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# PDV *OBSERVATIONS*

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## Importance of Return-on-Equity

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A company's return-on-equity (ROE) is one of the most important financial metrics to focus on when evaluating potential stocks. You can compute ROE by taking reported net earnings and dividing it by common shareholder equity. To determine common shareholder equity, you have to deduct all liabilities from total assets presented on the balance sheet.

ROE measures a company's profitability by indicating how much profits are made as a percentage of the common shareholder capital deployed in the business. You want to see a high return because capital has a cost and can be invested in other alternative competing investments. A high ROE shows the company is earning a high return on common shareholder capital deployed.

It is very difficult for a company to sustain a high ROE over time, since the huge profits attract competition that is likely to pressure those same profits going forward. Average companies typically have 10-12% ROE, with ROE above 15% considered excellent. Companies with very high ROE generally have some economic moat to mitigate competition and protect their high profits.

It is important to realize profits of companies with high ROE do not necessarily grow at ROE. Many companies do not reinvest all their reported net earnings into the business; instead they pay out part of the net earnings as dividends. Often, the reason not all the net earnings are reinvested is because a company's business is not that capital intensive and therefore does not require reinvestment to that extent. If the company is well managed, the excess capital should be paid to shareholders as dividends. As a common shareholder, you would not want the company to retain this unneeded capital, because the capital will be under-utilized or invested in inferior businesses (the famed investor Peter Lynch called the latter "di-worsification"). However, retaining the capital for reinvestment does offer tax advantages, because the after-tax net earnings are not taxed again if reinvested in the business. In contrast, paying the net earnings out as dividends would result in double-taxation, once at the corporate level and a second time at the shareholder level.

Here's an illustrative example. Let's say a company has reported net earnings of $10 million and common shareholder equity of $50 million. Its ROE is $10 million divided by $50 million, or 20%. How much of the net earnings the company retains versus paying out as dividends

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is known as the ***retention ratio***. If the company does not need a lot of capital, it might for example pay out $6 million in dividends and retain the remaining $4 million of net earnings for reinvestment into the business. The retention ratio is $4 million divided by $10 million or 40%. This means for next year the 20% ROE applies to the sum of a) $50 million (this year's shareholder equity), and b) $4 million retained (rather than the entire $10 million net earnings). A company's net earnings will always grow at a slower rate than its ROE if the retention ratio is lower than 100%. In this example, net earnings will grow at ROE times 0.4 or 8% (compared to 20% if all net earnings are reinvested). While as a common shareholder you benefit from receiving dividends, this is counterbalanced by the slower growing net earnings compared to 100% retention.

Blindly buying stock in companies generating high ROE is unadvisable. As always, it depends on the price you pay for the stock. Remember that if you overpay for a high-quality *company*, you will end up with a poor *investment*. The most appropriate valuation tool to use along with the ROE metric is the price-to-book value ratio (P/BVR). Why? Book value is the same as common shareholder equity. If you pay a price per share that is equal to BV per share, you avoid paying any premium for a company's net assets. Assuming 100% retention ratio and 20% ROE, buying in at book value means you will attain a 20% return the first year, with that initial 20% continuing to compound at 20% a year going forward. With such a high return, you could pay 2 times BV and still do very well. In the first year of your investment, the company's net earnings would provide a 10% return on your purchase price (since you paid 2 times BV), but by the second year that 10% return would be growing 20% a year compounded. However, there is a limit to how high the P/BVR you can pay before your investment becomes unattractive.

To find attractive stocks, it is not sufficient to look for companies with high ROE. Rather, you also need to pay attention to their valuation by using P/BVR analysis. High ROE companies can be inferior investments relative to lower-ROE companies if you pay too high a P/BV multiple for those highly profitable companies.

# Social Security Retirement Benefits

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Deciding when to begin taking your Social Security retirement benefits can be a daunting task. But since it might be one of your most reliable sources of retirement income, it is important to know how you might maximize your benefits. In this article, we will discuss the factors to consider in deciding when to start your Social Security retirement benefits.

You have the option to start your Social Security retirement benefits earlier or later than your ***full retirement age***. Your full retirement age is dependent on your birth year, and the earliest you can start receiving Social Security retirement benefits is at age 62. However, if you retire before reaching your full retirement age, your monthly benefits will be permanently reduced by the following: 1) 5/9 of 1% for each of the first 36 months between a) when you begin taking benefits and b) when you reach your full retirement age; and 2) 5/12 of 1% for each additional month beyond the first 36 months prior to your full retirement age. Under current laws, the reduction in benefits as a result of taking benefits beginning at age 62 can be as much as 30% of the full retirement benefit amount.

If you choose to delay receiving Social Security retirement benefits ***beyond*** your full retirement age, your benefits will increase by varying percentages depending on your year of birth until you start taking benefits or reach age 70, whichever comes first. Regardless of when you begin your Social Security retirement benefits, your benefit amount will be adjusted annually to account for increases to the cost of living.

**When to take Social Security retirement payments?**

By starting benefits before your full retirement age, you will receive a smaller monthly benefit amount but for a longer period of time. By delaying benefits, you will receive a larger monthly benefit when you start taking the benefits. A simplistic approach to determine whether it is more economically advantageous to start your benefits early or late is by figuring out your "break-even age" and comparing it with your life expectancy. The break-even age is the age at which your total lifetime benefits from taking the earlier but lower payments would equal to that from taking the delayed but higher payments. For example, consider an individual who is eligible to receive a reduced benefit of $750 per month if he starts taking benefits at age 62 but could receive the full retirement benefit of $1,000 per month if he waits until his full retirement age of 66. His break-even age in this case would be age 78. If he doesn't expect to live past age 78, then it is better for him to begin taking benefits at 62 to collect as many payments as possible during his lifetime. If he expects to live well past age 78, then he should wait until age 66 to take the higher payments that would give him larger total lifetime benefits.

But as you might have expected, a more realistic approach to decide when to take Social Security retirement benefits requires more than examining just the break-even age. Here are some other factors to consider:

***Your anticipated earnings beyond age 62***. You can receive Social Security retirement benefits and work at the same time. If you have reached full retirement age, earnings will not reduce your Social Security retirement benefits. But if you are younger than full retirement age, your retirement benefits will be reduced, as follows:

1. In the years before the year you reach full retirement age, benefits will be reduced by $1 for every $2 in earnings in excess of an annual limit. In 2011, this limit is $14,160.
2. In the calendar year you reach full retirement age, benefits will be reduced by $1 for every $3 in earnings in excess of an annual limit until the month you reach your full retirement age. In 2011, this limit is $37,680.

Keep in mind though that any such deductions are not permanent. At your full retirement age, your benefits will increase to account for the benefits withheld due to earlier earnings. Studies have shown that if you anticipate earning more than the threshold amount referenced above in the years before your full retirement age, you would be better off delaying your benefits.

***Investment growth rates***. When you delay benefits to receive higher payments in the future, you are giving up the returns that you could earn from collecting the lower payments early and investing them. The more you could earn on the early payments, the later your break-even age would be, and the more likely you would be better off taking benefits early. Conversely, with lower expected returns, the break-even age would come sooner, and you would more likely be better off delaying your benefits.

***Taxes***. Under the current laws, a portion of your Social Security benefits may be subject to federal income tax. Studies have shown that taxes increase the advantages of delaying Social Security retirement benefits.

***Spousal Benefits***. Upon meeting the qualification requirements, your spouse could claim one of the two benefits from Social Security based on your earnings record: spousal benefits or survivor benefits.

When you file for your Social Security retirement benefits, your spouse can begin collecting spousal benefits based on your earnings as early as your spouse reaching age 62 even if he/she has never worked. Depending on your spouse's age when spousal benefits begin, the spousal benefits amount can be up to 50% of your full Social Security retirement benefit amount, even if you are receiving reduced benefits due to early retirement. Spousal benefits that begin before the spouse's full retirement age will be reduced by:

1. 25/36 of 1% for each of the first 36 months between a) when the spouse begins taking benefits and b) when the spouse reaches full retirement age; and
2. 5/12 of 1% for each additional month beyond the first 36 months referenced above.

Upon your death, your surviving spouse can begin collecting "survivor benefits" as early as reaching age 60. If your spouse has already been collecting spousal benefits based on your earnings record, the benefits will be automatically switched from spousal benefits to survivor benefits. The survivor benefit amount is based on either the deceased worker's full Social Security retirement benefit amount, or the deceased worker's adjusted benefit amount if he/she started taking benefits at a time different from the full retirement age. The benefit amount is adjusted down (by no more than 28.5%) if benefits begin before the survivor reaches his/her full retirement age for survivor benefits.

If you decide to take benefits early, not only will you get reduced retirement benefits, but your spouse will also receive a reduced survivor benefit upon your death. Multiple studies have shown that for a married couple to maximize their combined Social Security benefits, ***the lower-earning spouse should begin benefits as soon as possible, while the higher-earning spouse should delay benefits until age 70***.

As you can see, the decision as to when to receive Social Security retirement benefits involves multiple factors and is unique to each retiree. Some simply have to retire early because of lack of employment or poor health. However, for those who have the financial flexibility to delay taking Social Security retirement benefits, doing so could potentially maximize their lifetime benefits from the system.