

Thoughts from

Hanson Investment Management Inc.

VOLUME 11, NUMBER 6

FEBRUARY 2006

Is This Really 1932? . . .



**431 Pine Street
P.O. Box 819
Burlington, VT 05402
U.S.A.**

Phone: 802-658-2668
Fax: 802-658-1027

E-mail:
ehanson@hansoninvestment.com

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.

©2006 Hanson Investment Management

THE PERSONAL SAVINGS rate in the U.S. last year was a minus 0.5%. This means Americans spent not only all their after tax income but also dipped into previous savings. The only other time this has occurred was 1932 and 1933 in the depths of the Great Depression. Are we really in this bad shape today?

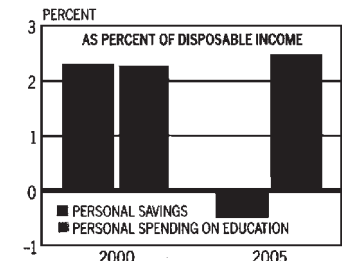
We have definitely been in a “wageless” recovery where profits are soaring but personal income growth has been very sticky. It is also true that Americans have used the rising value of their homes as a virtual ATM machine cashing out equity and shoring up their flat wages. But still it is hard to imagine that we have dropped all the way to a negative savings rate.

Business Week did a cover story recently (February 13) titled *Why the Economy is a Lot Stronger Than You Think*. In it they point out that government statistics are not keeping up with changes in the economy. We measure things today much the way we did fifty years ago even though the economy has morphed from manufacturing to services and now to knowledge based production. Education expenses for example, those \$40,000 a

Investing in The Kids

Households are spending more on education even as the savings rate falls

READING, WRITING, AND CHECKBOOKS



Data: Bureau of Economic Analysis

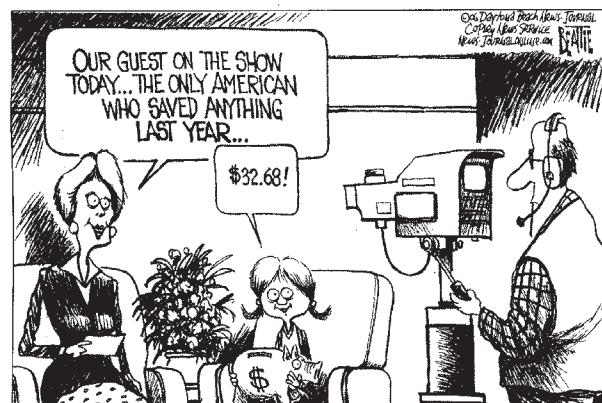
Source: Business Week

year tuition payments, are considered consumption not investment. They fall in the same category as buying sneakers or ice cream cones even though education is really not consumption but an investment in a future generation.

If you adjust the savings rate for this (see chart above) the current minus number turns into a positive 2%. And the government does other strange things. Pension contributions and capital gains are not considered savings. Hello?

Again adjusting for this increases savings.

I am not going to apologize for everything here and blithely whistle past the graveyard. The fact is we are spending too much and saving too little today but let's be realistic and not morbid. This is not 1932 redux and the economy and the consumer are not in as bad shape as a minus 0.5% savings rate implies.



Source: USA Today

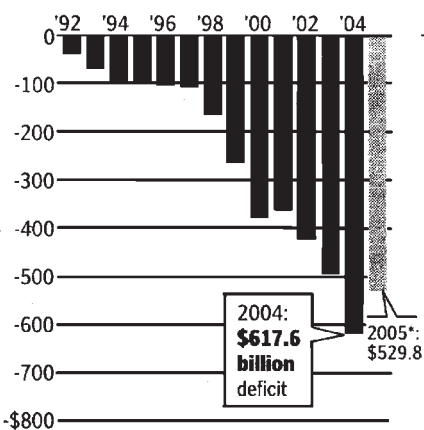
Whither The Dollar . . . Who wants to be a trillionaire? . . .

A YEAR AGO the consensus was the dollar would definitely fall. Well it didn't happen and in fact the greenback appreciated 15%. Now the consensus again is the dollar will fall and this time we think the consensus is right. For a number of reasons.

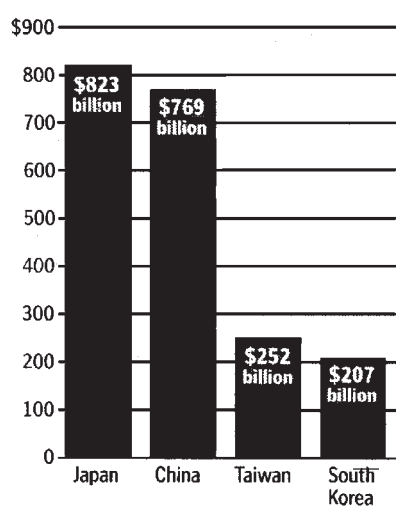
A Growing Gap

Many of the dollars Americans spend on foreign goods end up in the coffers of Asian central banks.

U.S. trade balance (goods and services)
In billions of U.S. dollars



Foreign exchange reserves
in selected Asian central banks; in U.S. dollars



*January-September

SOURCES: U.S. Census Bureau, official central bank data

Source: Washington Post

First the rest of the world is recovering today (*see page 3*) and this probably means higher interest rates in Europe and Japan. This will attract money away from the dollar. Also, the Fed's program of raising interest rates appears close to an end. This will make the dollar less attractive. Finally, an interesting twist is coming out of the Middle East. When energy prices spiked back in the 1970's, petrodollars poured back into U.S. bonds and investments. Today we are not seeing that same flow. Why? One reason is the Middle East is absorbing more of its own money. Stock markets in the region are booming and there is enormous property development going on in places like Dubai and Abu Dhabi.

A final factor in the dollar call is the foreign currency holdings of China and Japan (*see chart to the left*). China's foreign reserves will probably top \$1 trillion this year. An amazing total seventy percent of these reserves are in U.S. dollar assets. Since January China has been signaling it is rethinking its policy meaning it will probably diversify its base further. Don't expect a dramatic move here anytime soon however since it is super important for China to keep us strong and buying their goods but any reserves not flowing to the U.S. means a softer greenback.

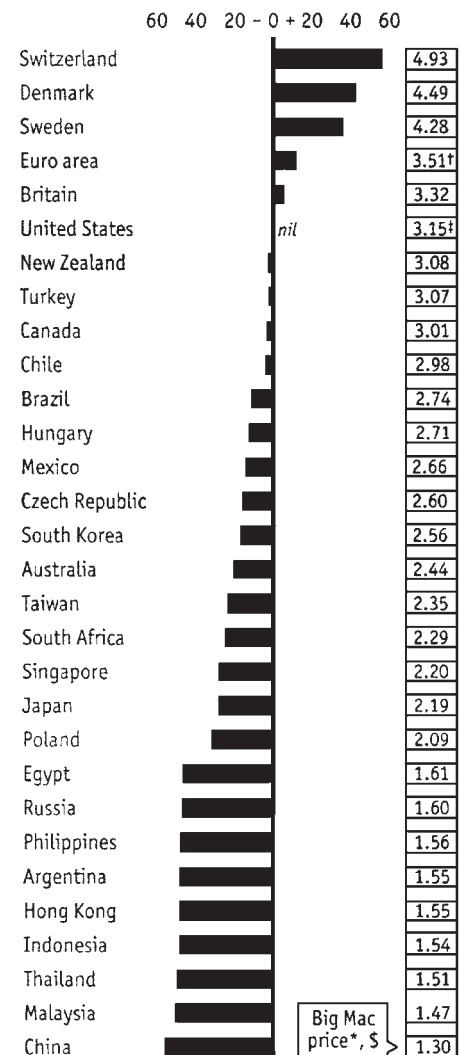
Will China revalue its currency? It certainly is undervalued by some amount as the Economist's Big Mac index indicates. But the Chinese will only do what's in their best interest and a big revaluation is not one of these.

A weaker greenback this year is not all that bad for us. It will help U.S. exporters and also help multinationals who on average have 40% of their sales abroad. A stronger local currency means profits get translated back into more dollars. This helps earnings per share. The big loser in all this? You and me – tourists. If your budget is tight this year my advice is to take your vacation earlier than later.

Big Mac index

The Economist's Big Mac index is based on the theory of purchasing-power parity, under which exchange rates should adjust to equalise the cost of a basket of goods and services, wherever it is bought around the world. Our basket is the Big Mac. The cheapest burger in our chart is in China, where it costs \$1.30, compared with an average American price of \$3.15. This implies that the yuan is 59% undervalued.

Local currency under (-)/over (+) valuation against the dollar, %



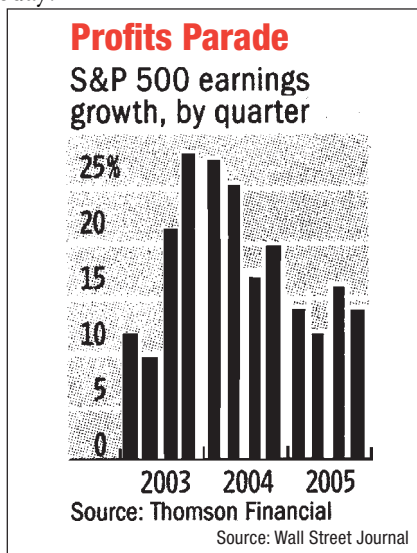
*At market exchange rate (January 9th)

†Weighted average of member countries ‡Average of four cities
Source: The Economist using McDonald's price data

Global Prospects . . . Wow, we finally have company . . .

ONE OF THE BIG CRITICISMS of the global recovery is it is a one trick pony. It is led by the voracious appetite of the U.S. consumer who has been supplied an ever increasing amount of cheap goods by the manufacturing juggernaut, China. When the consumer finally collapses from exhaustion or indebtedness or both, the king will indeed have no clothes and the global recovery will collapse. At least this is the conventional wisdom.

But things are changing quickly today:



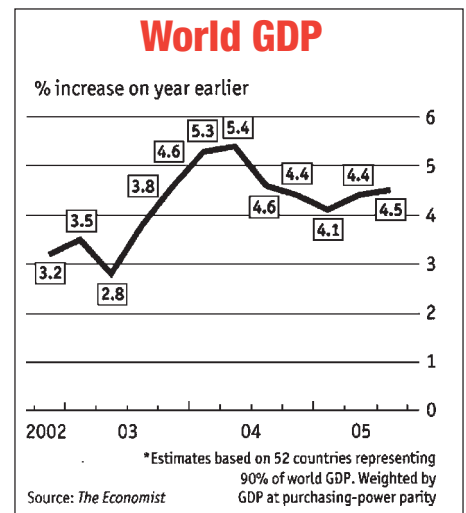
1. This dog still hunts. Although the U.S. economy is facing a large budget deficit, a large trade deficit and possibly (see page 1) a negative savings rate we continue to make headway. Profits are expected to be up another 10% in 2006, the fourth consecutive year of double digit increases. And GDP will move ahead 3% in real terms, a solid middle-of-the-road result. The Energizer Bunny lives.

2. Hello Europe and Japan. As the chart in the lower right shows, Japan and Germany are still significant players even as China moves up. Their economies together equal 75% of ours and they are #2 and #3 in the world respectively. Both economies have floundered this decade (Japan since 1990), but now both are rallying. Germany has made many

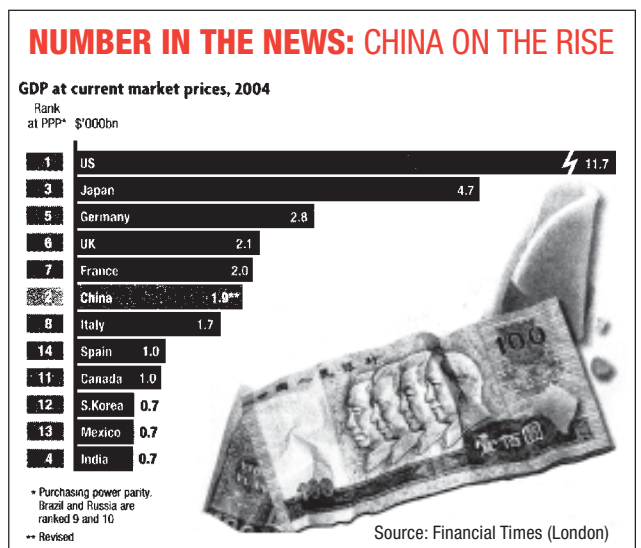
structural changes even though it has not moved as fast as many would like. Business confidence and export growth today is strong and even the consumer is starting to show signs of spending. The same goes for Japan. Real gains are being seen and there is even talk, amazingly, of interest rate increases after seven consecutive years of deflation. A rate increase would do more to show confidence in the system than hurt the prospects for growth.

3. The Emerging Consumer: The standard thinking is China is an export driven machine fueled by low incomes and low wages. The same goes for India even though their high tech workers in Bangalore are relatively high paid. The fact is Emerging Markets are now becoming the Emerging Consumers. Goldman Sachs recently reported that Brazil, Russia, India and China (the BRICs) have in recent years contributed more to world domestic demand than to GDP growth. This means Emerging Markets are going from export driven platforms to internal consumption machines. India has been notorious for keeping out large retailers like Wal-Mart. This is starting to change and Wal-Mart has a representative office in India now although no stores yet. Reliance Industries, India's largest petroleum and refining group, has announced plans to invest \$5 billion in a chain of hypermarkets to be ready for the competition from Wal-Mart and France's Carrefour. The Emerging Market consumption boom is still in its infancy and we are doing our homework here on U.S. and foreign companies who will benefit from this growth.

At the recent Davos World Economic Forum Larry Summers, the



President of Harvard University and a former U.S. Treasury Secretary, said that we are in the third biggest economic revolution in history now, alongside the Renaissance and the Industrial Revolution. This new global economy with its knowledge workers and warp speed trade flows is unbelievably difficult to handicap. But it seems right now we may be looking at a classic soft landing with the U.S. consumer being joined in the lead by a number of others including Germany and Japan and the Emerging Market consumer. If things work out, and certainly there are plenty of potholes ahead, we will have made an amazing economic transition from U.S. centric to more balanced global growth. Great for investment markets.



Investment Strategy . . .

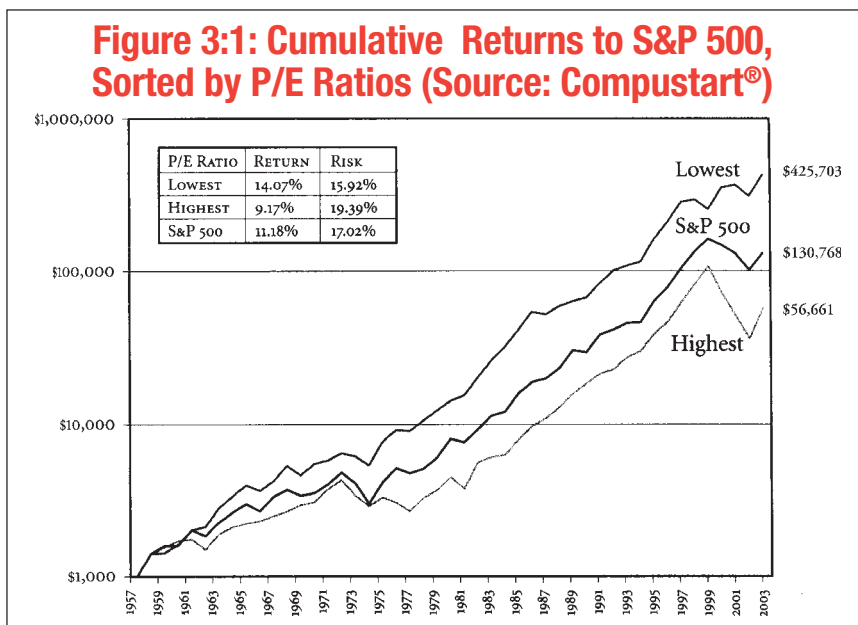
So How Do We Manage Money? . . .

MANY PEOPLE PUT investment managers in the same camp as car mechanics. They know they need the services of these folks, but they have a very limited idea of what they do. I think this mindset works fine with cars but in today's world of 401(k)s and IRAs I am not sure that it's a smart way to handle your finances. More importantly, I think investing is a lot easier than car repair. True, many fund managers will have you believe that investment success requires mensa-level intelligence. But in reality, following a few basic principles greatly improves your overall chances for success. Here are some of the strategies we use when putting money to work.

The Big Picture: Investors spend a lot of time thinking about individual stocks. But how you split your money up between stocks, bonds and cash has a bigger impact on returns than individual security selection. To arrive at a suitable mix, you must understand how you feel about risk (i.e., volatility) and what kind of return you need (income, capital appreciation or both). Unfortunately, assessing your return objectives and risk tolerance is a somewhat inexact science. But it is also not brain surgery. Most people have a pretty good sense of how they feel about the market's gyrations and a handle on their financial objectives. An asset allocation based on this understanding that you stick with through the market's ups and downs is an important first step.

Spread Your Risks: Diversification remains the single most important means of reducing investment risk. Funds should be spread across different asset types and, within stocks, across a wide range of economic sectors. Last year, energy and utility shares were the place to be but that leadership will not last forever. To cover our bases, we purchase securities from 8 different economic sectors.

Keep Costs Down: Investors often shell out 2%-3% ever year to cover



various investment expenses. Trading commissions, which can range anywhere from \$10 to \$300 a trade, are probably the least understood piece of the cost puzzle and can really add up. This is particularly true in portfolios that experience rapid turnover or trading. A recent study by Vanguard founder Jack Bogle measured the impact of turnover on investment performance. His work, which examined returns of all domestic equity funds over 10 years, found that the funds that traded the least had an annualized return of 11.49% while those that traded most had a return of 9.78%. This almost 2 percent difference over 10 years resulted in a return of 197% vs. 154%. If you hadn't guessed it, we try to be patient, keep our turnover down and our trading costs low.

Go Global: Approximately 50% of the world's stocks as measured by capitalization are traded outside the United States. This statement illustrates the cost associated with limiting your investment selections to only firms based within our borders. The vast majority of our portfolios have some direct or indirect exposure to what we believe are fast growing international markets. And in addition to boosting return, international stocks can reduce portfolio

volatility as the returns from foreign markets do not move perfectly in sync with those in the U.S.

Ok, Now Let's Talk About Individual Stocks: So what do we look for when selecting individual securities? As value investors, we focus on stocks that are inexpensive. Often, these are issues that have hit some bump in the road and whose share price is down from earlier highs. We assess value by comparing the stock price to measures of earnings, cash flow and book value. Buy candidates should also have little debt on their books, a strong competitive position and management team. Stocks paying attractive dividends are also favored. Finally, we look for some reason or catalyst for a change in investor perception. Has new management been brought in or is the company launching a promising new product or service? But investment success is also about avoiding losing stocks. We work hard to not get caught up in issues that are rapidly rising in value and trade at expensive valuations. We remain patient and wait for perceptions to change. *As the chart above shows*, this focus on underappreciated (low P/E) shares has produced favorable returns over time.

– Anne Williams Doremus, CFA