

Thoughts from

Hanson Investment Management Inc.

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Happy Holidays . . .

WE ARE CONTINUING OUR TRADITION of a Gift recipe for the Holiday season. Profiteroles or puff pasties are filled with vanilla ice cream and covered with chocolate sauce!

We want to thank the many readers who spend time each month going over the newsletter. We hear back from you and your comments are always helpful

and flattering. Even when it involves an embarrassing slip on our part. Last month two readers pointed out that one does not have too many quivers in one's bow as we wrote. Oops. We wouldn't have gotten far in French Indian War with that.

We hope you enjoy this recipe and from all of us here we wish you a prosperous, safe and happy New Year!



PROFITEROLES (PUFF PASTRY SHELLS)

When puff paste (pâte à choux) is baked, it is one of the apparent miracles of cuisine. The paste expands to many times its original size and a mass of air occurs in the center. Still, it is one of the easiest of foods to prepare. The only "secret" is to add the flour all at once and fearlessly to the water-butter mixture.

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1-cup water
1/4 pound butter
Pinch of salt
1 cup flour

4 eggs
Vanilla ice cream
Any rich, rich, rich chocolate sauce

1. Preheat oven to 450 degrees
2. Combine the water, butter and salt and bring to boil. Remove from the heat and add the flour all at once. Stir vigorously until the mixture leaves the sides of the pan and forms a ball around the spoon. If a ball does not form almost immediately, hold the saucepan over low heat and beat briskly a few seconds. Cool slightly.
3. Add the eggs, one at a time, and beat until the mixture is smooth and glossy after each addition.
4. Drop the mixture by rounded tablespoonfuls onto a greased baking sheet, leaving two inches between the puffs to permit spreading.
5. Bake 15 minutes. Reduce the heat to 350 degrees and bake until no bubbles of fat remain on the surface and the sides of the puffs feel rigid, about 30 minutes longer. Cool. Cut a cap off each puff and fill with ice cream. Replace the cap.
6. Drizzle (or drench!) with chocolate sauce and serve.

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. Market . . . So, which way now? . . .

THIS IS A GLASS HALF FULL, glass half empty story. The bad news is the U.S. economy is weak. September marked the twelfth consecutive month of decline in U.S. industrial output. This is the longest uninterrupted industrial decline since World War II. And in October the U.S. Labor Market shed 418,000 jobs, the largest one-month drop in more than twenty-one years. November was not much better with a loss of 300,000 plus jobs. So things are bad.

Compounding the problem is that the rest of the world is also in a downturn, the first synchronized contraction since the oil shock of the early 1970's (see page 3).

So with all this bad news why is the stock market so strong and why are price to earnings ratios so high? When Alan Greenspan made his famous irrational exuberance speech in 1996 the market PE was 23 (see chart). It subsequently went much higher and now it is down but only to the 1996 level.

One reason for this is that many

investors are expecting a quick recovery. Most of the traditional signals of a long lasting downturn are not there. Interest rates are low this time, inflation is not a problem, inventories are not overbuilt, the banking system is in good order, energy prices are reasonable and the government is riding hard to the rescue with additional interest rate cuts and a pretty monster-size fiscal spending boost.

Secondly, the optimists say the New Economy is still alive and well and sectors such as biotech and medical care will lead us out of this downturn. In addition, we should continue to see above average productivity increases as the 1990s high-tech spending boom works its way through the system.

And the final reason the Bulls are bullish is interest rates. The stock market is a discounting mechanism or as Warren Buffett says, a weighing machine. When interest rates are down stocks have a much lower hurdle to step over. Burton Malkiel of Princeton made this case in an op-ed piece in the *Wall Street Journal* recently. He thinks today's PE's are justified.

Market Valuations

P/E ratios at the time of Mr. Greenspan's speech and subsequently.

	1996 4th quarter	1999 2d quarter	Current
U.S. S&P 500	23	34	24.5
Frankfurt DAX	27.6	26.9	15
London FTSE 100	15.9	26.2	17.6
Tokyo Nikkei 225	108.7	91.1	39.1

Source: Leuthold Group

IHT

Source: International Herald Tribune

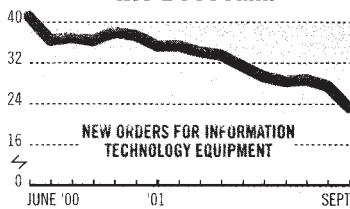
And what is our opinion? We are suspicious of the quick bounce back, V-shape recovery story. We think the recovery will be slow and probably frustrating. There is no obvious growth engine today to pull us out of this mess. But we remain 100% invested nonetheless.

This is not that unusual for us; we are 100% invested almost all the time. With the future so uncertain, we think it makes most sense to simply buy good quality stocks with low PE's and hold them till they work out.

The average recession since the Second World War has lasted eleven months. The poubahs who know say this recession started in March so we may be close to a turn today. The average upturn typically lasts three times as long as a recession. Our strategy now is to make sure we are there when the recovery takes old, regardless of when, where or how it starts.

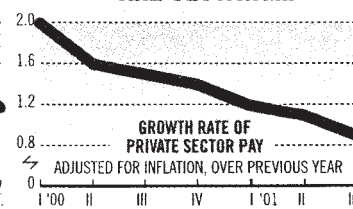
WHERE YOU STAND DEPENDS ON WHERE YOU SIT

TECH HAS NOT HIT BOTTOM...

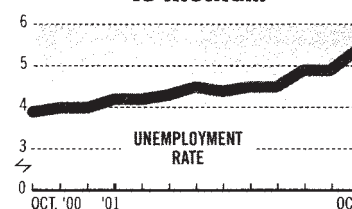


Data: Bureau of Labor Statistics, Commerce Dept., Patent & Trademark Office, Federal Reserve

...WAGE GAINS ARE SLOWING...



...AND UNEMPLOYMENT IS RISING...

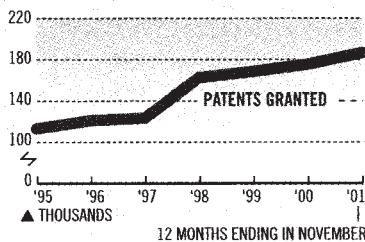


...BUT PRODUCTIVITY REMAINS STRONG...

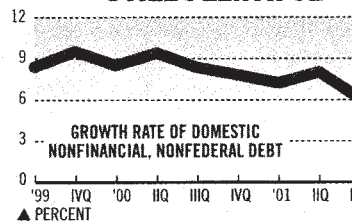
RECESSION	EXPANSION
1973-75	1975-80
0.2%	1.6%
1980	1980-81
-1.2%	2.1%
1981-82	1982-90
-0.2%	1.8%
1990-91	1991-2001
-0.6%	2.1%
2001*	
2.4%	

*TWO QUARTERS SINCE RECESSION BEGAN

...INNOVATION CONTINUES...



...AND FINANCING IS STILL PLENTIFUL



Source: Business Week

The Global Scene . . .

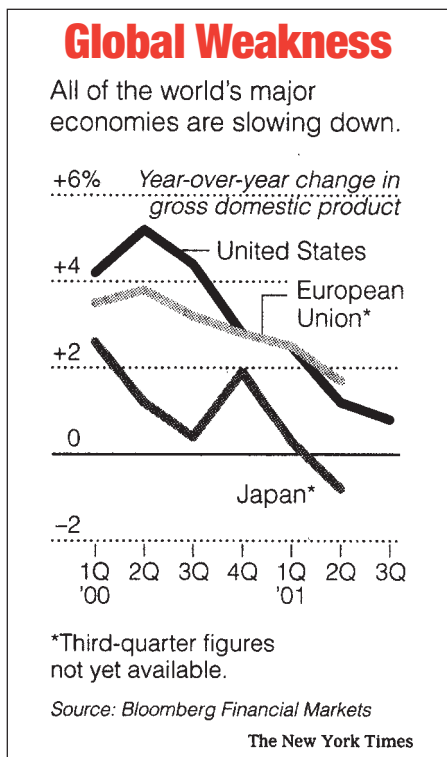
Some bad news . . . but also some good . . .

THE SEPTEMBER 11 TRAGEDY has thrown some real challenges at the world. The global economy was already weak prior to September 11 and now it is that much weaker. Take a look at the chart to the right. The United States, Japan and Europe are now in their first synchronized contraction since the oil price shocks of the mid 1970's.

The September tragedy will increase global costs in a number of ways. David Hale, the global economist at Zurich Financial Services, estimates that total U.S. spending on security is \$250 billion a year or 2.5% of GDP. He estimates that the increased cost of security after September 11 will be an additional \$20-\$50 billion a year. This is equivalent to .3-.4% of GDP. This may not sound like much but with the economy typically growing 5-6% a year before inflation, added security costs will slow our growth rate by 5% or more. Then there are the increased costs of insurance and shipping, etc. The list goes on.

A second cost involves the whole issue of globalization. Stephen Roach at Morgan Stanley points out that exports and imports today account for twenty-six percent of the U.S. economy. This is up from 17% just twenty years ago. September 11 will throw sand in these gears. Goods may not flow as easily across borders now, supply chains may be disrupted and capital may be more reluctant to move from country to country. All in all a pretty gloomy picture.

But there is a bright side here. The World Trade Organization, which was created out of the General Agreement on Tariffs and Trade (GATT) in 1995, had its bi-annual meeting in Doha, Qatar recently. The surprise outcome was that the 142-member organization agreed to begin a new round of trade talks, to commence now and to be completed by 2005. This is the first new round of talks since the Uruguay round was concluded in 1994. The WTO decision is a major vote of confidence for globalization and the whole idea of world trade. Why is this important? Because world trade is the engine that keeps World GDP



growing. World trade has been growing for over a decade now at twice the rate of World GDP. This added growth is what allows for higher living standards in emerging countries and higher growth rates here.

The chart at the bottom shows a snapshot of what the WTO agenda will look like. Developed countries had to






give some ground in intellectual property (drug patents specifically) and in farm subsidies in order to get the issue of tariff reductions on manufactured goods onto the table. The press has generally concluded the developed world came out better in the agenda setting than the emerging ones. I tend to disagree.

Farm products and labor-intensive manufactured goods such as textiles make up 70% of the exports for the poorest countries of the world. It is discouraging that the U.S. refused to give further ground on textiles but the battle is not over. Simply opening up the whole discussion of lower tariffs and easier access will also include clothing. And remember the WTO operates under a unique system of consensus. All 142 countries have to sign on to any new trade agreement. There is going to be a lot of jockeying prior to consensus and emerging economies still hold many of the trump cards. If emerging markets win in these trade talks then everyone wins.

The bad news now is the world economy is weak and 2002 will be a struggle. The good news however is that September 11 has not derailed globalization. Slowed it down possibly but the WTO vote at Doha is a ringing endorsement that world trade is still alive and kicking.

WINNERS AND LOSERS AT DOHA

The agreement in Doha, Qatar, to start a new round of global trade talks was bitterly contested because it sets the agenda for those talks. While a final deal is still years away, here's an early look at the potential impact.

ISSUE	WINNERS	LOSERS
 Public health trumps patents	AIDS patients in Africa	Drug companies
 U.S. antidumping laws up for negotiation	Foreign steel makers	U.S. steel makers
 U.S. refused to import more textiles from poor countries	U.S. textile makers	Pakistani textile makers
 Tariffs on industrial goods to be cut or eliminated	Big multinational manufacturers	Subsidized manufacturers in protected markets
 Farm subsidies to be phased out	Farmers outside high-subsidy countries of Europe, Japan, Korea	French farmers

Source: Wall Street Journal

U.S. Investment Markets . . .

“The More Things Change, the More They Remain the Same . . .”

DURING THE 1990s CORPORATE America became addicted to growth. Success, in most executive suites, was measured not by market share gains or new product developments but by the latest quarter's earnings growth rate. The competition to win the earnings game was intense and caused respected managers of even the largest U.S. companies to predict sustainable 20% profit growth.

During those heady days, many market strategists predicted that overall U.S. corporate earnings growth would exceed 10% annually for the foreseeable future. Technological innovation and globalization were pointed to as factors that would fuel profit growth beyond its 7% historic average. Well, as they say, that was then and this is now. After taking into consideration the sharp profit drop this year and expected modest gains for next, it now appears that the cumulative annual earnings gain since 1990 is on course to average just 7% a year – right in line with its historic average.

The recent profit declines, however, are not just the result of a weak economy. Over the last decade, U.S. companies have increasingly relied on creative accounting practices to achieve profit growth expectations. As the economy slows, the negative impact of

some of these policies is now coming to light. Historically, U.S. firms have relied on a set of rules or Generally Accepted Accounting Principles (GAAP) to calculate earnings. While standardized,

GAAP earnings include a lot of non-cash charges and onetime expenses that make assessing a company's earnings prospects difficult. To get a better handle on core business results, companies have increasingly relied on an operating earnings calculation.

Approaches to calculating operating earnings vary widely from company to company and this lack of standardization is casting doubt on their credibility. The recent rather discretionary use of “one-time” write-offs has probably been viewed as the area of greatest abuse. Write-offs are supposed to be reserved for expenses considered so extraordinary that including them would distort the company's true performance. Cisco's recent inventory write-off provides a good example of abuse. In the midst of the downturn last spring, Cisco took a \$2.2 billion charge for inventory that it

considered obsolete despite the fact that in the high tech world inventory losses are a normal part of doing business. Further, after the write-off, Cisco reported that it had sold off \$187 million of the supposedly worthless goods and booked the proceeds as a reduction to costs, increasing margins. And Cisco is hardly alone. Consider the chart to the left. This year Corporate America is expected to charge-off a record \$125

Total Returns on Large Cap Stocks

	Sources				
	Earn Growth	Divids	Earn & Divids	P/E Inc'r's	Total Return
1926-1981	*4.3%	4.8%	9.1%	0.0%	9.1%
1982-2000	6.6%	3.4%	10.0%	5.7%	15.7%

* Includes impact of Depression & World War II
Sources: Ibbotson Associates, Sanford Bernstein

billion for assets, investments and inventory that aren't worth as much as once thought.

These write-downs and earnings revisions cast new light on current market valuations. As the chart above shows, from 1926-1981 stocks provided 9% average total returns. This return closely mirrored the rising trend in corporate earnings plus the return provided by dividends. From 1982 on, however, average annual stock returns of 16% far outstripped the growth in earnings and dividends. The higher stock returns over this later time period came solely from the sharp increase in price/earnings (P/E) ratios.

Today, the S&P 500 trades around 22 times its expected earnings, well above its historic average P/E of 15. While there is no “correct” P/E ratio for stocks, many strategists consider the market overvalued at current levels. Others, such as Princeton Economics Professor Burton Malkiel, argue that the current low level of interest rates and inflation justifies higher valuations. As students of history, we know that making short-term predictions regarding the market is costly. We also know that one way to protect against overpaying for stocks is to focus on the inexpensive sectors of the market where high quality companies are selling at low P/E ratios. This value-oriented approach to investing has worked well in the past and will continue to in the future.

Anne Williams Doremus

