Thoughts from

Hanson Investment Management Inc.

VOLUME 7, NUMBER 8 — **APRIL 2002**

The Man Who is a Bear on the Future of the U.S. Will Always Go Broke . . . —J.P. Morgan

I AM STILL VERY OPTIMISTIC about the long-term outlook for the U.S. We will have our cycles *(see p. 2)* but the long-term trend is still up. Consider these three examples:

Demographics

Fertility rates are generally falling throughout the developed world. Even in China the median age will go from 30 to 45 by 2050. The U.S. is getting older but at a slower rate. Our fertility rate is the highest in the developed world and we have been more open to immigration. A younger more dynamic population means faster economic growth and less pressure on fiscal policy.

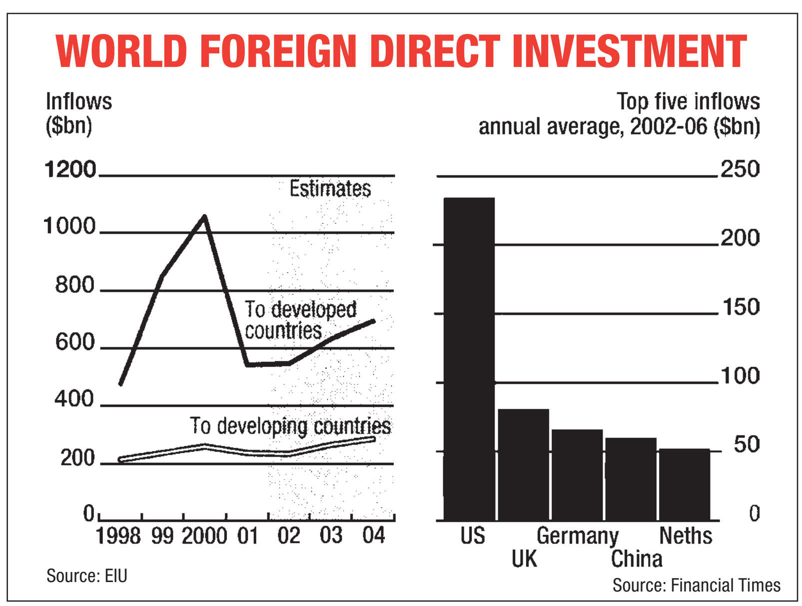
Productivity

The big surprise of this recession has been productivity. Between 1970 and 1995 output per worker hour averaged a sluggish 1.4% per year. Then over the next seven years it jumped 2.2% per year. And the recession has done nothing to slow this. The New Economy may be dead in the stock market but it certainly is alive in the economy. Higher productivity means a higher standard of living and a greater ability to meet foreign competition.

Foreign direct investing

The conventional wisdom is we are in a "race to the bottom." Capital is migrating to the lowest cost country. But this just isn't so. The U.S. has long been the number one country for inward investment and will remain so *(see chart)*. When Haier, the Chinese maker of small refrigerators, decided to enter the U.S. market it didn't import its machines. It decided to make them in South Carolina. Toyota factories and dealerships in the U.S. now employ 123,000 Americans — more than Coca-Cola, Microsoft and Oracle combined.

So don't give up on the U.S. just yet. Our future is still remarkably bright.



431 Pine Street
P.O. Box 819
Burlington, VT 05402
U.S.A.

Phone: 802-658-2668
Fax: 802-658-1027

E-mail:
ehanson@hansoninvestment.com

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.

The U.S. Scene . . .

Dr. Jekyll & Mr. Hyde Are Still Alive!

THE U.S. ECONOMY is a tale of two extremes today. On the one hand the recession of 2001 will probably go down as one of the mildest on record. GDP actually grew last year by 1.2% even though the gurus deemed a recession to have started in March 2001. Manufacturing is rebounding, consumer spending remains buoyant and unemployment continues to slip. All in all we seem set to record growth of 3% to 4% in the first half. Not much of a recession by my standards!

But on the other hand, the corporate sector has suffered its deepest recession since the 1930's. There has been a massive plunge in profits. Reported after tax income last year fell by nearly 50%.

Why this dramatic divergence between GDP up and profits down? There are a number of reasons. First overall demand stayed strong last year due to the resilience of the consumer. Consumer spending makes up 2/3 of the economy and when the consumer stays strong the economy stays strong. Consumer spending held up because the biggest asset on most people's balance sheet is real estate and housing. Real estate prices refused to budge in this downturn helped by low interest rates and consumers, seeing their balance sheets still solid, kept right on shopping.

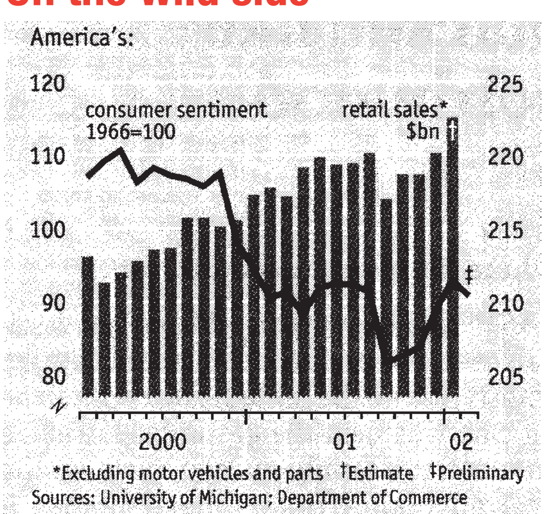
But corporate profits have been hit by the Perfect Storm. The economic momentum in the late 1990s was driven by demand for capital goods and especially high tech ones. Everyone seemed to need to build a new internal computer and communications network and this required tremendous investment. But demand fell off a cliff in the fourth quarter of 2000. Oversupply of capital goods needs to be worked off before a new cycle can start. Corporations have been doing their best to cut expenses and get their businesses more in line with revised sales forecasts but the slowdown has taken its toll.

In addition we are living in a world today with little or no pricing power. Manufacturers everywhere are experiencing margin pressure. There are too many car plants, too many clothing suppliers and too many personal computer makers. No one seems to have the ability to raise prices. This is not so bad if productivity is moving up rapidly. Rising output per worker hour allows businesses to make more money even when prices are flat. But productivity can only go so far. At some point the pressure of expenses is just too great. Some analysts see pricing power coming back as early as next year and the Federal Reserve's recent remarks hinting at higher interest rates lend support to this idea.

And finally there are the issues of plant utilization and the extra September 11 costs. As the chart to the right notes, manufacturing utilization today is at 73%, the lowest level since 1983. Like the chicken and the egg, both capital spending and capacity utilization are sitting waiting for the other to pick up. September 11 has added to operating costs. Insurance rates are higher, shipping fees are up and the whole global sourcing system is now more sticky. So profits have taken a pummeling.

Our take is we have probably seen the worst of this recession but the recovery will not be normal. No dramatic bounce back in production and profits. More a sluggish stop-and-go recovery. But this is not all bad. We concentrate on value stocks here, that is companies selling cheap relative to earnings and assets. Many issues in our universe have hit bottom profit wise and the stock market isn't expecting much from them. Investors can make money in these issues even in a slow economy. This at least is how we are playing our cards. There will be plenty of pitfalls along the way however so we are staying well diversified both in terms of the number of industries we invest in and the different size companies we look at. Getting rich slowly seems to be the name of the game now and that's fine with us.

On the wild side



Source: The Economist

WHY THEY WORRY

Despite a wave of encouraging data, other factors make CEO's reluctant to act on the good news.

UNCERTAIN DEMAND

◆ While the economy could grow 3% to 4% in the first half of the year, inventory replenishment is driving much of that rise. Many execs fear that growth will slow in the second half once shelves are restocked.

WEAK PROFITS

◆ Corporate earnings have suffered one of the worst declines since World War II. Even if the current 17% consensus earnings estimate for the S&P 500 is right, that would only get profits back to their 1999 levels.

MARGIN PRESSURE

◆ Consumer demand remains strong. But with steep discounts fueling much of that demand, margins remain thin. That is forcing CEOs to rein in costs and continue implementing layoffs and wage reductions.

IDLE PLANTS

◆ Capacity utilization in manufacturing was just 73% in January, the lowest since 1983. Most managers won't feel things are really humming until they see a much bigger upturn in demand.

MANAGING EXPECTATIONS

◆ Many CEOs got walloped by Wall Street for posting weak earnings. So most would rather underpromise now and benefit later if profits improve toward yearend.

Source: Business Week

The Global Scene . . .
The Return of the Emerging Markets . . .

YOU REMEMBER EMERGING markets don't you? Those fast growing meteors of the 1980's and 1990's, which were going to make all our goods, steal all our business and be the investment answer for all ages. Well, it didn't work out that way. In fact over the past ten years it has been more like Submerging markets than Emerging markets. The chart to the right shows that between 1990 and the end of last year, the Dow Jones Industrial Average returned 281%. Other International developed markets were up 12.4% and Emerging markets were dead last up only 7.7% for the entire twelve-year period. Ugh!

Well things might be changing now. One of the selling points of Emerging markets is that they are cheap. Take a look at the chart in the bottom right. The five largest NASDAQ and S&P 500 companies are compared to a list of twenty-four large non-Japanese Asian companies. The NASDAQ stocks trade at 52 times their earnings, the S&P 500, 31 times and the Asian companies at only under 9 times earnings.

But one of the rubs against Emerging markets has been that you can't believe the accounting. John May a consultant for CLSA Emerging Markets has looked at reported earnings and also GAAP (Generally Accepted Accounting Principles) earnings for the same U.S. and Asian group. He found that the S&P and NASDAQ companies actually overstated their reported earnings relative to what came out in GAAP form, whereas the Asian companies were conservative and understated them. After Enron you have to wonder who is aggressive on accounting and who is conservative, the U.S. or Emerging markets?

Emerging market companies are also paying more attention to profitability today. Historically it has been the inside investors who have benefited and outside investors who have suffered. But the *Financial Times* reported recently that Asian returns on equity will be 12% this year very competitive with the long-term U.S. average of 12% to 15%. In the past Emerging market ROEs have languished in the 2% to 5% range.

Finally Emerging markets are more stable today. Yes, I know there are still Argentinas out there but most if not all-major Emerging markets have switched to floating exchange rates from fixed and this reduces significantly the chance of currency attacks. Emerging markets are also doing a better job with fiscal policy. Brazil tackled its triple digit inflation more than ten years ago and has been diligent since. If it can get through the Presidential election in October another major hurdle will have been cleared. Historically the biggest problem for emerging markets has been keeping government policies prudent and consistent over an extended period of time. It looks like they are winning now.

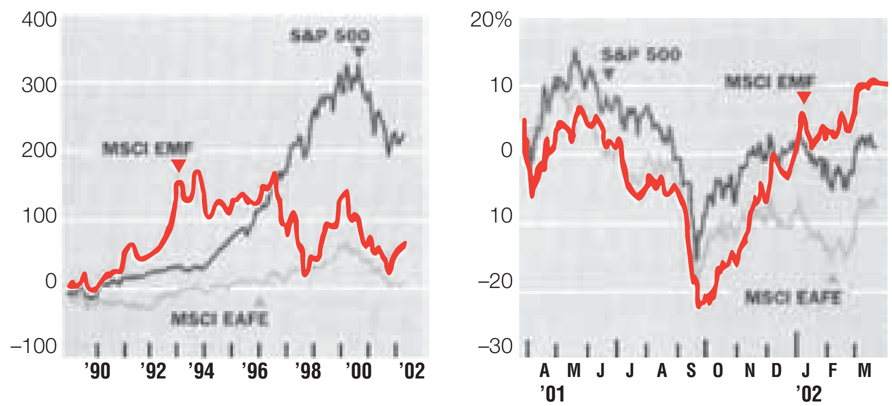
But Emerging markets are not problem free. Jim Rogers the portfolio manager and author of *Investment Biker* has taken two well publicized round the world trips, one in 1990 and the other just completed last year. He has been a consistent fan of globalization. But now he is more glum. Countries are starting to close themselves off, protectionism is in the air and tribal, ethnic and religious feuds are cropping up more frequently. The benefits of globalization may be out there but Rogers is not optimistic about Emerging market investing today.

This is always the problem with the world. The outlook is usually murky and the coast is never clear. I think, however, the sky is clear enough for Emerging markets now; stock valuations are low and globalization continues to pay dividends. This is a time to be well diversified and diversification in my mind includes Emerging markets.

END OF AN ERA?

For more than a decade the U.S. has been the global stock-market leader, but recently the foreign markets seem to be closing the gap. Performance of the S&P 500 index vs Morgan Stanley Capital International's Emerging Markets Free Index (EMF) and its Europe, Australasia and the Far East Index (EAFE).

Long term performance . . . **And the short term.**

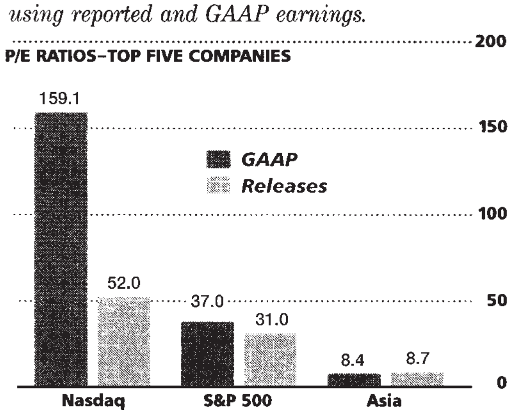


Source: Thomson Financial/Datastream

Source: Wall Street Journal

HOW GOOD ARE ASIA'S EARNINGS?

▸*Asian companies' earnings reports seem to be more accurate than those in the U.S., as indicated by the smaller difference between their P/E ratios using reported and GAAP earnings.*



Source: Barrons

Investing Themes . . .

Blue Gold . . .

THE DROUGHT OF THE PAST YEAR has given Vermonters a small taste of what much of the rest of the world struggles with on a daily basis. Today, the World Bank estimates that approximately half of the globe's 6 billion people lack proper sanitation and 1 billion cannot get safe drinking water. While Vermont's drought may end soon, the global water shortage will not. Take a look at the chart to the right. Without new spending, it has been estimated that by 2025, 1 out of every 3 people will be without clean drinking water.

To understand the great irony of the growing water shortage, consider the following fact. Although two-thirds of the planet is covered with water, less than 1% of that water is available and suitable for human use. And the water that is available is not evenly spread across the globe. Historically, water scarcity and lack of proper sanitation have made water shortage a developing country phenomenon. But longer term, clean water is going to be everyone's concern for two simple reasons. First, global consumption of water is increasing. Second, the water resources now available are becoming increasingly contaminated.

Traditionally, the job of ensuring safe water has fallen to local and regional governments. But as water treatment and supply solutions have become more costly and complicated, governments have turned to the private sector to help solve their needs.

On the front line of efforts to provide clean water are large utilities that own and operate former municipal water systems. The two largest companies are Paris-based Suez and Vivendi Environmental. These two firms have been aggressively investing in utilities and major water and wastewater treatment operations across the globe. Today, Suez is helping to operate water systems from Atlanta to Shanghai to Casa Blanca. Vivendi operates numerous systems in the U.S. and its international operations include contracts with Berlin and Prague. Because the global water supply industry remains highly fragmented, opportunities for further growth are enormous. In the U.S., for example, less than 5,000 of the 55,000 water systems are now privately operated.

In most large urban areas, getting clean water to those who need it means repairing aging distribution lines and treatment facilities. While funding this work will not be easy, growing concern over contaminated water and stiff water quality regulations should support increased public sector spending. A wide range of water technology firms will benefit from this spending spree. Insituform, for example uses new techniques to clean water lines while avoiding disruptive and time consuming digging operations.

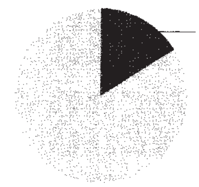
Technology is transforming water treatment in other areas as well. In the pharmaceutical industry, new separation technologies are used to develop biotech products while innovative filtration techniques are being employed in semiconductor manufacturing. Hans Portner, a water industry investor, estimates that a semiconductor company needs about 7,900 gallons of ultra pure water to produce a single microchip. Finally, new membrane-based methods of separating salt from seawater is now making desalinization a more cost effective option for many water deprived countries.

Water stocks, long viewed as stodgy, low growth investments, have not gone unnoticed by Wall Street. Water stocks' steady earnings streams have attracted investors looking for an alternative to the formerly high-flying tech stocks. Numerous acquisitions over the past two years has further supported investor interest. Schwab Capital Market's Index of water stocks has performed well this year after topping the major stock averages the past two years.

While not as cheap as they once were, we think individual stocks in the group look interesting. Demand for clean water is sure to grow. Water quality regulations should further support growth and industry consolidation remains in force. Our preference is to look for companies with strong products and services and patiently wait for individual buying opportunities.

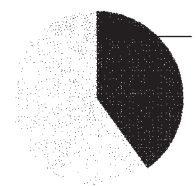
Anne Williams Doremus, CFA

An Untapped Market



16% of the world's population—some one billion people—currently lack clean water.

If more money isn't invested, that is likely to rise to ...



40% of the population by 2025—some 2.5 billion people.

Water is a $400 billion global business. But most cities in the developing world have inadequate systems that would benefit from privatization. Since only 5% of the water industry is currently in private hands, the potential for growth is great.

Source: Fortune

Water Works

Company	Ticker	Price (4/5/02)	52 Week High-Low	Market Value (millions)	Price to Earnings Ratio	Dividend Yield	Debt to Total Capital
Groupe Danone	DA	$24	(28-22)	$16.7 bn	21x	1.4%	72%
Insituform	INSUA	$26	(43-13)	684 mn	17x	0.0%	27%
Millipore	MIL	$42	(67-41)	2.0 bn	23x	0.0%	50%
SUEZ	SZE	$28	(40-28)	28.8 bn	17x	0.0%	71%
Vivendi Environment	VE	$31	(40-30)	10.7 bn	23x	1.3%	73%

Source: Hanson Investment Management