

Microsoft Conquers China . . . Not

The Chinese don't like to be "held up" by rich country technologies. Here in the West we pay Microsoft between \$100 to \$200 per computer to access Windows and Office. We also pay dearly to Qualcomm for their integrated circuits which allow cell phones to operate and we pay a pretty penny to Intel to make our PCs go. The Chinese don't cotton to all these patent protected Western products and fees.

'Monopoly' is the accepted word when talking about the political power of the Communist Party but monopoly does not go down well with the Chinese when discussing economic

matters at least not when discussing those matters where foreign companies hold all the power. If you travel to China you have no problem buying Windows or Office for \$1 or \$2 a copy on the street. Until a few years ago the Chinese were actively encouraging companies to use the free open-source Linux operating system as a way to thwart the power of Microsoft. The Chinese phone companies have been working for years to come up with an alternative integrated circuit to Qualcomm in the cell phone area. They are still struggling with this.

Fortune recently titled an article "How Microsoft conquered China." It is an interesting idea. There is no business leader that is received with such adulation in China as Bill Gates. He is a true rock star in the Middle Kingdom. In this respect Microsoft has indeed conquered China. But from a business standpoint it can be argued the opposite is true. Early on Microsoft blustered its way into the country charging Western prices and suing anyone who dared to pirate copies. This went on until the late 1990's and the result was very much not a victory. The only debate was whether 85% or 95% of Microsoft installed software

was pirated. To its credit Microsoft conceded defeat, changed strategies and it has been scoring victories ever since. The company now understands that if you want to be successful in China you have to partner with the government. It has set up a design studio in Beijing which has attracted some of the best software minds in China. Also they reconfigured their pricing so that you can now buy licensed product at about the same price as the pirated stuff. This has worked and the government is now actively encouraging everyone to buy legal copies of Microsoft. The company has scored a major victory in market share. Microsoft is definitely the dominant supplier of PC software. Linux is an after thought. But on revenues Microsoft appears to have lost the pricing war giving in to the Chinese model – give us your product cheap or we will simply steal it.

The Chinese are incredible capitalists. They can outwait anyone, they know what they want and they usually get it. As *Fortune* notes, it took Microsoft fifteen years and billions of dollars to learn how to do business in China. They have finally learnt but at the expense of losing the war?

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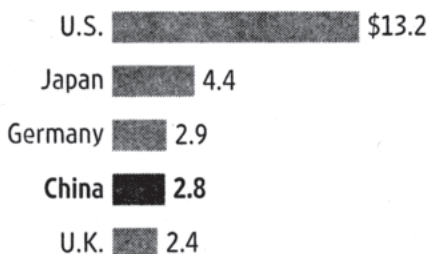
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Coming Up Fast

Fast-growing China could become the third-biggest national economy this year.

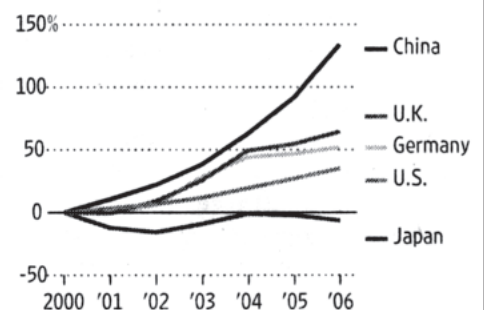
2006 GDP, in trillions



*Based on GDP measured in U.S. dollars

Sources: Chinese government (China);
International Monetary Fund (other countries)

Cumulative change in GDP since 2000*



SOURCE: *The Wall Street Journal*

The End of Easy Money . . .

I apologize to *Time* magazine for stealing the title, but it's a good one and sums up the current situation nicely. I can't remember a time when we have gone so quickly from viewing the world as a glass half full to viewing it as half empty. Volatility has increased with a vengeance recently.

The reason can be seen in *the chart at the bottom*. Since 1982 we have seen falling interest rates for almost 25 straight years. This unprecedented period of ever-cheaper credit has finally come to an end. In addition we have also woken up to the fact that risk has a cost. Oh sure, we saw risk in the tech blow up in 2000 and this was painful but for the most part especially the past ten years, we haven't paid risk much attention. Spreads have narrowed dramatically between high grade Treasuries and lower rated things like emerging market debt and high yield (read: junk). Now we are suddenly aware that there is a big difference between Treasuries and high risk and we are scrambling to get paid for it.

The question now is, if interest rates are not going to fall any further and if the spreads between high quality and low quality are going to increase, does this mean the end of this cycle and the start of a slowdown/recession? This is basically what is on everyone's mind and is causing all the volatility in the stock market. On the surface it doesn't seem like the subprime lending mess is that big a problem. Subprime means banks and mortgage packagers lent to people whose credit was dicey at

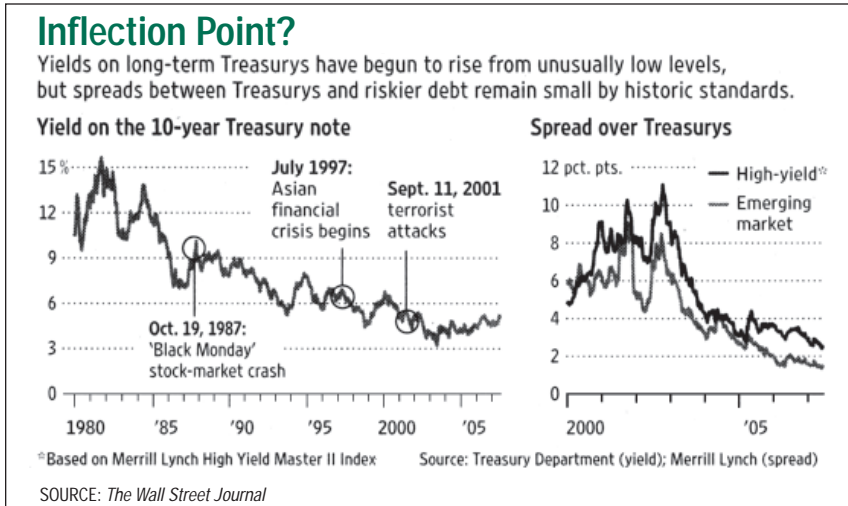


best. These borrowers are now defaulting and causing a lot of pain. But the amount of loans in the subprime category relative to either the total mortgage market or to the total economy, is small. Also because the loans were packaged as bonds and sold widely to money managers and hedge funds and pensions, no one sector is going to take that big a hit. Markets have done what they are supposed to, they have taken concentrated risks (subprime loans) and distributed them widely.

A second reason I do not worry that much about the subprime problem is that the global economy is on a tear. A recent article in *Fortune* was titled "The Greatest Economic Boom Ever" and David Hale, a very well respected economy watcher in Chicago, penned an op-ed piece in the *Wall Street Journal* titled "The Best Economy Ever." You don't see these kinds of articles very

often. The basic point of both is that the world economy is growing at 5% a year now and has been for over three years. This is the highest level since the late 1960s. Globalization has brought more than 3 billion people in places like China, India, Eastern Europe and Africa into the market economy. This is unprecedented and has led to the growth spurt which is continuing.

Even if the US economy slows the rest of the world is strong enough to power this train forward. Europe, Japan and especially the Emerging BRICs (Brazil, Russia, India and China) are either feeding off past successes or starting to feel the wind at their back. Growth looks to continue at 4-5% for the foreseeable future. Edward Yardeni, President of Yardeni Research and one of Wall Street's favorite strategists, notes that the housing slowdown here and implosion of subprime lending is the first Stress Test of this global boom. He thinks we are going to pass the test. The problem obviously is, will the subprime panic spread to the other parts of the economy (the regular mortgage market, private equity deals) and how will this affect growth. We think all of this will be a speed bump, not a game ending event. Yardeni does note that if Alan Greenspan were still in charge interest rates would probably be coming down now to fight the slowing housing market. Mr. Bernanke is more inclined to let the credit cycle run its course. But so be it.



Tried and True Value Investing . . .

Every day, because I put myself on the mailing list, I get emails from my fellow business school alumni seeking advice for their startups or spreading the word on opportunities. It's a nice little network. But last week, I saw a classmate post that he is looking for an assistant to help him start a hedge fund that will replicate the investment success of major university endowments. I thought he was joking at first. But when I read through the description of his little startup, I realized he wasn't. I also realized there was no hint of a strategy for replicating the stellar performance of the Harvard and Yale endowments. Nothing against his endeavor – mind you, he's a smart guy. But the last I knew of him, he was all about tech startups on the Peninsula (between San Francisco and San Jose, California). Now that he's onto the next big thing, I can't help but wonder about signs of excess in the investment world.

More than a few seem to be wondering the same thing, including some very smart investment people. Bill Gross of PIMCO and Jeremy Grantham of GMO both have written recently about high finance folk flying a little too close to the sun and the regular folk on the ground getting a little peeved. Both wonder how it is possible for private equity billionaires to pay a lower tax rate than your average everyday salary earner. Both can't help but marvel at the amount of excess they see – in leverage, in buyouts, in ridiculous displays of wealth. (Both can be read online. Check out www.pimco.com for Bill Gross and [google](http://google.com) Grantham's piece by typing in "Blackstone Peak.")

Grantham thinks asset prices have gotten unsustainably high, and the day after he put forth his bearish view in the Blackstone Peak letter, the Dow Jones Industrial Average fell by more than 300 points – something Grantham attributes to coincidence. Remember, Grantham is known for being grimmer than necessary. But recent volatility makes it clear that the "let's-all-look-like-Yale-effect"

– which is what he calls it – is making others pretty nervous too. So now, as we watch stock charts zig and then zag, it might be a good time to remind ourselves of some basic investment principles that hold in times of market gyrations, and more important, over much longer time periods.

The thing that we think works is Value investing. That means that for whatever fundamentals you look at to value a stock – whether price to earnings, price to book, or another attribute – we choose to buy at the low end of the price spectrum. These stocks are cheap and out of favor. At the other end of the spectrum are Growth stocks, which carry high expectations for earnings growth and a lot more glamour.

There have been short periods when Value has outperformed Growth and others when Growth has outperformed Value. Growth stocks, in fact, look to be edging out Value for the first part of this year. The last time they did so was 1994-1999 – and at the height of the tech frenzy in 1998-1999, Growth was outperforming Value by more than 20% by some measures. Nevertheless, over longer periods, it has been shown quite clearly that Value beats growth, (see chart). From 1969 through the end of 2006, according to Ibbotson Associates, Value outperformed Growth by an average of 2.5 percentage points a year. Not only that, but Value stocks exhibited 15% less risk than Growth stocks. And different studies show similar results. For example, from 1979 to 2006, the Russell 1000 Value Index outperformed the Russell Growth 1000 Index by 2.4%, and the Russell 2000 Value Index outperformed the Russell 2000 Growth Index by 5.1%. For the Russell 1000 indexes, Value

stocks were 30% less volatile than the Growth stocks.

There is more than a little debate in the profession over why Value does well over long time periods. But we think it comes down to people overestimating the prospects for Growth stocks and underestimating those for Value stocks. As humans, we make many mistakes, and one is to focus on the recent past and assume that things will keep going the way they've been going. People tend to think that glamorous stocks will stay glamorous and that dogs will stay dogs. Yet empirical evidence shows that Growth stocks hold a small edge over Value stocks for only a short time before they revert to the mean.

The problem with Value investing – and the reason more people don't do it – is that it is hard to do. Not only do you have to go against the crowd, but the pressures to bail out at exactly the wrong time are huge. That's why it's a good idea to step back in times of volatility and remind ourselves that Value investing works over the long term.

And by the way, we're not anywhere near Grantham in his bearishness. We see some excesses in the market and agree that Value has gotten harder to find these days. But we still do find it.

