Investment Policies and Procedures of the Social Security Trust Funds

by Robert J. Myers*

In this article, the Deputy Commissioner of Social Security for Programs describes the policies and procedures that have been followed in investing the assets of the Social Security trust funds, explores possible alternative investment areas, and counters criticisms of investment results and maturity durations. The author's analysis shows that a departure from the current practice of investing most of the assets in long-term special issues of Federal debt would have adverse consequences for the private industrial economy, the Treasury Department, or the economy in general. He notes that, although the interest income of the trust funds in 1980 amounted to only 2.46 percent of the Social Security program's total income, the amount involved—$3.85 billion—was 1.5 times as large as total administrative expenses.

This article discusses the current and past investment policies of the four Social Security trust funds—the Old-Age and Survivors Insurance (OASI) Trust Fund, the Disability Insurance (DI) Trust Fund, the Hospital Insurance (HI) Trust Fund, and the Supplementary Medical Insurance (SMI) Trust Fund—especially as they relate to securities that are specially issued to the trust funds. The investment of the assets of these funds is, by law, the responsibility of the Secretary of the Treasury, as Managing Trustee of the Board of Trustees of the several trust funds. However, the Social Security Administration has, understandably, always taken a great interest in this matter.

Although the interest income of the Social Security program is not a major factor in its financing—whereas in funded private pension plans investment income is a very significant element—neither is it of negligible importance. For example, in calendar year 1980, the interest income of the four trust funds was only 2.46 percent of the total income. However, such interest income amounted to the not insignificant sum of $3.85 billion, which was 1.5 times as large as the administrative expenses of the program.

Investment Procedures

The basic operating principles as to investing the assets of the trust funds have changed relatively little since the program was enacted. In general, the trust funds receive the taxes and other income and pay the benefits and administrative expenses. The excess of the income over the outgo is invested in obligations of the Federal Government, and the interest therefrom augments the income of the system.

Before July 1940, the authorized appropriations to the Old-Age Reserve Account (as it was called then) were not specifically to be measured by the taxes collected, but rather they were to be "an amount to be determined on a reserve basis in accordance with accepted actuarial principles." Underlying legal and constitutional aspects that made a distinct division between the taxes collected and the benefits paid seemed desirable. In actual practice, however, this language was interpreted to mean that the appropriations should be the estimated net proceeds of the taxes, after deduction for the estimated administrative expenses (which procedurally were paid out of the General Fund of the Treasury but, of course, in practice came from the gross Social Security tax receipts).

After the program was declared to be constitutional in 1937, this indirect procedure was no longer necessary. As a result, the 1939 Amendments to the Social Security Act provided for the current automatic-appropriation basis, under which the Social Security tax collections are automatically appropriated to the trust funds as they are collected by the Treasury Department.

The trust funds can be invested in any interest-bearing security issued by the Federal Government. Some regular Government securities have been bought, both on

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the open market and when they were offered to the general public. Also, special legislation has provided that certain semi-Government issues—such as those of the Government National Mortgage Association—can be purchased by the trust funds, even though they are not guaranteed as to both principal and interest by the Federal Government. Most of the investments, however, have been in special issues of Federal debt that are offered only to the trust funds. As of June 30, 1981, about 92 percent of the assets of the four trust funds were in such special issues (table 1).

The original 1935 Act provided that any such special issues should bear an interest rate of 3 percent. The 1939 Amendments changed this basis so that newly acquired special issues would carry an interest rate slightly below the average coupon rate on all interest-bearing obligations of the United States outstanding at the end of the month preceding their issuance.

The 1956 Amendments to the Social Security Act changed the interest basis for special issues so that it was determined from the average coupon rate on all long-term Government obligations (those issued initially for 5 or more years), rounded to the nearest 1/8 percent. The 1960 Amendments revised this interest basis, so that the interest rate is now determined from the average market yield rate on Government obligations that are not due or callable for at least 4 years from the date of determination. The actual experience over the years as to the interest rates applicable to special issues and the durations until their maturities is described in the appendix to this article.

For some years, the maturity dates of newly issued special issues have been set by a definite procedure, which was established by the Managing Trustee with the agreement of the other Trustees—and not by the law. Specifically, as soon as payroll-tax revenues are received by the Treasury Department, any funds available for investment are put into special issues called certificates of indebtedness. These certificates mature at the end of the investment year, which runs from July 1 to the following June 30.

Each June 30, the certificates of indebtedness are redeemed and the proceeds are put into long-term special-issue bonds, each with a maturity date of June 30 in some future year. The terms to maturity of newly acquired special issues are set so that, as much as is possible, one-fifteenth of the total portfolio of special issues (including those bonds on hand on the June 30 date) will mature in each of the next 15 years. This procedure has the result, generally, of a sizable proportion of the bonds being purchased on any given June 30 having a maturity of 15 years thereafter (because on the previous June 30, when long-term bonds were bought, this point of time was beyond the 15-year period then considered).

Table 1.—Distribution of assets of Social Security trust funds, by type, June 30, 1981

[In millions]

Category	Total	OASI	DI	HI	SMI
Total assets	$52,430	$27,147	$3,884	$17,599	$3,800
Special issues	48,412	23,393	3,569	17,659	3,791
Marketable securities [1]	2,291	1,996	295	....	....
Participation certificates	605	555	....	50	....
Undisbursed balances	1,121	1,203	19	-110	9

[1] U.S. Treasury securities only (participation certificates of the Government National Mortgage Association are also marketable, but are not included here).

During the investment year, securities must be sold to meet benefit obligations (which peak at the beginning of the month for the OASI and DI Trust Funds, but not for the HI and SMI Trust Funds). The special issues with the shortest durations until maturity are sold first. Thus, any certificates of indebtedness are the first to be so sold. In the event that there are several securities with the same duration until maturity, those with the *lowest* interest rate are sold first.

When special issues are sold, they are redeemed by the Treasury Department at their par value, which is their purchase price. This option is not available to other purchasers of Federal securities who might wish to sell them and is of considerable financial advantage to the trust funds in times of rising interest rates (which, in general, has been the situation in the last two decades). If the investments were required to be made only in marketable obligations, the securities would be redeemable only on a market-value basis. Under such conditions, significant losses of principal would often be involved, especially when securities with low coupon interest rates were redeemed. Under other circumstances, this procedure of redemption of special issues at par value could produce an unfavorable result for the trust funds compared with a market-value redemption basis—namely, when the securities to be sold have a higher coupon interest rate than the average market-yield rate at that time.

In summary, the procedure followed as to redemption of securities before their maturity is an equitable one insofar as the trust funds are concerned. In recent years, when interest rates have been rising, this procedure has generally (but not always) been financially advantageous to the trust funds. Further, because of the rules being prescribed, all conflicts of interest involving the Managing Trustee are eliminated.

Possible Alternative Investment Areas

Although there has, at times, been considerable opposition to investing the excess income of the system in Government bonds, no compelling case has been offered for any other form of investment. All other possibilities seem to have one or more objectionable features.

One possible investment practice would be to purchase securities of private concerns, either bonds or

stocks, as part of the portfolio. There are several objections to this approach. First, with the large amounts of money possibly available (especially if the trust-fund balances increase in the future from their present relatively low levels), the Federal Government would control a considerable portion of the private industrial economy, which would, in effect, result in "socialism by the backdoor method."

Another practical disadvantage would be the need for a far-reaching and deep-searching investment policy that would permit the trust funds to obtain an adequate rate of interest with reasonable security of principal. Under such a policy, the Federal Government would, in effect, be setting itself up as a rating organization, because the investment procedures would naturally have to be open to full public view. If no preference were shown for different types of securities, but rather investments were made widely and indiscriminately, there would be a substantial risk of diminution of investment income, or even loss of principal.

In any event, a sizable proportion of the trust-fund assets would have to be invested in Government securities, because of the wide fluctuations in the fund balances, both over the months of a year and over the days of a month. The redemptions of securities needed for these purposes would disrupt the private market if the investments were in private-sector securities.

Another possible procedure would be to invest the funds in social and economic activities such as the construction of housing, hospitals, and the like (as is done in some countries). This method would be open to objection on the grounds mentioned previously—increased governmental entry into private fields of activity. Even more serious is the argument that any use of public funds for such purposes should be under the control of the elected representatives of the people (Congress), rather than a social insurance organization. Also, such forms of investment are not very liquid, and the monies involved would not be readily available at times when outgo exceeded income. Accordingly, it may properly be concluded that investment of the assets of the Social Security trust funds are most properly invested only in securities of the Federal Government.

Criticisms of Trust-Fund Investment Results

In light of current high interest rates, there has been criticism of the investment results of the Social Security trust funds. For example, it has been pointed out that, during the 12-month period ended June 30, 1980, the effective annual rate of interest earned by the combined OASI and DI Trust Funds was only 8.4 percent, whereas at that time private money managers were earning about 13 percent.

This is not a valid comparison, because it contrasts the investment return of a portfolio of securities purchased over a long period with the current, relatively high new-issues rate. The securities bought by the trust funds in the past bore interest rates that were proper and equitable at the time of purchase.

On the other hand, the high interest rates quoted for private money managers are those obtained for securities purchased currently. Any private investment organization that has built up a portfolio over the years (and has done so in a prudent manner) would currently have a much lower *average* rate of investment return for its total portfolio than it would for securities bought currently. Another important element in such comparisons is whether the investment procedure is to invest in short-term obligations or in long-term ones (which matter will be discussed in the next section).

Thus, in comparing current investment managers, one should not simply measure the average rate of return on their total portfolios, which may have been acquired with much different timing, but rather one should take into account other factors—for example, how they are doing on their current investments. In that regard, the Social Security trust funds have been obtaining relatively high interest rates on their current investments. For example, the interest rate on special issues acquired in June 1981 was 13 percent, and it was at this rate that some $20 billion of new issues were acquired on June 30, with maturities of up to 15 years.

Moreover, as old securities mature, and as new higher-interest securities are purchased, the *average* effective rate of return for the assets of the trust funds will rise. Thus, compared with the rate of 8.4 percent for the year ended June 30, 1980, the rate for the year ended June 30, 1981, was 8.8 percent. Table 2 shows these effective rates of return for various years for each of the trust funds. It is significant to note that, despite each of the funds receiving exactly the same rate on special issues purchased at the same time, the average effective rates for various years differ significantly. This is, of course, due to the different times of purchase of the various securities.

Also, it is significant to note in considering the investment rate of return of the OASDI Trust Funds in the 12-month periods ended June 30, 1980, and June 30, 1981—8.4 percent and 8.8 percent, respectively, or an average of 8.6 percent—that the net rate of investment income (before Federal income taxes) of all United States life insurance companies in calendar year 1980 was 8.0 percent.[1] Thus, the trust funds had an investment experience closely comparable with that of life insurance companies in the aggregate.

A life insurance company formed in 1980 would, of course, have had a much higher rate of return, because it would be holding only new investments, bearing a

[1] American Council of Life Insurance, **1981 Life Insurance Fact Book**, 1981, page 61.

Table 2.—Effective rates of return for Social Security trust funds in various years

12-month period ended June 30	Rate (percent)				
	OASI	DI	OASDI	HI	SMI
1961	2.7	2.7	2.7	(1)	(1)
1962	2.8	2.9	2.8	(1)	(1)
1963	2.9	3.0	2.9	(1)	(1)
1964	3.0	3.1	3.0	(1)	(1)
1965	3.1	3.2	3.2	(1)	(1)
1966	3.3	3.6	3.3	(1)	(1)
1967	3.6	3.9	3.6	4.6	4.6
1968	3.9	4.2	3.9	4.9	4.8
1969	4.1	4.8	4.2	5.3	5.2
1970	4.7	5.6	4.8	6.0	5.9
1971	5.2	6.1	5.3	6.5	6.4
1972	5.3	6.1	5.4	6.7	6.2
1973	5.5	6.1	5.6	6.4	6.1
1974	5.9	6.4	6.1	6.7	6.8
1975	6.5	6.8	6.5	7.2	7.1
1976	6.8	6.8	6.8	7.2	7.2
1977	6.9	7.0	6.9	7.3	7.4
1978	7.2	7.4	7.2	7.4	7.4
1979	7.4	7.9	7.4	7.7	8.2
1980	8.3	8.8	8.4	8.2	8.3
1981	(2)	(2)	8.8	8.9	8.7

[1] Trust fund began operation in 1966.
[2] Rate not computed because of distortion caused by reallocation of OASDI tax rate between OASI and DI during year.

Table 3.—Average market-yield rate[1] on marketable interest-bearing obligations of the United States, as of the beginning of June of various years

Year	Rate (percent)		
	All obligations	Special-issue rate for trust funds in June[2]	Difference
1967	4 1/8	4 3/4	-5/8
1968	5 3/4	5 5/8	1/8
1969	6 1/2	6 1/2	. . .
1970	5 1/2	7 5/8	-2 1/8
1971	5 1/4	6 1/8	-7/8
1972	4 5/8	5 3/4	-7/8
1973	6 7/8	6 5/8	1/4
1974	8 3/8	7 5/8	3/4
1975	6 1/4	7 3/8	-1 1/8
1976	6 5/8	7 1/2	-7/8
1977	6	7 1/8	-1 1/8
1978	7 3/4	8 1/4	-1/2
1979	9 1/2	8 3/4	3/4
1980	8 7/8	9 3/4	-7/8
1981	14 7/8	13	1 7/8

[1] Rounded to the nearest 1/8 percent.
[2] Average market-yield rate of U.S. marketable obligations with 4 or more years until maturity.

relatively high rate of interest. This, however, would not "prove" that the company was a sagacious investor or, on the contrary, that the older, well-established companies were stupid investors.

Criticism of Duration of Investments

Finally, the criticism has, at times, been levied that the Social Security trust funds should be invested in short-term obligations of the Federal Government, rather than long-term ones. It would have been feasible for the investments of the Social Security trust funds to have been put in short-term obligations subject to a rollover every year (or even every month) instead of in long-term obligations, generally having a maturity length of 15 years. Such an investment procedure could presently take advantage of the high current short-term interest rates. In hindsight—just as with other investment experience—this strategy might have proven to be more advantageous.

Certainly, the general experience in the past has been that long-term interest rates are somewhat higher than short-term ones, even though this is not so at the moment. Accordingly, over the long run, the long-term-interest-rate procedure would seem preferable. Table 3 compares the average market-yield rate of all obligations of the Federal Government with the corresponding long-term rate that the trust funds have received on new special issues. For 1967-81, the interest-rate basis used for Social Security trust-fund investments was higher than the all-obligations rate in 9 years (with 1 year being the same). The average excess was 0.35 percentage points.

Furthermore, the current high interest rates of, say, 13 percent are unlikely to last for much longer. With interest rates lower in the years ahead, a change now to short-term securities would not be nearly as advantageous as continuing the present procedure and having the very large amount of long-term investments that are now "locked in" at 13-percent interest, compared with the much lower rates that might be obtained in the future.

Another investment strategy that is recommended occasionally is for the assets of the Social Security trust funds to be rolled over each June 30 into new securities with the highest current yield, but only for such existing securities that have a lower yield than current yields. Such a strategy would be very advantageous to the Social Security program, but correspondingly disadvantageous—and, in fact, inequitable—to the General Fund of the Treasury, which would have to pay the higher amounts of interest due from general revenues. Thus, while the Social Security trust funds would do better with such a strategy, the additional interest earnings would *ultimately* be reflected in higher Federal income taxes or in a larger Federal deficit. In other words, it would be an indirect form of general-revenue financing for Social Security. And then too, private investors are not given this "best of both worlds" possibility.

Summary and Conclusions

The present investment policies and procedures for the Social Security trust funds seem to be proper and equitable both to these funds and to the General Fund of the Treasury. Likewise, both the insured persons under Social Security and the general taxpayers—who are, by and large, the same persons—seem to be treated in a fair, equitable, and consistent manner.

The rates of return obtained by the trust funds currently appear reasonable in light of past investment experience. It can well be viewed that the appropriate investment procedure is to choose one investment policy and remain with it, rather than attempt to do better by speculating, through jumping back and forth among investment strategies.

Appendix

Durations Until Maturity of Special Issues

In 1940-43, the new special issues in which the assets of the Social Security trust funds were invested were for durations of 4 or 5 years. Beginning in 1944, some new special issues were for durations of 1 year or less; beginning in 1945, all new special issues were of this duration. Accordingly, beginning in 1947, the entire investment portfolio was reinvested each year on June 30. This procedure was followed until 1957, when a transition was begun toward spreading the investment portfolio of each of the trust funds over the following 10 years. Investments during a fiscal year were made in certificates that matured at the end of the year, on June 30. At that time, the funds from the maturities were reinvested in long-term notes (up to 7 years until maturity) or bonds (with maturities of 7 years or more).

Then, in 1959, the permanent portfolio of special issues was spread more or less equally over the next 15 years, and this principle was followed until the late 1960's. Then, to be equitable to the trust funds as interest rates rose above 4 1/4 percent, this principle was suspended, and new special issues were given a maturity of 7 years, because other provisions of law prohibited a rate higher than 4 1/4 percent for longer-term securities. Such prohibition was removed insofar as the trust funds were concerned in mid-1974. Blocks of special issues at an interest rate of 7 5/8 percent were then purchased with the funds available for investment, in equal amounts maturing in each year 1981-89. Since 1974, the "equal spreading over 15 years" principle has been followed.

Interest Rates on Special Issues

The special-issue interest rate was initially 2 1/2 percent (in 1940), but as large volumes of long-term Government bonds were floated to finance World War II, the rate gradually decreased and reached a low of 1 7/8 percent in the period from May 1943 to July 1946. Thereafter, the rate gradually rose to 2 5/8 percent for the period from July 1958 to September 1960, which was the last month before the new basis provided by the 1960 Act went into effect. (The interest rates on special issues purchased from January 1951 to December 1981 are shown in table I.)

When the interest basis was changed by the 1956 Amendments to the Social Security Act (effective for October 1956), there was no change in the rate actually made available to the trust funds. As it happened, under the conditions prevailing at that time, the new method of basing the rate on long-term obligations (rather than on all obligations) produced a slightly lower unrounded rate, but the change in the rounding procedure produced a final result that was exactly the same as the previous basis.

The new basis under the 1960 Amendments produced a sharp increase in the special-issue interest rate, yielding rates of 3 5/8 to 4 percent for issues purchased in the last 3 months of 1960—appreciably in excess of the 2 3/4-percent rate that would have been in effect under the old basis. During 1961-65, this interest rate was generally between 3 3/4 percent and 4 1/4 percent, but thereafter it rose significantly, reaching a high of 7 7/8 percent in February 1970. Then the rate fell somewhat and was about 6 percent during 1971-72, but rose to about 6 3/4 percent during 1973. It increased further in 1974, reaching a peak of 8 1/8 percent in September, but fell to about 7 to 7 1/2 percent thereafter through 1977. In 1978, the rate increased to as much as 8 7/8 percent and was as high as 10 1/2 percent in late 1979. It then increased sharply in early 1980, peaking at 12 3/8 percent in March, then fell to 9 3/4 percent in June, and thereafter rose to 12 1/8 percent in December. In 1981, the rate experienced a rising trend and peaked at 15 1/4 percent in October, falling to 12 1/2 percent for December.

Table I.—Interest rates on special issues purchased monthly by the Social Security trust funds from January 1951 to December 1981

Month	Rate (percent)							
	1951	1952	1953	1954	1955	1956	1957	1958
January	2.125	2.250	2.250	2.375	2.250	2.375	2.500	2.500
February	2.125	2.250	2.250	2.375	2.250	2.375	2.500	2.500
March	2.125	2.250	2.375	2.375	2.250	2.375	2.500	2.500
April	2.125	2.250	2.375	2.375	2.250	2.500	2.500	2.500
May	2.125	2.250	2.375	2.375	2.250	2.500	2.500	2.500
June	2.125	2.250	2.375	2.250	2.250	2.500	2.500	2.500
July	2.250	2.250	2.375	2.250	2.250	2.500	2.500	2.625
August	2.250	2.250	2.375	2.250	2.250	2.500	2.500	2.625
September	2.250	2.250	2.375	2.250	2.375	2.500	2.500	2.625
October	2.250	2.250	2.375	2.250	2.375	2.500	2.500	2.625
November	2.250	2.250	2.375	2.250	2.375	2.500	2.500	2.625
December	2.250	2.250	2.375	2.250	2.375	2.500	2.500	2.625
Average annual rate	2.188	2.250	2.354	2.302	2.292	2.469	2.500	2.562
	1959	1960	1961	1962	1963	1964	1965	1966
January	2.625	2.625	3.750	4.000	3.750	4.125	4.125	4.625
February	2.625	2.625	3.750	4.000	3.750	4.125	4.125	4.750
March	2.625	2.625	3.625	3.875	3.875	4.125	4.125	5.000
April	2.625	2.625	3.750	3.750	3.875	4.250	4.125	4.750
May	2.625	2.625	3.625	3.750	3.875	4.125	4.125	4.750
June	2.625	2.625	3.750	3.750	3.875	4.125	4.125	4.875
July	2.625	2.625	3.875	3.875	3.875	4.125	4.125	5.000
August	2.625	2.625	3.875	4.000	3.875	4.125	4.125	5.125
September	2.625	2.625	4.000	3.875	4.000	4.125	4.250	5.375
October	2.625	3.625	3.875	3.875	4.000	4.125	4.375	5.125
November	2.625	3.750	3.875	3.750	4.125	4.125	4.375	5.000
December	2.625	4.000	4.000	3.750	4.000	4.125	4.375	5.000
Average annual rate	2.625	2.917	3.812	3.854	3.906	4.135	4.198	4.948
	1967	1968	1969	1970	1971	1972	1973	1974
January	4.625	5.625	6.000	7.750	6.125	5.625	6.125	6.750
February	4.500	5.375	6.125	7.875	5.875	5.875	6.375	6.750
March	4.750	5.375	6.250	7.000	5.625	5.750	6.500	6.875
April	4.375	5.625	6.250	7.000	5.250	6.000	6.625	7.375
May	4.750	5.625	6.125	7.625	6.000	5.875	6.500	7.750
June	4.750	5.625	6.500	7.625	6.125	5.750	6.625	7.625
July	5.125	5.500	6.625	7.500	6.625	6.000	6.750	7.875
August	5.000	5.250	6.625	7.375	6.750	5.875	7.500	8.000
September	5.125	5.375	6.750	7.250	6.000	6.125	7.000	8.125
October	5.250	5.375	7.625	7.000	5.875	6.125	6.500	7.750
November	5.625	5.500	7.000	7.000	5.625	6.125	6.625	7.625
December	5.625	5.625	7.250	6.125	5.875	6.000	6.625	7.375
Average annual rate	4.958	5.490	6.594	7.260	5.979	5.927	6.646	7.490
	1975	1976	1977	1978	1979	1980	1981	
January	7.125	7.250	6.375	7.625	9.000	10.000	11.875	
February	7.125	7.250	7.125	7.750	8.750	10.750	12.125	
March	6.875	7.250	7.125	7.875	9.000	12.375	12.875	
April	7.250	7.125	7.125	8.000	8.875	12.250	12.500	
May	7.625	7.125	7.125	8.000	9.000	10.375	13.500	
June	7.375	7.500	7.125	8.250	8.750	9.750	13.000	
July	7.375	7.375	7.000	8.375	8.500	9.625	13.250	
August	7.500	7.250	7.125	8.375	8.750	10.125	14.000	
September	7.625	7.125	7.000	8.250	9.000	11.125	14.875	
October	7.875	7.125	7.125	8.375	9.250	11.500	15.250	
November	7.375	6.875	7.375	8.875	10.500	12.000	14.250	
December	7.625	6.500	7.375	8.625	10.000	12.125	12.500	
Average annual rate	7.396	7.146	7.083	8.198	9.115	11.000	13.333	