fly. I promise you - you will have to help pay for your neighbors' failure to save for retirement - whether you like it or not.

Let's talk first about the Public sector.

The first Big Deal pension plan was introduced after the Civil War. The federal government gave pensions to disabled Union Army veterans and war widows. In 1890 the government expanded benefits to all veterans who were 65 years old. Not many people got the benefit - they died before the money kicked in.

Today, not counting federal workers, there are more than 14 million public employees and 6 million retirees who are entititled to future pension and health care benefits.

The estimated price of these entitlememts is $2.4 trillion dollars. State and local government in America have not set aside enough money to pay the tab.

In 2003, for example, states and local government contributed $46.2 billion **into** public pension plans. In 2004 the annual pay out was $118 billion.

In 2004 local governments in the State of New York had to increase their pension contributions by 248%.

New York City's pension costs were projected to be $650 million in 2004. The actual cost was $2.46 billion or 9% of the city's budget. Somebody in city hall did a poor job on the cash flow projection. New York is not alone.

The city's 2007 pension contribution is projected to be $4.9 billion or 12% of city's estimated $40.5 billion budget. (Remember the New York transit strike and the recent dispute at Franklin County Children Services).

The city of San Diego's retirement system has a deficit of more than $1.4 billion, and as a result – the city is now having difficulty gaining access to capital markets.

The city of Duluth's pension plan is under funded by $180 million – more than double the city's annual operating budget. The Mayor plans to reduce benefits for both active and retired city workers. Good Luck. A difficult thing to pull off if you want to continue being mayor.

The combined pension under funding for New Jersey, Alaska, Maryland, Michigan and Illinois is estimated to be $110 billion. A total of 14 state pension plans have a funded ratio of less than 70%. West Virginia has the lowest funded ratio at 40%, and Illinois has the largest unfunded liability in the US - $43 billion.

The State of Alaska has closed its defined benefit plan to new state employees starting this year; a tough political decision that few mayors, governors and legislatures will be willing to make.

It is easier to raise your taxes then it is to take retirement benefits away from public sector workers.

Total state and local public pension and health care under funding is estimated to be a trillion dollars nationwide.

But that's not the bad news. The bad new is that the public doesn't know much about the problem - **yet**. That is, unless you live or work in Alaska or Duluth.

Starting this year, with the adoption of accounting statement 43 and 45, the Government Accounting Standards Board will require state and local governments to disclose their long tail pension and other post employment liabilities.

Politicians are uncertain how the public will react to these mandatory disclosures. Nor do they know how capital markets will react to the funding shortfalls. I predict that the cost of public debt will go up. Good for the bond investor; bad for the taxpayer. (Ohio is a revenue state with a general obligation debt limit of $750,000)

So, what happening?

Public sector employees often retire younger and are living longer while receiving full pension and health benefits.

9% of private sector workers and 43% of public sector workers are unionized and retirement and health care benefits are, and have been, a priority in labor/management negotiations.

The health care benefits in most public plans are generous; some believe, too generous. Health care costs are increasing faster than the tax base in most places. In 2005 health-care related costs increased more than 15%.

The average annual premium for family medical coverage in public plans was $10,000 in 2004, up from $6,250 in 2000 - a 59% increase. Meanwhile, inflation went up 9.7% during the same period.

90% of public sector workers have a defined benefit pension with a guaranteed payout and the promise of lifetime health benefits. Only 24% of workers employed by the private sector have like benefits.

The Ohio Public Employees Retirement System recently set up the Health Care Preservation Fund. It carved out $12 billion of assets to capitalize the account. The conservatively invested portfolio yielded 8% in 2005. Not bad. The health care cost went up 15%.

The current unfunded actuarial accrued liability of the health care fund is $18 billion as of 2004. Do you follow my point here…?

The average annual salary for a public employee in 2004 was $49,200 compared to $34,500 for everybody else. White collar workers in state and local government had about the same average annual income as private sector workers.

When it comes to pension plan benefits, however, there's a big difference. Public workers get $16,200 per year, on average, versus $7,200 for private workers: a $9,000 annual difference.

The retirement costs for public sector employers are 60% higher than private sector employers. 48 states and half of all local governments provide a defined benefit pension and health care benefits for their workers after retirement.

Ohio has five public pension plans and one deferred compensation plan. Assets total $150 billion. The Ohio pension plans funded ratio ranges from a low of 74% for State Teachers to a high of 87.6% for Ohio Public Employees. Each of the systems is at or near their legislatively mandated contribution rates.

Ohio pension plans with a funded ratio of less than 80% will have to consider their options.

State and local governments have been operating on a pay as you go basis. That is, giving workers an IOU today that will not come due until tomorrow. Well, for public sector pension schemes, tomorrow is now.

And what about the private sector?

The first private sector pension was offered by American Express in 1875. In those days you had to work for the company for 30 years to get a retirement benefit. Again, most people died first.

After World War II, pensions were offered to workers because of the wage freeze. Union leaders saw pensions benefits as a way to boost worker compensation; not to be confused with worker pay.

By 1960 more than 40% of private sector workers had a pension. That's changed! As of 2003 21% of large private companies are offering **both** pension and health care benefit to retirees.

Companies, such as Hewlett Packard, Sears, Verizon Lockheed Martin, Motorola, United, Delta and IBM are freezing their defined benefit pension programs. It is projected that fewer than 10% of retirees will be covered by private employer pension and health-care plans in 20 years.

General Motors has the nation's largest corporate pension plan with $107 billion in assets. GM has to earn 7% on plan assets so it can pay out $6.5 billion a year to retirees and cover the cost of plan administration.

The big three automakers now spend more on health care for workers than they spend for steel. This does not work long term.

The future impact of retirement expenses on private companies will be on display starting this year. Like statements 43 and 45 for public employers, FASB statement 106 requires private companies to put their pension and other post retirement liabilities on the balance sheet. For some companies this will have the effect of cutting shareholder equity.

Speaking of shareholder equity, companies are permitted to include what they expect their pension assets to earn on the income statement. It's called pension credits. Lucent Technologies, for example, reported a profit in 2004 and 2005. The 2005 profit was $1.2 billion. $973 million or 82% were pension credits. The profit from operating the business was $212 million.

If you're evaluating a stock you may wish to look at price/earnings net of pension credits.

Unlike public sector pension plans, private plans can look to the Pension Benefit Guaranty Corporation. PBGC was created by congress in 1974 to protect retirees' benefits if an employer went out of business.

To unload pension liabilities a company must declare bankruptcy. A bankruptcy judge must agree that the company could not survive unless the retirement liabilities are removed from the balance sheet. Getting pension liabilities off the balance sheet is increasingly becoming a business management tool.

The pension insurance fund reported assets of $39 billion and liabilities of $62 billion in 2004; a shortfall of $23 billion. The Congressional Budget Office estimates that the fund deficit will grow to $88 billion in 10 years and to $142 billion by 2025.

Companies pay an insurance premium of $19.00 per employee. There is no risk pricing in the rate structure and Congress is having a hard time raising rates because employers warn that they will stop offering pensions if they are charged higher insurance rates. Catch 22.

Well, there's a lot to think about when it comes to the various public and private pension schemes.

> We can talk about the effect under-funded plans will have on capital markets; or
>
> The need for risk priced pension insurance premiums; or

Are we kidding ourselves using an 8% actuarial rate? Is a rate of 7% to 7.5% a better bet?

What's the prospect that pension reform legislation will heighten transparency of the funded status of plans?

Will policy makers and private pension executives be forced to confront under-funding;

Will heightened transparency cause pension fund investment professionals to look for ways to reduce portfolio volatility? Some economists' project that plans will become net sellers of equities and seek – and thereby bid up - fixed income products.

Who knows?

In short:

Pension fund managers must accept that the cost associated with operating a pension business matters and that lower cost is a potential source of alpha;

That an operational knowledge of best management practice, concisely applied, inside and outside the enterprise, will, over time, improve investment returns;

That the work of the pension fund investment professional is a means to an end - not an end in itself, and lastly;

Your neighbor does not have enough savings or pension income for retirement and you're going to get the bill.

Thank you

Warren Tyler
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