thoughts

FROM HANSON+DOREMUS **SEPTEMBER 2021**

"Things are hopeless but not serious."

(Viennese Satirist, Karl Kraus)

The Social Security Trustees recently released their Annual Report August 31, which warned that the Social Security Reserve Fund would run out of money by 2033, one year earlier than previously projected. Social Security is paid from two sources: First from FICA payroll taxes, the 7.65% of gross pay paid by both employees and employers. Not all the FICA revenues goes to paying Social Security, however. Part goes to cover Medicare.

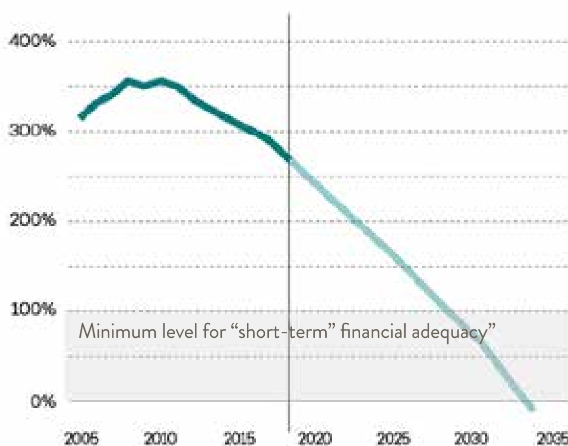
The second contributor to Social Security payments is the Social Security Trust fund. This is the fund which is running out of money (*see below*). In 2033, if the Trust fund does indeed go broke, Social Security payments will be reduced by approximately 20-25%.

This is the bad news. The good news is it will almost certainly be fixed. Social Security is just too important to too many Americans. But fixing Social Security requires a certain amount of pain, and Washington does not do well with pain. It is much more comfortable kicking the can down the road. A fix to Social Security will probably not come until the cliff edge is precariously close in sight.

How do you fix Social Security? You either raise taxes or reduce benefits or a combination of both. Remember I said fixes require pain. It's estimated that if you raised the 7.65% payroll tax by 1.6% for both employers and employees you would solve the problem for 75 years. 1.6% doesn't sound like a big number, but it is a 20%+ increase in total FICA taxes and a reduction in take-home pay. Another option is to increase the amount of current wages subject to the payroll tax. Currently, this is $142,800. A final option is to reduce future benefits by changing the inflation adjustment to annual Social Security payments. This keeps the system solvent longer.

MONEY IN THE SOCIAL SECURITY TRUST FUND

Reserves shrink as costs rise



Source: ssa.gov

The whole Social Security "cliffhanger" is perhaps a good wake-up call. We need to take control of what we can control and not wait for Washington to decide on Social Security. Social Security is an important factor in retirement planning, but it is just one. Social Security is estimated to replace about 55% of lower income Americans' pre-retirement income. That still leaves a lot to cover. And higher income Americans are less dependent on Social Security.

We need to save as much as we can as early as we can, and we need to think about retiring later if that is a possibility, physically and/or psychologically. Most Americans working today reach "full" Social Security retirement at age 67 but they can take Social Security as early as 62. The difference in benefits between taking them at the earliest possible time and the latest (age 70) is 76%. This is a big number especially since your initial Social Security benefit (plus annual inflation adjustments) stays with you the rest of your life.

\- Eric Hanson

Hanson+Doremus 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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INVESTMENT WISDOM

By Eric Hanson

Wall Street explained - the CliffsNotes version

Those of us of a certain age will remember "CliffsNotes," the condensed study notes that saved a lot of procrastinating students from academic purgatory. I still have never read *War and Peace*, but the CliffsNotes were great!

Back in 2012, Jason Zweig, the excellent columnist in *The Wall Street Journal,* came up with the idea of asking five investment gurus for the "secret to success," but instead of requesting 300 pages of single-spaced typing he said, give it to me in 10 words. Shown below are the results. The wisdom 10 years ago is still good advice today. There is an emphasis on being contrary (if everyone wants it, avoid it), an emphasis on controlling what you can control (costs and taxes), and an emphasis on psychology and emotions (you can't take it with you).

The one piece of wisdom I would question is, do you really think you are smarter than the average professional investor? Due to the extreme emphasis on short-term performance today and the pressure to beat the S&P 500, the professional investor is often the poster child for herd mentality. He jumps from the unpopular to the popular at the first sign of underperformance. Individual investors have only themselves to answer to and can be more patient and more long-term. At least in theory. There will always be the day traders and those wrapped up in the emotions of the moment, but sensible, long-term individuals often outperform the professionals.

I thought it would be a good exercise to ask those of us here to put down our thoughts – 10 words or less – on how to be a successful investor. The quotes above are a good reflection of how we manage money. We prize doing our own independent research. We look for quality companies which have a competitive advantage – but which are selling at reasonable prices. We also emphasize long-term investing, letting time in the market play out to our advantage. And finally, we recognize the need to stay patient even as the waterfall of daily information pressures us to panic and overreact.

The best definition of Wall Street I know of is, "The stock market is only indirectly related to economics. It is a reflection of human fear, greed and apprehension, all overlaid on a business cycle." We try here to balance the fundamentals of investment markets with the psychological and the emotional.

HOW TO SUCCEED IN THE STOCK MARKET - HANSON + DOREMUS

(in ten words or less)

"Buy good companies, trading at reasonable prices, then sit tight."
- Anne Doremus

"Invest long-term, diversify, manage emotions, and control costs."
- Sven Eklof

"Optimism and patience pays, exercise discipline, time in the market."
- Eric Hanson

"Find growing companies with solid competitive advantage or just index."
- Alex Watson

"Buy quality for not too much. Stay patient. Stay humble."
- Julie Won

"Know what you own and why you own it."
- Art Wright

Source: Hanson + Doremus

THE STOCK MARKET IN 10 WORDS OR LESS - *THE WALL STREET JOURNAL*

"If everybody wants it, I don't. Avoid crowds."
- Gus Sauter, Chief Investment Officer, The Vanguard Group

"Control what you can: your savings rate, costs, and taxes."
- Don Phillips, President, Fund Research, Morningstar

"In the end, you cannot take your investments with you."
-Meir Statman, Finance Professor, Santa Clara University, and author, *What Investors Really Want*

"Are you smarter than the average professional investor? Probably not."
- William E. Sharpe, Emeritus Professor of Finance, Stanford University and Nobel Laureate in Economics

"Spend less. Diversify globally. Own whatever's feared, shun whatever's beloved."
-Robert Arnott, Research Affiliates LLC

Source: The Wall Street Journal

CLASSIC BOOKS

By Julie Won

Watch the scotch tape expense and don't confuse luck for brains

"When mortals go through a prosperous period, it seems to be human nature for expenses to balloon. We are going to be the exception," wrote Alan Greenberg, chair of Wall Street firm Bear Stearns, in one of his famous memos exhorting partners to watch expenses like a hawk and pinch every penny. It's perfectly sensible advice.

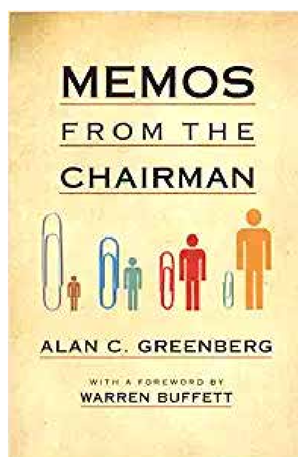
But then he goes off the deep end a little and declares the firm will no longer approve the purchase of paper clips. They're a waste of money, he thinks, when there are plenty of paper clips already circulating around the office. Diligently collect them, and you'll soon be awash in more than you need.

Was he joking? It's hard to tell. But the tongue does seem planted firmly in cheek a few lines later when he rhapsodizes about selling the firm's surplus paper clips at a profit ("…since the cost to us is zero, the Arbitrage Department tells me the return on capital will be above average.") The man did have a sense of humor.

He also had a point, which was that getting petty on expenses instilled a shared mindset that, "All of us are going to help the bottom line grow."

Alan Greenberg started out as a clerk at Bear Stearns in 1949 after getting rejected by five white-shoe Wall Street firms. He moved to the trading floor (which he loved), became chief executive in 1978, and then chairman in 1985. According to his obituary in *The New York Times*, "Mr. Greenberg's nickname was 'Ace,' and he kept a deck of cards on his desk, ready to deal. He was a champion bridge player, a magician who conjured coins with sleight of hand, a show-off who could whiz-bang a yo-yo, an adventurer who played pool with sharks and stalked game in Africa."

He also was a colorful writer. His memos, collected in the classic book shown here, push, pull, and nag his employees through Bear Stearns' rapid rise between 1978 and 1995. They are funny,



Workman Publishing
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whimsical, sometimes stern -- and probably rubbed people the wrong way at times. But Greenberg keeps things light by invoking an alter ego -- the wisecracking and ridiculously named Haimchinkel Malintz Anaynikal -- to impart his most important messages and business philosophies.

In his forward to the book, Warren Buffett says there's a lot to learn from Haimchinkel, who is "cheap, smart, and opinionated." And Jeff Bezos (who famously made employees pay for their own parking at Amazon), keeps *Memos From the Chairman* on his required reading list.

But there's more to Greenberg's memos than saving money on paper clips (and rubber bands, scotch tape, electricity, and nearly everything else). More than anything, Greenberg's overriding message is to always "stay humble, humble, humble" and be wary of arrogance and complacency, especially in bull markets. "Humans tend to get sloppy when making money is easy." That's the time to "not confuse luck with brains" and remember that "this picnic will not last." In an especially good market in 1985, Greenberg laments, "Things are too good!! . . .Let us continue to watch the shop and realize that none of us are really very smart. We are just in the right place at the right time."

A born contrarian, Greenberg also sees bad markets as times of opportunity. He hires and expands when his rivals fire and downsize (a great time to pick up top talent). He enters businesses when his competitors exit them. He reminds everyone that "big money is usually made by contrarians," and that "our best moves were made against the thinking of the masses."

Readers will learn that Greenberg is a stickler about answering the phone in two rings, ensuring receptionists are polite, and returning calls to everyone and anyone immediately. He also has a strict rule to never knock other Wall Street firms in public. "Bear Stearns people do not denigrate our competition," he writes. "If you cannot say something nice about somebody, do not say it!"

But perhaps Greenberg is most human in the bleakest of times and the toughest of markets. He pushes the troops to keep their chins up and reminds them that markets always turn – sometimes very quickly, though "a bell will not ring to prepare you for the good times." Bad markets are really nothing to worry about, he says. "This is nothing next to Auschwitz, Buchenwald or Vietnam . . .This market will not get me down. It is just a minor challenge."

ECONOMIC TRENDS

By Anne W. Doremus

Electric utilities forge a new path forward

The Biden administration has laid out some aggressive goals to reduce greenhouse gas emissions. Among other things, these objectives aim to have "clean" energy (wind, solar, hydro, etc.) produce 80% of the nation's total energy generation by 2030, up from approximately 40% today. This target follows on the recently rejoined Paris Agreement's stated aim for net zero global emissions by 2050. While these sorts of goals have been promoted for years, a growing global consensus fueled by recent extreme weather events is beginning to take them more seriously.

Electric utilities which link energy producers and consumers will drive much of the global trend toward decarbonization. Electric generation accounts for one-third of U.S. energy sector carbon emissions so it is an obvious place to start. Happily, the industry has made good strides already with electric power emissions having fallen 39% from their 2008 peak. Increasing the use of renewables, using more natural gas, and retiring coal plants have all helped achieve these reductions.

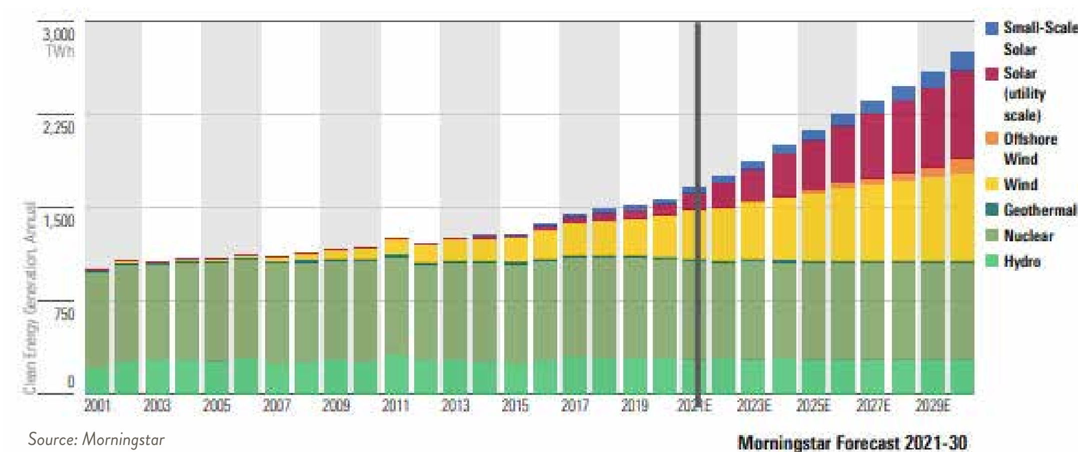
While we applaud these efforts, several questions remain. Will the sector be able to meet these targets? Utilities play an important stabilizing and income producing role in many investor portfolios. With that in mind, what impact will this energy transition have on utility profits? Finally, for the socially conscious (ESG) investor, can the utility sector ever truly reach "green" status?

Meeting the Paris Agreement's net zero emissions target by 2050 will be a challenge. According to a Princeton study, decarbonization here in the U.S. will require between $4-$6 trillion of new capital. Fortunately, U.S. consumers should be generally willing to fund these investments over time as electric bills typically make up a relatively small share of household spending. But other obstacles loom large. These include the reliability of green energy sources such as wind and solar, the additional land many renewables require, and an uneven regulatory process. Thanks to these and other constraints, most studies consider targets of 50%-65% renewable generation by 2035 more realistic.

Progress toward these goals will depend greatly on public policy. Fortunately, the growing demand for clean energy from both residential and corporate customers is fueling supportive regulations and the utility industry's decarbonization efforts. According to the Renewable Energy Buyers Alliance, Fortune 1,000 companies in the U.S. are expected to increase their renewable energy demand eightfold by 2030. In the U.S., state level renewable energy mandates and federal tax credits have helped drive the expanded use of renewable energy. Today, 30 states have passed legislation requiring distribution utilities to supply a specific percentage of renewable energy to their customers. <u>These mandates generally allow utilities to recover their capital costs and earn a reasonably attractive rate of return on green investments</u>. Utilities operating in states with these favorable structures (e.g., California, Illinois, and New York) should continue to enjoy profit tailwinds in the years ahead.

Finally, there has been much debate about whether energy producing utilities can ever be considered "green." The transition to a carbon-free economy will take lots of time and money. Until then "dirtier" energy sources like natural gas will likely remain important bridge fuels. Investors committed to a no-carbon mandate may find this exposure unacceptable. Others who view the path to decarbonization more flexibly may be able to reconcile the short-term exposure as a necessary part of achieving their longer-term goals. As always with ESG investing, investors need to both be clear on their own goals and read the fine print to understand exactly what they are getting.

WIND AND SOLAR DRIVE CLEAN ENERGY GROWTH OUTLOOK



Source: Morningstar

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