HEAD INVESTMENT PARTNERS

Fiduciary Hot Topics

Q2 2023

Without Congressional Action the Social Security Trust Funds will be Exhausted in 2034

- If current trends continue, the Social Security trust funds will be completely depleted in 2034. This is according to the most recent annual report published by the Trustees of Social Security. This is one year sooner than was projected in last year's report.

- While the media often portrays the situation as more dire than it is, if Congress does not effect changes before 2034, there will have to be a reduction in scheduled benefits. The only fixes are to increase payroll taxes, cut benefits or a combination of the two. Without a fix, it is estimated that when the trust funds are exhausted Social Security will only have enough income to pay approximately 80 percent of scheduled benefits.

- Social Security has always run on a "pay-as-you-go" basis. A major overhaul was required in 1983 to keep the System solvent. Congress moved the retirement age out to reflect increasing life expectancies and greatly increased payroll taxes.

- Following these changes, for almost three decades, income received by Social Security exceeded benefits paid. As a result, the trust funds have accumulated $2.9 trillion in assets. The cash flow surpluses realized by Social Security were borrowed by the federal government to meet its current needs. As a result, the assets in the trust funds consist entirely of US Treasuries. Arguably, this approach made sense as it allowed the government to meet its financial needs without borrowing more from the public.

- For the first time in 2021, benefits paid by Social Security exceeded income. If these deficits continue, the trust funds will be exhausted in 2034.

- Factors adversely affecting Social Security's finances include an economic slowdown, persistent inflation and weaker productivity growth. This is compounded by two demographic trends. The aging of the population due to

declining birth rates and the wave of retirements. Approximately 10,000 “baby boomers” are retiring every day.

- The Trustees annual report includes 75-year projections for the System. Over this period, the Trustees estimate the shortfall between income and scheduled benefits will represent 1.2 percent of GDP.
- Many commentators have stated that delays by Congress in making necessary reforms increases the deficit. This is not correct. The Increasing deficits are an artifact of the 75-year projections. Each year another year is added to the 75-year projection period with a relatively large deficit.
- However, it does makes sense for Congress to act sooner rather than later as the burden of necessary changes will be borne by more age groups. The continued delay means younger workers will shoulder a greater portion of any changes.
- Also, continued delay increases the size of necessary tax increases or benefit reductions. The Trustees estimate that an immediate increase in the payroll tax to 15.84 percent, or a 21.3 percent cut in benefits, would make Social Security solvent for the next 75 years. The current tax is 12.4 percent, divided equally between employers and employees.

Social Security Stats

$1.1 trillion	Income Social Security will realize from payroll taxes, taxes on benefits and interest in 2023
$1.24 trillion	Benefit payments in 2023
$2.9 trillion	Assets in Social Security Trust Funds
183 million	Workers covered by Social Security (90% of work force)
58 million	Workers age 65 and older in 2022
76 million	Workers age 65 and older in 2034
2.8	Number of covered workers for each beneficiary in 2022
2.3	Number of covered workers for each beneficiary in 2034
$1,614	Average monthly benefit in 2023 ($19,370 per year)
50%	Percent of beneficiaries for whom Social Security represents 50% or more of their income

ESG Investing - Congress jumps into the Fray and the President Issues His First Veto

- ESG investing, (sometimes known as socially responsible investing), aims to generate returns by picking stocks based on environmental and social concerns and issues of corporate governance. This is in addition to looking at the financial metrics of companies.
- ESG investing has been a political football in Washington for many years. As administrations have changed, the Department of Labor has gone back and forth over the years on its position regarding ESG investing. Democrats

endorse the concept while Republicans tend to be skeptical. The debate over ESG has become even more heated in the last year and it now appears it may be an issue in the upcoming presidential election.

- Notwithstanding the controversy surrounding ESG investing, it is clearly here to stay. A major reason there continues to be strong interest in ESG investing is the growing concern regarding climate change.

- At the end of last year there were nearly 600 mutual funds with an ESG mandate, up from a little over 300 at the end of 2019. Assets in ESG funds are now approaching $40 trillion. Last year, mutual funds and ETF's had net outflows of $370 billion for the first time on record. However, ESG funds defied this trend with net inflows of $3.1 billion.

- Even traditional asset managers, who do not follow an explicit ESG strategy, feel pressure to adopt ESG policies requiring consideration of factors other than traditional financial criteria in evaluating companies.

- The returns of ESG funds suffered in 2022 because these funds tend to have relatively high exposure to technology and little or no exposure to energy, the top performing sector last year. This left the many ESG funds in the bottom quartile of their peer group. However, most of these funds have three and five year returns in the top half of their peer group.

- At the very end of the Trump administration, the Department issued final regulations on ESG investing which made it difficult for plan fiduciaries to add ESG options to plan investments. Almost as soon as President Biden took office, his administration announced it would roll back these rules.

- Proposed regulations published in 2021 arguably mandated consideration by plan fiduciaries of ESG factors, especially climate change. However, the final regulations published last November backed off significantly. Under the final rule, plan fiduciaries may consider ESG factors, but the regulations make clear that the core ERISA principal remains that the duties of prudence and loyalty must prevail. In other words, plan fiduciaries cannot sacrifice returns to accomplish ESG goals.

- Despite the fact the Department backed off in its final rule, the response from Republicans in Congress was to introduce the "Safeguarding Investment Options Act." This legislation would amend ERISA by limiting consideration of nonfinancial factors in investment decisions for defined contribution plans.

- This bill passed the House along party lines. It passed in the Senate 50 to 46 with Joe Manchin of West Virginia and Jon Tester of Montana, two Democratic senators, joining Republicans.

- President Biden vetoed this bill. This was the first veto of his administration. An attempt to override his veto, failed. Overriding a veto requires a two thirds vote in both houses.

- Not to be outdone, three Democratic representatives have introduced a bill in the House which would amend ERISA to explicitly allow plan fiduciaries to consider ESG factors in making investment decisions.

- This bill is fairly modest in what it attempts to accomplish. It would incorporate the tie-breaking approach in the final rules issued by the Department at the end of the Trump administration although with a somewhat lower standard. Also, this bill would make explicit that additional documentation of the consideration of ESG factors is not required. In view of the fact both houses voted for a bill amending ERISA to prohibit ESG investing, it seems unlikely this bill has much chance of passing.

The Majority of States Have Implemented or are Considering Programs for Private Sector Workers Not Covered by An Employer-Sponsored Plan

- A fundamental flaw of the private retirement system in the United States is many small employers do not sponsor a plan leaving about a third of the workforce without a retirement plan.

- While ninety-one percent of employees in state and local governments are covered by a retirement plan, in the private sector this number drops to 68 percent. Although 86 percent of individuals are

covered in managerial professional positions and related occupations, this number falls to 40 percent in the services sector.

- Most states have established programs to facilitate retirement saving for private sector workers not covered by an employer sponsored plan. Forty-six states have either implemented such a program, introduced legislation to establish a plan or authorized a study. Only four states have taken no action - Alaska, Alabama, Florida and South Dakota.

- These programs are similar in design:

    - An IRA is established for each participant;
    - These IRAs must comply with the requirements in the Internal Revenue Code;
    - These IRAs are funded entirely with employee contributions;
    - In most programs these are Roth IRAs, although some programs allow the participants to elect a traditional IRA;
    - Employees are automatically enrolled and must affirmatively elect out;
    - Employers that do not sponsor a retirement plan must participate / the only exception is New Mexico where participation is voluntary;
    - Very small employers are exempted / California, for example exempts employers with fewer than five employees;
    - Employers are required to give employees notice of the program, collect contributions and forward these funds to the state;
    - There is no cost to the taxpayers as these programs are self-sustaining / administrative expenses are paid out of participant accounts;
    - The governor appoints a board that oversees ongoing administration which includes high-ranking members of state government such as the state treasurer and the commissioner of insurance;
    - The investment lineups are typical of defined contribution plans / the default is a target date fund and there are often index funds tracking US and global equities.

There are now over half a million participants in these programs. Assets exceed half a billion dollars, most of which is in the programs of Oregon, California and Illinois. The companies contracted to administer these programs are some of the better-known names in the business including Vanguard, State Street and BlackRock.

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