Thoughts from

Hanson Investment Management Inc.

VOLUME 11, NUMBER 8 **APRIL 2006**

Anxiety Amid Prosperity ...

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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.

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THIS IS HOW ROBERT Samuelson characterized the U.S mood in *Newsweek* recently. On the one hand the global economy is doing just fine *(see chart at bottom)*. The U.S. is growing 6% in nominal terms and the rest of the world is kicking in, even Japan starting this year. But investors are as anxious as they can be now. What gives? According to Samuelson globalization has added a new twist to the cycle. Intense competition is forcing the economy to make constant minor adjustments. These midcourse corrections have muted the periodic sharp ups and downs of the cycle. The economy is actually more stable today than in the past. Look at what little damage rising interest rates, an oil shock and two big hurricanes have done to the overall numbers. But individual sectors like autos have been in incredible turmoil as they wrestle with decades of built up problems.

Marc Faber in his "Gloom, Boom and Doom Report" recently reviewed the book, *Our Brave New World,* by the team at Gavekal Research. Their thesis, somewhat similar to Samuelson is that globalization, specifically outsourcing is making us more stable not less. Manufacturing and basic services are being outsourced today. These are the most volatile jobs and the first ones to be cut in a slowdown. The U.S. so far is holding on to the 'creative' jobs in marketing, product design, etc. The implication is our economy can take bigger shocks and financial markets can sell at higher prices due to the greater stability.

A recent Sunday *New York Times Magazine* story noted that according to the Human Security Report 2005, the number of armed conflicts in the world has steadily decreased since the end of the Cold War. The world is actually becoming more secure, not less. But we here are feeling the opposite. The reason is that terrorism is replacing lethal conflicts and the U.S. is target #1 for terrorists. Direct conflict and "lethality" may be down but our sense of insecurity is up.

So there you have it. On one hand we are looking at a world that is possibly getting more stable. On the other hand we are feeling the anxiety of unstable sectors (autos and others) and the pressure of terrorism. On this one where you stand definitely determines where you sit!

The Global Delta in 2005

(Dollar-based nominal GDP at market exchange rates)

	Growth %	Growth, US$ bil.	$ growth per pctg pt., US$ bil.	Share of world GDP, %
US	6.1	718.1	117.7	28.4
Europe	3.5	446.7	127.6	30.3
Japan	0.0	1.1	46.7 *	10.6
Asia ex-Japan	12.9	541.4	42.0	10.8
China	15.5	256.0	16.5	4.4
India	12.2	81.0	6.6	1.7
Emerging Europe	20.1	335.0	16.7	4.6
Latin America	19.3	346.6	18.0	4.9

* Japan calculation derived on the basis of hypothetical 1% increase in nominal GDP.
Source: IMF, Morgan Stanley Research

U.S. Market . . .
Value versus growth and big versus small . . .

WE CALL OURSELVES VALUE Managers. We look for stocks selling cheap relative to earnings and assets. We avoid growth stocks which are companies with fast growing sales and earnings that typically sell at high stock valuations. We are suspicious that investors have already discounted the strong sales of growth stocks and any earnings misstep could send the price down sharply. We think over time that value outperforms growth and most of the research we have seen bears this out.

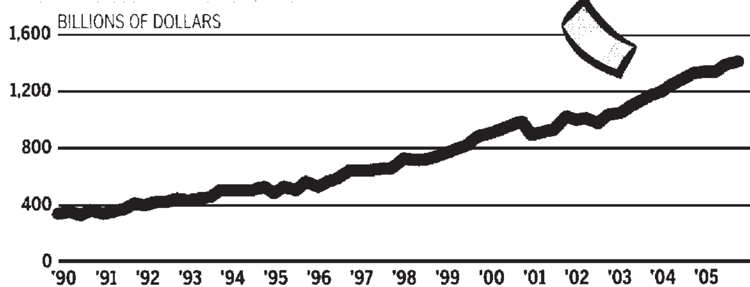
But the problem is companies do not wear nice neat investment badges. They are not born "growth" stocks or "value." Most companies morph back and forth between one camp and the other. For instance, GE is sometimes seen as a growth stock and sometimes as value. Warren Buffett likes to say growth and value "are joined at the hip" and he is right. We are agnostic about stock titles. We simply look for good quality companies selling at cheap valuations. This is our take on Value.

This brings us to the issue of big versus small. Last month marked the sixth anniversary of the record high for the stock market. The S&P 500 is still down 15% from 2000. But the damage has not been equally distributed. *Take a look at the chart at the bottom.* If you had been in small caps you would have doubled your money in the past five years. But large caps have lagged. Why? Maybe it is because they were overvalued in 2000 but the fact is they were nowhere near as high priced as the tech issues. Or maybe it is because small cap issues are more nimble and perceived to be better long term value or maybe because Hedge Funds, the new kid on the block, are looking for quick profits and see small caps as the vehicle. Who knows.

What we do know however is that big caps have continued to earn good money. General Electric for instance has shown an earnings increase of 22% from 2001 to 2006 while its stock price is down 15%. Coca-Cola has jumped 37% in profits but the stock price is down 27%. The list goes on. As value buyers we were never much attracted to large big blue chip names in the past. They looked expensive probably because their consistent earnings and strong brand power kept them in solid demand. Now however they look decidedly out of favor and cheap.

Cash, Cash, Everywhere

Corporate America* is sitting on record amounts



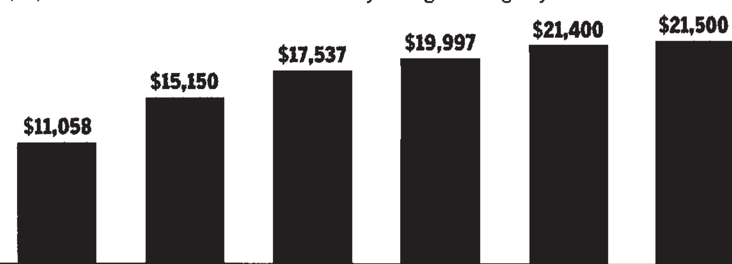
*Nonfinancial U.S. companies

Source: Business Week

This is not something only we have noticed. Analysts and the press have been touting the story for some time. But the under performance continues and might go on for some time. It is not uncommon for markets to go way too far in one direction before reverting back to the mean. But in a slower growing economy like today large companies have real strengths. Their strong brand power protects earnings and rising short term rates will not hurt them that much. *Take a look at the chart in the upper right.* Corporate America is awash in cash today. Large companies do not need to go to the debt window. In fact pressure may be building from hedge funds and others for large companies to return cash to shareholders in the form of more dividends or stock buy backs.

James Stewart in a recent *Smart Money* column notes that when someone asks you if you are a value or growth buyer, you should answer, "it depends." It is all about current valuation and all about future prospects. Today it looks like current valuation and future prospects favor large caps over small. The only small problem is, uh, the timing!

Coming Up Short



Data: Bloomberg Financial Markets — TOTAL RETURNS, INCLUDING REINVESTED DIVIDENDS, WHERE APPLICABLE

Source: Business Week

The Melting Pot . . .

“We wanted a labor force, but human beings came . . .

WOW, THIS IMMIGRATION thing is a real conundrum. Back in 1993 before NAFTA there were an estimated 2.5 million undocumented Mexicans living in the United States. Today there are an estimated 11 million illegals total, three quarters of them from Latin America.

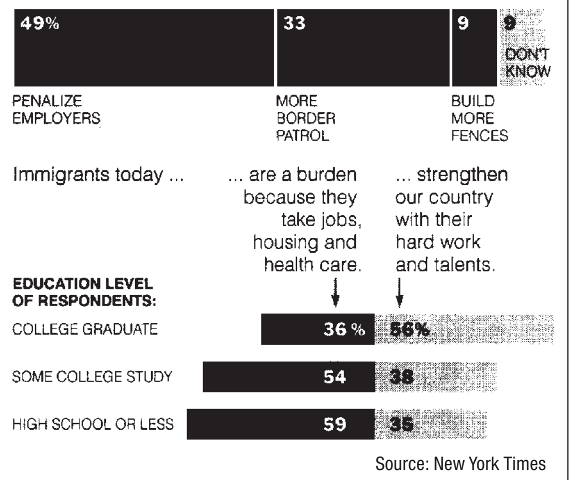
What to do about them? I don’t know exactly but let me first say I am pro immigration. Thomas Friedman noted recently in the *New York Times* that immigration is deeply rooted in our culture. The flow of immigrants makes for a more flexible, competitive and hard working society. I agree. But there has to be a real cost to 500,000 new illegal residents a year. It is interesting that three of the best columnists I read, Thomas Friedman and Paul Krugman in the *New York Times* and Robert Samuelson in *Newsweek* are starting to sing the same tune. All agree we need to do something “to control our borders.” But what? A bigger fence along the entire 1,100 mile border with Mexico? More money for Border guards or more punishment for businesses hiring illegals? And then what do you do about the 11 million illegals already here? “Earned status” or send them home? Not easy stuff.

The fact is there may be no solution to this problem. Fareed Zakaria notes in *Newsweek* that there are no two countries in the world with a common border that have a bigger income gap than the U.S. and Mexico. The difference in manufacturing wages is eleven times and for farm labor probably more. Can anything stop the movement of humanity here?

Clive Crook summarizes the immigration debate well in a recent issue of the *Atlantic Monthly*. There are three major complaints from rich countries about illegals today. First, they lower wages of competing domestic workers. The *Economist* estimates that for low end jobs this is 0-10%. Second, immigration imposes a financial burden, including healthcare and welfare costs. And third, immigration arouses fears that our culture is being sacrificed or our security threatened.

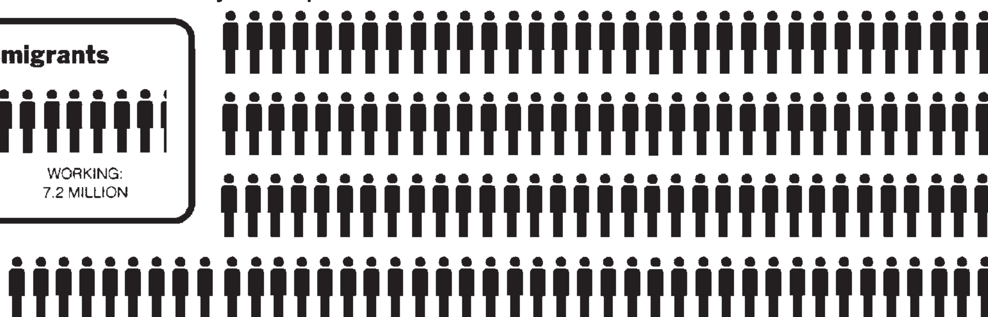
On the positive side immigrants add low cost labor which makes everything we buy cheaper. Second, Americans are quite compassionate towards immigrants since almost all of us hail from somewhere else originally.

My sister is a consultant to the horticulture industry in Maryland (and a card carrying liberal just to let you know where she sits). Growing plants on the Eastern Shore is big business and 100% of the farm workers are Hispanic. The growers pay good wages and time and a half for overtime. Could they attract Americans to work? Signe doesn’t think so even if they offered $18 an hour. The work is just too hard. She also thinks many Hispanic workers don’t want to live here permanently. Their dream is a house and business in Mexico. This flies in the face of what many commentators think. Paul Krugman for instance says raise wages high enough and American workers will come. Fareed Zakaria says a big population of guest workers without access to citizenship is bad and dangerous for American Democracy. Who knows who is right. I am still pro immigration. I just don’t have a solution quite yet.



The American Work Force: 148 Million

Each symbol represents 1 million workers in 2005



Source: New York Times

About 4.9 percent of all workers in the United States are illegal immigrants.

Market Trends . . .

The ABCs of ETFs . . .

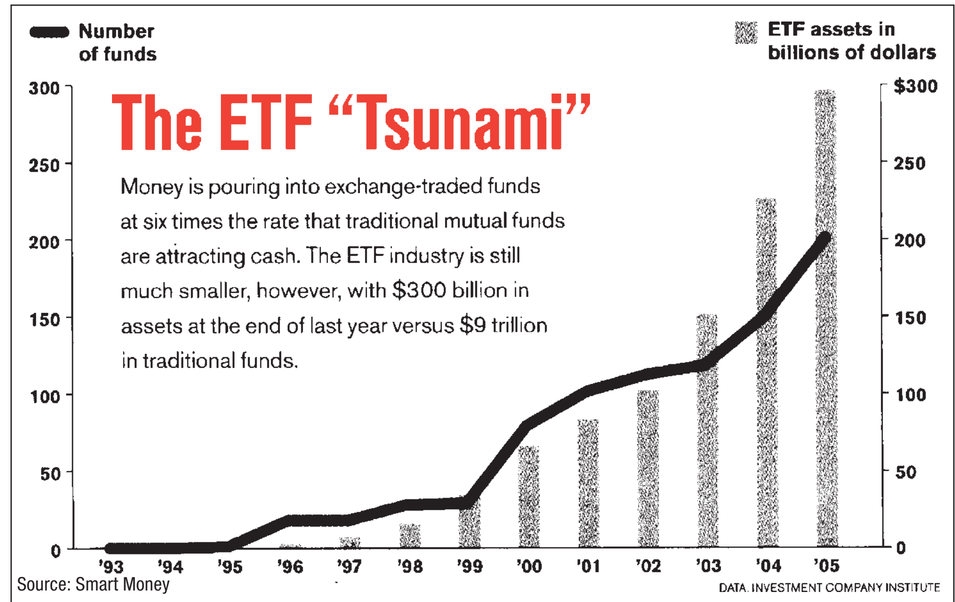
EVERY YEAR, WIZ KIDS ON Wall Street come up with new financial products. Typically, these pretty complicated offerings are just new ways to slice up the same old risk and return. But occasionally, something truly innovative arrives on the scene. Exchange Traded Funds (ETFs), first launched back in 1993, represent just such a breakthrough.

Originally, financial institutions designed ETFs as an alternative to index mutual funds. Like their counterparts, ETFs invest in a basket of stocks that track a particular index such as the S&P 500. But where mutual funds can only be bought or sold at the close of trading, ETFs are traded throughout the day just like stocks. And ETFs can have significant cost advantages as well. According to Morningstar, the average domestic equity ETF has an expense ratio of just 0.41% compared with 0.77% for the average domestic equity index mutual fund.

Probably the biggest advantage of ETFs has to do with their tax efficiency. Typically, a mutual fund must sell holdings to raise cash when a sell order comes in. Gains realized from such sales are distributed to shareholders and show up in their tax bill each year. But ETF fund managers are able to delay distributing most of these gains. Instead of selling holdings to raise cash, ETFs can trade mutual fund shares for securities in the fund and avoid the related gains.

As the chart above shows, ETFs have been well received by investors. Back in 1999, banks such as Barclays and State Street offered around 30 different ETFs. Today, over $312 billion has been invested in over 200 different offerings. And instead of just tracking broad market benchmarks such as the Wilshire 5000, new ETFs are tracking individual industries, countries and fixed income markets. The latest funds, launched just this month, track the price behavior of commodities such as silver and oil.

But ETFs have drawbacks too.



Because ETFs trade like stocks, buying and selling them requires paying a brokerage commission. These costs can really add up for someone using a dollar cost averaging approach or investing a very small amount of money.

And because many of the newer ETFs target very narrow market sectors, they can be quite volatile. Consider Merrill Lynch's Internet Architecture ETF. This fund holds the shares of companies whose products are designed to enhance internal and external computer networks. The fund holds only 20 securities and has almost 30% of its assets invested in its largest holding, IBM. This degree of concentration is not unusual for ETFs whose issues are held in direct proportion to their relative market weight.

Despite these drawbacks, I think ETFs can play an important role in many portfolios. First, broad based ETFs offer a low cost way for investors with a small lump sum to achieve diversification. Second, ETFs can be used to target attractive market sectors. This is particularly true for difficult to analyze or emerging technologies such as alternative energy or biotechnology. While these industries have a great future, picking the winners from the losers can be like finding a needle in a haystack. Buying a "basket" of leading firms, such as those offered by an ETF, helps investors avoid getting "burned" by putting their money on the wrong horse.

Finally, ETFs provide a low cost way of investing in attractive international markets. Consider the case of Taiwan. Taiwan's geographic location and close economic ties to mainland China make it well positioned to benefit from its neighbor's explosive growth. But for most investors, buying shares on the Taiwanese exchange is an expensive and time consuming process. Barclay's Taiwan ETF, however, has ample liquidity and a relatively low expense ratio.

The rapid growth in ETF issuance shows no sign of slowing down. This year, the Amex expects to add another 50 funds. New entrants, however, are no longer just index products. Instead of tracking a specific market or index, ETFs are now using a range of strategies to outperform their benchmarks. This new twist puts ETFs in direct competition with old fashioned mutual funds. The increased competition will give investors more choice and put downward pressure on mutual fund expense ratios.

— Anne Williams Doremus, CFA