



Why I want Social Security reform

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The health and future of Social Security has been part of the national dialogue for as long as I can remember. It's been called a Ponzi scheme, broke, and a lie. Let's explore whether these charges have any merit.

I recently discovered an article written by Dr. Adrian Krieg, an author, historian and engineer. He says, "For the last ten weeks, politicians, including Obama and others, have been harping about the out-of-control social costs of Social Security and Medicare and our immediate need to raise taxes and reduce benefits. These political ideologues are liars because the entire Social Security system is nothing but lies."

Pretty strong stuff. Is there any backup for such charges?

His justification is as follows: "According to the Social Security Administration (SSA), the average recipient collects

\$500,000 in retirement benefits but pays in only \$278,000. They lie! What they conveniently don't mention is that if the average beneficiary pays in \$278,000, and the employer matches that with an equal amount, the SSA collects \$556,000 per recipient."

He goes on to point out that the SSA does not pay one cent of interest on monies that they hold for an average of 35 years per recipient. The compounded interest on \$556,000, based on a moderate average of 4% annually beginning with zero and climbing to the total amount paid in at time of retirement, results in about \$540,000 of interest.

Thus the paid-in plus accrued amount per citizen is actually \$1,096,000, nearly \$600,000 more than the SSA pays out. In fact, if the proverbial "Lock Box" into which SS payments are supposed to go actually ex-

isted, then the entire present outlay of all SS payments could be made out of the interest collected on funds in that "Lock Box" – the interest alone! (Note: This data serves as the basis for the suggestion to privatize Social Security.)

Dr. Krieg asked an actuary for the New York Life insurance company to calculate how much NY Life would pay upon retirement at age 65 if the retiree had paid all SS payments to them along with those paid by the employer.

He calculated the retiree would receive \$3,400 per month, or \$40,800 per year. In addition, if he died before age 85 his spouse would receive over \$80,000.

In contrast, the Social Security payout is \$1,200, or \$14,400 per year, and the spouse will receive \$34,000 upon the death of her spouse.

(cont'd page 4)



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Be more like a farmer



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Recently there was an article in the Wall Street Journal that focused on what investors were doing with their money during the tumultuous market conditions we are currently experiencing. As in 2008-2009, many investors expressed frustration with the daily volatility and decided to sell their stocks until conditions improved.

What really caught my attention was that one of those throwing in the towel was a financial planner.

Yes, investing is hard, and most individuals fail because they believe the market is always right. In a market decline, for example, they accept the market's short term verdict and exit the market. Why stay in and lose more money? This is a short-sighted view that usually leads to long term underperformance.

Instead of thinking of the stock market as a casino that is rigged against you by the usual suspects (Wall Street banks, hedge funds, day traders, etc.), envision your portfolio like a farmer thinks about his land.

While the land might be considered his investment portfolio (assets), the crops he grows each year are

analogous to stock dividends. Yes, the farmer does care what happens to the value of his land, but this is a secondary consideration. What is more pressing is how much cash the land can generate each year to cover his expenses.

Investors should ask a similar question regarding their stock holdings. This approach will help investors to avoid panic selling in a down market and help them focus on the long term prospects of the company.

Let's review how this approach worked in the 2008-09 financial crisis. Certainly some companies (banks, etc.) were forced to cut their dividends, but there were many companies (Pepsi, Kimberly Clark, McDonalds & Wal-Mart to name a few) that not only maintained, but increased their dividend.

That's impressive given the type of recession we went through. It would be similar to a farmer being hit with a natural disaster (drought) and still being able to produce his crop. Investors should react similarly.

While the 2008-09 period destroyed a lot of wealth, it also gave us insight into

those companies that can take a punch.

In the past, especially during bull markets like in the 1990's, investors shied away from dividend paying stocks, arguing they were too boring. However, recent studies have pointed out that dividends historically have accounted for much of the stock market's gains. (The tortoise wins the race.)

For those who can afford to reinvest the dividends back into the stock market, the compounding effect will serve your portfolio well. Also, to the extent that the company is able to increase its dividend year after year, then the dividend yield will increase when calculated on your original purchase price. For example, a \$100 stock with a 4% dividend will deliver \$4/yr in dividends. If that company can increase the dividend 7% over the next ten years then the dividend will increase to \$8 or 8% per year.

If that poor financial planner (figuratively speaking and possibly literally) was invested in the proper stocks for his risk tolerance, then he might view the current market situation as a passing storm rather than a level 5 hurricane requiring evacuation.

Market Commentary

This time it's different

Our training and experience have taught us that the above advice is extremely dangerous and almost always wrong. Whether it was the Japanese economic juggernaut of the 1980's, the dot-com bubble of the 1990's or the real estate bubble experienced a few years ago, economic trends do not continue on forever.

Nonetheless, when the unemployment rate has increased from under 5% in 2007 to 9% in 2011, even when the current real GDP is **higher** than in 2007, we are forced to conclude that some new economic dynamics are emerging. This conclusion is reinforced by the apparent lack of success of the most aggressive fiscal and monetary policies we have ever seen.

The initial caveat noted above notwithstanding, the global economic system is experiencing a crisis for which it does not yet have a solution. A comprehensive discussion regarding the causes and potential solutions is beyond the scope of this article. A summary of our thoughts is provided below.

Is the problem fixable?

We are optimistic that pol-

icy solutions can and will be found. We look to the 1970's for what **not** to do. Price controls, profits taxes, high tax rates, regulatory excess, reckless monetary policy and out-of-control spending can ruin the U.S. economy.

We are not convinced of the correctness of Keynesian economics. Bottom line, we find little evidence that it works (see above). Our preferred economist is Joseph Schumpeter, an Austrian economist and a contemporary of Keynes.

Schumpeter's hero was the entrepreneur. The entrepreneur disturbs the existing economic equilibrium and is the prime cause of economic development. Schumpeter is most famous for the phrase "creative destruction," a process in which the old ways of doing things are destroyed and replaced by new ways.

Another word for entrepreneur is "small businessman." Examples include Steve Jobs, Bill Gates, etc. Creative destruction is the process by which companies like Intel, Apple and, more recently, Google, have overturned and reinvented their respective industries. Successful creative destruction results in an

enormous increase in societal wealth and millions of new jobs. The solution to our current economic woes lies in this area.

Investment Strategy

Are the best investment decisions based on a rigorous examination of past historical patterns or by a more subjective degree of belief about an uncertain future? The controversy has never been resolved, but we admit to lean increasingly toward the latter approach.

Spreadsheets that calculate weighted average costs of capital and discounted cash flow projections are useful up to a point, but are not terribly helpful to handicap political calculations that can make or break an economy.

At the end of the day, we are nervous and cautious regarding the short term (12-18 months) market outlook and will invest accordingly.

Longer term, we are confident that the next generation of creative destruction will emerge, and we are decidedly bullish, given current equity valuations.

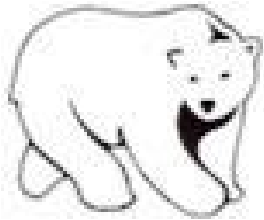


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Why I want Social Security reform (cont'd)

From Dr. Krieg's example, we can see how well-intentioned entitlement programs like Social Security can be manipulated by government in a less than financially responsible manner.

We all want to achieve a secure retirement, have adequate and affordable healthcare and address the needs of the less fortunate members of our society. We acknowl-

edge that achievement of these objectives is extremely difficult in these economic times. It takes leadership in Washington on both sides to effectively address these issues rather than focusing on getting re-elected.

Demonizing those who attempt to address these issues and scaring senators for votes is not leadership. What is

needed is a dose of "creative destruction" that is discussed on page 3 of this newsletter.

