

Thoughts from

Hanson Investment Management Inc.

VOLUME 8, NUMBER 4

DECEMBER 2002



A Holiday Gift to You . . .

THIS IS THE FIFTH OF OUR DECEMBER HOLIDAY RECIPES. We have concentrated on desserts and specifically chocolate desserts. How long can this go on? We are confident we will never run out of mouth-watering ideas in the chocolate dessert category!

This year we looked no further than the Café right below us. Amy Harris and Dave Bissonette run the Café Piccolo literally right underneath us on the first floor of the Maltex Building, 431 Pine Street. If you haven't discovered Amy and Dave you should. They are great long time restaurant people. Dave was Sous Chef at the Inn at Shelburne Farms and Amy was the pastry person. They bought Piccolo two years ago.

When I asked them for a recipe for the newsletter they didn't miss a beat – "put in the chocolate maple pecan pie; it's always a winner".

Well we marched right into our test kitchen and put it through its paces. It is a winner. We enjoyed the first pie so much we made a second, which unfortunately our Bernese Mountain Dog Yoda found and devoured. He gave it four paws.

From everyone here at Hanson Investment Management, have a very Happy Holidays.

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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.

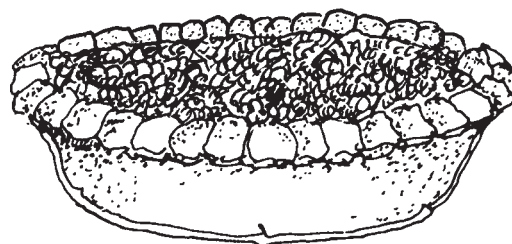
Chocolate Maple Pecan Pie

4 eggs	} Whisk Together
2/3 cup sugar	
1/2 cup of pure Vermont Maple Syrup	
1/2 cup Karo Syrup	
3 oz melted butter	

Sprinkle 3 oz. finely chopped chocolate on bottom of an unbaked pie crust.

Layer pecans (two to three cups) on top. Pour liquid pie filling over.

Bake 350° – one hour 15 minutes or until pie filling firms.



The U.S. Market . . .

OK, I realize the world is uncertain but what can I really earn in this market? . . .

JOHN BOGLE, THE FORMER Chairman of Vanguard, is a very clear and logical thinker. I try never to miss one of his articles. This piece comes from a speech he gave recently at University of Missouri.

We have said on many occasions that the stock market goes up for only two reasons. The first is corporate earnings. If companies do better over a long period of time then their stock price will also. The second reason is psychological. At times investors are willing to pay more for a dollar of earnings, and when they do, price to earnings ratios rise and stocks do also. In times of disappointment however the opposite happens. Bogle has broken out these influences on the chart in the lower right. In the 1990's earnings went up 7.4% a year and dividends averaged 3.2%. This is a 10.6% return but stocks did much better, up 17.8% per year. This is because the price to earnings ratio rose.

The Bears today say that price to earnings ratios have to come down a lot to compensate for the over expansion in the 1990s. In 1999 Mr. Bogle projected that earnings over the next ten years would average 6%, the dividend yield 1.1% and price to earnings ratios would contract bringing the expected ten-year return to 1.8%.

His thinking wasn't far off. The sharp drop in the NASDAQ and the Standard & Poor 500 the past two years has brought price to earnings ratios down considerably. Depending on how you do the numbers the market PE today is roughly 15, close to the long-term average. When Mr. Bogle redoes his projections now he still looks for an earnings increase of 6% per year the next ten years, a dividend yield of 1.8% (higher than previously due to the decline in stock prices) and a price to earnings ratio of 18 instead of the long

term 15. When you add everything up Bogle is looking for a total return of 9% from stocks the next decade.

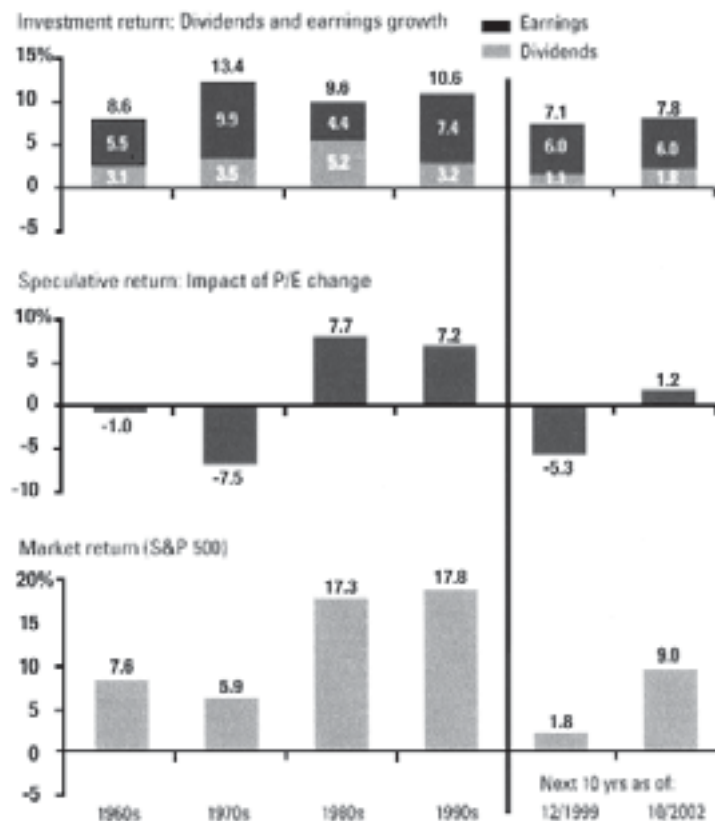
How likely is it that PEs will average 18 in the future? Jeremy Siegel, the finance professor at Wharton and the author of the popular book *Stocks For The Long Run*, thinks they will. Trading costs are lower today, monetary and fiscal policy is more stable and investors are more educated about the long-term return from equities. These factors suggest a higher premium for the market.

Warren Buffett is more dour on this score and thinks PEs have further to fall and earnings are not going to grow as nicely as Mr. Bogle projects. Buffett is using a range of 5 to 7% per year for stocks the next decade. As the hand-cappers say, differences of opinion make

a horse race. We are siding with Bogle and Siegel on this one.

But stocks don't trade in a vacuum. How do bonds look today? The ten year treasury bond currently yields 4.1%. Bogle notes that the correlation between the initial yield on bonds and the subsequent ten-year return is a very high .91. This means that the 4-5% current yield will translate into a 4-5% ten-year return. Not an altogether enormous return. A 9% return from stocks going forward is less than what equities earned in the 1990s but still attractive relative to bonds. The future always looks very uncertain and today is no exception. Projections can easily go awry and many of ours have but we are betting that the stock market today is still a rewarding place to be.

PAST STOCK RETURNS, AND A LOOK TO THE DECADE



SOURCE: Bogle Financial Markets Research Center

Investing Trends . . .

Whatever goes around comes around . . .

SOMETIMES THE NEXT GREAT idea is sitting there right under your nose. We are betting this is the case this time. I am talking about dividends. The dividend yield on the market shrank recently to 1.4%, the lowest rate in memory. Fewer companies are paying dividends today and those that are are increasing them less generously. Whereas 94% of the Standard & Poor 500 paid dividends in 1980, today only 70% do.

What happened? A number of things. First taxes. Corporations can deduct the interest they pay on bonds but not dividend payments. Many corporations argue that since shareholders pay taxes on their own on dividends, double taxation makes dividend payments uneconomic all around. Better to hold on to the money and use it to increase research and development or to buy other companies.

Then there is the issue of stock options. With the granting of ever-larger option packages in the 1980's and especially the 1990's, companies risked dilution as more shares were issued. By buying back shares with the cash saved from the dividend, dilution could be neutralized. Companies also argued that buying back stock pushed up the price. Capital gains are taxed at a lower rate (20% plus state taxes) than dividends so investors should be happy getting more return in the form of appreciation.

We are not convinced. One of the problems with hoarding cash to buy other companies, is management has to be smart enough to know what they are doing. Often they aren't. Have you noticed that when an acquisition is announced the target company goes up but the acquirer goes down. Part of the explanation is the expected dilution from newly issued shares but an equally big problem is that the history of takeovers is not good. Managements often overpay and then investors are left holding the bag as it takes years to clean up the mess. Better to give investors a

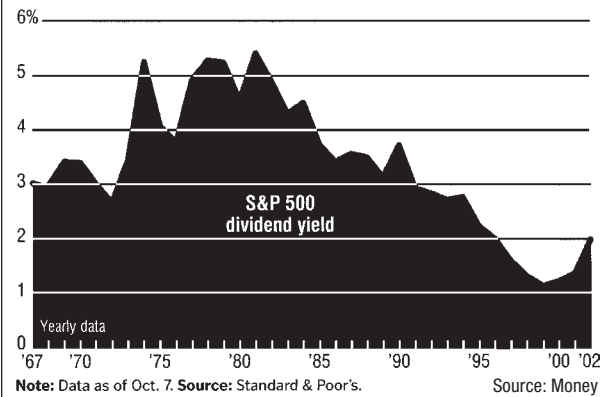
bird in the hand in the form of a dividend and let the real "owners" of the company decide what to do with the winnings.

Momentum is building to bring dividends back as a major investment feature. If you look at the chart to the right nearly one half of the long-term return from stocks has come from dividends and their reinvestment. It is a lot more normal for stocks to yield 3 to 5% over time than the 1 to 2% today. Washington may be ready to put some fizz back in dividend payments. It is rumored President Bush's fiscal stimulus package will include the elimination or reduction in taxes for part or all of dividends. Remember that until 1986 the first \$400 from dividends was tax-free on personal tax returns. Reinstating this at perhaps a higher level or making dividends totally tax exempt at the corporate level would be a big boon for investors.

Investing in dividend paying stocks has not been a bad idea even in the racy days of technology and price appreciation. The chart below shows that stocks with yields have outperformed this year

Dividend Yield Through the Decades

The market's plunge has halted the S&P's long slide from the 5%-plus yields of the late '70s and early '80s.

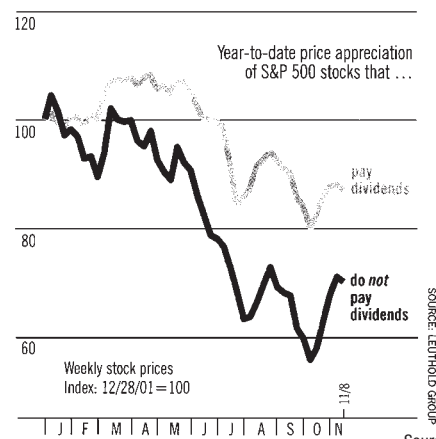


and also outperformed over the past 20 years. This is not all that surprising. Recent research by Arnott and Asness shows that companies with rapidly growing dividends have rapidly growing future profits. This is probably because a big increase in the dividend reflects greater confidence in the business outlook.

Yield is an important ingredient in value investing. We would much rather get our return upfront in the form of cash than risk everything on price appreciation. Our bet is that any tax change favoring dividends will be great for the market. We are keeping our fingers crossed.

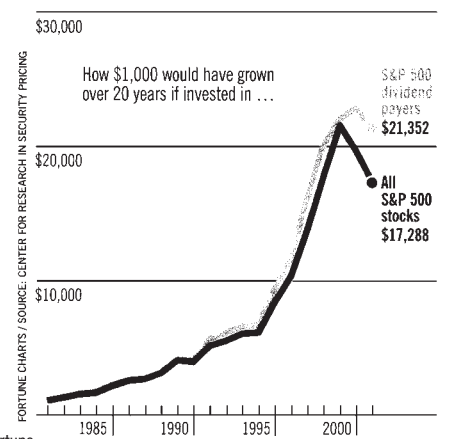
Yielders outperformed this year...

From Jan. 1 to Nov. 8, the S&P 500's average dividend-paying stock has fallen 13.1%. The dividend-less? Down 29.9%.



... and they also win over time

\$1,000 invested in today's S&P dividend payers 20 years ago returned 23.5% more than if it were invested in the overall index.



Stock Market Trends . . .

Reversal of Fortune . . .

THIS YEAR HAS CERTAINLY provided investors with plenty of issues to worry about. Daily reports of ethical lapses in corporate suites, weak employment data and rising international tensions to name just a few. So what else can go wrong you ask? Recent headlines are now serving up a new course that will surely give investors indigestion – under-funded pension obligations.

So why is this rather dreary topic moving from the footnotes of financial statements to headlines? *Take a look at the chart below. For the first time in over a decade, America's largest companies no longer have enough money put aside to pay their obligations to future and current retirees.* Two distinct trends are behind the rather dramatic financial reversal. First, falling interest rates over the last several years have increased pension plan liabilities. The lower rates are, the more regulators require a company set aside to meet future obligations. Second, 2½ years of bear markets have depleted pension assets which are on average 60% invested in stocks.

This represents quite a turn-around for most companies. As recently as 1999, 76% of S&P 500 companies enjoyed

pension plan surpluses i.e., assets exceeded plan liabilities. Now, 91% will likely end the year in the red and under-funding by the group is expected to total some \$243 billion according to David Zion of CSFB.

Analysts today are debating the impact of this shortfall. Corporate earnings will likely be influenced in two ways. First, pension rules require management to make an assumption about what plan assets will earn over the long term – say 9%. In years when actual results exceed the long-term average, the company can record a pension gain as income. Clearly, as a result of the weak stock market, companies will be taking smaller gains this year. Second, many companies are making overly aggressive long-term return assumptions. As managements slowly adjust these returns downward, liabilities, under-funding levels and required plan contributions will increase.

For a handful of companies, pension shortfalls are being taken particularly seriously and rightly so. Those in most trouble tend to be old-line industrial companies with large defined benefit plans. Think autos, airlines and steel companies. Companies with serious shortfalls may be required by federal law to write down some of the liability against shareholders equity. This move can boost leverage and threaten debt ratings.

But lower funding levels do not spell disaster for every company. First, federal pension law requires companies to contribute additional assets if the plan's funding status falls below an average of 90% for three consecutive years or below 80% in any one year. In addition, companies have 3-5 years to make up the shortfall and can fund the deficiency with either cash or company stock. These rules should "smooth-out" the impact of negative returns in any one

PENSION PROFITS?

► These companies plan to make contributions to shore up their pension plans, which will give a boost to their bottom lines. But investors should be aware of the peculiar nature of those gains.

Company	2002 Cash Contribution (mils)	Expected Rate of Return	Expected Increase in Operating Profit (mils)
IBM	\$3,000	8.5%	\$255.0
Unlted Tech	1,000	9.6	96.0
3M	789	9.0	71.0
Pepsico	750	8.5	64.0
Delphi	400	10.0	40.0
Boeing	325	9.3	30.0
AMR	246	9.5	23.0
Delta	175	10.0	17.5
Honeywell	100	10.0	10.0
ITT	100	9.6	9.6

Source: Barrons

year and give companies some breathing room.

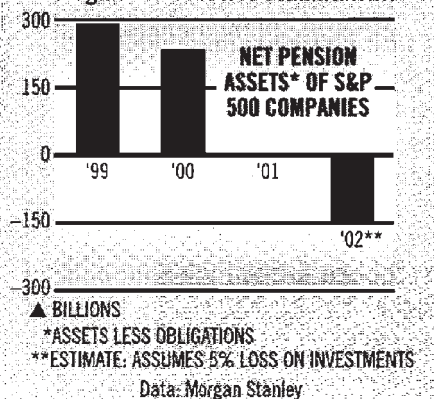
Further, a quirk in pension accounting rules is supporting company efforts to increase plan contributions. Consider a company with an extra \$50 million kicking around. Management can either decide to invest those funds in outside projects or contribute them to the pension plan. Contributing these funds to the plan lowers pension expense and boosts future earnings. This can look like an especially good move if competing investment opportunities promise lower returns. *The above chart lists some companies that have announced plan contributions this year and the positive impact on earnings.*

So what is an investor to make of the current pension debate? Regardless of the arcane accounting rules, under-funded pensions will have a definite economic impact. Increasing pension plan contributions means that there is less money available to spend on business investment or research & development. Investors should certainly keep an eye on pension funding levels but for the majority of companies this liability should prove manageable going forward.

Anne Williams Doremus, CFA

THE SURPLUS VANISHES

Three years into a bear market, once-flush corporate pension plans are no longer big enough to meet future commitments



Source: Business Week