# A REALISTIC VIEW OF RISK AND REGULATORY NEEDS

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In my allotted time this afternoon, I want, obviously, to talk about risk: the common misconceptions of investment risk that prompt many objections to the privatization of Social Security and the more realistic risks with which such a privatized plan must deal. Then, I would like to outline what I believe is a reasonable regulatory regime to guard against such risk without either hamstringing the investor or distorting financial markets as some suggested rules would do.

***Misplaced Notions of Risk***

Apart from the red herring of transition costs, risk is the primary focus of most objections to Social Security privatization. Especially in government circles, those in authority remain concerned that the average American—Joe and Jane Sixpack—will fail to mange his or her investments sufficiently to provide for retirement. Some have worried about how vulnerable Joe and Jane might be to unscrupulous financial types, who will channel their privatized retirement fund into dubious investments and charge high fees that eat up any returns. (The last time I looked, we in this country had the Argus-like vigilance of the Securities and Exchange Commission (SEC) to guard against such abuse, but evidently, some officials lack faith in the ability of other officials to protect the public.) Mostly, however, the objections to a privatized plan worry over Joe's and Jane's ability to invest money properly so that it will survive the inevitable vicissitudes of financial markets and grow enough to provide for retirement.

I will leave questions of rapacious Wall Street to the experts at the SEC. On investment risk, the possibilities, once you get into detail, are, of course, infinite and so, therefore, are the specific grounds on which people can object to privatization. In essence, however, the worries center or three issues, all of which have an answer in standard, indeed elementary investment principles. A modest, that is a minimalist regulatory regime should provide an answer to this risk, though we all must admit from the outset that nothing can erase risk entirely.

The first concern is that Jane or Joe will retire in a down year for the market and so have to cash out with insufficient assets. This, I think, is the most popular worry. Certainly, it is the one I hear and read most often. I cannot see why it is so popular. It not only flies in the face of sound investing; it flies in the face of common sense.

Why, I have to ask, would anyone, whether they are an investment guru or a socialist who hates “The Street,” want to withdraw all their investments on the day that he or she retires? To be sure, that person might want to buy an annuity, but you prepare for that. You do not wake up on the first Monday after you retire and swap your stocks into an annuity. Most people, when they retire, plan to live for a few years, at least, and they want keep their investment to provide for this future. The actuarial tables say that at 65 you have 17-18 years to provide for before it doesn’t matter anymore. Why, then, would you want to withdraw all your money?  Even if you thought that you fit the table perfectly and you planned to eat up your savings gradually until the end, you would only liquidate a little over 5 percent of your holdings in that first year, and even that would take place gradually over the year, not on the day you retire. Such a commonsensical approach would then leave 95 percent of your life savings to enjoy the inevitable up leg of the market’s inevitable variations.

But the damage this argument does to common sense is dwarfed by the violence it does to rudimentary investment sense. Indeed, it shows a complete ignorance of the most elementary of investment concepts. Fear not, I will not launch into a lecture from the financial analysis certification course. But there is a simple rule: Because markets are so very volatile, timing them is a dangerous business, and so you average in and average out, buying bit by bit over time, and selling in the same way. This is called “dollar cost averaging.” It is not rocket science. Neither is it an arcane concept. High school business students learn about it. (Sadly, the collage-bound are left to their own devices.) When you want to get out of the market, because of some life style change like retirement, you plan it well ahead of time and move out gradually over a period of years perhaps, so that you do not get stuck having to cash out in a down year.

So in the first instances, we want our system to dissuade Joe and Jane from throwing their respective portfolios into and out of asset classes quickly.

The second general risk that seems to concern folks about privatization is that Joe and Jane, in their impressionable ignorance, will chase investment fads, like the dot.com craze, getting into them too late (in other words buying high) and getting out too late (in other words selling low.) More seriously, people worry that Joe or Jane will get bad advice, from whatever source including themselves, and place their faith in investments that promise great things and then fail. Since this can happen to even the most seasoned professional -- witness the dot.com craze—the investment principle is always to avoid putting all your money in a narrow group of securities or even a single asset class: stocks, bonds, real estate, and so forth. You diversify your holdings across a number of securities and different asset classes. Presumably, and the statistics verify it, if your holdings are sufficiently diverse, you will dampen the volatility of your whole portfolio and more important, you will guard it against loss in any single holding. The holdings that rise in any point in time offset those that fall.

So in the second instance we want our rules to ensure that Jane and Joe have portfolios diversified across a good number of holdings and across different asset classes.

The last general fear is that Joe or Jane will fail to build a portfolio that is right for his or her circumstances, that he or she will miss needed growth when young or fail to build in the kinds of holdings that throw off income when he or she is older and needs to live off the investment nest egg. There is no denying that different stages in life require different sorts of investments. Young folks should like aggressive, growth-oriented stocks, while old retirees should like bonds and annuities. This is not because young people are adventuresome and like risk, and old folks are not and do not. Rather it is because retirees need income from their investments, which bonds and annuities provide better than stocks, and young people, because they have no immediate need for the funds, can ride out the swings of the stock market in order to capture the greater returns provided—over time—by aggressive growth-oriented stocks.

So in the third instance we want our rules to help Jane and Joe configure their investments accordingly.

### ***Reasonable Regulation***

If our regulations simply direct people according to these simple and straightforward investment principles--avoid market timing, diversify thoroughly, and make the portfolio reflect personal circumstances--they will guard effectively against most investment risks, at least as well as any sophisticated corporate pension does.

Many privatization proposals accomplish some of these objective with unnecessarily rigid constraints. Chile, our great privatization pioneer, for example, goes some way down this road. On my last look, the rules there insisted that investors have at last half their assets in government or government guaranteed securities, no more than 30 percent of their assets in stocks, no more than 7 percent of their assets in one company, and no pension portfolio can own more than 7 percent of a single firm. This certainly covers much of the needed ground. It ensures diversification of a sort and impedes moving money speculatively in concentrated amounts quickly into and out of asset classes. Some proposals have responded differently, trying to meet these needs by suggesting a mandated participation in an index fund, that is a stock fund that mimics a widely known stock index, like the Standard & Poors 500 composite. This, too, imposes diversification of sort.

Aside from imposing excessive constraints, these and other solutions like them can introduce as many investment problems as they solve. Chile's rules, for instance, while protecting against speculative shifts and too much portfolio concentration, fail to allow sufficient flexibility for changes in a person's life. The rigid maximums and minimums on stocks and government bonds make it difficult to pursue growth when young. Such rigid schemes also have drawbacks in that they world impose distortions on markets. Keep in mind that Social Security is enough money, if all Social Security is privatized, to affect even the huge, liquid markets in this country. Take the indexing suggestion, for example. If all the privatized Social Security money followed a single list of stocks, it would drive up their prices relative to those outside of the index list. Imagine what would happen, when, as frequently occurs, a stock is replaced on the list, because of mergers, acquisitions, or simply the relative growth rates of firms. Everyone would sell the stock dropped from the list in order to acquire its replacement. One price would plunge and the other would soar. The traders and arbitrageurs would have a field day. The public would lose on one stock and pay up for the other and to no purpose.

Even a simple quest for administrative control, presumably to keep participants out of certain dangers, needlessly introduces problems. There is, for example, the suggestion that privatization be structured as a kind of national 401(k), where the government administers a scheme, much like many corporations today, in which participants can establish accounts with selected mutual funds. But for a national 401 (k) to be diverse enough, it would to have to have so many options that it would require mind-boggling complexity to administer, certainly centrally, or for participants to make their decisions in. Limiting the number of funds participating, as companies do with corporate 401 (k) plans, would defeat the objective of maximizing diversification. (It would also introduce politics into the selection of funds that can participate).

A better idea would resist such rigid and controlling options. Instead, it would keep our regulatory eye on the investment principles, and that requires allowing for great flexibility and diversification. You get both elements, in part, from a great diversity of opinion. It is fine, I think, to have maximum holdings for individual securities, as Chile has, but beyond that, we want to minimize the control of the actual investment choices, and we want to involve as many advisors and administrators as possible. This need is why it is important that the privatized scheme be structured more like today's IRAs than a 401(k) or more old fashioned corporate model. Setting it up like an IRA, let's call it an SSA (Social Security Account), would involve a legion of financial advisors. Since each of them would presumably bring investment principles to the process, they would keep the individual investor adequately diversified and on track with the right sort of portfolio for his or her time in life. And since each of this array of advisors would bring his or her own take on investing or that of their firm, always, of course, within the general investment principles, the purchasing and sales would be broad-based enough to keep from distorting markets.

Of course, there is some concern about policing these advisors to ensure that they follow the investment principles I have outlined. It is, of course, not sufficient to say that they are all duely licensed by federal authorities and audited by others. There is a need to go beyond that.

First, to ensure that funds actually get invested, we could have each employer send the required deduction directly to a custodian for the SSAs designated by the individual involved. They, in turn, be they a bank or broker or family of mutual funds, would have to have reporting obligations to the authorities, perhaps a rump old Social Security Administration.

Second, to avoid rigid limits, except perhaps mandated percent maximum for individual holdings, I would suggest that the government, in concert with the financial community, establish general portfolio guidelines or a series of guidelines for different stages in a person's life. These would not consist of a list of stocks and bonds. That would impose the concentration that investment principles tell us to avoid. Rather these guidelines would offer a description of the sort of assets that are appropriate. For example, young people just starting their work life would be advised to hold their assets in a diversified stock portfolio maybe one with a growth bias. Middle aged people would get a more conservative picture, with value-oriented stocks for say 60 or 70 percent of their holdings and the rest in high-grade bonds. The guidance for older people would migrate almost entirely toward bonds and annuities. Individuals would have these suggestions as a benchmark against which to compare the advice of their financial advisor. If they preferred, participants could instruct their advisor simply to buy into the model as a fail safe portfolio. The advisors could then implement that order through some kind of a random rotation of qualified mutual funds that fit the recommended criteria. This would guard against too much concentrated buying and ensure, without rigid limits, that each participant was fully diversified.

I have spent time talking about financial advises and I am sure many of you are skeptical about whether Joe or Jane could attract one. Before you dismiss me, go onto the Cato Social Security website and look at the arithmetic there. You will see that very quickly even low wage people in a privatized scheme will have enough to attract financial advisors, and if the advisors are smart, they will cultivate clients even before their assets are big enough to throw off adequate fees so that they will have a loyal client later when those assets do.

One last word on fees. I know there is an impulse to dictate or cap these, but I think we can count on the market to minimize them. We can be sure that every broker, every bank, every mutual funds would want to participate, not just to gain the assets but because it would go hard in marketing elsewhere if they were not a participant in such a visible program. The competition for this business would be intense and could even bring down fees throughout the financial service industry.

These ideas are offered as a start to the discussion. There is much more that needs to be clarified. There are insurance considerations that I have not even mentioned. What I have covered, I believe, captures the critical elements that any regulatory regime must preserve.