

# News You Can Use

## Your investments could be in jeopardy!

Three factors conspire to derail the economy, the stock market, and to a lesser degree, the bond market over the next decade. The aging and retirement of the Baby Boomer population, inflation resulting from a lack of labor (especially skilled labor) supply, and the increasing pressure of government expense obligations all threaten to place a heavier burden on taxpayers, increase the cost of living, and increase sales pressure on investment markets. These factors will be set in motion by the aging U.S. population...

## Boomers: How they will affect your investments next decade

By Chris Renner

The biggest population segment in the United States are called "Baby Boomers"; the segment of the population born between 1945 and 1961 (some extend the definition to 1963). Approximately 28% of the population belong to this segment. More importantly, according to the US Census Bureau, Baby Boomers control nearly half of the nation's wealth. Right now, they are in their peak earning years and preparing for retirement. Beginning in 2010, the first Baby Boomers will reach age 65 and, coupled with pre-Boomer retirees and a death rate factor, over the ensuing 15 years, one-sixth – nearly 17% – of the population will be retired, a statistic that has never before occurred in the history of the United States. (The retiree percentage as of 2000 was approximately 12%.)

From the time they were born, baby boomers have created trends. As kids, baby boomers were behind the explosion of Barbies, Hula Hoops, and primary schools. As teenagers and young adults, automobiles, rock n' roll, and university enrollment reached unprecedented heights. As working adults, baby boomers have led huge expansions in housing and technology and by their sheer numbers created their very own baby boomlet generation. As we prepare for the next decade, these Boomers will begin and continue to retire en masse and not only flood emergency rooms, doctors offices, and hospitals, but also affect the level of employment, fluctuations in the investment markets, residential real estate prices, and political decisions throughout the following 25 years!

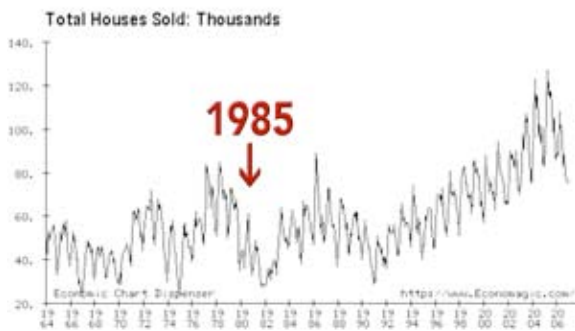
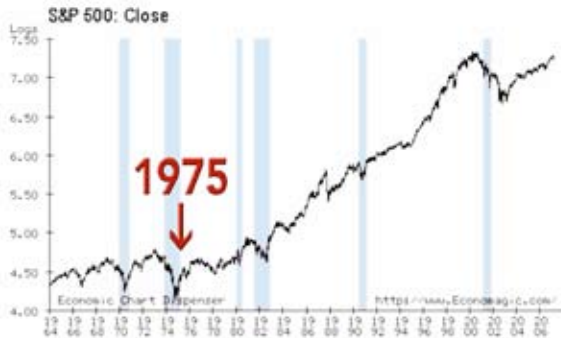
*This is the second in a series of how Baby Boomers will affect America over the next decade. These articles will hopefully create some insight into potential investment opportunities, alert you to some investment hazards, and allow you to consider the potential affects to the overall economy during the next decade. Part 1 ([www.medamerica.com/mafs/newsletters/newsletters.asp](http://www.medamerica.com/mafs/newsletters/newsletters.asp)) highlighted the potential affects of Baby Boomers on health care. Part 2 highlights the U.S. economic climate during the next decade and Part 3 will highlight specific investment opportunities that will take advantage of trends associated with the Baby Boomer retirement years.*

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## Baby Boomers and their Effect on the Economy

As stated on the first page, approximately 28% of the United States population can be classified as “Baby Boomers” and these Boomers will control approximately half of the nation’s wealth<sup>1</sup> by 2010. This wealth is invested in mutual funds, stocks, bonds, real estate and other assets. Much of this wealth has come about through savings, inheritance and investment gains.



In analyzing the effect of the baby boomer on investments, one only has to look at a chart on the growth of the S&P 500, an index used to monitor the performance of the overall stock market. Notice that beginning in 1975, when the average Boomer was age 22 and just entering the work market, until now, the stock markets ended a predominantly flat period and have continued upward virtually unabated. The average American purchases their first house when they hit age 29<sup>2</sup>. The first Baby Boomer hit age 29 in 1974 and the average Baby Boomer reached age 29 in 1982. Since 1982, the number of housing units sold has increased from 34,000 per month in 1982 to over 100,000 per month in 2004 and 2005. It is no coincidence that the median price of a U.S. home during this period has increased nearly 350% from \$69,225 in 1982 to \$236,500 in 2005. There is no question that interest rates and other factors also contributed to this type of growth but the primary factor responsible for this tremendous growth was a question of supply and demand; and the demand of Baby Boomers was the primary force behind much of the investment growth between 1975 and today.

From the time that Baby Boomers became employed members of society until now, the demand for investment assets outpaced the supply of those same assets. By their sheer size, Baby Boomers were buying more real estate, stocks, bonds, and other securities than was either being offered for sale or withdrawn from those same assets. Simply put, when demand is greater than supply, prices rise. It’s a very basic economic principle and Baby Boomers have validated this principle continuously since 1975. It is also why the stock market will likely continue to rise over the next 2 years in advance of the Boomers’ retirement.

However, what happens when the Boomers start to retire? Do all the gains from the past begin to evaporate? Will any potential decline be quick or drawn out? Do the Boomers alone dictate market fluctuations? What other major factors will affect the investment markets over the next decade?

<sup>1</sup> Estimates derived from U.S. Census Bureau, 2000

<sup>2</sup> Century 21 Homebuyer Survey 2006





## Let's introduce some facts:

- As stated before, Baby Boomers make up 28% of the population and control about 48% of the wealth in this country.
- Between 2010 and 2025, approximately 4 million Boomers, or about 1.8% of the population, will retire each year.
- According to the Employee Benefit Research Institute, only 30% of all Americans have saved enough for their retirement. Obviously, that leaves two types of Boomers facing retirement:
- Those who retire and start drawing down their assets from their retirement plans.
- Those who, out of necessity, will delay retirement and continue to work. Eventually, however, these Boomers too, will retire.
- According to the Dept. of Labor's "2002 Consumer Expenditure Survey", American consumers over the age of 65 spend 34% less than a consumer aged 45 – 54. The report also states that, during our retirement, we continue to spend less as we age. While retirees spend less on just about every category (food, clothing, etc.), a greater percentage of income is spent on healthcare, recreation & leisure, and home furnishings (which includes electronics).
- By the middle of next decade, 3.6 million new workers (age 21 – 25)<sup>3</sup> will enter the workforce each year. When offset against the number of Boomers who will retire next decade, there will be on average, 400,000 less workers in the workforce each year from 2012 to 2018!
- Unless our federal legislators intervene, the income tax and capital gains tax reductions in 2001 are set to expire at the end of 2010. (Congress would have to introduce legislation to make the tax cuts permanent. If they never bring the issue up to a vote, taxes automatically increase without one legislator even registering an opinion.) As such, most everyone's federal income tax will increase by about 3% in 2011 and the long term capital gains tax will increase from 15% to 20% in 2011.
- The implementation of GASB 45, an accounting requirement that obligates all governmental entities to account for the future health care expenses of its retirees, goes into effect in January 2008 (fully implemented by January 2009). In the past, these government agencies have paid for retiree benefits from the existing budget using a "pay as you go" approach. However, with the huge increase in Baby Boomer retirees, agencies must cover these benefits as well as the benefits of their existing workers. For example, it is expected that the state of California must come up with \$60 billion to pay for these future benefits. New Jersey and Michigan must come up with \$20 billion and \$30 billion respectively. Even the Los Angeles Unified School District must come up with \$5 billion! Many entities have not performed the actuary analysis to even come up with a number. Judging from initial estimates, these agencies will need to increase their annual budgets by 8 – 10% to satisfy the health care demands that were promised to their workers.
- With the influx of Baby Boomers onto the rolls of Medicare, the level of federal Medicare spending will increase from approximately 13% of Gross National Product to over 20% of GNP by 2025. Current government actuarial computations project Medicare to effectively become bankrupt in 2019.

<sup>3</sup> U.S. Census Bureau – Census 2000

Because of the timing of the Baby Boomer retirement period, these factors could create an economic environment where inflation is higher than average, investment withdrawals are greater than investment purchases, and the level of government expenses necessitates increased government fees, debt incursion, and taxes. Historically, the economy has shown that it can withstand the effects of any one of these factors but with all of these factors converging on next decade at the same time.

- **The Next Few Years will be Good for Investments** - Most Boomers are still trying to sock away funds for their retirement. Remember that only about 30% have saved enough for retirement. Until they actually retire, Boomers, who are in their peak earning years, will be trying to fund their retirement and sock away as much into savings as possible. For the next few years leading into next decade, investment assets should continue to grow because the demand for asset accumulation will be greater than the supply of assets. [With the recent drop in residential real estate demand, stocks and bonds could benefit from this continued demand for higher investment return assets.]
- **Saving vs. Spending** - Prior to 2010 when the Boomers begin to retire, the nation will be at its peak savings rate<sup>4</sup>. Beginning in 2010, 4 million Boomers will go from being "savers" to "spenders" each year. To illustrate, if an individual saved \$10,000 into their 401k at age 64 but retired at age 65 and began "spending", or at least withdrawing from savings \$40,000 each year, there is a \$50,000 "swing" and that individual has gone from being a buyer (or saver) of investment assets to becoming a seller (or a spender) of those same assets.

Beginning in 2010, this transition will begin to put sales pressure on those investment vehicles, driving down the prices of stocks, bonds, mutual funds, real estate and other investment vehicles. As more and more Baby Boomers retire, there will be an increasing amount of spenders and less savers, exacerbating this gap and accelerating the drawdown of assets throughout the next decade. With each succeeding year, the sales pressure (and corresponding drop in prices) will continue until such time that younger workers can earn and save enough to offset the asset sales of retirees.

How long could this decline last? It will continue until the amount of "buyers" or "savers" equals or surpasses the number of "sellers" or "spenders". Remembering that Baby Boomers possess nearly half of all the assets in the United States, the collective remainder of the population (everyone younger than 44 and older than 64) would have to offset the increasing Boomer sales pressure with corresponding purchases to prevent any drop in the investment markets. Frankly, with the supply of newly eligible workers (see below under "Wage Inflation") insufficient to offset the number of retiring Baby Boomers, the number of sellers will outpace the number of buyers well into next decade. Your investment savings are at risk because it is very conceivable that U.S. investment markets will suffer a prolonged drop in prices during the next decade. The stock market declined 47% from 1969 to 1975. It declined 74% from 1929 through 1932. The U.S. stock market is not immune from prolonged declines.

<sup>4</sup> The U.S. Personal Savings Rate (from the U.S. Dept. of Commerce) is widely distributed and has shown that the average savings for an average American has dropped significantly from its high in 1982. In fact, the rate has recently gone negative, meaning that Americans spend more than they earn. However, the Rate is fairly useless because it does not include the amount of savings that Americans place into retirement plans, instead categorizing such investments as expenses.





- **Wage Inflation** - By the middle of next decade, 3.6 million new workers (age 21 – 25) will enter the workforce each year. Unfortunately for the economy, there will be about 4 million retirees each year. That means there will be about 400,000 jobs that go unfilled each year for roughly 6 years! That accounts for about 2% of all the jobs in America! Even if technological improvements, outsourcing, immigration, and workers delaying retirement, account for half of this drop in jobs, there are still and estimated 1.2 million jobs (about 1% of all jobs across the nation) that could go unfilled. When the demand for workers is greater than the supply of workers, the resulting effect is wage inflation, a condition that necessitates the price increase of products and quickly erodes the purchasing power of Americans and is a major factor in overall inflation.

Consider that wages are approximately 67% of a company's expenses. If a company must pay more for its workers, it must ultimately raise the prices of its goods. By raising the prices of a gallon of milk or an automobile or accounting services, the cost of living or inflation also rises. When inflation rises too much, the economy suffers. Purchases of luxury items decline. Mortgage rates increase, making the purchase of a house more difficult. Interest rates increase, making new business investment stagnate.

In prolonged inflationary periods, unemployment ultimately rises and investment returns suffer. One only need look at the late 70's and early 80's to remember what an adverse effect inflation has the U.S. Economy. In 1980, inflation peaked at over 15%, interest rates hit 19%, housing construction all but stopped, unemployment was over 10%, and bonds had negative returns. The stock market rose 7.5% each year from 1980 to 1983 but with inflation averaging 12% during that same time, investors were losing over 4% per year against the cost of living!

The United States is approaching a decade in which the supply of workers will not meet the demand for jobs. At a time when we will probably need more health care workers to meet the health care demands of Baby Boomers, the supply of eligible workers is diminishing. This forthcoming demand / supply inequity will usher in a new era of inflation. Unless technology can make up the difference or retirees postpone their retirement, it is conceivable that inflation could reach double digits by the middle of next decade. If this occurs, Americans' purchasing power will erode, bond prices will suffer, and overall investment returns will not keep up with the cost of living.

- **Government Needs** – The greediest entity in the United States is government. While corporations expand in prosperous times and contract in unprofitable periods, the amount of government spending at nearly all levels never contracts. Since 1920, the level of government spending, has, with the exception of a post World War II period, always increased and as a percentage of Gross Domestic Product, has also always increased. In 1990, federal, state, and local government spending across the United States accounted for nearly 26% of GDP. By 2004, this figure had increased to 32%<sup>5</sup>. That means that out of every dollar the private sector produces, 32% is deducted to pay for government services. By 2010, this number could increase to 35% and with the future effects of Medicare, Social Security, prolonged military expenditures and other health care and pension needs, analysts expect total government expenditures to exceed 40% of GDP by 2020. Without a major overhaul of government expenses, the absolute need for higher government revenues will be inevitable. Bluntly put, this means increased fees, increased government and municipal bond offerings, and ultimately increased taxation. While this means less personal spending for you and me; on a macroeconomic level, increased fees and taxes also mean less money matriculating their way through the economy and less savings ending up in the stock market.

Can government spending be curtailed? Certainly, but entitlements like Social Security and Medicare will continue to grow and force politicians to either make tough cuts in education, defense, and health care or increase revenues by raising fees (permits, tolls, licenses, etc.), initiating bond offerings, or increasing property, sales, or income taxes. Most people are unaware that unless Congress acts proactively, the 3% tax reduction that occurred in 2001 will expire at the end of 2010. Federal income taxes are scheduled to increase by about 3% for everyone in 2011 and the federal capital gains rate will also increase to 20% from 15% in 2011. If you are uncertain as to how higher tax rates affect economic productivity, one only needs to look at the many western European nations that have essentially stagnated since the 1970's because of high tax rates.

Because of huge budget deficits of over \$1 billion, Michigan has cut major portions of its public safety, education, and Medicaid budget over the past several years. They have also stopped reducing a 1.9% single business tax on all businesses and are proposing a 2 cent tax on service industries. New Jersey recently raised their sales tax rate by 1% but still expects a budget deficit of \$170 million this year. California, which has a \$7 billion annual deficit, just proposed a 4% health care fee or tax on hospitals and physicians to cover each Californian's health care. While states like Utah, Arizona, and Georgia have their fiscal house (mostly) in order, if you live in a state with high deficits, you should be very concerned about potential fee or tax increases.

So what are the prospects for additional fees and taxes in the future? As I spoke about in Part I of this series, as Baby Boomers age, their need for health care will grow. Medicare / Medicaid spending could exceed 20% of GNP by the mid Twenties, creating a huge need for tax receipts or, as I stated in part I, an increase in taxes in exchange for a nationalized health care system.

Many states, as well as cities and other municipalities, are also facing a health care crisis because of the Baby Boomers. During the 70's and 80's, when government union employees could not get raises to keep up with inflation, these municipalities promised greater pension

contributions and lifetime health coverage as a trade off. The state or city or district reduced short term expenses in favor of down the road costs. Over the years, health care premiums and expenses have been paid from the existing budgets. However, with the impending retirements of baby boomers and the fact that health care inflation has far outpaced general inflation, the future liabilities for these soon to be retirees has skyrocketed. However, these government entities have continued the "pay as you go" model and only now are beginning to see the effects of not allocating resources for these future expenses.

Recently, accounting standards under GASB ("Government Accounting Standards Board") Rule 45 have been adopted for all public entities. According to estimates required with the adoption of GASB 45, however, public entities are ignoring their future costs and not setting aside funds to meet these promises. It is estimated that the state of California needs to set aside \$60 billion to meet their retiree health care needs (about 65% of the state's annual revenues). Michigan (over 200% of the state's annual revenues) and New Jersey (95% of the state's annual revenues) need to raise \$18 and \$30 billion respectively for future health care liabilities. The Los Angeles Unified School District needs to prepare for potential health costs equivalent to 80% of its annual budget. Some municipalities may follow the lead of Duluth, MN and cease hiring new employees for the next ten years! While these public entities are not obligated to set aside these funds for future use, they do so at their own peril. Failure to recognize the amount will affect their credit ratings and increase the interest rates on their debt obligations.





With health care inflation outpacing overall inflation, the amount of their health care liability will only increase. In order to meet these ever increasing obligations, public entities have three options to meet these and future state expenses: Cut public sector jobs and/or benefits, float additional bonds (perhaps at higher rates of interest), or if they have taxing authority, raise taxes. It is quite conceivable that some public entities will declare bankruptcy over the next ten years!

Given that all levels of government will be expected to provide greater health care services to Baby Boomers, the pressure to raise fees, float bonds, and / or increase taxes will be very tough to ignore. While raising taxes takes spending money away from Americans, it does not always mean that the economy will fall into recession. However, if inflation is higher and Baby Boomers are selling their assets to live on, increased taxes next decade may just exacerbate the problem and hurt the underlying economy and stock market.

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## Summary

In the 1890's, the stock market dropped 35% due to the currency crisis. In the 1930's, the stock market dropped 74% in the Great Depression! In the early 1970's the stock market dropped 47% due to an oil crisis. America is headed into an era where the aging population will take more and more of our resources away from other areas of the economy and funnel them into health care. Will the aging crisis precipitate a substantial drop in the stock market? I don't know. There is no guarantee that these factors will even occur but I believe that even their potential occurrence should cause investors to reconsider their investment allocations over the decade of the Teens. In the next article in this series, I will look at some historical stock market trends and provide some suggestions on how best to allocate your portfolio to prepare for the next decade.

I hope this article was thought provoking. If you wish to call me to discuss the ramifications of these factors on your portfolio, I always welcome your calls. If you are a medical director and would like me to attend a future dept. meeting and discuss investment options for you and your physician colleagues, I will try to oblige. While each participant is ultimately responsible for the investment of their own assets, MedAmerica Financial Services attempts to inform and educate its participants so that they can each make decisions on the allocation of their own assets.

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# CONGRATULATIONS TO OUR PARTICIPANTS!

Using information from 300 Schwab Retirement Plan clients, Schwab has compiled rate of return information for the average plan within their database. In comparison with the average Schwab client plan, MedAmerica clients fared tremendously well over the last two years (the only two years that Schwab reviewed). In 2005, the average participant within MedAmerica's client population earned 1.5% more than the average Schwab participant. In 2006, MedAmerica affiliated participants earned almost 3.3% more than the average Schwab participant! To put that in context, if a MedAmerica participant and an average Schwab participant each started 2005 with \$100,000, you would have earned over \$4,800 more than a similar Schwab participant!

One interesting observation from their data showed that on average, participants who utilized Schwab's Guided Choice Financial Planning assistance, earned about 7% more (over two years) than participants who did not use Guided Choice. If you are unsatisfied with your rate of return, you may wish to explore the benefits of Guided Choice. You can speak with Guided Choice representatives by calling 1-877-285-4929 or by using the weblink at [www.schwabplan.com](http://www.schwabplan.com) and linking to the Guided Choice module that is listed under "[Guidance Links](#)".

## Schwab Initial Rates of Return Results (2005 / 2006)

Schwab Wide Data <sup>1</sup>	2005	2006
<b>Average Rate of Return (all Plans)</b>	<b>6.66%</b>	<b>10.50%</b>
Avg. Rate of Return (Guided Choice)	9.20%	14.11%
Avg. Rate of Return (Non-Advice)	6.60%	9.64%
<b>MedAmerica Client Averages</b>	<b>8.18%</b>	<b>13.78%</b>
EMA (577 Participants)	8.08%	13.57%
EPIC (76 Participants)	8.03%	15.41%
EPMG (466 Participants)	8.05%	14.88%
MA / CEP (1498 Participants)	8.28%	13.45%
Sm. Grp <sup>2</sup> (64 Participants)	7.98%	13.27%

<sup>1</sup> Results based on 300 different plans (over 187,000 participants)

<sup>2</sup> Small Group Data includes participants from Arizona Emergency Physicians, DeKalb Emergency Physicians, Iroquois Emergency Medicine Specialists, and Willamette Emergency Physicians