Thoughts from
Hanson Investment Management Inc.

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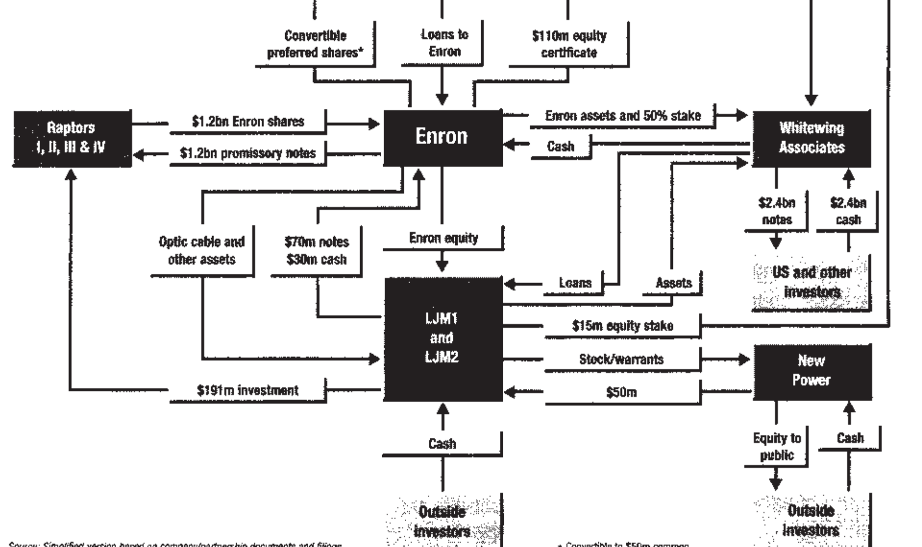
"I don't know, I don't remember, I don't recall . . ."

IS THIS THE ENRON executive's mantra today? Seems so. There is so much blame in the Enron story you don't know where to start. The special committee of Enron's board says the collapse was caused by "a flawed idea, self-enrichment by employees, inadequately designed controls, poor implementation, inattentive oversight, simple (and not so simple) accounting mistakes and overreaching..." Not much wiggle room here for positive spin!

What is our take on Enron? That it is an example of a system run amok — capitalism on steroids. Can anyone even start to figure out the partnerships below? But the bigger issue is how all this will affect the thing we need most in the investment process: trust. Trust in management, trust in Boards of Directors and most importantly trust in the auditors. Remember what the auditor's opinion says: these statements "present fairly, in all material respects, the financial position" of the company, "in conformity with accounting principles generally accepted in the United States of America".

If there is any good to come out of the Enron mess it is that the "era of laxity" as Paul Krugman calls it in the *New York Times*, is now at an end. Hopefully we will better define the auditor's role and get rid of some of the conflicts of interest and hopefully the SEC will also force a more clear definition of corporate profits. "Net income" for instance is what is reported to the SEC. It is GAAP compliant. But "operating earnings," "Core earnings," "pro forma earnings" and "EBITDA" are all just what a company wants to report. As they say, these include "everything but the bad stuff."

We rely on Corporate Statements and management integrity to judge investments. Let's hope that Enron gets us to fairer more honest reporting — and does so quickly.



Source: Financial Times

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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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The National Scene . . .

So what's our take on the economy now? . . .

THE STOCK MARKET is betting the worst is over. Or at least this was the case in the fourth quarter. Right after the September 11 attacks the market fell sharply but then all the averages soared by 20%. Many of the traditional economic signals say this recession, which started in March 2001, will be short and shallow.

Interest rates are low now; inflation is bumping along the bottom and the over expansion of inventories, which often causes a recession, has not happened this time. Congress did not come up with a major fiscal stimulus package that everyone could agree on but government spending nevertheless will be more expansionary this year than last.

We are not as optimistic as the consensus on the economy right now. The current recession has been caused by three big excesses. The first is over investment in high tech equipment. The surge in spending in the late 1990's left us with a lot of excess capacity in telecom and other areas. We aren't going to see a new burst of spending until the old gets used up.

The second excess is the stock market itself. The Nasdaq Composite was up 40% in 1998 and then an incredible 86% in 1999. We have now corrected some of this Irrational Exuberance. The NASDAQ is down nearly 60% from its high of 5000 in March 2000. But still price to earnings ratios are high.

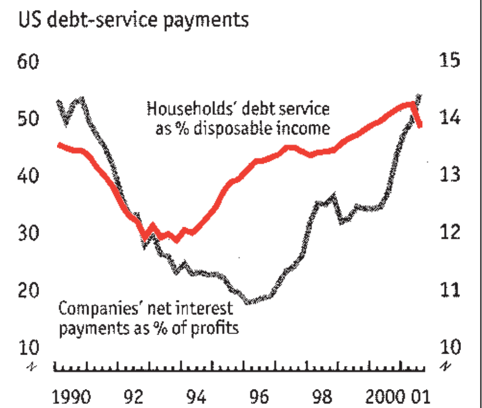
The third excess is the overall debt level in the system. *The Economist* points out that excessive borrowing by companies, households and the government is the root cause of nearly every economic crisis of the past twenty years. American companies and consumers borrowed freely in the 1990's and this is reflected in the increased debt service ratio now *(see chart)*. The optimists say that the glass is still half full not half empty on this one. If you look at debt as a percentage of total assets then the consumer balance sheet is in much better shape. But remember debt is a fixed value whereas consumer assets like home prices and stocks can fluctuate a lot and this means they can go down. When they do, debt becomes a much bigger percent of assets. This could happen especially if house prices weaken.

We don't see the economy spiraling out of control from here. But at the same time we don't see any engine out there to lead us higher. The housing market is still near its high so there isn't a lot of pent-up demand here we can draw on to start a rebound. Zero percent auto financing and aggressive markdowns at Christmas accelerated some consumer demand into 2001 that would ordinarily have fallen into this year. So we can't expect much from the consumer either. This is important since the consumer makes up 60% of the overall economy. The *New York Times* recently reported that colleges have seen a sharp increase in the number of parents asking to stretch out tuition payments because of job and income losses. Times are not flush.

Stephen Roach of Morgan Stanley thinks it is possible we will see a double dip recession this time. Five of the six full-blown recessions since the 1950's have included double dips. Inventory restocking will make first quarter numbers look good, but if sales then do not pick up we may fall back into the economic conditions of the Fall.

Our best take is that the economy will be lackluster this year. We won't stumble badly because interest rates and inflation are low but we will drag along the bottom for some time until a new economic driver is found. Not too exciting a forecast to be sure but it may not be all that bad for stock prices. *See page 3.*

Increasing Interest



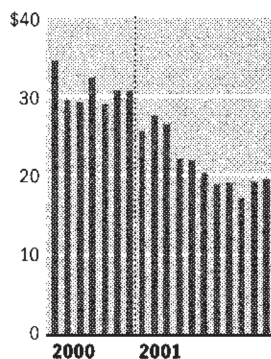
Sources: US Federal Reserve; Dresdner Kleinwort Wasserstein

Source: The Economist

SIGNS OF A TURNAROUND?

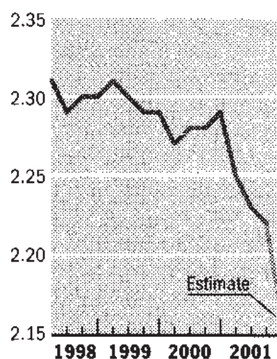
High-tech spending is stabilizing

Orders for high-tech goods[1], in billions



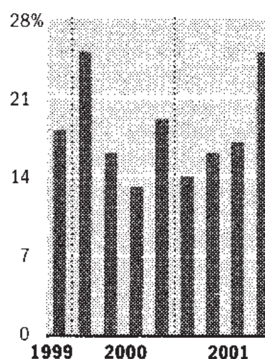
Excess inventories are down

Ratio of private inventories to final sales, adjusted for inflation



Rays of light break the profit gloom

Percent of earnings pre-announcements that were positive[2]



[1]Computers, communications equipment, semiconductors and related products

[2]Data are as of first week after the respective quarter

Sources: Commerce Department via economy.com; J.P. Morgan Chase; First Call

Source: Wall Street Journal

The U.S. Market . . .

How Warren Buffett made his money . . .

JIM GRANT points out in a recent edition of *Forbes*, that Warren Buffett did not get rich by outguessing the blue chip economic forecasters each year. No, he got rich by focusing on buying good quality companies at reasonable prices and then holding them, holding them, and holding them some more.

Our take is the U.S. economy will be lackluster at best this year *(see p. 2)*. But this does not mean stocks are a bad bet. After two years of down prices many securities are selling at very reasonable prices now. The secret to successful investing is the same today as it was in 1987 right after the crash and the same as 1982 when we had just finished ten years of dismal markets.

Bonds Top Stocks – But Not Very Often

(Percentage of time since 1957 when U.S. Treasury returns exceeded common stocks)

1957 TO DATE COMPARISONS	
Over 3 years	23% of the time
Over 5 years	19% of the time
Over 10 years	16% of the time
Over 15 years	2% of the time

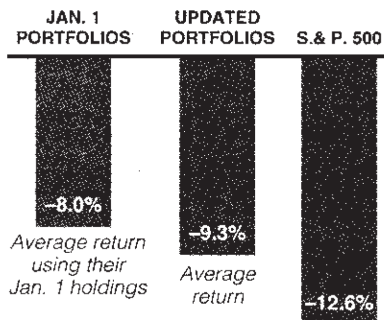
SOURCE: The Leuthold Group

Source: Bloomberg

The Price of Change

Portfolios updated throughout the year by 500 investment newsletters performed worse, on average, than they would have if they had stuck to their recommendations on Jan. 1.

Data through Nov. 30



Source: New York Times

The secret is first; find companies with decent understandable businesses, clear accounting and little debt or other leverage. As value investors we were not interested in Enron at $100 nor have we been involved in Tyco, Calpine, Qualcomm or any of the other companies accused of questionable accounting practices. Value investors look for understandable businesses with simple accounting. As Warren Buffett says, he would much rather step over a one-foot fence than try to leap over a six-foot wall.

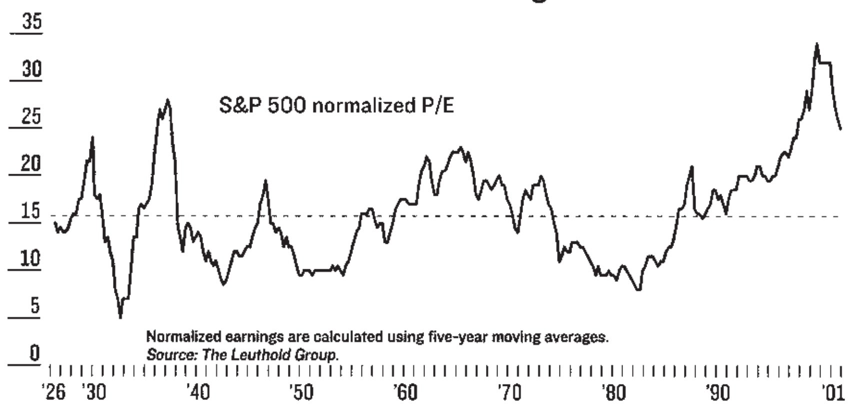
Second, value investors look for companies selling cheap relative to earnings and assets. Today the average stock sells at over 20 times earnings *(see chart below)*. This is high. But we are looking at cheaper issues where PEs are between 10 and 15 or even lower. Remember it is far easier for a company to beat low expectations than high ones. Rarely does the world work out perfectly for any company for very long. Better not to pay too much for earnings forecasts.

Third, we take a long-term perspective. As the chart above shows, Treasury Bonds outperform stocks at times but they don't do it for very long. We have said here before that investors should exercise extreme sloth when it comes to Wall Street. Take a long-term view and don't over trade your portfolio. Even professional newsletter writers get this one wrong. The chart to the left shows that if you just left well enough alone on January 1 instead of trading in and out, you would have done a lot better.

And finally remember that investing is about your heart as well as your head. When fear and panic grips us as it did after September 11, it is difficult to think logically about investing. But once emotions recede, we are surprised how much better we feel and how much brighter the world looks. Corporate profits will most probably increase 6% to 7% a year in the future just as they have in the past. When you add in dividends of 2%, a total return of 9% is what we can probably expect. Relative to bonds today of 5% to 6% and money market funds of under 2%, well-chosen common stocks still make a lot of sense. This is how it has worked in the past and this is how it will most probably work in the future.

Too Rich for Comfort?

Stocks that are overpriced relative to long-term forecasts could be the most vulnerable if earnings continue to slide.



Source: Forbes

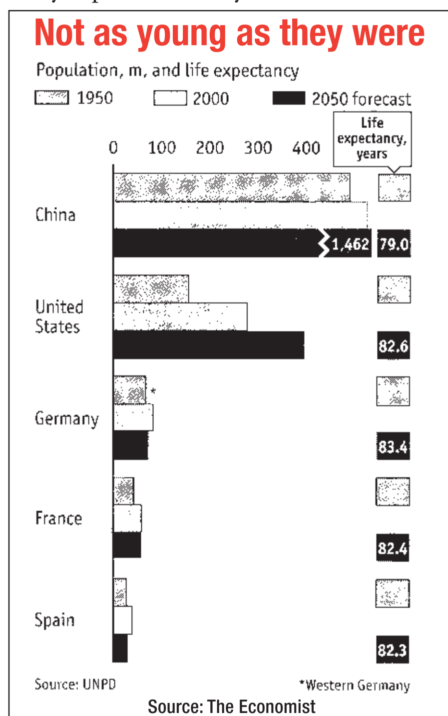
The Global Economy . . .
Where Do We Go From Here? . . .

LAST YEAR provided little opportunity to reflect on the course of future events. Terrorist threats and anthrax scares had most of us just trying to make sense of each day's headlines. Not surprisingly, an *Economist* article in November on future global trends received scant attention. But this piece by Peter Drucker should not be missed. Drucker, a prolific author on business, identifies the following factors that will influence society over the next several decades.

Global Aging

A rapidly growing older population will perhaps be the greatest factor to influence developing countries going forward. This trend is evolving for two distinct reasons. First, improved healthcare and technological advances are producing longer life spans across the globe. Take a look at the chart below. By 2050, life expectancy rates in most developed countries will exceed 80 years of age. Declining birth rates are also playing a role. In most developed countries, the United States included, birth rates remain well below replacement level.

This "aging explosion" will impact every aspect of society. A healthier, older population and constrained pension resources will cause people to work longer. Current estimates suggest that by 2030, the age at which full retirement benefits start will have risen to 70 in all developed countries. A rising ratio of retirees to workers will also require countries to rely more heavily on immigrants to meet their growing workforce needs.



Source: The Economist

The Emerging Knowledge Worker

First, land was the key productive resource. Then, in the midst of the industrial revolution, capital was king. Today, knowledge has become the critical resource. In most developed countries today, "knowledge workers" or people whose jobs require formal and advanced training are the fastest growing employment group. In the United States, they are estimated to make up one third of the workforce and to outnumber manufacturing workers 2-to-1.

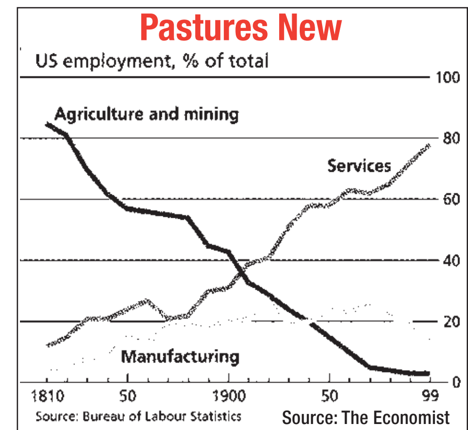
This new workforce is altering most traditional definitions of employment. Knowledge workers, because of their high level of skill and training, typically identify more closely with their profession than with their employer. These individuals generally view themselves as professionals and require high levels of initial and continuing education.

Declining Role of Manufacturing

At the beginning of the 20th century, farmers made up the single largest group in the working population. As new farming techniques emerged, productivity jumped and employment fell. Today, farmers account for no more than 3% of any developed country's total work force.

Manufacturing is now experiencing the same transition. One forecast today suggests that by 2020, the manufacturing ouput of developed countries will double while manufacturing employment will decline to 10%-12% of the total workforce.

The continued transition away from manufacturing will not occur without some pain. As jobs vanish, threatened industries will increasingly call for protection in the form of tariffs, quotas and subsidies. Trading blocks such as NAFTA and the European Union will also be relied on to support these threatened industries.



Source: The Economist

The Evolving Corporation

Multinational corporations will not have an easy time adapting to these major societal changes. Jobs and benefits must evolve to meet the needs for an older, more educated work force. Companies which have become accustomed to serving a youth market will have to become adept at serving a growing "mature mass market." Global competition will intensify as companies attempt to exploit their knowledge resources. Most importantly, an ability to adapt will be the hallmark of success.

How will these trends impact investors going forward? For a number of reasons, I expect the U.S. to fare relatively well in the face of these changes. First, the U.S. enjoys the highest birthrate of any developed country and, unlike the rest of the West, should see its population expand over the coming decade. In addition, our work force should remain relatively young, provided we are able to maintain our historically liberal immigration policies. A growing domestic market and relatively young labor force will not solve all the economy's problems. But these strengths will greatly support the country's transition to a more knowledge-based economy and this is good news for investors.

Anne Williams Doremus, CFA