

Thoughts from Hanson Investment

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HANSON

Investment Management

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



Julie Won, Eric Hanson, Anne Doremus

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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Our April 15th F.Y.I. . . .

Mention the alternative minimum tax (AMT) and eyes start to glaze over. With tax season just around the corner we bring you help: an understandable definition of the AMT and, to offset the bad news here, a visual reminder that one tax at least is at an 80 year low.

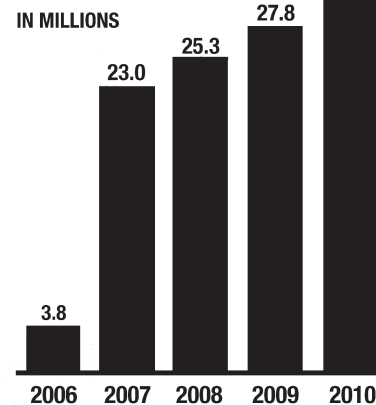
Alternative Minimum Tax

“Democrats have vowed to protect middle-class households from the alternative minimum tax. The tax was created in 1969 after it was discovered that 155 households with incomes over \$200,000 had used deductions, shelters and other gimmicks to erase their federal tax liability.

To force the wealthy to pay the IRS, Congress created the minimum tax, essentially a flat tax with two rates (26 percent and 28 percent) and far fewer deductions. Households that AMT could apply to are required to calculate their tax bill twice – once under regular tax rules and once under AMT rules – and pay whichever is higher.

Because the AMT was not indexed for inflation, it has ensnared a growing number of upper-middle-class households. Add the Bush tax cuts, which lowered tax rates under the

Projected number of returns affected by alternative minimum tax under current law

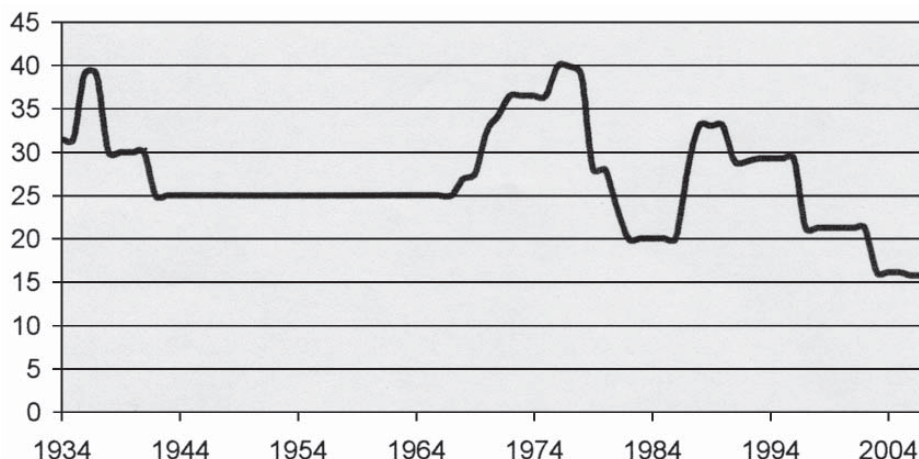


SOURCE: Washington Post Weekly

regular rules but not under the AMT rules, and the number of taxpayers who could be caught by the AMT is set to soar from 3.8 million this year to more than 30 million in 2010.

In the past, Congress has limited the scope of the AMT by temporarily increasing the size of the exemption accorded AMT taxpayers. But that stopgap could cost nearly \$50 billion next year. And repealing the AMT would cost more than \$1 trillion over the next decade.” (*The Washington Post Weekly*).

Top U.S. capital gains tax rate (%), 1934-2007



SOURCE: Citizens for Tax Justice

More Good News Than Bad . . .

Things are awfully good in the world of profits today. The *chart at the bottom* shows corporate profits as a percentage of GDP are higher than at any time in seventy-five years. No one is quite sure why. Globalization might be the reason. Or maybe it is the decline in union power or maybe it's just that management has finally gotten things right. We just don't know. But corporate profits have been soaring. We have had eighteen consecutive quarters now of 10% or more growth. The stock market has responded with higher prices even as valuation levels (PEs) have drifted down to the more normal levels (15-17X). All is good in stock market land.

The problem is it is doubtful that corporate profits can continue to increase at today's pace. And the pessimists say that the pendulum will swing back to more normal levels of 5-6%. This would make it a lot more difficult for the stock market to make headway. Our take is that profit margins are indeed unsustainably high and will probably settle back but we don't see any dramatic falloff. The economic consulting firm of Gavekal has an interesting take today on the U.S. business landscape. They were recently written up in a story in *Barron's*. The French/British firm argues that American businesses are moving to a new model which will mean higher profitability and great stability. Many U.S. firms

are already virtual or 'platform' companies. They do less manufacturing and more design and marketing. Nike is probably the poster child for this. The company makes almost none of its own shoes. For decades they have designed in Beavertown, Oregon, sourced manufacturing all over Asia and then turned on their marketing magic and sold at very attractive profit margins.

The Gavekal folks think more and more companies are moving in this direction. This will lead in the aggregate to higher quality earnings and more highly valued companies. The manufacturing side of most businesses is where the big costs are and also where the big volatility is. When you reduce or eliminate these costs you get greater profitability and greater stability. Manufacturers like the Chinese are accepting more of the volatility today. When orders are cut back they are the ones who have all the costs that need to be eliminated.

U.S. companies now are putting less money into plant and equipment (you need fewer plants when you outsource) and more into research and development (to come up with the hot new

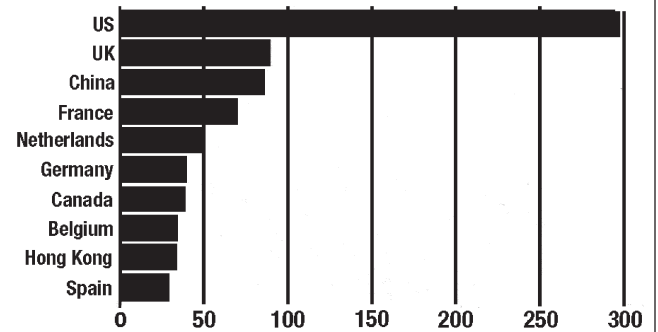
ideas like iPods). Higher value added means higher wages, greater profits and a higher standard of living. This all sounds like nirvana but obviously things can go wrong. Protectionism is one threat here as countries and companies try to limit their losses and erect barriers to entry to thwart competition.

If virtual business is one thing working in our favor today another factor is how the rest of the world views us. There is a lot written about China and how foreign investment is pouring in there to take advantage of low cost production. But *if you look at the chart in the upper right* you see that the United States will continue to be the largest recipient of foreign direct investment. Just look at how Toyota, Nissan and Honda are expanding in the American Midwest. There is confidence in our system and this is encouraging.

The market today looks fairly valued to us. It is neither wildly over priced nor wildly under priced. Our strategy is to look for the undervalued areas and the undervalued companies that are selling cheap relative to earnings and assets. And when we find these companies we buy and wait patiently for the market to come around and drive stock prices higher. The formula has worked in the past and we think it will continue to work in the future. The U.S. economy and corporate profits look healthy and growing today. The 10% profit margin may be a thing of the past but we don't expect the well to dry up any time soon. 2007 looks solid.

Foreign direct investment recipients

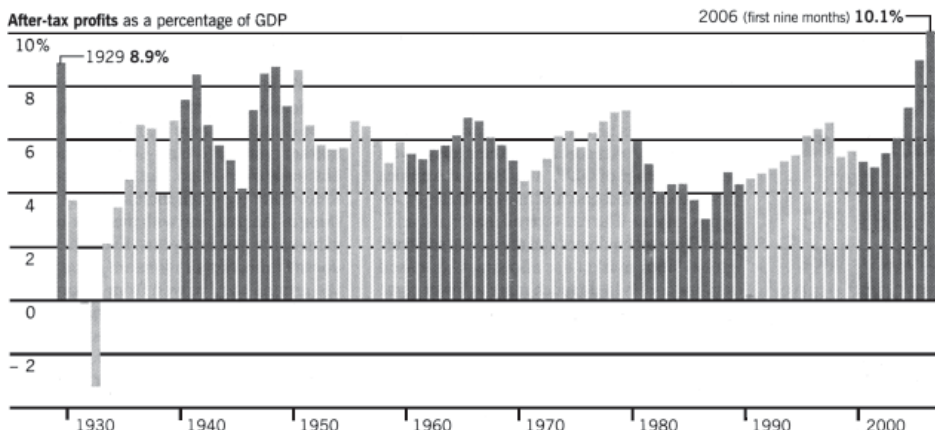
2006-10 forecasts, annual average (\$bn)



SOURCE: *Financial Times*

HAPPY DAYS ARE HERE AGAIN

After-tax corporate profits measured as a percentage of GDP are as high as they've ever been.



SOURCE: *Fortune*

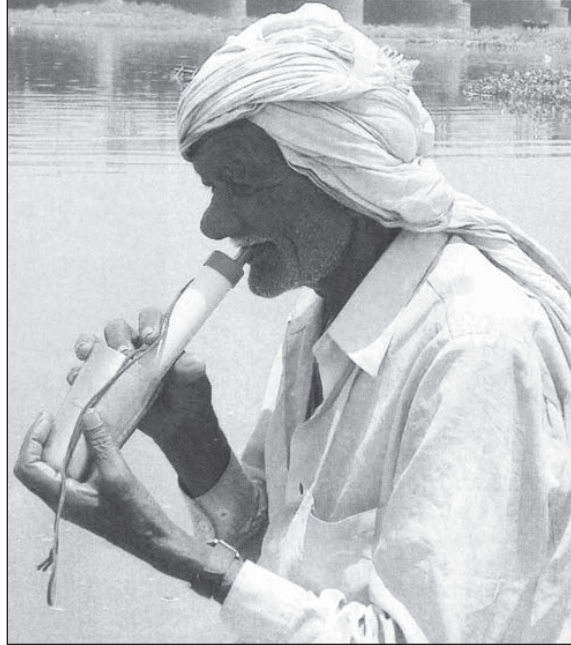
The “One-Lakh” Car and Other Product Innovations

Have you ever imagined buying a brand new car for about \$2,000? One may be on the way from Tata Motors, at least for consumers in India. Now in the design phase, it is known as the “one-lakh” car because one lakh is 100,000 rupees or about \$2,100. It is just one example of how emerging markets are driving product innovation.

We all know there is huge opportunity in emerging markets. Growing income levels and populations – and untapped needs yet to be explored – are too attractive to overlook. But until recently, companies have mostly been selling products very similar to those sold in developed markets. Now businesses and humanitarians are coming out with more products uniquely designed for the developing world. Some efforts are focused on bringing prices on products we know way down so that they are within the grasp of the average consumer. Others are more “disruptive” innovations. Here is a quick look at some of our favorites.

The “one-lakh” car

Tata Motors’ “one-lakh” car is not just an inexpensive, reduced version of existing car models, but a completely new design. It is meant to be good-looking and comfortable, has a rear-mounted engine, four seats, and offers a choice of four and five-door models. The car just went through the first round of trials late last year, and though material costs have brought the price beyond one lakh, the company still expects to be able to sell the car for less than \$3,000. The big question is whether the car will be able to meet emission and safety standards. In addition, there are other players in the market. Bajaj Auto is considering a low-cost car based on a motorcycle engine, while in Pakistan, the Transmission Motor Company sells basic



The LifeStraw in use

SOURCE: lifestraw.com

vehicles for as little as \$2,200 and exports them to Sudan, Qatar, and Chile.

LifeStraw

This product addresses one of the most challenging problems faced by the emerging world: access to safe drinking water. LifeStraw is a personal water purification system consisting of a plastic tube with built-in filters that remove harmful particles and bacteria. The beauty of the product is that you can carry it with you and drink through the tube as you would from any straw. The other plus is that it costs just \$3. LifeStraw is made by Swiss company Vestergaard-Frandsen and so far has been distributed only for humanitarian relief: 70,000 LifeStraws were handed out to victims of the Kashmir earthquake. However, Vestergaard is hoping to bring in small local distributors to get them to consumers.

The \$100 laptop

This product, the “XO-1,” is being developed by One Laptop Per Child (OLPC), the organization spearheaded by Nicholas Negroponte of MIT’s Media Lab. The goal is to get laptops with

Internet access costing \$100 to as many children around the world as possible. The XO-1 is no ordinary laptop either. It can be powered by a hand-pulled device if access to electricity is an issue. It can withstand extreme dust, sand, heat, and cold. And it has a powerful Wi-Fi antenna that allows children to network from remote places. The goal of getting the price tag to \$100 has involved enormous technical challenge, as every design component has had to be scrutinized. So far, the cost is down to \$150 if 5 million orders can be secured. The hope is to hit \$100 by 2008.

Everyday consumer products

Many companies have started selling everyday products like toothpaste and shampoo in tiny-sized packages for just two or three uses that make them affordable to more people. And paint in India is now sold in small 100 ml sizes rather than half-liter containers. However, some companies are doing much more than changing packaging. Procter & Gamble spends 30% of its \$1.9 billion R&D budget on creating new products for low-income consumers. It has laboratories that recreate the heat and humidity conditions of Mexico and China, and it sends researchers to live in people’s homes to learn exactly how products are used. All of this has given rise to completely different versions of Tide laundry detergent and diapers.

There are plenty of other examples of new products for emerging economies. Phillips Electronics has developed lights that stay on for several hours after power failures – a common event in the developing world – while Nokia and Motorola have been working on no-frills cell phones for \$40 – \$50. Certainly, even more products are coming down the road.

The Coming Political Debate . . .

January marks the start of the 2008 Presidential campaign. And while we don't yet know the list of contenders, we can get a good sense of the issues that will dominate political debate over the next 21 months. Historically, candidates have fared well by focusing on issues that impact voters' pocketbooks. With that in mind, get ready to see lots of coverage, and let's hope some new policy ideas, on the following economic issues.

Living Standards

By many measures, the average American should be feeling good. The economy just completed its 6th year of expansion, inflation remains under control and unemployment low. But in the midst of all this good news is a growing realization that many workers have missed out on the benefits of growth. *Take a look at the chart to the right.* Between 2000 and 2005, median hourly wages in the U.S. rose by just 3% in inflation-adjusted terms.

A coincident explosion in the incomes of the nation's wealthiest citizens is also making this trend particularly difficult to bear. A recent analysis of IRS data by David Cay Johnson found that in 2004, the top 130,500 taxpayers had more income than the 120 million Americans at the bottom.

A range of policies are now being discussed to address these trends. Many, such as increased trade barriers, seek to protect the jobs of middle class

Americans. While such policies are popular, they often depress economic growth and do little to stem the tide of globalization. Government incentives aimed at boosting math and science training are also being considered and may prove more effective. Achieving bipartisan agreement in these areas will not be easy so expect a lot of heated debate here.

The Deficit

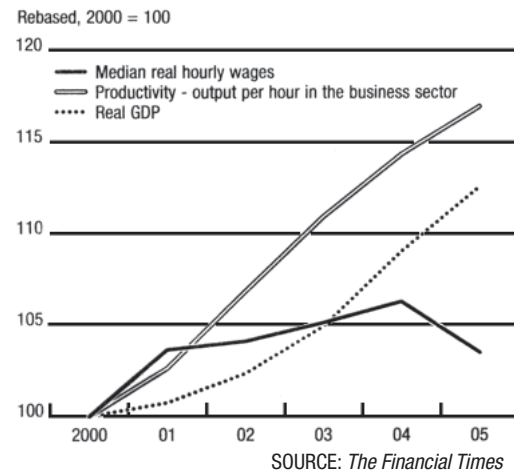
As the chart below shows, there has been some good news recently on the deficit front – analysts now expect the 2006 deficit to decline to “only” \$290 billion. But despite this short-term progress, the U.S. must still confront two long-term budget busters. The first is the cost of the war in Iraq and Afghanistan. This year, President Bush plans to ask for as much as \$170 billion for the conflicts on top of the half trillion already spent. Second, are the rapidly escalating costs of government health programs and Social Security.

Initial efforts from both parties however look promising. Initiatives to restrict “earmark” provisions that provide funding for billions of dollars of “pork” projects are gaining steam. And don't rule out some compromise on Social Security reform.

Health Care

The nation's current healthcare system suffers from at least two basic problems. The first is inadequate coverage. Current estimates hold that as many as 47 million Americans lacked health insurance in 2005. The second problem has to do with the escalating cost of healthcare. The U.S. spent an average of \$6,102 per person on healthcare in 2004. This level, which has been increasing at a 7%-8% rate for some time,

The gap between productivity and wages



is approximately twice the level spent by other developed countries such as France and Canada. And despite the higher spending, healthcare measures such as life expectancy and infant mortality are not markedly better here than abroad.

Proposals for a single payer or government run system are likely to gain steam in the months ahead for at least two reasons. First, several states, including Massachusetts, New Mexico and California have already launched limited government run programs. Second, despite much opposition, approximately 50% of U.S. healthcare expenditures are already doled out by the government through federal and municipal healthcare programs.

Global Warming

New research and some very suspect weather is bringing the issue of global warming to center stage. To date, policy responses have focused on two very different approaches. The first, imposing an energy tax, can be very effective by increasing the cost of putting carbon dioxide into the air. The second centers on a variety of regulations, such as higher gas mileage requirements, that limit carbon use. While I am not particularly hopeful for action here, some progress may be possible if gas prices remain high or if the issue is combined with the increasingly popular goal of fostering energy independence.

