Research supports investing Social Security funds in equities

By Editorial Staff *Thu, Jun 22, 2017*

"Investing a portion (a maximum of 40%) of Social Security trust fund assets in equities would reduce the need for greater payroll tax contributions or benefit reductions," said a new issue brief from the Center for Retirement Research at Boston College.

Given all the reasons not to talk about Social Security—politicians would rather discuss cutting taxes, repealing Obamacare or investigating the president—it's not surprising that so little is heard lately about patching the program's demographically-driven funding hole.

But when the Old Age and Survivors Insurance program regains the spotlight, as it will eventually, policymakers will probably consider investing some of Social Security's excess tax receipts in U.S. equities, as a recent **report** from the Center for Retirement Research at Boston College recommends.

"Investing a portion (a maximum of 40%) of Social Security trust fund assets in equities would reduce the need for greater payroll tax contributions or benefit reductions," said the May Issue Brief. "If equity investment had begun in 1984 or 1997, trust fund assets would be higher than they are currently, despite two major stock market slumps and a financial crisis."

Investing trust fund assets in equities instead of special-issue U.S. Treasury bonds would not be anymore disruptive to the stock market than the equity investing that U.S. state governments already do, wrote Gary Burtless of the Brookings Institution, Alicia Munnell, the director of the CRR, and CRR researchers Anqi Chen and Wenliang Hou.

In addition, "equity investments could be structured to avoid government interference with capital markets or corporate decision making; and accounting for returns on a risk-adjusted basis would avoid the appearance of a free lunch," they wrote.

The idea of invigorating Social Security's investment returns with equities isn't new. It came up two decades ago when then-President Clinton asked the 1994-1996 Social Security Advisory Council to consider options to achieve long-term solvency. It came up again when the George W. Bush administration was considering letting taxpayers direct part of their Social Security contributions into private defined contribution accounts.

The CRR paper doesn't suggest that Social Security should include individual accounts, or that the program turn into a hybrid of defined benefit and defined contribution. They suggest that the equity investment start small and build up incrementally over many years until reaching a maximum of 40%.

Despite their confidence in the higher returns of equities over risk-free government bonds, the authors expect equity returns to be lower in the future than in the past. The average price/earnings ratio of U.S. stocks, which was 25.8 as of last December, suggests future real returns of 3.9%.

The current cyclically adjusted P/E (CAPE) ratio is 28.7 (as of February 2017), suggesting a future long-term return of 3.5% percent. Assuming, as an alternative, that the growth rate of stock prices will equal the growth rate of GDP, the forecast is for 4.3% average real equity returns. The median projection for future returns, the authors write, is 3.9% real and 6.6% nominal.