

Thoughts from

# Hanson Investment Management Inc.

VOLUME 9, NUMBER 8

APRIL 2004



**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 Masters Is All About Golf, Right? . . .

**W**HERE YOU STAND depends on where you sit on this one. It was certainly a thrilling victory for Phil Mickelson this year. But the Masters is also about money and globalization. Duffers drool over the equipment and clothes of the smooth swinging pros. And there is no better seller than Tiger Woods. Thank goodness he made the cut this year. Nike dresses and clubs Tiger and it decides up to a year in advance what he is going to wear. How did you like that fashion forward black mock turtle on Saturday? No collar. Pretty risqué for the Masters. On Sunday Tiger wore red in a new double mercerized 100% cotton with a more luminescent sheen and smoother look. And you thought he just pulled something out of the closet!

When Tiger last won the Masters in 2002 Nike was aghast that his Sunday polo was wilting badly in the Georgia humidity. Monday morning the global supply chain crackled to life with the new marching order: make a shirt that won't wilt.

Esquel is one of the big players in the ultra competitive Chinese textile market. Historically they made inexpensive clothing for Kmart. Now they have moved up the quality curve. They control every facet of the clothing process from growing cotton, to spinning and weaving, to producing the final product. And they do this to the tune of 60 million shirts a year. By October 2002 the new "wilt free" Tiger shirt was rolling off the line.

So now the important question is: what is Tiger wearing next year? He probably doesn't even know yet but you can be sure they know in China.

### Demand & Supply

How a wrinkle in Georgia became a work order in Guangdong

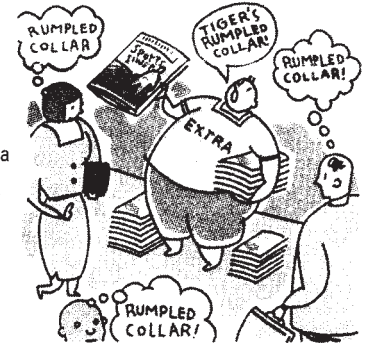
**April 14, 2002:** Tiger Woods wins the Masters Tournament in Augusta, Ga., wearing a Nike Golf polo shirt with a collar spoiled by southern humidity.



**The next day,** Esquel Apparel, a Hong Kong shirt maker, receives a call from Nike to design a polo-shirt collar to withstand the weather.



**April 22, 2002:** Sports Illustrated runs a cover photo of the victorious Woods and his droopy collar.



**Immediately,** Esquel's research and development team in China begins work on the new fabric. This is a task made simpler by the fact that the 47,000-employee company controls every link in its supply chain, from cotton fields in Xinjiang to factories in Gaoming.



Source: Esquel

**By May,** Esquel sends prototypes to Florida for field testing.

Illustrations by Ward Schumaker  
Source: Wall Street Journal

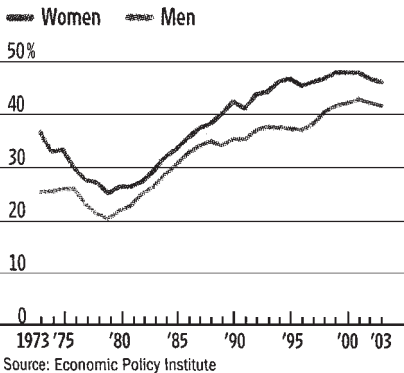
# The Global Economy . . .

## This Is My Big Worry . . .

WHEREVER YOU TURN TODAY there seems to be a story about outsourcing. Actually outsourcing is not the exact right term. No one cares when IBM hires another U.S. firm to do catering or contact research or whatever. What we are alarmed by is offshoring or shipping U.S. jobs to India and China to be done at lower cost.

### Prizing Education

The premium employers pay for workers with four-year college degrees over those with high-school diplomas has risen over the past 20 years



Interestingly we have been a big beneficiary of outsourcing/offshoring historically. When a lawyer in New York does work for a German auto company or when a U.S. investment banker does a deal in Europe, this is outsourcing and we benefit. The value of all U.S. exports of legal work, computer programming, engineering, management consulting, etc was \$131 billion in 2003, up 7% from the year before. We have consistently run a surplus in outsourcing to the tune of \$77 billion in 2003.

“Insourcing” is also something we don’t focus on, but something we benefit from greatly. Foreign companies now employ 6.4 million Americans here in the U.S. (see chart in lower right). Even though this is a smaller number than what American firms employ abroad, the number of U.S. workers of foreign companies has been growing rapidly.

But the fact remains foreigners are becoming more and more educated and

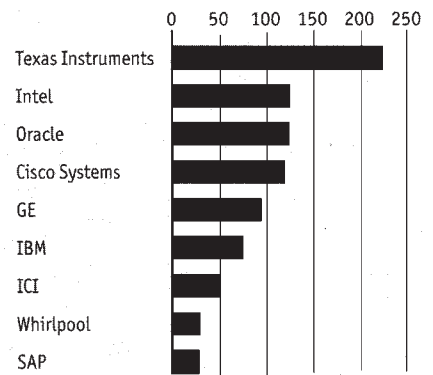
finding more innovative ways to eat our lunch. I am not that worried about lower value added call centers moving to India. What I am worried about is tomorrow’s high value added jobs bypassing the U.S. and ending up at foreign sites of U.S. firms. IBM today has over 9,000 employees in India and as the chart in the upper right shows, these employees are doing higher value added work. They are not just writing code to maintain legacy systems but are doing R&D for tomorrow’s cutting edge products.

And India may be the leading edge of a new model for high tech or innovative industries. Everyone is finding it more expensive to maintain large research and development staffs especially between product cycles. Wipro, one of India’s largest outsourcing companies, has addressed this by offering an “R&D on demand” service, if you will. They maintain a large R&D staff and you buy time on their system when you need it. This is similar to what the foundries are doing in the semiconductor business. Companies like Taiwan Semiconductor maintain extremely large and sophisticated semiconductor plants that produce chips for companies who do not have their own production facilities.

If this trend continues, meaning more high value added jobs leaving the U.S. for low cost areas, we could see a further jump in income disparity in the economy. Those at the high end with talent and education have nothing to fear. They will be in great demand and will do fine. And those at the lower end doing necessary service jobs will also be in big demand. The problem is those in the middle who are likely to get squeezed by college educated foreigners willing to work for lower than U.S. wages. The implications for the economy and our institutions are potentially major. Can a democracy deal with the increasing frictions of widening income disparity? And what are the implications for

### IP, IP, hooray

Current patents, by Indian entity



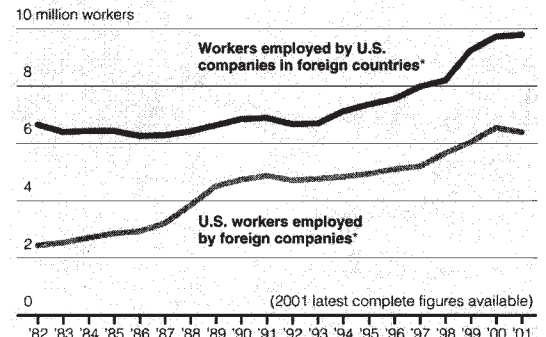
Sources: Nasscom; Evalueserve; Naissance Capital; companies  
Source: The Economist

fiscal policy when fewer people are earning good wages at the same time that more Baby Boomers are retiring?

Keep in mind I may be an alarmist here. A couple of months or a couple of years of good job data and this may all be forgotten. The U.S. has a history of destroying low value added jobs only to create higher value added ones on the other side. There is no reason to believe this trend won’t continue. But I have a nagging suspicion this time may be different. Educated emerging market workers are no longer just interested in menial jobs and cheap manufacturing. They are now interested in the top prize. And they are coming really well prepared today.

### Globalized Workers

Though more and more workers are employed abroad by American companies, the number of workers employed here by foreign companies, while fewer, has also been rising.



# The U.S. Market . . . Dow 10,000 . . . A Backgrounder . . .

**W**HEN MOST PEOPLE THINK of the market they think of the Dow Jones Industrial Average. Tell people the market closed at 1143 and they draw a blank. This is the level of the statistically correct Standard & Poor 500. But tell them the market is 10,400 and then there is some understanding.

The Dow Jones Industrial Average is an anachronism to many people. It is managed by the editors of the *Wall Street Journal* who make changes in the 30 components whenever they see fit. Recently three stocks were added and three stocks were removed. This is the

The principal criticism of the Dow today is, how can an Index of just thirty stocks represent the entire U.S. stock market? The Standard & Poor 500 is a much better barometer statisticians say. The S&P 500 includes 500 of the largest companies in the U.S. and it is capitalization weighted, computed by multiplying a company's outstanding shares by its stock price. The Dow in contrast is price-weighted meaning it looks at each component's share price. Higher priced stocks have a greater weighting than lower priced ones. But what happens when a \$90 stock splits its shares 3-1? The stock price immediately falls to \$30 and its weighting in the Dow falls by two thirds. And yet nothing fundamental has changed with the company. Ridiculous say the critics.

But the fact is the Dow has been a very good "measurer" of the market. Since December 1995 when I last wrote about the Dow here the Index is up 8.9% per year in price terms and around 11.5% per year when you add dividends back. The Standard & Poor 500 is up virtually the same amount, 8.5% in price terms and 11 or 11.5% on a total return basis.

There is an interesting statistical quirk happening with the Dow now. As mentioned earlier the original Dow was figured by adding the closing prices of all the Dow stocks and dividing by the number of components. But when stock splits occurred the divisor had to be reduced to keep consistency. Today the divisor is down to .135 from 30. When a divisor falls below 1.0 it becomes a multiplier. So if each Dow component were to move 1 point today the average would change 222 points. As recently as eight years ago with a higher divisor a 1 point gain or fall in each Dow component moved the market only 87 points. The lesson here: get used to even more volatility in the future in our favorite market index.

## The Original 12 Dow Companies

March 1896. Dow's point level was 40.94

- American Cotton Oil
- American Sugar Refining Co.
- American Tobacco
- Chicago Gas
- Distilling & Cattle Feeding Co.
- General Electric Co.
- Laclede Gas Light Co.
- National Lead
- North American Co.
- Tennessee Coal, Iron & Railroad
- U.S. Leather
- U.S. Rubber Co

Sources: Dow Jones Indexes  
Research Systems; WSJ

first change since 1999. AT&T, Eastman Kodak and International Paper were let go and American International Group, Pfizer and Verizon were brought in. Over the past ten years the index has become more service sector oriented and less focused on manufacturing. This reflects changes in the economy.

*Take a look at the chart to the right.* The Fortune 500 is a list of the 500 largest companies in the country ranked by sales. Fifty years ago when Fortune magazine first introduced the list they restricted membership to industrials. Today service companies are allowed in and of the 50 largest companies 33 are in the service sector and only 17 are industrials. The Dow Jones average has had to make adjustments for this shift.

## THE FORTUNE 500

*Since 1995 we've included service companies and industrials on the same list. Had we stuck to our original rules, 33 big names wouldn't have made the cut.*

**Companies in blue would not have been included on this year's list if we had used 1955 rules**

RANK	Company
1	Wal-Mart Stores
2	Exxon Mobil
3	General Motors
4	Ford Motor
5	General Electric
6	ChevronTexaco
7	ConocoPhillips
8	Citigroup
9	International Business Machines
10	American International Group
11	Hewlett-Packard
12	Verizon Communications
13	Home Depot
14	Berkshire Hathaway
15	Altria Group
16	McKesson
17	Cardinal Health
18	State Farm Insurance
19	Kroger
20	Fannie Mae
21	Boeing
22	AmerisourceBergen
23	Target
24	Bank of America
25	Pfizer
26	J.P. Morgan Chase
27	Time Warner
28	Procter & Gamble
29	Costco Wholesale
30	Johnson & Johnson
31	Dell
32	Sears Roebuck
33	SBC Communications
34	Valero Energy
35	Marathon Oil
36	MetLife
37	Safeway
38	Albertson's
39	Morgan Stanley
40	AT&T
41	Medco Health Solutions
42	United Parcel Service
43	J.C. Penney
44	Dow Chemical
45	Walgreen
46	Microsoft
47	Allstate
48	Lockheed Martin
49	Wells Fargo
50	Lowe's

FORTUNE CHART

# Financial Planning . . .

## How Long Will My Funds Last? . . .

**M**OST PEOPLE INVESTING for retirement want the answers to two basic questions. First, they want to know how much money they can annually withdraw from their portfolios without running out of funds prematurely. With life expectancy rates now pushing 80, this means that most retirees will want their funds to last 20-30 years. Second, they want to know how their portfolios should be invested to meet this objective.

An article by William Bengen sheds some interesting light on these questions. Typically, financial advisors approach retirement planning by first looking at historical averages for stock and bond returns and inflation. Using this data, they then build models to project how long your portfolio will last (portfolio longevity) under different withdrawal rates.

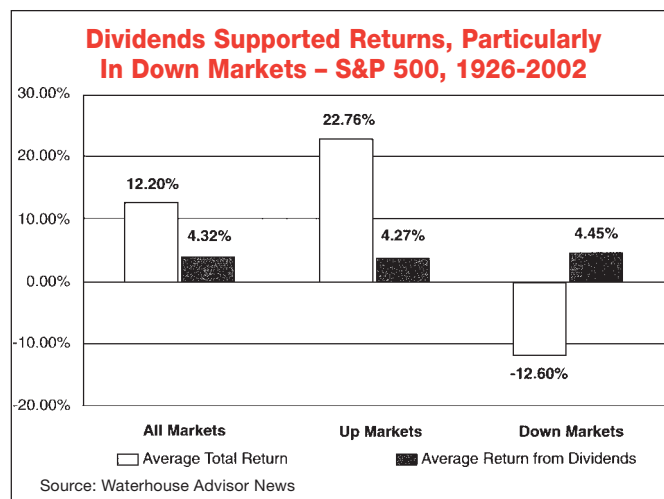
The problem with this approach, Bengen notes, is that real life rarely mirrors the averages. And what matters in investing is not just what return you earn but when you earn it. To address this, Bengen looked at the longevity of portfolios that started each year since 1926 assuming different withdrawal rates. This approach allowed him to mirror the impact of large negative market events at different times in a portfolio's history.

While his methodology can be somewhat confusing, his conclusions for a portfolio equally weighted in stocks and bonds are straightforward. Withdrawal rates up to 4% of a portfolio's initial

market value (and then subsequently adjusted for inflation) should be fairly safe for investors interested in having their funds last at least 30 years. Withdrawal rates exceeding that 4% rate, however, run the risk of exhausting portfolios much more quickly.

Bengen also examined what mix of stocks and bonds had the best chance of lasting given historical returns. *Take a look at the chart below.* For people in retirement, holding some combination of stocks and bonds makes sense. This is the old rule of diversification. Because stocks and bonds do not rise and fall together, combining them in one portfolio helps dampen volatility and enhance returns. In addition, portfolios with dominant (greater than 50%) stock positions produced the best results and holding too few stocks did more damage than holding too many. The recovery power of stocks is the force at work here. Consider market results of the last three years. Bonds, while stable, do little to help a portfolio snap-back after an extreme market downturn.

If the thought of adding more stocks to your portfolio still has you sweating, *take a look at the chart above.* Less risky dividend paying stocks can help balance investors'



needs for appreciation, stability and income. Over the 77 year period from 1926-2002, dividends contributed an average 36.3% of the market's total return. Dividend returns also have two reassuring characteristics. First, they have remained remarkably stable over time and second, they have actually tended to increase during market declines.

True, the average stock today offers a measly 1.6% yield. But I suspect, dividend yield will become an increasingly important contributor to stock returns going forward. The recent economic rebound is supporting higher corporate earnings and thanks to last year's tax law changes, companies are now more willing to pay these earnings out to investors in the form of dividends. Today, dividend income is taxed at the same 15% rate as capital gains. This favorable treatment has already led 229 companies to increase their dividends by an average of 26% and I expect more will follow.

While Bengen's work is useful, it should not be considered a prescription for every investor. Sound retirement planning starts first with a clear understanding of each individual's spending needs, risk tolerance and time horizon. But a review of actual historical results tells us that stocks play an important role in maximizing portfolio longevity. This is an important fact to keep in mind in both up and down markets.

– Anne Williams Doremus, CFA

