

Thoughts from

Hanson Investment Management Inc.

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Now or Later? Decisions, Decisions . . .



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WHETHER SOCIAL SECURITY is in crisis or not you still have to decide when to take it. Do I retire early at 62 or wait for full retirement (*see ages below*)? The good news is there is no wrong answer. If you live to your average life expectancy, 81 for men and 84 for women, the benefits you get at full retirement are just about equal to retiring early. You get lower payments at 62 but they run longer. At full retirement benefits are higher but they theoretically run fewer years.

But there are other things to consider. Are you going to make it to your average life expectancy? What's your family health history? Women tend to outlive men and they might wait for the higher payment since these could last much longer. If you start making good money late in life you should consider delaying retirement to extend the peak earning years. Women who left the labor force for part of their career should also consider working longer. The Social Security formula penalizes you for the "zero" years in your working

record. The tax system also penalizes early retirement. If you work between 62 and 65 Social Security is reduced \$1 for every \$2 you earn over \$12,000.

The age you retire is sometimes called your "primary portfolio decision." The longer you work the bigger your retirement nest egg and the greater your flexibility. Then the whole Social Security decision thing becomes pretty easy.

Waiting for full benefits

The federal government is gradually pushing back the age at which Social Security recipients qualify for full benefits.

Year of birth	Age to receive full benefits
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Source: Social Security Administration

Source: USA Today

Hanson Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.

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Income, retirement age factored in

Typical workers who turn 62 this year would receive these monthly benefits depending on the age at which they retire:

2004 income	Monthly benefit for retirement age					
	62	63	64	65	66	67
\$20,000	\$550	\$596	\$652	\$709	\$769	\$834
\$40,000	\$822	\$895	\$983	\$1,073	\$1,167	\$1,270
\$60,000	\$1,095	\$1,193	\$1,313	\$1,436	\$1,564	\$1,706
\$80,000	\$1,279	\$1,383	\$1,510	\$1,639	\$1,773	\$1,920
\$100,000	\$1,399	\$1,513	\$1,651	\$1,792	\$1,938	\$2,097

Note: All figures are in inflation-adjusted 2005 dollars. Source: Social Security Administration

Source: USA Today

The Trade Conundrum . . .

There are problems and then there are Problems . . .

THERE ARE A NUMBER OF problems today that don't worry me that much. One, for instance, is the budget deficit. Eventually we will just have to raise taxes. You can only cut non-defense, discretionary spending so much. After that you have to increase revenue.

But the trade deficit is a thorny problem with no easy solution. Traditional thinking has it you let the dollar fall. This makes imports more expensive and exports more attractive. Voila, back to balance.

But the numbers are so large today that the math doesn't seem to work. For instance U.S. imports total \$1.9 trillion and exports \$1.2 trillion. Exports need to increase 58% faster than imports just to keep the trade deficit level. This is hard to imagine. A second point is the manufacturing sector has shrunk. Employment in manufacturing is now 13% of total U.S. employment versus 22% in 1985. David Hale in a recent piece in the *Financial Times* pointed out that manufacturing may not be big enough anymore to dig us out of this ditch.

Well there is always Services right? This is the heavy lifter of the economy today. But Services exports, after factoring in inflation, have grown less than manufacturing the past 10 years. Post 9/11 regulations have made it

more difficult for tourists to come here and for students to enroll in colleges. Intellectual property theft is another reason Services exports are not growing faster. And many U.S. companies today choose to serve foreign markets from foreign outposts rather than export. Finally agriculture, one of our export pillars is showing signs of weakness. Sometime in the next decade Brazil will pass the U.S. as the world's largest agricultural producer. And in June the United States imported, yes imported more farm products than it exported.

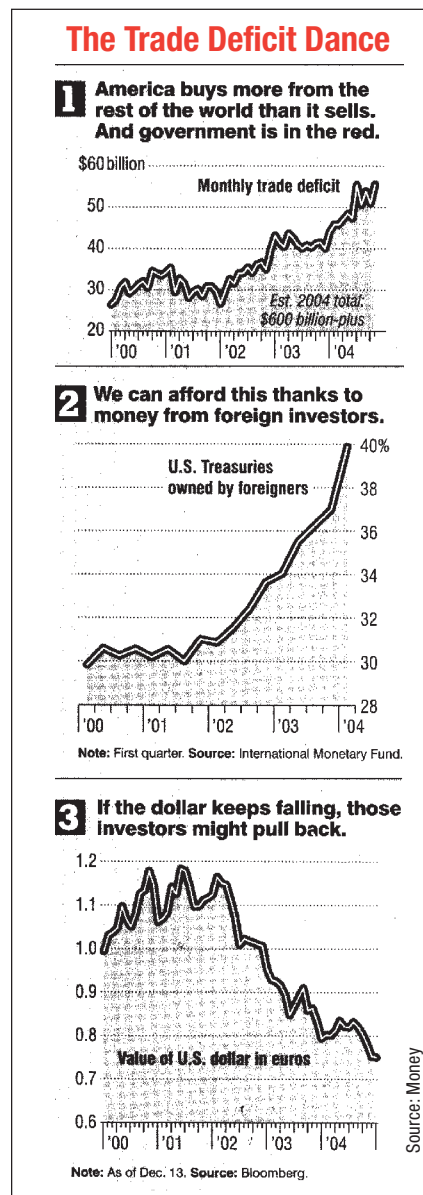
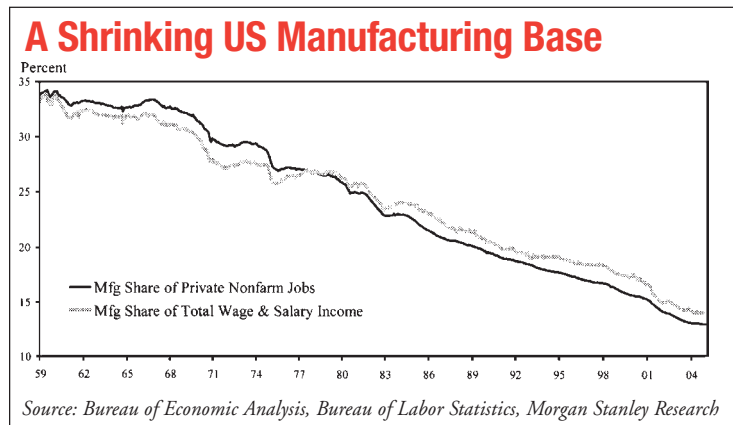
If a dollar decline and a trade increase aren't the answers, what will reduce the deficit? It may take a long, painful recession. The way the Bears see it, a dollar decline will force rates up to keep foreign investors in our securities. Rising rates combined with higher inflation from increased import prices will spell a slowdown in the economy maybe even the big R.

Warren Buffett proposed back in October 2003 a system of "import certificates" (IC) to solve the problem. Exporters would receive an IC for every dollar of foreign sales. Importers would be required to have an IC for every product brought into the country. ICs would trade publicly and might settle out at ten cents on the dollar. The negative to this is consumer prices might go up by the full amount of the IC but

the positive is import demand would slow and the profits of exporters would increase. This idea has been received with "deafening silence" in Washington, Mr. Buffett says.

But something has to give

here. Foreigners today own \$2.5 trillion more of our economy than we own of theirs. This \$2.5 trillion is about 5% of our total wealth of stocks, bonds and real estate. The trade deficit now is pushing the 5% figure up by about 1% a year. So to maintain our standard of living we are selling off assets. As long as we have family jewels there is no problem. But once they are gone, they are gone.



The U.S. Market . . . Show Me the Cash . . .

SINCE 1926 THE TOTAL return from common stocks has been 10.5% per year. I am sure you have seen these numbers. But the breakdown is something you may not be aware of. Stock appreciation, that is the increase in the market averages, accounts for 6.1% of the return per year. The balance, 4.4% is dividend return. So dividends have accounted for nearly 40% of common stock returns the past seventy plus years.

While IBM grew faster by every measure ...

Average annual growth	IBM	Exxon Mobil
Sales per share	12.2%	8.0%
Earnings per share	10.9%	7.5%
Dividend per share	9.2%	7.1%
Price appreciation	11.4%	8.8%
Sector size	14.7%	-14.2%

Exxon Mobil was the better buy with a higher dividend

	IBM	Exxon Mobil
Average P/E ratio	26.8	13.0
Average dividend yield	2.2%	5.2%

Source: Fortune

Companies today are not focusing as much on dividends. Twenty-five years ago 469 of the Standard & Poor 500 companies paid dividends. By 2002 this had sunk to 351. *The chart to the right* shows the percentage of earnings paid out in dividends. It has been going down since 1990. One reason is the increased popularity of stock options. Companies have been using cash previously earmarked for dividends to buy back stock to make stock options to employees. Also until recently the tax paid on a dollar's worth of stock appreciation was much less than the tax on a dollar's worth of dividends. So companies argued it made more sense to buy back stock.

The reduction in the tax on dividends to 15% has turned the equation around. Since the law changed there have been

421 dividend increases among the S&P 500 companies and twenty-four companies have started paying dividends for the first time. This is important because of the implications of *the chart to the right*. The average annual return from stocks in the 1980's and 1990's was about 12.5%. Nearly 60% of this return was from an increase in valuations or price to earnings ratios. PE levels today are higher than the long-term average and there isn't that much room for further increase. So stock returns are going to be driven by earnings and dividends.

Warren Buffett feels that the combination of already high PEs and slow earnings and dividend growth means a 6% return per year for the market the next decade. We are more optimistic about dividends and are using an 8% per year number.

Our stock selection process here favors dividend payers and companies that are likely to increase their payouts in the future. And you often find this in fairly boring companies. Who would have thought in 1950 that Exxon would produce a higher return than IBM over the next 50 years? But it has, 14.4% versus 13.8%. The reason is two fold: Exxon traded then and still trades now at a lower price to earnings ratio than

Behind the Bull Market

Much of the real increase in the Standard & Poor's 500-stock index in the 1980's and 90's came from investors' "revaluation" of stocks — an increase in what they were willing to pay for the future earnings from those stocks.

Components of stocks' average annual inflation-adjusted return during the 1980's and 90's

	PERCENTAGE POINTS
Revaluation	7.4
Average dividend yield	3.3
Real growth in earnings	2.0

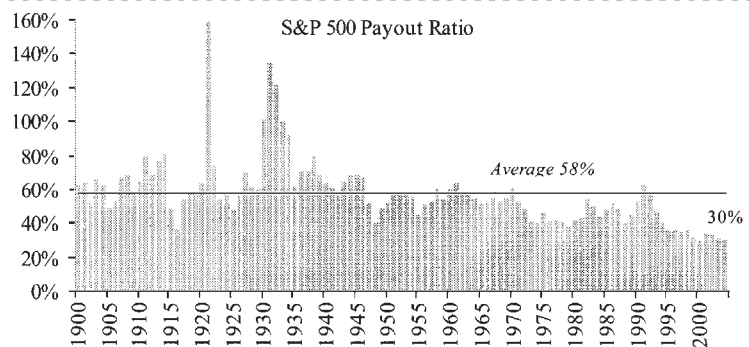
Sources: Robert D. Arnott; Robert J. Schiller (Yale University)

Source: The New York Times

IBM. This means there is more room for upward price movement when positive news occurs. Also dividends have provided a greater and faster growing part of Exxon's return.

A final factor in the dividend equation is that companies paying out more in cash have less leftover to make mistakes with. I realize this is the cynical view. James Surowiecki writing in the *New Yorker* notes that cash is freedom — "freedom from the scrutiny of lenders and shareholders, freedom from the consequences of bad decisions. Cash can be a cushion, a crutch, a hedge against failure." Favoring good dividend payers puts dollars in your pocket and also protects management from failure. How about that for a win-win!

Payout Ratios — Room for improvement



Source: Shiller data through Nov 1945; Standard & Poor's from 1946 onwards, Morgan Stanley Research

Industry Trends . . .

The Coming Nuclear Renaissance . . .

NUCLEAR POWER IS MAKING a comeback. For those of us who remember the nuclear accident at Three Mile Island in 1979 or the Chernobyl disaster in 1986 this seems somewhat unbelievable. But a number of forces are converging to bring the much maligned technology back into the limelight.

Put yourself in the shoes of any energy planning analyst and you will begin to understand the growing interest in nuclear power. Oil and natural gas prices are at record levels. Continued political turmoil in the Middle East and surging electricity demand suggest that fossil fuel prices will likely remain high and volatile. A recent MIT study forecast that worldwide energy demand could triple by 2050. And in the U.S. alone, electricity demand is expected to grow 40 percent by 2020.

Add to this list the threat of global warming caused by burning coal and other fossil fuels. According to a Harvard School of Public Health study, airborne heavy metals generated by coal burning electric power plants and other noxious pollutants cause 15,000 premature deaths annually in the U.S. alone. And it is estimated that a coal fired plant releases 100 times more radioactive material than an equivalent nuclear reactor.

Nuclear power, while shunned in the U.S., has gained a significant foothold in many countries over the last 25 years. France derives 78% of its total electrical output from nuclear plants while Sweden gets 50% and Belgium 55%. But here in the U.S., safety concerns put a virtual halt to new construction in 1973. Today, 103 nuclear plants scattered across the country provide 20% of our electricity needs.

Like many energy alternatives, nuclear power comes with pluses and minuses. Nuclear energy has a proven ability to supply relatively inexpensive, clean energy to large numbers of people. But serious concerns regarding the general safety of nuclear plants have often offset these advantages. Fortunately, new technology is making plants more efficient and safer. China, in particular, is

developing a new “pebble bed” reactor. These plants, fueled by thousands of small graphite balls with minute uranium cores, are said to have two primary advantages. First, the size and nature of the fuel virtually prevents nuclear core meltdowns. Second, the fuel design stymies nuclear proliferation because of the expense and difficulty of reprocessing spent fuel from the graphite balls.

But the biggest concern surrounding nuclear power has always centered on what to do with its radioactive waste. Today, the U.S. has accumulated 50,000 tons of highly toxic waste. The Federal government’s facility at Yucca Mountain, Nevada, has long been planned as a permanent storage site for this material. But the facility remains bogged down in the courts and waste is piling up in some 30 odd sites across the country. This lack of a permanent disposal solution remains the biggest obstacle to further nuclear power development.

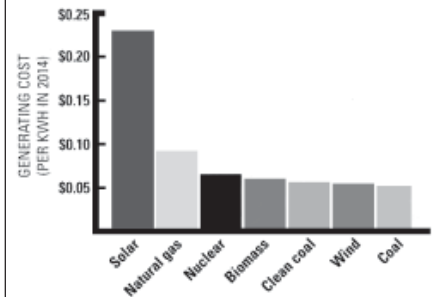
Without a doubt, conservation, efficiency and clean, renewable energy sources must all be an important part of any long-term energy policy. But improvements in these areas will not solve all our problems. Take a look at the chart to the right. Today, renewable sources produce just 9.1% of all U.S. electricity production, down from 11% just 15 years ago. Wind power represents perhaps the most promising renewable alternative. But while price and performance of wind power are likely to continue to improve, as an energy source it is inherently hard to capture and widely dispersed.

A growing number of countries will turn to nuclear power over the next several decades. China alone, with exploding energy needs and growing pollution problems, now expects to commission 30 new nuclear facilities over the next 10 years. In the U.S., permitting and regulatory hurdles will prevent this kind of ramp up. But, given the alternatives, my guess is that nuclear power will represent a growing percent of our future energy production mix.

— Anne Williams Doremus, CFA

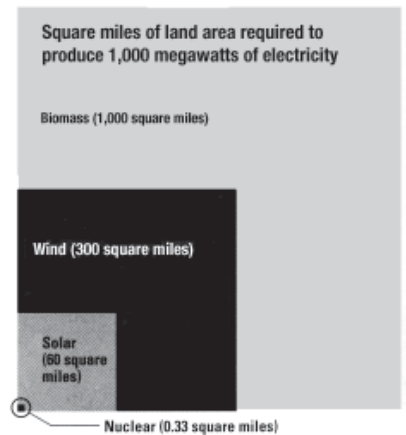
NUCLEAR ENERGY IS COST-COMPETITIVE . . .

Its production cost is similar to coal and other sources – and far cheaper than solar.



. . . SPACE-EFFICIENT . . .

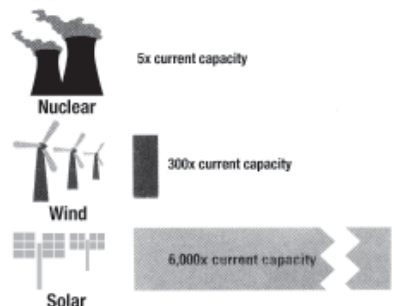
Nuclear power takes up less real estate than the usual green alternatives.



. . . AND IT SCALES

Reducing global carbon emissions by 15 percent would require relatively modest growth in US nuclear capacity – compared to radical expansion of renewables.

[What it would take to eliminate 1 gigaton of carbon emissions per year]



Sources: US Energy Information Administration; Electric Power Research Institute; Energy; Jesse Ausubel, Rockefeller University.

Chart: WIRED