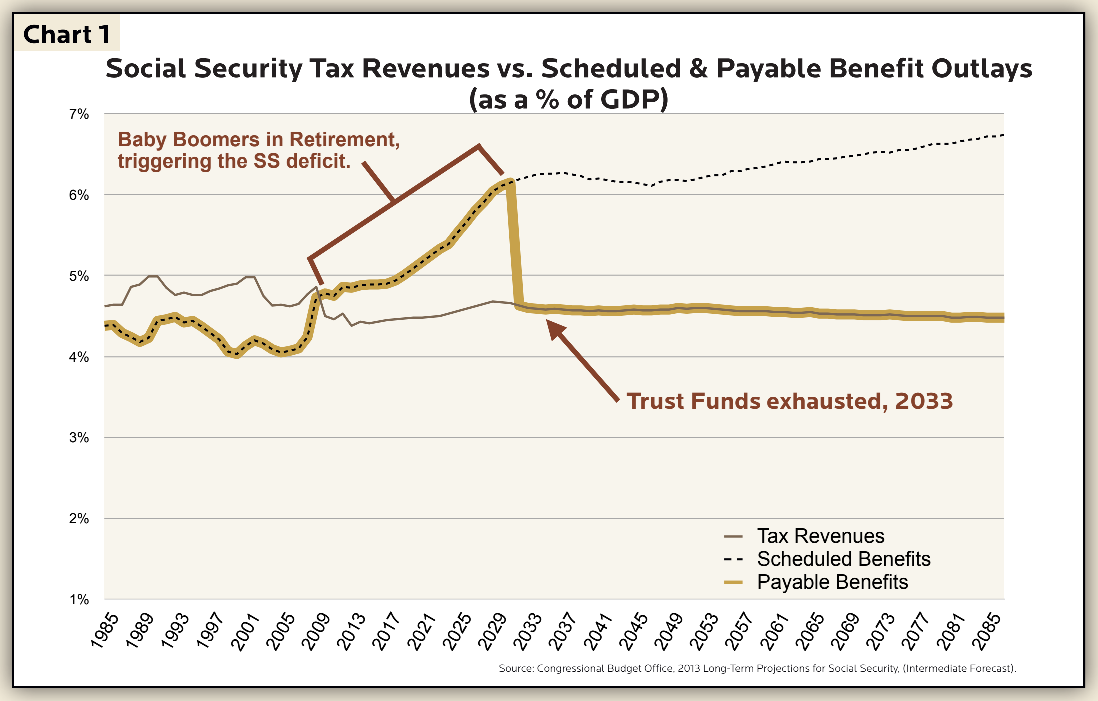
GHP Investment Advisors, Inc.
INVESTMENT INSIGHT
Second Quarter 2014

Social In-Security

Mike Sullivan, CFP®

"The social security program….cannot remain static. Changes in our population, in our working habits, and in our standard of living require constant revision."
President John F. Kennedy, 1961



If you attended our Economic Forum in May, please put this newsletter down and, by all means, go on enjoying your summer. Otherwise, the following is a refresher on the current status of the Social Security system and its implications for your retirement plan.

The Social Security Administration will turn 80 next year, and if it is to see 100, reform is vital. Since 2009, benefits paid out to retirees have exceeded tax revenues collected from workers (**see Chart 1**). This ongoing benefit deficit is projected to swell into the future along with the burgeoning ranks of Baby Boomer retirees, and as the Boomers march onward into retirement, the ratio of worker-to-beneficiary will continue to shrink. The 1960's ratio of 5 workers per beneficiary has fallen to 2.8 today, and is projected to eventually flatten out at 2 workers per beneficiary in the year 2030. Finally, one added "problem" is Americans are living longer lives, which typically equates to longer retirements, requiring more benefit outlays.

The good news is there are a variety of measures available to revise the system with relatively mild consequences. ***We even have precedent from the Reagan years to serve as a guide for reform that can be phased-in very slowly with modest tax increases and benefit cuts.*** Therefore, while restoring balance to the expanding deficit will require modifications impacting many of us, we believe a navigable course is attainable and the system will remain largely intact for current retirees and for posterity.

The Mechanics of Social Security, the Trust Funds and the Long-Term Deficit

From 1983 through 2009, tax revenues collected by the Social Security system exceeded all benefit outlays. Each year these surplus revenues were deposited within the two Social Security trust funds established for general retiree benefits and disability benefits. As a result, the trust funds grew from less than $25 billion to over $2.7 trillion during this period. These trust assets are invested in US Treasury bonds, which currently yield around 4% or $110 billion per year.

After more than 25 years of surplus, we are now in the fifth consecutive year of deficit. When deficits exist, the Social Security Administration (SSA) can dip into the trust fund assets to allow scheduled benefit payments to remain as promised. ***However, if the trust funds are exhausted, the SSA is prohibited from borrowing in order to bridge the scheduled benefit payments deficit.*** In this scenario, by law, the SSA may only make benefit payments equal to prevailing tax revenues in that year.

Current projections provided by the Congressional Budget Office (CBO) estimate trust fund depletion sometime around the year 2033. At this time, all scheduled benefits will be cut by an estimated 20-25% to put them on balance with annual tax revenues. Of course, such a reduction in benefits would cut deeply into the retirement income sources for a vast number of Americans.

Possible Options to Restore Long-Term Balance to Social Security: Tax Increases or Benefit Cuts

In dollar terms, the current annual deficit is roughly $80 billion or 0.5% of GDP. Most actuarial studies put forth by the SSA and the CBO project a 75-year deficit average ranging from 1% to 1.5% of GDP. Using today's GDP figures, this means tax revenues will eventually fall short of benefit payments by $160 billion to $240 billion – each year. So we either do nothing for 19 years and then we all receive a 25% benefit cut, or reform measures are implemented to either raise tax revenues, cut benefits, or some combination of these two.

The following are a few proposals for ***payroll tax increases*** that would narrow the deficit:

1. **Raise the payroll tax rate by 1% from 12.4% to 13.4%.** The most recent rate increase of roughly 1% was phased-in during the Reagan years, beginning in 1983. Employees split this tax rate with their employers, so a 1% increase would only add 0.5% to employee taxes.
2. **Raise the payroll tax cap from $117,000 to $180,000.** Social Security payroll taxes of 12.4% are only levied on earnings up to $117,000. In the 1980's, the cap (which does inflate each year) was targeted to capture 90% of all employment earnings in the US. ***However, due to the faster growth of earnings for higher income groups compared to lower and middle income groups, the current cap only covers 83% of all earnings. Boosting the cap to about $180,000 would recapture 90% of all earnings.***
3. **Eliminate the payroll tax cap.** Removing the cap would be similar to the way Medicare payroll taxes are currently applied.

The following are a few proposals for ***benefit cuts*** that would narrow the deficit:

1. **Index the Full Retirement Age (FRA) to changes in longevity.** The most recent increase of the FRA occurred in 1983 by setting the FRA at 67 for people born after 1960. This provided a 44-year phase-in for the impacted workers. A longevity index would only increase the FRA if improvements in mortality rates occurred, and would likely involve gradual phasing-in.
2. **Reduce the annual benefit Cost of Living Adjustment (COLA) by 0.5%.** The COLA is currently set to move upward with inflation. The 2014 COLA increase on benefits was 1.5%. Therefore, this COLA cut would have instead increased benefits by only 1.0%. There are several other wide-ranging proposals for adjusting the annual COLA increase.
3. **Reduce benefits for higher earners.** Once again, there are a number of proposals floating around concerning cutting benefits for higher earners, which promote the continuation of the progressive structure of Social Security (i.e. the system is considered progressive because retirement benefits replace a greater rate of employment earnings for those in lower income groups when compared to replacement rates for higher income groups). While most of these benefit-cut proposals are layered with complexity in the formula, ultimately, the average cuts would equal 10% to 15% of current benefits.

Other Reform Options: Means Testing, Investing the Trust Funds, or Privatization

"Keep your retirement and your so called Social Security….turn me loose and set me free." ~ *Merle Haggard*

Beyond raising taxes or cutting benefits, the following options have also been proposed:

Means-Testing: In other words, eliminating or reducing benefit payments for retirees with higher incomes. For example, a married couple declaring income of over $170,000 on their tax returns would have their benefits eliminated or reduced in the following year. This would impact approximately 5% of retirees, and their benefits would be reinstated if subsequent income levels fell below this threshold. ***Proposals for means-testing usually underscore that Medicare Part B premiums have been means-tested since 2007.***

Investing the Trust Funds: Rather than invest the trust fund assets conservatively in Treasury Bonds yielding 4%, follow the more diversified investment format akin to many state pension funds. Such funds, like Colorado PERA, invest over 50% of total assets into global stock allocations. PERA's 10-year annualized returns exceed 8%. However, the big catch with investing Social Security trust fund assets concerns the intra-governmental borrowing occurring with the $2.7 trillion. A complex system of IOU's exists at the Federal level, which includes these trust funds, making them dissimilar to pensions like PERA. Therefore, investing trust fund assets in anything other than US government bonds would prove challenging.

Privatization: Although proposals for privatization of Social Security are less popular in the post-financial crisis era, it is unlikely they will completely fade away. The most recent effort to implement privatization occurred a few times during George W. Bush's presidency.

GHP Investment Advisors' Case Study Concerning Benefit Cuts for Upper and Lower Income Groups

More than half of all retirees today (20 million+), derive over 65% of their retirement income from Social Security (**see Chart 2**). Therefore, an all-encompassing 25% benefit cut sometime around 2033 would have drastic implications for many in the lower and middle income groups. Conversely, those in the top income groups would experience a less material impact to their overall financial circumstances if benefits were cut, as they derive only a minority percentage of their income from Social Security.

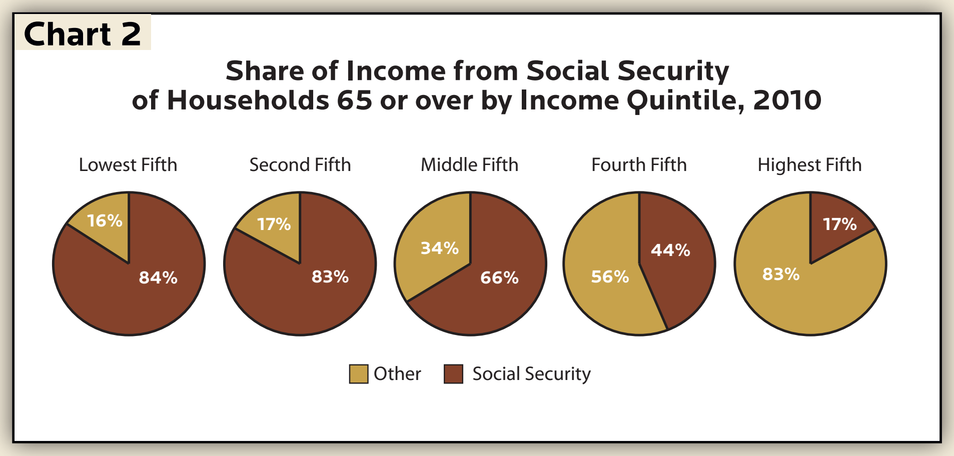
As most of you know, we regularly build financial models and forecasts for our clients to analyze retirement security, net worth and liquidity. We ran a few hypothetical projections to evaluate the impact of a 25% benefit cut on a 62-year old retiring in the year 2033 with $300,000 in net worth versus a **50%** benefit cut on a 62-year old with $3,000,000 in net worth (**see Charts 3 and 4)**. For both models, spending was kept constant, and we overlaid each projection with a glimpse of what the net worth would grow to if benefits remained as scheduled, without cuts. As we anticipated, the results were stark. Note the rapid collapse of net worth for the $300,000 case study by this person's age-81 (represented in red) as contrasted by the relatively flat net worth for the $3,000,000 model. ***Such an example illustrates the necessity of unreduced benefits for retirees in the lower income or net worth ranges and could portend as to which income groups are likely to incur the fuller brunt of Social Security reform.***

Conclusion

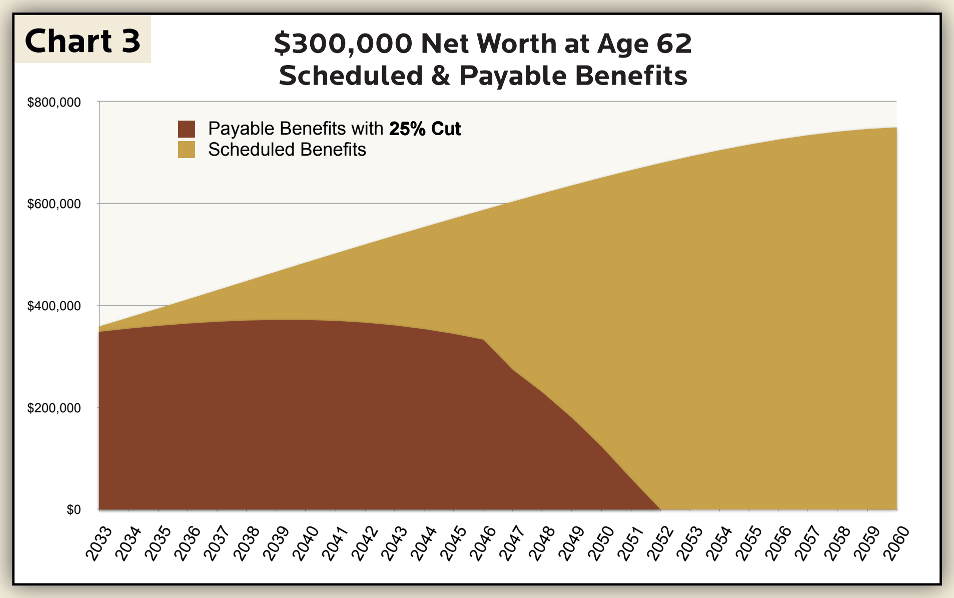
"Whiskey is for drinking; water is for fighting over." ~ Mark Twain

If Twain was still around today, then maybe he would have replaced water with Social Security for this statement. In discussions with clients and by ascertaining the general public sentiment, Social Security reform measures are quite polarizing. We prefer to assuage our clients' concerns by stressing several factors that frame the Social Security system in a more positive light.

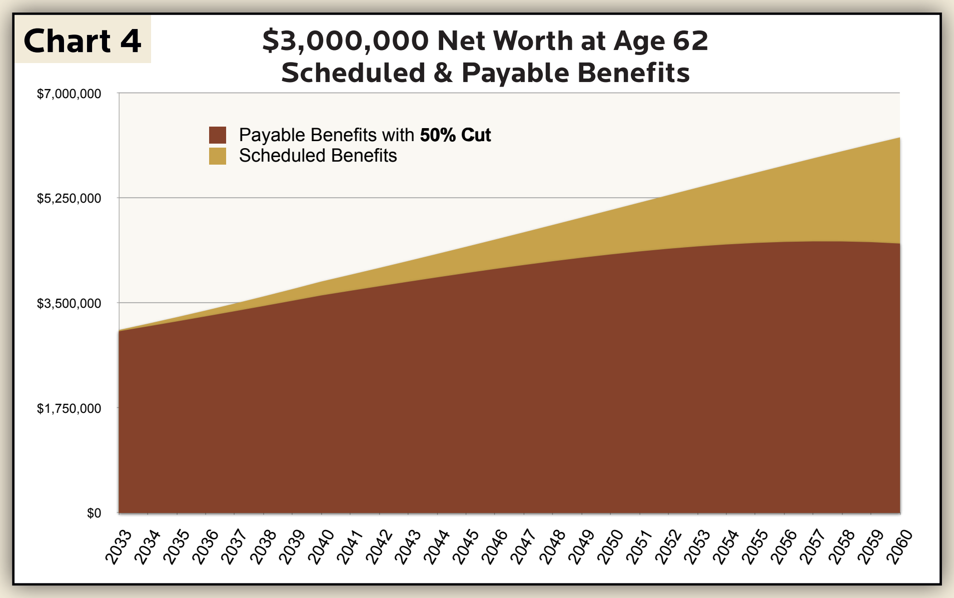
First, the system is not heading towards bankruptcy; rather, it would merely become insolvent with respect to upholding scheduled benefit payments if trust funds are in fact exhausted sometime during the next 20 years. Even in those uglier scenarios, payable benefits would still be maintained at 75% of former levels. Second, successful reform measures have been implemented in the recent past with rather modest adjustments, most of which were phased-in very slowly. Third, the SSA is prohibited from borrowing, and therefore, would be unable to increase US debt levels in order to balance its ongoing benefits deficit. Forth, although younger generations will undoubtedly bear the greater burden of Social Security modifications, they should have a lengthy period to adapt to these changes, allowing them ample time to increase their personal retirement savings and ensure financial security. Finally, if benefits are not cut for lower income groups and no sweeping tax increases are instituted, clearly, higher income groups will become the balancing force to narrow the deficit. While reform measures may be unpleasant for any income group, Social Security benefits represent a much smaller percentage of income for higher income groups; therefore, cuts would be less material to their retirement security. Wherever the fight goes with Social Security reform, be it taxes or cuts, we believe the necessary changes will be surmountable for our clients and for generations to follow.



Source: Social Security Administration, Income of the Population 55 or Older, 2012.Forecast).



Source: GHP Investment Advisors, Inc. & NaviPlan® V. 14.1.



Source: GHP Investment Advisors, Inc. & NaviPlan® V. 14.1.

The GHPIA Equity Valuation Dashboard

Asset Class	Price/ Earnings 2014:Q2	P/E Benchmark	Over/ Under Valuation	Price/Book Value 2014:Q2	P/BV Benchmark	Over/ Under Valuation	Price/ Cash Flow 2014:Q2	P/CF Benchmark	Over/ Under Valuation
Large-Cap Growth Stocks	**20.9**	**27.0**	**-22.6%**	**4.2**	**5.7**	**-26.3%**	**13.7**	**17.5**	**-21.7%**
Large-Cap Value Stocks	**15.6**	**20.2**	**-22.8%**	**2.0**	**2.5**	**-20.0%**	**7.4**	**13.1**	**-43.5%**
Mid-Cap Growth Stocks	**24.8**	**24.8**	**0.0%**	**3.4**	**4.5**	**-24.4%**	**14.7**	**16.1**	**-8.7%**
Mid-Cap Value Stocks	**21.9**	**19.1**	**14.7%**	**1.9**	**2.2**	**-13.6%**	**11.3**	**12.4**	**-8.9%**
Small-Cap Growth Stocks	**26.1**	**23.2**	**12.5%**	**3.1**	**3.5**	**-11.4%**	**15.0**	**15**	**0.0%**
Small-Cap Value Stocks	**27.2**	**18.2**	**49.5%**	**1.8**	**2.1**	**-14.3%**	**10.6**	**11.8**	**-10.2%**

**Please note that the P/E data reported above are based on "as reported" earnings information rather than "operating" earnings. "As reported" earnings include one time write-offs whereas "operating" earnings reflect the profitability of a company as a going concern. We believe P/E ratios based on operating earnings are a better long-term valuation indicator, but Standard and Poor's does not report this information for the style indexes used in our calculations. To address this issue we have also included Price to Book Value (P/BV) and Price to Cash Flow (P/CF) data, which are other important valuation indicators.*

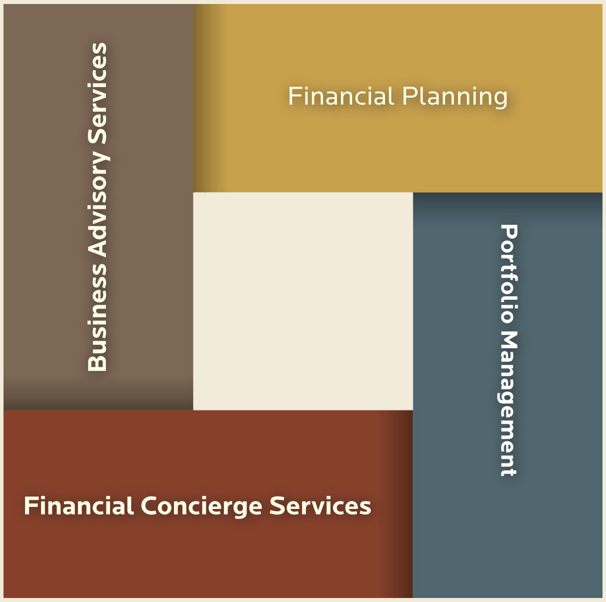
GHP Investment Advisors, Inc. benchmarks are based on proprietary models. P/E, P/BV and P/CF data are provided by Bloomberg L.P. as of 07/02/2014.

Returns by Index

Index	2014:Q2*	YTD*
DJIA Total Return	**2.83%**	**2.68%**
NASDAQ	**5.31%**	**6.18%**
S&P 500	**5.23%**	**7.14%**
S&P 500/Value	**3.96%**	**5.65%**
S&P 500/Growth	**5.38%**	**6.42%**
S&P MidCap 400/Value	**5.31%**	**9.00%**
S&P MidCap 400/Growth	**2.64%**	**4.59%**
S&P SmallCap 600/Value	**1.88%**	**3.65%**
S&P SmallCap 600/Growth	**1.60%**	**1.49%**

DJIA, NASDAQ & S&P Returns: Bloomberg L.P. as of 07/02/2014.

*Dividends Reinvested.



Financial Planning
We create a personalized financial plan to help you meet your wealth management goals – and give you peace of mind.

Portfolio Management
We develop and implement an integrated portfolio investment strategy, taking into account your individual investment goals, time horizon and risk tolerance.

Financial Concierge Services
We relieve you of the everyday burden of your financial affairs.

Business Advisory Services
We help you drive your continued success as a business owner, executive or entrepreneur.

Investment Insight is published as a service to our clients and other interested parties. The information within is not intended as investment advice. To update your address or to request additional copies of Investment Insight, please contact Sommer Vincent at (303) 831-5055.

GHP Investment Advisors, Inc.
Registered Investment Advisor

1670 Broadway, Suite 3000
Denver, Colorado 80202
P (303) 831-5000
F (303) 831-5082
Invest@GHPIA.com
www.GHPIA.com

Brian J. Friedman, CFA President
Robert W. Hochstadt, CPA/PFS Senior Principal
Steven I. Levey, CPA/PFS Senior Principal
Carin D. Wagner, CFP® Vice President of Personal Wealth Management
Sommer C. Vincent, RP® Client Relations Manager
Mike Sullivan, CFP® Wealth Management Advisor
Ron New Fixed Income Portfolio Manager
Deirdre McGuire Client Relations Specialist
Barbara Terrazas Client Relations Assistant
Brad Engle Research, Trading and Portfolio Analytics
Sebrina Ivey, CPA, CIA Operations and Compliance Manager
Dave Garcia Data and Operations Analyst
Ed Leone Jr., DMD, MBA, CFP®, RFC Associate