Stock Market Perspective: Is the Market a Ponzi Scheme?

The term has been used for dramatic effect, but usually incorrectly, recently by some politicians, which is hardly a surprise, but also by a few financial commentators who should know better. Some Republicans, including a "leading" contender for their presidential nomination (and for all I know a few Democrats also) have used the term to describe Social Security. Using their "logic" much of the stock market and other financial activities are also Ponzi schemes. I will dig into these claims by discussing what a Ponzi scheme really is and "revealing" Social Security's true nature as an insurance policy.

Is buying stock in Apple or Berkshire Hathaway a Ponzi scheme? The "logic" of some politicians says yes.

The reason given for calling Social Security by that derogatory term is that its payouts depend on money taken in from new "investors" (that is, taxpayers). While that is certainly true and is also the case for a true Ponzi scheme, it is a common arrangement for many financial activities. In other words, just because the money for future payouts is not already in hand and depends on a future source of funding does not make an arrangement questionable.

Let's apply the "thinking" to investing in stocks. When one buys a stock or a mutual fund that owns stocks, what are the sources of potential returns? One is that owners may receive dividends, so stocks can be a source of continuing income. However, many stocks do not pay dividends. For example, Warren Buffet has said that his company, Berkshire Hathaway, will never pay a dividend (at least as long as he is involved). Another notable example is Apple Computer, which has an enormous amount of cash on hand, but has never paid a dividend and apparently has no plans to do so. So how do investors who buy shares in these companies and the many, many others—often considered to be "growth" stocks—expect to profit? They hope to sell it to someone else for more than they paid for it. That other party may be the company itself, but that is hardly certain, and the two cited above have never repurchased shares[1]. Nonetheless, one would have profited handsomely by buying their shares, several years ago in the case of Berkshire, and later selling them. The buyer of the shares sold would be a "new investor" by either making an initial purchase or increasing the number of shares owned. So buying one of those stocks was getting taken in by a Ponzi scheme? I think you know the answer.

One might point out that stocks represent ownership of "real assets" (although in some cases those have proved to be mainly an illusion and not very real) that one hopes can generate profits. However, there is no way for an ordinary investor to force the sale of the assets in order to receive a payout from the stock. Moreover, as will be discussed, Social Security also has real assets.

Now let's see what characterizes a true Ponzi scheme. The defining trait is a promise of unrealistic and unsustainable paybacks. The typical ones, such as the one run by the eponymous con artist Charles Ponzi, promise "investors" enormous returns in a short time. The one run by Bernie Madoff took a different approach by promising very good and consistent returns with virtually no losing months. In all cases, the schemes do not own assets that can produce the promised payouts, but instead count on money coming in from new participants to provide returns to the earlier ones.

[1] After I wrote that, Berkshire announced that they will start repurchasing shares. Even so, the point is still valid since an investor can't be sure that the company will buy back some of its shares or when it will do it.

Does Social Security fit that description? Hardly. First of all, what Ponzi scheme requires one to pay in for a long time, a minimum of ten years and more typically forty or more? And what kind of exceptionally large returns does one get? Several years ago, President Bush was pushing to privatize all or part of it because it was a poor investment. Can you imagine a con person trying to get your cash by promising you such? Of course, there are examples of those who collect far more than they paid in, namely those who live to a ripe old age. However, there are those who die much younger who collect little or nothing at all although their families may get some survivor benefits.

The above describes an arrangement that could be offered by an insurance company. One pays premiums to the company for a certain amount of time and then, depending on circumstances, gets one or a series of payments; the latter usually is called an annuity. This is exactly how Social Security works. In addition to the retirement benefits annuity, it also provides disability insurance and to some extent life insurance in the form of survivor benefits that may be received by the deceased's family. Since it is insurance, it is not fair to describe or evaluate it as an investment.[2]

When one buys a policy from an insurance company, one of the risks is that the company won't be around or have sufficient assets to make the payments called for by the policy. How do these apply to Social Security when we view it as an insurance policy? I believe we can count on the "company" behind it, the U.S. government, being around or we likely will have much more serious worries. What about the assets behind the insurance? Some critics say there are no real assets, that it is all bookkeeping paperwork involving in effect IOUs to oneself in a kitchen drawer. They are referring to the "trust fund" that holds U.S. Treasury securities. There is a degree of truth to the criticism in that one part of the government, the part that spends money, has borrowed from another part, the Social Security trust fund. However, that does not make the trust fund's assets, U.S. government debt, any less real. If it does, we have managed to fool just about the whole world since our Treasuries are owned by governments, corporations, investment companies, banks, and individuals around the world because they are considered to be as safe or safer than any other investment. In other words, there is no way there will be a default on the holdings in the Social Security trust fund unless there is a default for all other holders.

(The question of how we will come up with the money to redeem our debt securities as they mature and issue new ones, likely in greater amounts, is a separate issue. It is at the core of the current "debate" about reducing the deficit, but it has no effect on Social Security being an insurance arrangement, not a Ponzi scheme.)

It has been pointed out that assuming the current rules about "retirement age" and how the payouts are determined, the trust fund will have used up all of its Treasury assets, possibly in the not very distant future. At that point, if Social Security were a private insurance company, it would be unable to meet the terms of its policies, so it would declare bankruptcy and not make all or part of the policy payments. It is unlikely this would happen with Social Security[3] because there are yet other assets behind it. Two of them are the ability to impose taxes and the capability of "printing" dollars.

[2] As an interesting side issue, for most workers purchasing this insurance is mandatory. One objection to the recent health care legislation is that it requires having medical insurance, although not necessarily from the government. Unless one candidate's assertion that Social Security is unconstitutional and hence illegal is valid, it seems that the government can require purchasing insurance in some cases. It will be interesting to see how the Supreme Court deals with this question and if what they rule may impact Social Security.

[3] This is a separate issue from the discussions about raising the retirement age and reducing the way payouts are calculated for future beneficiaries. In effect, this is saying the terms of the insurance policy will not be as attractive as they currently are. The terms have been changed in the past in both regards, so there is no reason to think such won't happen again.

To the extent the latter increases inflation, it is a hidden tax. If a genuine Ponzi scheme literally printed dollars, it would also be guilty of counterfeiting.

The next time you hear or see someone claim Social Security is a Ponzi scheme, either ignore them, or, if you can, ask them if they think buyers of Berkshire Hathaway and Apple have been duped into one.