

Thoughts from

Hanson Investment Management Inc.

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Holiday Cheer . . .



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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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DIDN'T F. SCOTT FITZGERALD ONCE SAY that "there are no second acts in American lives"? Well, he didn't live to see Martha Stewart. Love her or hate her, Martha is the ultimate survivor and to honor this we are drawing from her new cookbook, *Martha Stewart's Baking Handbook* (Clarkson Potter/Publishers) for our holiday chocolate recipe.

We wish you all the very best in this cold, snowy and festive Season and hope that if you encounter any rude surprises in the upcoming year, you bounce back as successfully as Martha!

MARBLE CAKE WITH WHITE-CHOCOLATE GLAZE

MAKES ONE 9-BY-5-INCH LOAF *We like the way this cake looks glazed with white chocolate, but you can substitute semisweet chocolate in the glaze recipe, if you prefer. Be careful not to overswirl the vanilla and chocolate batters when you are running a knife through the two; the marbling won't look as beautiful if you overdo it.*

1 stick (½ cup) unsalted butter, room temperature, plus more for pan	1 teaspoon pure vanilla extract
¾ cups cake flour (not self-rising)	⅔ cup buttermilk, room temperature
2 teaspoons baking powder	¼ cup plus 1 tablespoon Dutch-process cocoa powder
½ teaspoon salt	¼ cup plus 2 tablespoons boiling water
1 cup sugar	White-Chocolate Glaze (recipe follows)
3 large eggs, room temperature	

Preheat the oven to 350°F. Generously butter a 9-by-5-inch loaf pan; set aside. Whisk together the cake flour, baking powder, and salt; set aside.

In the bowl of an electric mixer fitted with the paddle attachment, beat the butter and sugar until light and fluffy, about 5 minutes. Add the eggs one at a time, beating until combined after each addition and scraping down the sides of the bowl as needed. Mix in the vanilla. Add the flour mixture in two batches, alternating with the buttermilk and beginning and ending with the flour. Set aside one-third of the batter.

In a bowl, mix the cocoa and the boiling water with a rubber spatula until smooth. Add the cocoa mixture to the reserved cake batter; stir until well combined.

Spoon the batters into the prepared pan in two layers, alternating spoonfuls of vanilla and chocolate to simulate a checkerboard. To create marbling, run a table knife (or wooden skewer) through the batters in a swirling motion.

Bake, rotating the pan halfway through, until a cake tester comes out clean, 40 to 50 minutes. Transfer pan to a rack to cool 10 minutes. Turn out cake from the pan and cool completely on the rack. Pour glaze over cake, letting it drip down the sides. Cake can be kept in an airtight container at room temperature for up to 3 days.

WHITE-CHOCOLATE GLAZE MAKES ENOUGH FOR ONE 9-BY-5-INCH LOAF

½ cup confectioners' sugar, sifted, plus more if needed	2¼ ounces best-quality white chocolate, melted and cooled
2 tablespoons milk, plus more if needed	

In a small bowl, whisk together the confectioners' sugar and milk. The mixture should have the consistency of thin sour cream. Add the melted chocolate and whisk until glaze is smooth. If it is too thin, add more sugar, 1 tablespoon at a time; if too thick, add more milk, 1 teaspoon at a time. Use immediately.

U.S. Science and Technology . . . Passing the Baton? . . .

I PUT A QUESTION MARK in the title because this is not a done deal but the U.S. today risks losing its leadership in science. *Take a look at the chart below.* China and India are graduating far more engineers and computer scientists than the U.S. and our Doctorates are often going to foreign nationals. I realize not all scientists are created equal and not all are up to U.S. standards but many are. IBM recently inked a deal with Indian outsourcing company HCL Technologies to do semiconductor design work and Microsoft and Intel have scads of young engineers in China

The Score Card

Engineering Graduates (2004)

China	500,000
India	200,000
U.S.	70,000

% of U.S. Doctorates awarded in Engineering and Computer Science in 2004 going to students from China, India and the former Soviet Union:

50%

Source: Barrons, National Academy of Sciences

and India working on software products. Technology is migrating.

Don't panic just yet however. *As you can see from the chart in the upper right,* 13 million jobs are lost annually to new technologies and competition. This is far more than the 350,000 jobs lost to outsourcing. What we need to worry

Fear vs. Danger

FEAR

Number of U. S. jobs outsourced in a year

350K

SOURCES: Economy.com, MONEY research.
Source: Money Magazine

REAL DANGER

Number of jobs lost to technology, competition

13 mil.

SOURCE: Charles L. Schultze, Brookings Institution.

WHAT TO DO

Socialize more, whine less, embrace tech.

You don't want to act like the old guy who no longer "gets it."

about is not China but good old fashioned job obsolescence. Technological change is the "creative destruction" of the economy.

The increase in competition from China and India for knowledge jobs helps explain one mystery of the U.S. expansion, that is, how can the economy be doing so well while wages are doing so poorly. Profits are up 50% since 2001 but real wage and salary income is up less than 7%. Competition from China and India with their lower wages is acting as a drag on wages here.

So what can we do? One suggestion often mentioned is to increase government spending on worker training and education. This is certainly a step but not the complete answer. Another idea is, if you can't beat 'em then join 'em or at least co-opt them. We have always been good at luring the best minds to study here and then giving them the incentive to stay. Since 9/11 (*see chart at bottom*) we have made it more difficult for students to get here and once here, harder for them to remain. I realize there are Homeland Security issues but if we

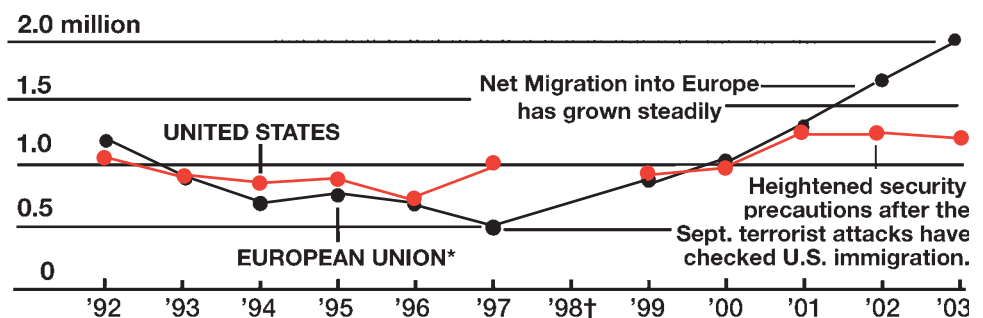
want to be competitive we need to keep attracting the best and the brightest. Canada is doing this and Australia too so we had better get cracking.

The battle for science leadership today is not just a two dimensional war, us against China, or us against India. The Indians are now moving into China setting up software facilities to compete with Chinese companies selling outsourcing services in the domestic market. Chinese manufacturers for their part are setting up design shops in India to learn from the Indians and take advantage of that country's big lead in programming. Everyone is competing against everyone. Cross pollination is the word of the day. U.S. multinationals like IBM, Intel and Microsoft have gotten the message and are acting.

Willy Sutton robbed banks because that's where the money was. If the supply of the best engineers migrates to new areas you can be sure the best jobs will follow. So we had better prepare. Think education, think retraining, and think immigration. Only the paranoid survive, as a former president of Intel said.

Net Migration in Europe and the United States

Net migration is the difference between immigration into and emigration from an area during a period of time. Annual figures are estimates



*Combined total for 15 original members. †United States data for 1998 not available

Source: International Herald Tribune

The U.S. Economy . . . Crystal Ball Gazing Time . . .

SO WHAT IS 2006 GOING TO look like? Our guess is pretty much the same as 2005. This means steady growth and continuing profits. The economy grew 4.3% in the third quarter and productivity came in up 4.7%. Both are super numbers. Productivity is important because a high number allows companies to operate more efficiently and maintain profit margins without raising prices. *The chart in the lower right shows how the U.S. has done the past ten years (and it is good).* Corporate profits surged in the third quarter advancing at a double digit rate for the fourteenth consecutive time. Profits should be up again in 2006 but maybe not as rapidly.

Personal worries are compounded by the mega problems of the trade deficit and the fiscal budget gap. Consumer spending is also a concern now that inflation has picked up and the housing market has (apparently) cooled. Oil prices are also much higher than they were a year ago. Finally you have the issue of the dollar and how long foreigners are going to be willing to hold our paper in return for all the goods they are sending us. A long list of problems to be sure.

Our thinking is the risk today is not so much an economic crash but that everything is going to grow more slowly. GDP, productivity and profits are all going to go up next year but not at the steroid induced rates we are used to. This is not a disaster by any means but it may be a shock to a market used to bigger gains.

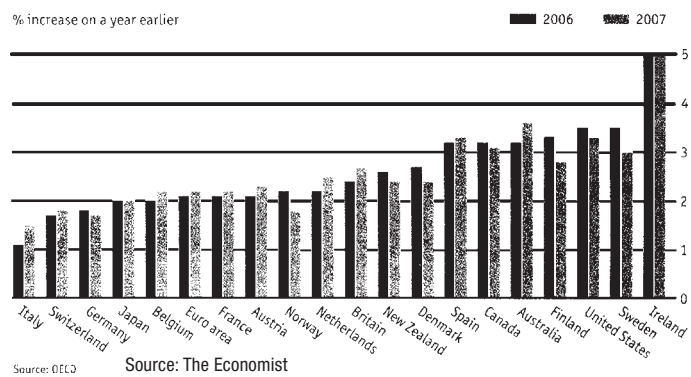
Outgoing Fed Chairman Alan Greenspan has made a number of speeches recently and we should pay attention since they signal his long term concerns. Greenspan is not as worried about the trade deficit as he has been in the past. Even though the current account deficit is a whopping 6% of GDP, the gap will narrow smoothly through market forces. This apparently means a lower dollar which will make imports more expensive and

exports more competitive.

Greenspan is more concerned about the fiscal deficit. The Bush administration has been the answer to everyone's fiscal prayers, considerable tax cuts on the one hand and no spending cuts on the other. The Fed Chairman worries about this complete lack of fiscal discipline. He is in favor of restoring the balanced budget rule which expired in 2002. Under this if you want tax cuts you have to make spending cuts at the same time. Pretty clear and simple but something neither the Republican nor the Democrats want to listen to right now. Did someone say, have your cake and eat it too?

GDP Forecasts

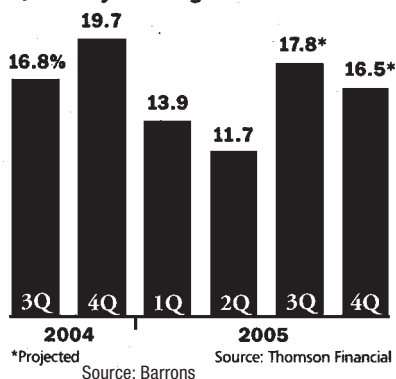
Stronger growth next year, but with bigger risks: that is the message of the OECD's latest Economic Outlook. The rich-country club expects its members' combined output to grow by 2.9% in 2006, up from a projected 2.7% in 2005. Euro-area growth is forecast to accelerate to 2.1% in 2006. The OECD frets about rising external imbalances: it expects America's current-account deficit to top 7% of GDP in 2007.



Raking It In

Analysts' forecasts now show great confidence that double-digit profit gains will continue through the year.

S&P 500 Companies Quarterly Earning Growth

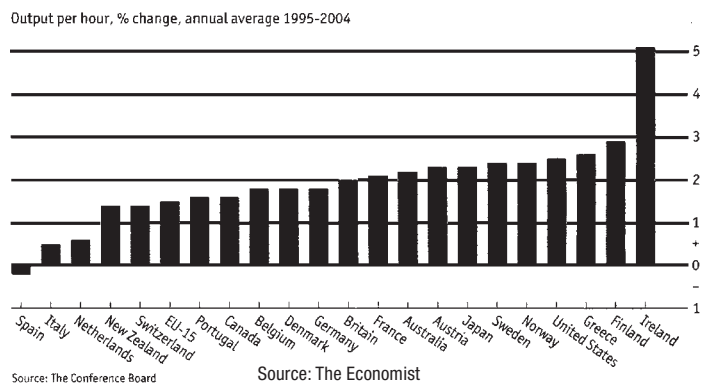


The U.S. economy today is extremely resilient. Our shock absorbers are working just right whether you are talking about higher oil prices or rising short term interest rates or natural disasters such as Katrina and Rita. The economic train has been tough to derail and absent some out-of-left-field shock, it should continue to be.

But if you ask the man on the street how things are, you don't get such a rosy picture. The big reason I think is the anxiety about job losses and outsourcing. We discuss this on page 2.

Labour Productivity

Since 1995, labour productivity in America has grown by 2.5% a year. This is a striking improvement on previous performance, and owes much to advances in information technology (IT). Most big European economies have failed, so far, to match America's record in using IT to boost efficiency. Far from accelerating, productivity growth in the EU-15 has decelerated to 1.5% a year over the same period.



Investment Strategy . . .

Where Is the Stock Market Headed? . . .

THE U.S. ECONOMY HAS performed remarkably well over the last year. Inflation remains tame, job growth is strong and importantly, productivity measures continue to improve. These results are impressive considering the recent economic headwinds. Over the last twelve months, we have faced soaring energy prices, two devastating hurricanes, multiple interest rate increases and rising trade and budget deficits.

The stock market, however, has been rather unimpressed by the economy's strong results. *Take a look at the chart to the right.* While most international and emerging markets have produced double digit returns so far this year, the U.S. market has basically moved sideways.

Stock valuation levels go a long way to explaining the divergent performance of the economy and the stock market. A year ago, the S&P 500's P/E multiple was well above its long term average of 18. Over the last year, the P (price) has gone nowhere while the E (earnings) has increased about 18%. As a result, stocks have gotten cheaper and the S&P 500's P/E ratio is now more in line with its historic average. Unfortunately, however, U.S. stocks remain expensive compared to foreign shares.

Corporate profit growth is the other primary driver of stock returns. Beginning in 2002, declining interest rates and the rebounding economy supported strong earnings gains. But a number of recent trends, such as high oil prices and rising interest rates, suggest that profit margins may have peaked. Earnings for the S&P 500 should advance between 14% and 16% in this year's second half. While sizable, these gains represent a slowdown from the 20% plus advances witnessed during the first half of 2004.

With average stock valuations and solid though decelerating profit growth, my guess is that stocks will produce modest gains over the next year or so. Recent trends in mutual fund flows could further support the positive case

for U.S. stocks. Professional and amateur investors have a long history of piling money into hot sectors just as they begin to underperform. American based mutual funds have poured \$29 billion into international and emerging markets this year while flows into U.S. funds have lagged. If history is a guide, then these trends suggest that U.S. shares may be poised for a comeback.

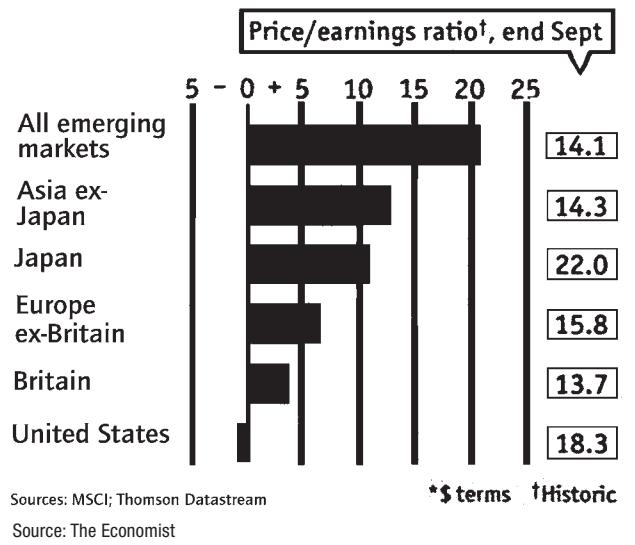
But my confidence in this forecast is pretty low. Predicting short term movements in stock prices has historically been an unrewarding endeavor. As anyone who witnessed the massive stock sell-off in 1987 knows, investor sentiment can be very fickle. And the factors that drive corporate profits, such as raw material costs and consumer spending patterns can be equally difficult to predict.

In his recently published book, *Foiled by Randomness: The Hidden Role of Chance in Life and in the Markets*, author and philosopher Nassim Nicholas Taleb suggests that unexpected, random events often have the biggest impact on the world. Consider the implications of this for the market. Current stock prices reflect investors' predictions regarding a whole range of factors such as earnings, economic growth and interest rates. Prices adjust incrementally to changes in these assumptions on a daily basis. But big, unexpected events such as terrorist strikes, oil price spikes, and natural disasters typically have a large impact on stock prices, and by definition these cannot be factored into investor's decisions.

So what is an investor to do in the face of all this uncertainty? One answer

America Splutters

Total returns*, Dec 31st 2004-Oct 12th 2005, %



is to focus on strategies that do not rely on forecasting. We use a "bottom-up" approach in our stock selection work for example. This means that we focus on the fundamentals of individual companies and avoid basing our decisions on large, and often difficult to predict, macroeconomic developments. We make sure our portfolios are well diversified. At its heart, diversification is an admission that you cannot be right all the time, so you better spread your bets. As value investors we seek out good companies selling at a discount to their perceived underlying value. We can't predict all the factors that impact a stock's returns going forward. But if we buy the issue cheaply enough and wait for earnings to improve, then above average returns should follow. Finally, we keep focused on the long term. While predicting short term movements in the market is tough, history tells us that stocks produce solid returns over long periods of time. A nose for value, patience and diversification are our best defense in a world of uncertainty.

— Anne Williams Doremus, CFA