Thoughts from
Hanson Investment Management Inc.
VOLUME 6, NUMBER 8 APRIL 2001

Stay focused on what you can know . . .

AND DON'T WORRY ABOUT WHAT YOU CAN'T. This good advice comes from Brad Perry, retired chairman of David L. Babson.

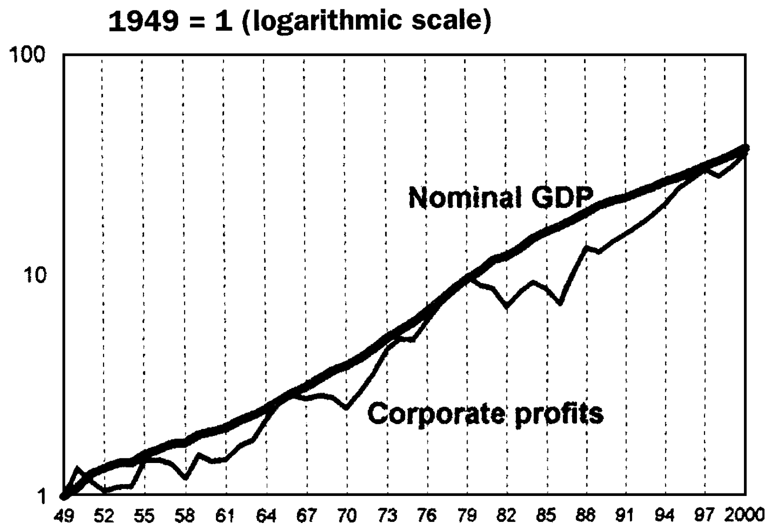
Are we in a recession now or just a downturn? Has the stock market found a bottom? These are all questions we can't know the answers to. But there are plenty of things we can know.

The first is that the economy will continue to grow in the future. How much? Pretty certainly 6% a year or more. How do we know this? Because the long term record of growth is very consistent and we know the breakdown of this growth. Over the past fifty years GDP has grown 7.4% per year. This is made up of two components. The first is inflation, which has averaged 3% to 4%. The second is real GDP or inflation adjusted growth. This has also averaged 3% per year. Real GDP consists of the annual increase in the U.S. work force (about 1%) and the increase in productivity (about 2% to 3%).

Knowing that GDP will grow is important because corporate profits track very closely with economic activity *(see below)*. And stock prices in turn track very closely with profits. The 7.4% increase per year in GDP over 50 years compares to a 7.6% increase in after tax profits and an 8.3% per year increase in the Dow Jones Average.

The immediate future is uncertain but it is a lot less so when you factor in the consistent long-term prospects for GDP, profits and the stock market. So stick to what you can know not what you can't. Buy companies selling at reasonable valuations to their sales and earnings and then ride the wave of GDP and corporate profit growth.

Corporate Profits After Tax vs. Nominal GDP, 1949-2000E



Source: Peter L. Bernstein, Inc. Source: The Gloom, Boom and Doom Report

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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.

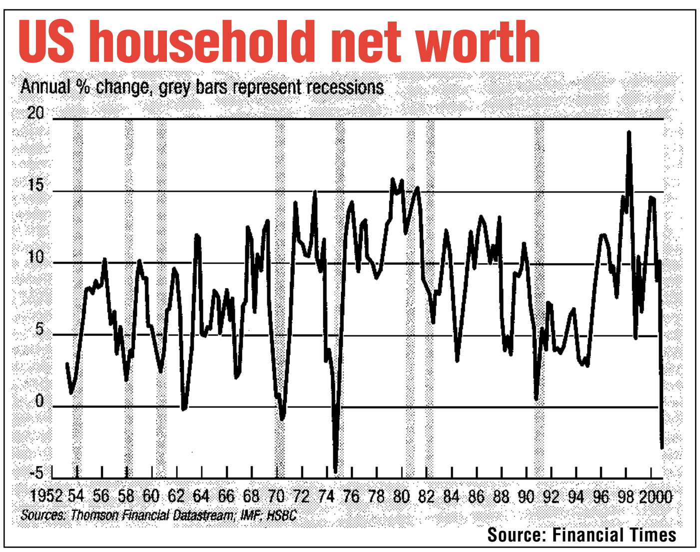
The U.S. Economy (take 1) . . .

Toto I don't think we are in the 1990's anymore . . .

THIS DOWNTURN SEEMS a lot different from the more shallow, quick to bounce back ones of the 1990's. I don't want to rain on anyone's parade but the symptoms this time look a lot more ominous. Typically demand is the problem at the end of economic cycles. Excess buying pushes up inflation and then the Fed steps in, raises interest rates and causes a slowdown or even worse a recession.

This time supply is the culprit. We had a blow-off in business capital spending in the 1990s. This led to a big build up in production and now excess capacity in many sectors. With demand drying up layoffs are mounting, consumer confidence is slipping and individuals are getting ever more in debt *(see chart to the right).*

The thing that worries me most now is not the excess supply but the financial fall out of the boom. When tech demand grew in the 1990s, tech stocks got positively red hot. The NASDAQ Composite nearly doubled in 1999. And individuals jumped in with both feet. By 1999 Americans had 60% of their investments and savings in the stock market, double the percentage of 1982. People's financial lives got very tied up with the stock market.



Source: Financial Times

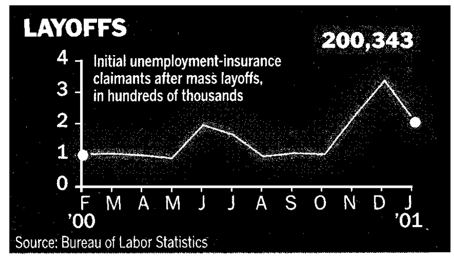
Then prices fell. Take a look at the chart below. U.S. household net worth actually declined last year for the first time since the mega-recession of 1974. This is very unusual. And unfortunately there is not much room for error in the average consumer's balance sheet. Debt levels are already high and savings last year fell to below zero as a percent of income for the first time ever.

When you take a step back however and look at the big picture you wonder what we have to complain about today. Living standards are the highest in history, disease is down and life expectancy and personal freedom is up. This is our Golden Age. But money does strange things to people. Daniel Kahneman and Amos Tversky, two of the earliest researchers in the field of behavioral finance, found in studies that people are far more concerned with changes in wealth than the absolute level of wealth. A high income is important but a rising level of income is even more important. This is what gives us our sense of security.

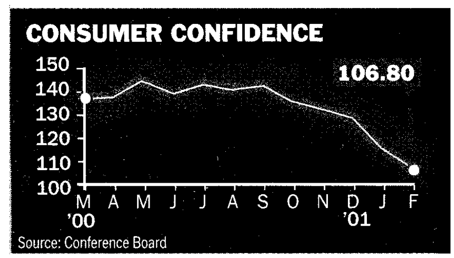
And sense of security is what we don't have today. Net worth down, job losses are up and balance sheets are stretched. This is what worries me now. In an attempt to rebuild liquidity and long-term savings the consumer may just go on a buying boycott. The boom of the 1990s took years to develop. It may take years to work off the excesses. *(For a more upbeat take on the world see page three).*

POTHOLES

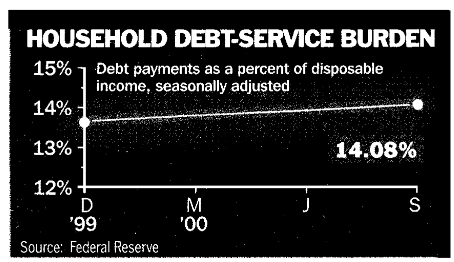
The stock market isn't the only indicator signaling trouble



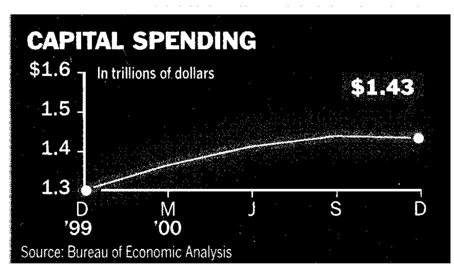
It's not just the dotcoms: JC Penney, Compaq and Chrysler are slashing jobs



This closely watched indicator has reached its lowest point since June 1996



A heavy debt load will limit consumers' ability to spend



Slowing capital expenditure is choking growth in high-tech areas

Source: Time

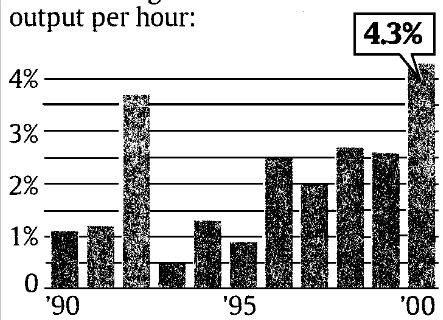
The U.S. Economy (take 2) . . .
Yes this Dog still hunts . . .

PAGE TWO CAUTIONED that this downturn might not be fixed as easily as ones in the 1990's. But there are still plenty of reasons to be optimistic.

The first is that this downturn is supply caused and supply can get absorbed quicker than we think. Sure there is an awful lot of excess bandwidth, excess routers and excess computers out there but the demand for high speed Internet connections, wireless phones and semiconductor chips is incredible and like real estate in the early 1990's it doesn't take much of an upturn to get supply out of the way.

Productivity rockets

Productivity growth soared since the mid-1990s, marking the greatest productivity surge since the late 1960s. Annual changes in non-farm business output per hour:



Source: Bureau of Labor Statistics

By Adrienne Lewis, USA TODAY

A second reason for optimism is that the traditional signs of economic distress are just not there now. Take a look at the chart to the right. The housing market is in good shape, inflation is low, even with oil prices up and interest rates have come down and will continue to.

And a third big reason for optimism is productivity. Alan Greenspan has said numerous times in testimony, today's crucial economic news is that American companies are squeezing more output out of every hour of work. "We are only part way through the most remarkable period of technological advance which is crucial to productivity growth," he says.

The *Wall Street Journal* recently ran two front-page stories on productivity. These were not pie in the sky stories of E Commerce this or Virtual Networks that. Instead they are stories about real companies doing real things. Huffman Corp in Clover South Carolina for instance is a maker of machine tools. They have been able to reduce the time it takes to produce their highest end machine by 60%. Using sophisticated semiconductor chips Huffman grinding machines are so precise and so fast that auto companies can now remove almost all the friction in the gears in automatic transmissions. This means longer life and significantly less noise.

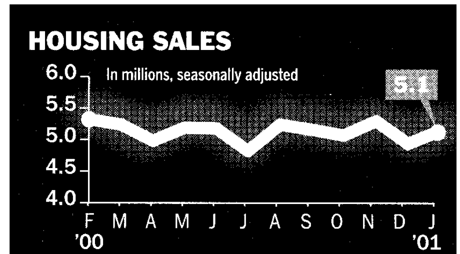
High technology has allowed LTV, the steel company, to boost its output of steel per employee from 514 tons in 1994 to 629 tons now. And Pratt & Whitney using new processing procedures and smaller more sophisticated machine tools has cut the total lead-time to make and finish a turbine blade from 22 days to 7.

Foreign companies are also helping us out. Toyota produces 1.3 million cars in the U.S. now and they want to go to 2 million by the end of the decade. Toyota has pushed its local U.S. suppliers to be as productive and quality conscience as suppliers in Japan. This has meant improvement for Toyota and also improvement for Detroit, which buys from many of the same suppliers. General Motors has increased the number of cars produced right the first time from 55% to 70%. They continue to chase Toyota's league leading 80%.

In summary the U.S. Economy is dangerously close to a recession now. But this is the temporary problem. Longer-term prospects for the economy remain very good. Inflation and interest rates are low, the housing market is solid and productivity gains spurred by advancements in technology are pushing us to new high ground.

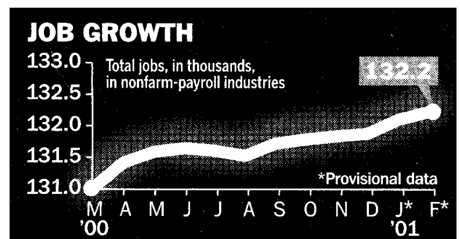
SHOCK ABSORBERS

For all the talk of recession, the U.S. economy has several areas of strength



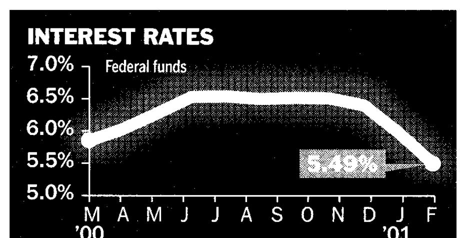
Source: National Association of Realtors

Existing-home sales have held fairly steady; construction is also strong



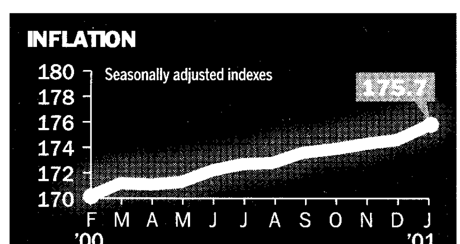
Source: Bureau of Labor Statistics

Despite layoffs, unemployment is low (4.2%), and new jobs are being created



Source: Federal Reserve

Rates are falling, putting more money in people's pockets



Source: Bureau of Labor Statistics

There's little risk that inflation is going to have a resurgence

Source: Time

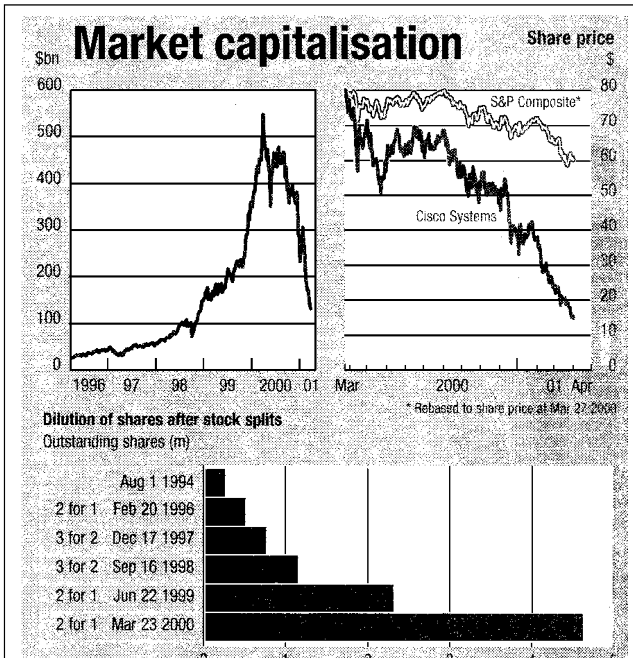
Investing Trends . . .

"Nothing sedates rationality like large doses of effortless money." *Warren Buffet*

PERHAPS NO STOCK SERVES as a better poster child for the recent meltdown of technology stocks than Cisco Systems. Although we at Hanson have never owned Cisco, the story behind this dominant company explains a lot about how technology powerhouses are built *and* dismantled.

Take a look at the chart below. Slightly over a year ago, Cisco became the world's most valuable company with a market capitalization of $550 billion dollars. Today, Cisco's share price lies 80% below its all time high and its market capitalization of $109 billion is nearly half that of such "old economy" stalwarts as Exxon-Mobil and Walmart.

During the early 1990s, Cisco became a dominant supplier of equipment that powers the Internet and corporate computer networks. While Cisco's products enjoyed strong demand, much of its growth came from acquiring small companies with promising technologies. Since 1991, the company purchased over 70 companies and between 1999 and 2000 it was acquiring firms at the rate of two a month. This powerful combination of strong internal growth and acquisitions fueled consistently rising earnings and a soaring stock price. By March of 2000, Cisco was trading at a price-to-earnings ratio of over 160.



Source: The Financial Times

The rising stock price also helped Cisco in other ways. Throughout the late 1990s, stock options became the compensation of choice for most high tech employees. With its share price doubling every twelve months, Cisco was able to attract and retain the industry's best and brightest engineers.

But what a difference twelve months can make. Many of Cisco's competitive advantages have evaporated in the face of the stock market's decline. A weak share price has robbed the company of the currency needed to aggressively pursue acquisitions. Attractive option packages once dangled in front of prospective employees no longer look so appealing. According to one estimate, up to 70 percent of the company's current employees are now holding stock options that are effectively worthless.

Rising bankruptcies in the Telecommunications and Internet sectors, two of Cisco's core markets, are also proving especially difficult today. Many customers are cutting back on orders and those customers in bankruptcy are unloading used Cisco equipment at substantial discounts to listed price. The downturn in these markets is also negatively impacting Cisco's vendor financing business where the company lends money to its customers to purchase big orders. Now, many are questioning how these loans will be repaid.

While the above mentioned difficulties will be tough to overcome, perhaps the greatest challenge to Cisco relates to its sheer size. In the last six years, Cisco has grown from 3,000 employees to more than 44,000. Annual revenues have increased 15-fold since 1995 to over $19 billion. Although size and scope are considered competitive advantages in many industries, they can be fatal in the technology field where entrepreneurial spirit and creativity are critical to survival.

Certainly, Cisco is not the first company to experience these growing pains. Consider the results of a recent survey by Sanford Bernstein. Over the last fifty years, only 10% of companies in the S&P 500 have increased their earnings at an average rate of at least 20% a year for five years. Only 3% have raised earnings at least 20% annually for a decade and none have sustained 20% earnings growth for 15 or more years.

Only one high-tech company has sustained double-digit earnings growth for more than twenty years and that is IBM. The secret to IBM's success relates partly to its broad diversification. In addition to its well-known mainframes, IBM has strong software, services and personal computers businesses. Equally important are the company's strong research capabilities. IBM's research labs are incredibly productive with the company registering more patents last year than any other US firm.

While Cisco's current challenges now appear daunting, don't count the company out just yet. Its products and services are still world-class and it operates in a business whose long-term prospects are bright. To take the business to the next level, however Cisco's management will have to keep one eye focused on the strategies of long-term survivors like IBM and one eye over their shoulder at emerging competitors like Procket Networks, Sycamore and Juniper.

—Anne Williams Doremus