Thoughts from
Hanson Investment Management Inc.

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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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I Hope He Is Not Too Right This Time . . .

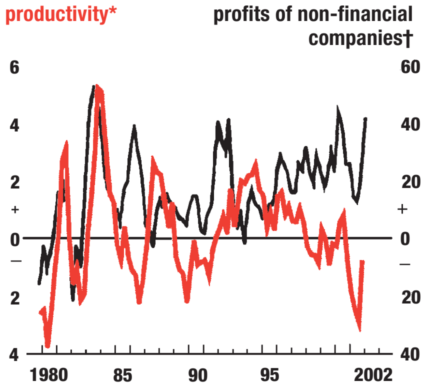
THE BEST ECONOMIST I read is Stephen Roach at Morgan Stanley. He is clear, to the point and not afraid to take a controversial line. He was one of the first economists calling for a double dip recession last year. He looked pretty stupid then but now everyone is worried he is right.

Roach's point is that we still haven't worked through all the excesses of the 1990s. Our balance of payments deficit is large. The consumer has too much debt, there still is excess industrial capacity and our savings rate is low. We need more time for things to right themselves.

I agree with Roach's logic but there are still a lot of signs out there of a sustainable recovery. Mark Zandi, Chief Economist for Economy.com, says that the recession last year was entirely due to a collapse in investment spending. As the chart at the bottom shows we have had six consecutive quarters of down business spending. Now we have seen a turn. If this continues the economy will get an important boost.

The Profit Paradox

US, % change on a year earlier:



Source: HSBC

* Non-farm business sector
† Adjusted for inflation

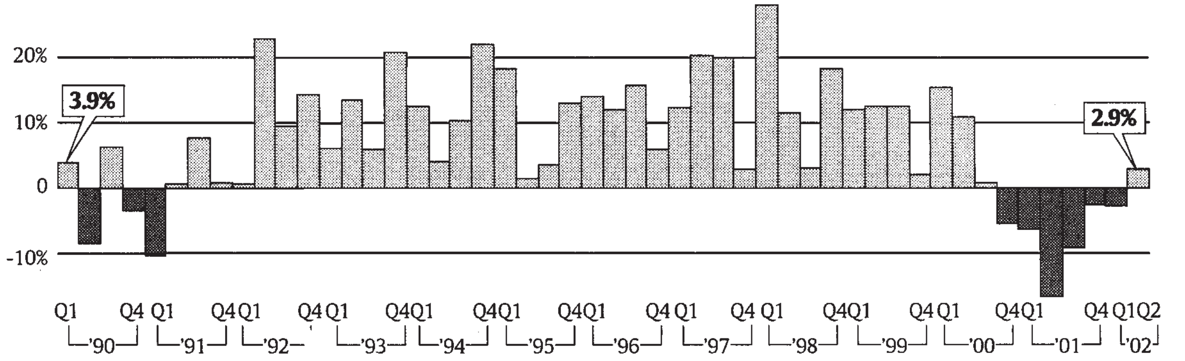
Source: The Economist

Also productivity has stayed remarkably solid during the recession. Companies seem to be using computer and other investments more wisely. A higher productivity rate means more vigorous growth during the cycle.

Our take is a recovery is still in place. It will be sluggish but still positive. We are betting on continued growth, not the dreaded double dip.

Business investment struggles to recover

Quarterly measures of the increase in business investment show that spending on machinery, computers and software rocketed throughout most of the 1990s, crashed in late 2000 and 2001, and has barely begun to revive.



Note: Seasonally adjusted at an annual rate

Source: Commerce Department

By Adrienne Lewis, USA TODAY

U.S. Accounting . . .
This Problem We Can Fix . . .

BUT ONLY IF WE WANT TO. And that's a big if. What I am talking about is the trust that has been lost in U.S. accounting practices. Some of the problem has to do with out and out fraud. Enron and WorldCom and Adelphia certainly did cook the books. But these are the exceptions not the rule. Fraud is only a small part of the accounting problem today.

The bigger issue is the number of companies who have pushed the letter of the law and the "principles" of accounting to the limit. Now we have to work our way back and get confidence in the numbers again. There are plenty of proposals in Congress to do this and many are good.

> **It seems to me that the realities of stock options can be summarised quite simply:**
> **If options aren't a form of compensation, what are they?**
> **If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?**
>
> Warren Buffett's letter to Berkshire Hathaway shareholders, March 1, 1993

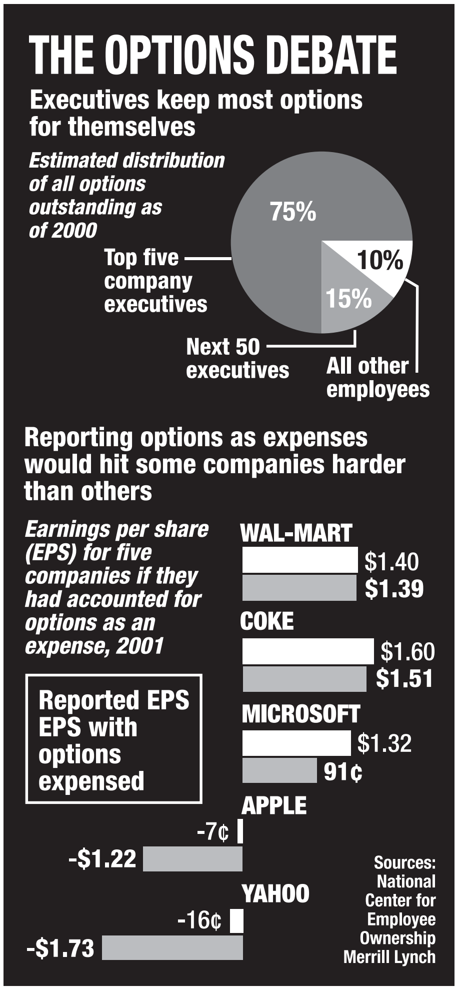
But the solution doesn't require a blunt instrument. Warren Buffett pointed out in the *New York Times* recently that the solution is pretty simple, "CEOs should tell their accountants today to quit recording illusory pension income and start recording all compensation costs. They don't need studies or new rules to do that. They just need to act." Buffett is one of the clearest thinkers around and his comments on stock options *(see box)* dating back to 1993 before anyone else was interested in the issue are right on. We will have to see if Corporate America has the courage to step up to the plate on this one. Some big names such as GE, Coke and GM have acted and this is encouraging but the rest may have to be dragged kicking and screaming.

The two big areas that need to be addressed are accounting for stock options and overly ambitious assumptions for pension fund returns. When stock options are first issued no expense shows up on the income statement. Only much later, when options are exercised does something get recorded. Buffett thinks this is ludicrous. In the same vein companies are overestimating what they think their pension funds can earn and based on these ambitious assumptions they are taking excess earnings and recording them as annual income. Again an abuse of the rules.

Barton Biggs at Morgan Stanley thinks a third accounting abuse needs to be reined in. This is the increasing use of "non-recurring" charges. When a company has a legitimate one-off charge that will not occur again, then it should be on the income statement as non-recurring. But today many companies are lumping in ongoing expenses as non-recurring charges. This makes the basic operation look a lot better than it actually is.

Biggs estimates that expensing all stock options would reduce S&P 500 earnings by 8% and that more conservatively estimated pension earnings would reduce profits another 2%. So we are talking about a one-time haircut of 10%. Based on this the S&P 500 might earn $50 to $55 a share next year compared to $45 this year. But earnings could be a lot higher. Steve Galbraith the equity strategist for Morgan Stanley thinks low interest rates could add $2 to $3 a share to S&P earnings. Low interest rates mean lower corporate interest charges and this means higher earnings. Also the decline in the dollar may add another $4 a share to earnings over the next couple of years. Thirty percent of S&P earnings are derived from abroad and a weak dollar means higher earnings when foreign currency profits are translated back to our shores. So the silver lining may be that the drop in earnings from more conservative accounting practices may be offset by the benefits of low interest rates and a falling dollar.

Trust is not something that is repaired overnight and it is impractical to expect all big corporations will "do the right thing" just because the winds have changed. But the accounting issues today are pretty straightforward. We know what the problem is and we know what the solution is. This is not like recession or and an uncompetitive economy where we are just shooting in the dark for a solution. Here we have a road map. I hope this means we are more than half way there to a solution.

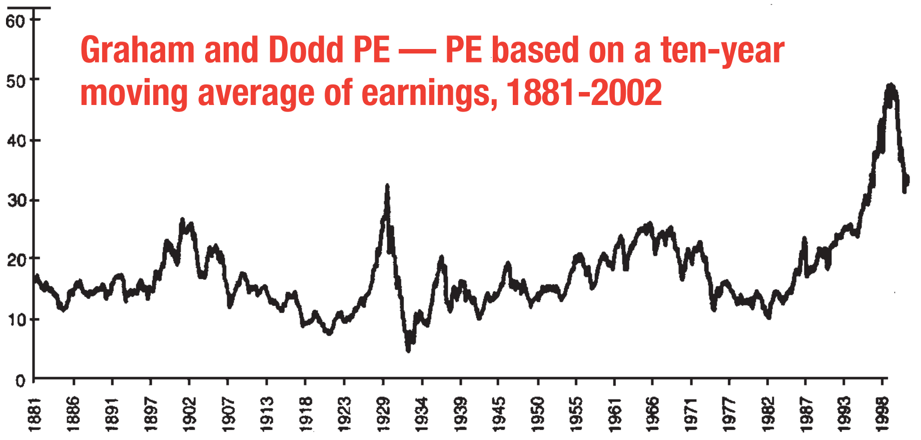

THE OPTIONS DEBATE

Executives keep most options for themselves

Reporting options as expenses would hit some companies harder than others

Source: Time Magazine

The U.S. Market . . .
Just the facts, Ma'am . . .



Graham and Dodd PE — PE based on a ten-year moving average of earnings, 1881-2002

Source: The Gloom, Boom and Doom Report

Source: James Montier, Dresdner Kleinwort Wasserstein

LIKE SGT. JOE FRIDAY on *Dragnet* we are just looking for the facts on this market now. Are things cheap or expensive? On page two we outlined what earnings might look like after a conservative accounting haircut. The S&P 500 is selling at 15-17X next year's adjusted earnings of $50 to $55. Historically PEs have ranged from below ten at the bottom (the 1973-74 market for example) to 20-25X at the peak. In this last cycle you had to throw away the books. Pick a number and had the high PE: 40X, 50X or 60X, whatever. Today we are back to the mid range.

What do we think about market valuations now? Some models are signaling, "buy". The Fed reportedly likes to look at a model that compares the earnings yield of the Standard & Poor 500 (defined as the reverse of the price to earnings ratio or earnings divided by price) to the current yield on the ten year Treasury Note. This model, similar to the one below is screaming, "buy".

Jeremy Siegel, author of the very popular *Stocks for the Long Run* (1994), is also bullish. He thinks the market's normal PE should be higher now than in the past, maybe in the low 20's. This for two reasons. First, transaction costs have declined over the years. It is much easier to get in and out of stocks and the array of stock and stock fund choices is much greater. Secondly, the economy is more stable now than in past cycles. Central bankers are more intently focused on price stability and the chance of a major shock to the system is smaller. Greater stability in the economy and better liquidity in the market should mean higher stock valuations.

But there are dissenting voices. Robert Shiller of Yale, the author of the more skeptical *Irrational Exuberance* (2000) plays the bear to Siegel's bull. Shiller like legendary investor Benjamin Graham says the only way to get a proper take on valuation is to smooth earnings over a longer period. When you do this *(see chart above)* stocks still look very expensive.

So where do we come down? We are more in Siegel's camp than Shiller's. We have said before that corporate profits should continue to go up about 7% per year, the same rate they have gone up over longer periods in the past. When you add in a dividend yield of 2% you get to a total return expectation of 9%. This assumes a stable PE however. With PEs now back to their historic mid-range and with Siegel estimating higher normalized PEs anyway this is a reasonable assumption.

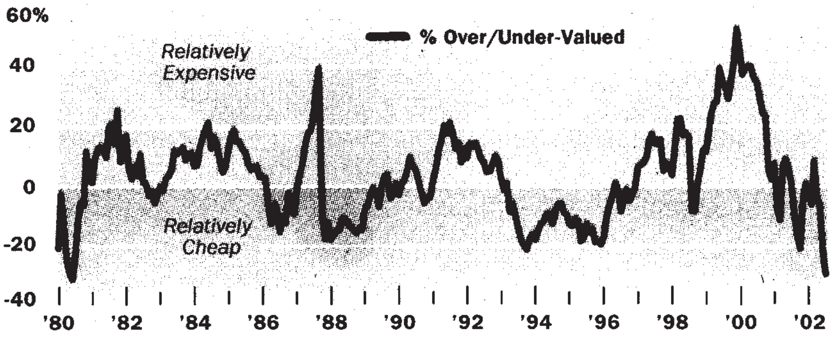
We are not afraid of stocks now. The last time the market suffered a decline similar to today (1973-1974), the scene was set for a major bounce back. Between 1975 and 1982 the Standard & Poor 500 registered a total annual return of 15%. We are not predicting this type of return now but after our sharp decline we could certainly see 9%.

Can bonds do better than this? It is possible but unlikely. The ten-year Government Note currently yields 4.4%. To get anywhere near 9%, bond yields would have to drop to 1.5%. Not a great bet. So my take is, the portion of your assets in stocks right now is going to work out. Sit tight.

Screaming Buy?

▸The stock market model used by Morgan Stanley strategist Byron Wien suggests the S&P 500 is 35% undervalued based on current Treasury bond yields after being overvalued by 50% at the market peak in 2000. The model says the S&P hasn't been this cheap since the early 1980s. Opportunity?

Wien's Model *(Equity risk premium=2%, profit growth=9.8%, 10-yr Treasury yield)*



Source: Barrons

Source: Morgan Stanley Research

Investment Trends . . .
Of Tulips, Trains and Telephones . . .

AS A STUDENT OF FINANCIAL HISTORY, I had long ago become familiar with investment manias. Periods such as the tulip bulb craze in the mid-1600s or the rush to invest in railroad shares in the middle of the 19th century. During both episodes, the promise of superior returns led to over-investment and inflated asset prices. The subsequent "busts" of both investment bubbles inflicted significant financial damage and led to calls for reform.

If all this sounds familiar, it should. The recent turmoil in the telecommunications industry qualifies as one of history's largest speculative bubbles. Consider the following. Over 500,000 jobs have been lost in the industry since the beginning of last year. Dozens of companies have gone bankrupt and the share prices of most surviving firms are down 75% or more. Further, industry experts suspect that over half of the $880 billion invested in the industry since 1997 may have to be written off.

So what forces contributed to this most recent market bubble? During the late 1990s, deregulation and new technologies combined to create what looked like a once in a lifetime investment opportunity in the telecommunications sector. On the technology side, the advent of the Internet led to predictions of soaring demand for transmission capacity. Deregulation allowed dozens of new companies to join traditional providers in meeting this demand. Between 1998 and 2001, the amount of fiber optic cable increased fivefold according to Andrew Odlyzko, a researcher at the University of Minnesota. At the same time, technological advances increased the transmission capacity of each fiber strand 100 fold.

Industry predictions of annual Internet traffic growth of 700%-1,500% kept the investment dollars flowing. But while traffic growth was indeed strong, it could not keep pace with the soaring capacity. Predictably enough, as supply began to outstrip demand, prices for data transmission began to fall. According to Eli Noam, a professor of finance at Columbia University Business School, from October 1998 to February of this year, transmission capacity across the Atlantic increased by a factor of 19 while the price of a leased transmission line fell from $125,000 to $10,000.

At the same time, a similar story was unfolding in the wireless arena. 3-G wireless networks promising a whole new range of video and data transmission services whetted investor appetites. In Europe alone, over $90 billion was spent on licenses to build 3-G mobile networks. But here too, the demand for new data services has not followed suit. As any cell-phone customer knows, falling prices have been the standard in this sector too. Consider that the average US cell phone customer talked 50% more in 2001 than 2000 but paid only 5% more for the privilege.

So where is the industry headed now? The recent telecommunications meltdown has resulted in over-capacity and mountains of debt. Today, annual Internet traffic growth has settled down to 70%-150%, well less than originally expected but still not shabby. Faster capacity absorption will depend on the development rate of new data-intensive services. Clearly, it will take years for demand to catch up with supply and some capacity may eventually have to be written off. To deal with the debt, most surviving firms are selling off assets, retrenching in home markets and issuing new equity.

Who will be the survivors of the recent industry meltdown? Many industry analysts today believe that the former Baby Bells will likely come out on top. I agree with this prediction although I do not think the road ahead will be any easy one. Technological innovation will require continued high levels of investment. Translating these investments into new customers and services such as high speed web access and corporate data networking will be key. Further, the Bell's traditional land line business will continue to face intense competition from both wireless and cable offerings.

But the Baby Bells also have some significant advantages. Importantly, these firms are considered safe especially when compared to the more recent industry upstarts. Their relatively strong financial position will allow them to bid on distressed assets as the industry consolidates. Second, their current role providing local phone service to the nation's 180 million customers means that they control the important "last mile" to business and recreational customers. This near-monopoly status should provide a significant advantage as the industry begins to consolidate and recover.

— *Anne Williams Doremus*

Baby Bell Blues

Company	Price	52-Week Range	P/E Ratio	Price to Book Ratio	Yield	Market Capitalization
Bell South	$23.97	($43-$20)	11.5X	2.2X	3.3%	$44.9 Billion
SBC	$25.72	($48-$22)	11.3X	2.6X	4.1%	$85.9 Billion
Verizon	$29.47	($56-$26)	9.8X	2.2x	5.1%	$80.2 Billion

Source: Hanson Investment Management