TRUST

INVESTMENT PERSPECTIVES

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It's All About Medicare

It's been another excellent year for both the U.S. stock and bond markets. For 2012, the S&P 500 Index was up 16 percent while the Barclays Aggregate Credit Index was up 8 percent. Although the uncertainty of the presidential election did cause a decline in the stock market this fall, the market rallied 6 percent in the last six weeks of the year.

Of course, the real issue is what's going to happen in 2013 and beyond. While markets have been volatile lately, particularly due to the focus on the "fiscal cliff," we're actually optimistic that we will have positive but below average stock returns in the coming year. We have decent valuations as the S&P 500 is trading at 14 times last year's earnings, respectable but not great expected earnings growth, reasonable expectations about the economy that we should be able to satisfy, continued stimulus from both fiscal policy and monetary policy and a moderately improving labor market.

With respect to the bond market, interest rates are near all-time lows which means that bond prices are high and that means we should be very cautious. Over the longer-term, our high and growing federal debt will likely lead to higher interest rates. Given that long-term outlook, we feel investors should avoid the temptation to stretch for yield by investing in longer-term bonds. Of course, while higher interest rates would mean lower bond prices, we'd welcome the return to more "normal" yields where your bond investments actually earned a real return from their coupon payments.

Since the markets seem to be focused on the fiscal cliff, I want to take some time to share my thoughts on the topic. The fiscal cliff actually makes me both optimistic and nervous at the same time. My optimism stems from the fact that we're finally discussing the real long-term issues that will affect us, our children and our grandchildren: we spend more than we take in, we already have too much debt and we've made promises for the future that we cannot keep. My nervousness comes from the possibility that our politicians will continue to "kick the can" down the road and not deal with the biggest underlying problem: government expenditures on healthcare (primarily Medicare and Medicaid).

While the fiscal cliff was averted as 2013 dawned, the agreement between Congress and the President was not the solution many had hoped for. Maybe it was too much to expect that the Republicans and Democrats would finally address the long-term structural issues that underlie our problems. We have been running annual deficits of more than one trillion dollars for each of the last four years and our elected officials appear unwilling to put partisan politics aside to construct a viable long-term solution to our deficit and debt problems.

SPENDING VS. TAXES

Currently, everyone seems focused on their divergent views as to how to solve our short-term deficit. To oversimplify the debate, Democrats would like to raise taxes on those with the highest incomes while Republicans would like to reduce government spending. At this point, I think most of us recognize that our debt has now risen to a level that we're going to have to do both: cut spending and raise taxes. With that said, if you look at the chart on page 3, from a historical perspective spending appears to be more of a problem than taxes.

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James F. Arens II
Executive Vice President & Chief Investment Officer

VIEWPOINT

A Message from the Desk of Tom Wilkins

I always like the promise of a new year and 2013 is no exception. Sure, I will miss 2012 — at least in some ways. It was certainly a good year for stocks and bonds. As we visited with clients near the end of the year, many were surprised at just how good of a year it was for their investments. It also was an exhausting year though, with the term "fiscal cliff" replacing "Happy New Year" as 2012 expired.

We go into 2013 with a fresh energy. Several of our colleagues received well-deserved promotions at the end of 2012. While I don't want to leave anyone out, there were more promotions than I have space to list. What a great problem to have! I will point out our new senior vice presidents: Cameron Turner, portfolio manager, Joanna Murphy in personal trust, and Karen Ellis, manager of our retirement benefits group. In addition, two colleagues are brand new officers: Jean Kates in personal trust and Vicky Brown in the retirement benefits group. Please take a look at the back page to see all of our officers. All promoted officers have an asterisk by their name. Congratulations to all.

With the start of every new year, we at Trust Company are reminded just how fortunate we are to be working for the clients we have. From our earliest days, our company has been built upon the trust and confidence you have placed in us. Every day is a joy to be here because of you. I thank you for your support, confidence and friendship.

Thomas W. Wilkins *Chairman, President & Chief Executive Officer*

For me, there are three takeaways from this chart. First, over the last 66 years, taxes have averaged 18 percent of GDP while spending has averaged 20 percent. Second, over the past few years, spending has increased to 24 percent of GDP (4 percent above the historical average) while taxes have declined to 17 percent of GDP (1 percent below the historical average). A significant part of this dismal change has been caused by the recession as the government has been spending more to stimulate the economy and provide a safety net to those who lost jobs. Of course, tax revenue has decreased because there are fewer people working, payroll taxes have decreased and fewer capital gains are being reported. Third, if we want to avoid a situation in which our debt-to-GDP ratio explodes, our spending will have to decrease while our tax revenue will likely need to increase.

As we continue to debate these issues, it's easy to recognize that reasonable people can disagree as to whether we should increase taxes or cut spending. The reality is that most citizens don't want to pay higher taxes, but they don't want their benefits cut either. While we continue to struggle with this debate, we must also recognize that this debate has a cost. We have great uncertainty with respect to taxes and their effect on the overall economy and this has made some businesses reluctant to hire employees and/or invest their capital. Unfortunately, this uncertainty will continue until we put together a long-term solution.

Our problems are deeper than what appears to be a short-term political dispute. As we have discussed in past articles, our government's debt is reaching unsustainable levels. Our debt is now $16.4 trillion which represents a 7 percent increase over the last 12 months. This $16.4 trillion debt figure is a misleading number since it fails to tell the whole story. If you add the present value of the unfunded liability for Social Security and Medicare to this figure, our total liability is closer to $60 trillion. Unless we're going to change (reduce) our promises, you should think about our unfunded liability as a debt. If you want some context when thinking about such large numbers, $60 trillion of "debt" is more than $500,000 per household!

MEDICARE COSTS

Regardless of which side of the aisle you are on, the enormity of these numbers should be apparent. We have made promises for the future that we simply can't afford. The primary promises that we've made involve Medicare, Medicaid and Social Security. In fact, Medicare and Medicaid now represent $38 trillion of our $46 trillion unfunded liability. This liability will continue to grow unless proactive changes are implemented. Unfortunately, we have to make some really hard decisions. It all boils down to whether we want to pay more in taxes and/or reduce benefits. Of course, our views are split by different political beliefs, different financial needs and different age groups.

As mentioned previously, from a historical perspective the growth in government spending appears to be more of a problem than taxes. There is really no way to increase taxes to the point that we can afford the promises that have been made. If we look at government spending, we can divide it into three broad categories:

1. *Mandatory Spending*
   Social Security, Medicare and Medicaid along with other retirement, disability and unemployment related spending
2. *Discretionary Spending*
   All non-mandatory spending items such as defense and education
3. *Interest Payments on Debt*

Over the past 32 years, mandatory spending has been growing at a faster rate than discretionary spending. From 1979 to 2011, man-

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datory spending increased from 44 percent to 56 percent of total government spending while discretionary spending decreased from 48 percent to 37 percent.

When you look even further into the increase in mandatory spending, you see that healthcare is the primary reason why mandatory spending is growing at such a high rate. The data shows that Medicare and Medicaid spending increased from 18 percent of mandatory spending in 1979 to 31 percent in 2011, while Social Security payments decreased from 46 percent to 36 percent of mandatory spending.

It's clear that the Medicare and Medicaid programs have been the primary drivers of spending growth and persistent deficits over the past 40 years. Unfortunately this trend is expected to continue. Medicare spending, which totaled $492 billion in 2012, is expected to increase to $895 billion in 2022, according to the Congressional Budget Office (CBO).

This is not a new trend. According to the CBO, over the past 25 years, Medicare costs per person have grown 1.5 percent faster each year than the per-person GDP. Unfortunately, Medicare costs will continue to increase for a variety of reasons. The most obvious is the aging of the baby boomer generation. In addition, we're spending more on each Medicare beneficiary and we are living longer. These factors result in Medicare's expenditures rising faster than the economy grows. If we don't find a way to reduce Medicare expenditures, they will continue to take a greater share of the national budget. This, in turn, will reduce our ability to fund other critical federal programs.

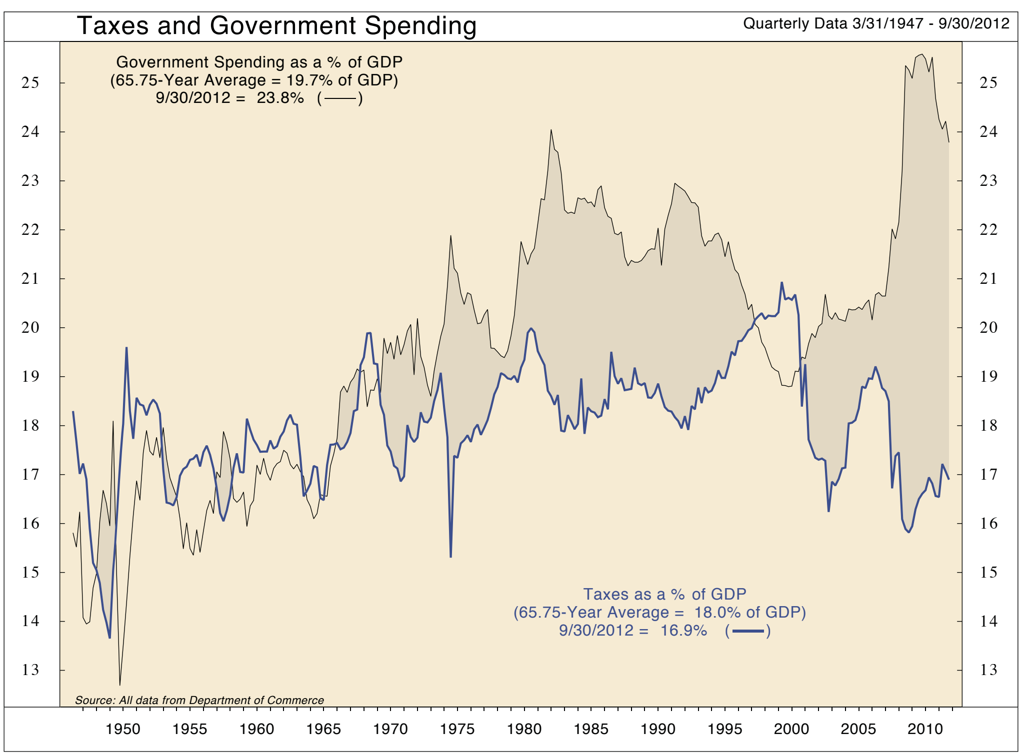
MEDICARE SOLUTIONS

In the near future, we're going to have to make some very difficult decisions. Do we want to limit Medicare benefits? Do we want to raise the qualifying age that you must reach before qualifying for Medicare? Do we want to limit payments to providers — primarily doctors and hospitals? Unfortunately, there are no easy solutions. Voters may rebel against candidates who vote to cut benefits. Similarly, if we cut payments to providers, more doctors may not accept patients that are covered by Medicare.

So where does this leave us? A sustainable Medicare program will require a number of structural reforms. But we also will need to address the fundamental drivers of health care costs including: changing the way physicians are reimbursed, improving the coordination of patient care, avoiding duplicative and unnecessary services, adopting electronic medical records, reducing fraud and abuse, having more Americans embrace healthy lifestyles and making sure everyone gets access to primary care. The long and short of it is nothing will be easy. But then, what are the alternatives?

The bottom line is that we shouldn't be satisfied with yet another short-term agreement to resolve the fiscal cliff. In fact, I won't be comfortable that our politicians are addressing our fundamental debt and deficit problem until they implement proactive changes that address the escalating cost of Medicare. Unless we solve this issue, any announced "solution" to the fiscal cliff is merely a smoke screen, one that increases the likelihood of much deeper problems down the road.

I am hopeful that our politicians will ultimately address the escalating cost of Medicare and the other structural issues facing our country. The question is when and whether they will act on their own or if the markets will force them to act. Unfortunately, I think it will be the latter. History has proven that politicians typically aren't willing to make tough decisions until they are forced to act. Only time will tell what course our politicians choose to take this time.



Is Free Market Capitalism Fair?

One of the themes that kept being promoted during our nation's most recent election process was that reform was needed in our tax and monetary systems. There was a lot of talk about how we need to have a system that is fair for everyone. Our economy has been the envy of the rest of the world for many decades. So I pose this question to all of us: "Is free market capitalism fair?"

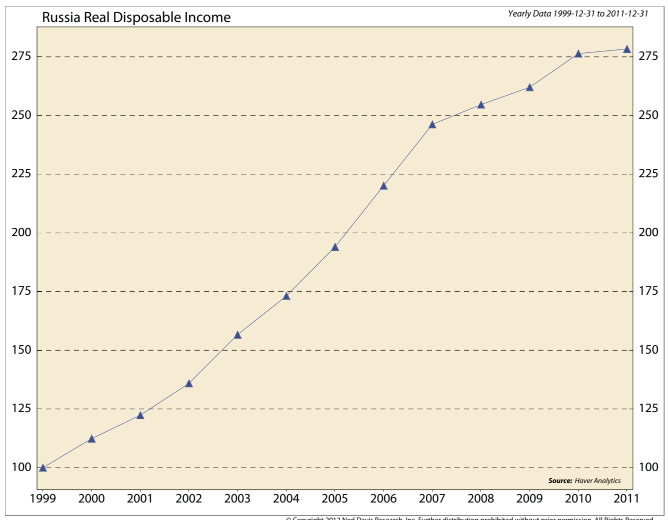
The definition of fair found in Webster's Dictionary is the following: reasonable or unbiased; not exhibiting any bias, and therefore reasonable or impartial. With that definition, it would be hard to call free market capitalism (FMC) unfair.

There is no doubt that within our economy there are clear winners and losers. What determines who will win and who will lose? This is the beautiful part of the wisdom of FMC as no one thing determines the winners or the losers.

The circumstances of your birth, the education you pursued, the jobs you took, the jobs you quit, or the jobs you didn't take cannot fully account for your success under capitalism. What capitalism can afford you is the opportunity to try, to pursue, to fail, to achieve, and to be rewarded for your efforts.

Capitalism cannot account for the size of your reward, nor guarantee that it will be commensurate with the effort expended in the attainment of your goals. All capitalism does is say, "Go for it!"

The graph below details the real disposable income of Russia from 1999 to 2011. As Russia began to move toward a more open free market economy in the 1990s, disposable income grew, even amidst the global economic crisis of 2008. Yes, even in post cold war Russia, FMC works.



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When people state that our system should be fair, they are really saying that everything in our economy should be equal. Capitalism is fair but not equal. The definition of the word equal, also from Webster's, is the following: identical in size, quantity, value, or standard.

If you think that equality sounds good, let me say it another way: "To each according to his need, from each according to his ability." This statement promotes the idea of equalization and is also the foundation of socialist economic theory.

People may still balk at the idea of socialism, but they may not realize that their views on forced equality are socialist theoretical principles.

Now take a look at successful business leaders under a capitalist system. For example, Colonel Sanders' secret chicken recipe was rejected over 1,000 times before a restaurant finally accepted it. He founded KFC when he was 65 years old.

How about Evan Williams? Before founding the social media sensation Twitter, he founded a company called Odeo, a podcasting platform. Soon after Odeo's launch, Apple announced that its iTunes store would include a podcasting platform, thus making Odeo obsolete.

Before starting the Woolworth Company (now FootLocker), Frank Winfield Woolworth worked at a dry goods store where his boss thought he "didn't have enough common sense to serve the customers." The Woolworth Company was one of the original five-and-dime stores (upon which Sam Walton based Walmart). In the 1970s, Woolworth became one of the largest retail chains in the world.

During my career, I have worked with and continue to work with many people who have been extremely successful. They would be considered the winners in the FMC game. What I find so interesting is how quickly some discount the path that led to their success. It seems that many feel successful people are just lucky or favored in a way that is not fair. There are certainly isolated examples where this is true, but is it true for our economic system as a whole? I do not think so. Typically when people win in a way that is not fair, it does not end well.

The road to winning is not an easy one. In fact, most of my clients who have achieved immeasurable success also have experienced extreme failure at some point during the journey.

FMC in America is alive and well, and thank heavens, it is not equal.

David T. Stanley
Executive Vice President

Retire On Time

Retirement planning isn't something that gets a lot of attention until some event triggers concerns about retirees' financial future. The market meltdown of 2008 has certainly gotten the attention of many soon-to-be retirees.

Why is planning important? According to the Employee Benefit Research Institute, just 14 percent of Americans believe that they have enough to retire comfortably, while 37 percent of Americans expect to work past age 65 — whether they want to or not.

There are four principles you can focus on to make sure your retirement has the best chance to be successful:

ELIMINATE DEBT

This should be obvious, but holding on to a lot of debt such as credit card balances isn't good planning. Never settle for making just the minimum payments on credit cards. It's financial suicide on the installment plan. It makes compound interest work against you. The same goes for fixed debt such as your mortgage or auto payments, even though they are less damaging.

BUILD A CASH CUSHION

Retirees should be concerned with unexpected expenses. Add up your insurance deductibles on your auto, home and healthcare policies. This will give you a base to start from. From there, add in any unbudgeted needs, and keep these funds in a safe, accessible account.

INVEST FOR YOUR TOTAL RETIREMENT

Many retirees are inclined to invest very conservatively. But being too conservative is risky. Interest rates are at historic lows. Chances are, one spouse will live well into his or her 90's. Achieving growth to overcome inflation remains important to fund a retirement that will last for decades.

PLAN FOR THE UNEXPECTED

Rules of thumb, such as spending 4 percent of your retirement savings per year, don't always take into account your unique needs. Stress testing your plan helps you understand your personal retirement limitations and makes sure your plan can survive the unexpected. Unless you have a crystal ball, it is best to factor in different spending scenarios.

By keeping these four principles in mind in your planning, you can make your retirement more secure. We can help you prepare for a successful retirement. Please call us to help shore up your plan.

Paul Giehm
Senior Vice President

LET US KNOW

Each quarter Trust Company of Oklahoma publishes our newsletter "Investment Perspectives." Our professionals write informative articles on topics we think would be of interest to you. But we want to know what you think. What are some topics that you would like to read about? Send your thoughts to Marketing@TrustOk.com and we will do our best to include your interests throughout the upcoming year.

The Parent Child Center of Tulsa (PCCT) is a non-profit whose mission is to prevent child abuse and neglect through education, treatment and advocacy. The prevention of child abuse and neglect results from increasing protective factors including teaching responsible parenting skills and reducing risk factors to make the home environment safer.

Prevention pays tremendous dividends for the individual child, the family and our entire community. Children who are safe and nurtured in their early years are more likely to thrive, learn and become healthy, productive citizens, contributors to the community and loving parents themselves.

Studies show that every dollar spent on prevention today saves an estimated $16 in future costs to taxpayers from the consequences of childhood trauma. These costs are the issues that concern us all: substance abuse, mental illness, domestic violence, incarceration and child abandonment.

Even though the financial costs of abuse are great, the human costs are much greater. Child abuse numbers in Oklahoma are staggering. Last year, 7,248 children were confirmed to be abused or neglected. And, tragically 40 Oklahoma children (70 percent under the age of two) died from abuse or neglect.

PCCT has worked proactively on the change side of child abuse by strengthening parent-child relationships for over 37 years. PCCT's prevention programs range from trying to break the cycle of abuse with programs that work one-on-one with families to helping children recognize signs of abuse and ask for help if they are not safe with programs such as puppet shows in elementary schools. All told, PCCT's programs reached 27,133 people in the Tulsa community last year.

PCCT is a partner agency of Tulsa Area United Way and nationally accredited through the Council on Accreditation, an independent evaluator of community-based behavioral health care and social service agencies.

To learn more about our impactful work, please visit parentchildcenter.org.

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FORWARDING SERVICE REQUESTED

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Trust Investment Perspectives is a quarterly publication written and produced by Trust Company of Oklahoma. It is intended to provide insight and investment perspectives to the company's clients and associates.

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