

Thoughts from

# Hanson Investment Management Inc.

VOLUME 8, NUMBER 11

JULY 2003



## Seeking: Exciting Work, No Heavy Lifting . . .

**C**HARLES ELLIS IS ONE OF WALL STREET'S MOST NOTED observers, consultants and writers. He is the author of *Winning the Losers' Game*, one of the classics in the investment business and also the editor of two anthologies of Investment articles. This following piece is from a speech he gave in Toronto in 1988. With the zigs and zags of the economy and the market recently his words are as appropriate today as they were fifteen years ago.

### *Three Ways To Succeed As An Investor:*

*There are three ways in which you might try to achieve superior results: one is physically difficult; one is intellectually difficult; and one is emotionally difficult.*

*Warren Buffett, John Templeton, Dean LeBaron and Warren Goldring and a very few others have staked out the intellectually difficult way of beating the market.*

*Intellectually difficult investing is pursued by those who have a deep and profound understanding of the true nature of investing, see the future more clearly and take long-term positions that turn out to be remarkably successful. We admire them, but usually only in retrospect. At the time of their doing their best work, we see them as misguided. We do not want to do what they are doing because it looks so unpromising.*

*Most of the crowd is deeply involved in the physically difficult way of beating the market. See if you don't recognize the physically difficult right away. They come to the office earlier; they stay later. They read a larger number of reports more rapidly. They go to more breakfast meetings and more luncheon meetings and more dinner meetings. They are on the telephone, making calls and receiving more calls than all the rest. They carry huge briefcases home at night, determined to get ahead by reading more reports before the morrow. In every way they possibly can, they put enormous physical energy into trying to beat the market by outworking the competition. What they don't seem to recognize is that so is almost everyone else.*

*Being incapable of doing the intellectually difficult, and reluctant about the physically difficult, I have set about the emotionally difficult approach to investing. This straightforward, untiring approach is simply to work out the long-term investment policy that's truly right for you and your particular circumstances and is realistic given the history of the capital markets, commit to it and – here is the emotional difficult part – hold on.*

*When your friends turn to you and say, "Wow! Have I got an opportunity for you! This is a great time to buy!" be absolutely uninterested. And when they turn to you and say, "Oh, Lord, this is it. It's going to be one hell of a crash. Get out now while you can!" You must simply be not interested, absolutely sound asleep. No intellectual effort; no physical effort; but for most, emotionally far too difficult. It suits me just fine. It requires no great genius and no great brawn, but it works.*

–Charles Ellis

**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.**

Successful investing is all about controlling the controllable. It's awfully simple in theory... just hard in practice!

# The Emerging Giants . . .

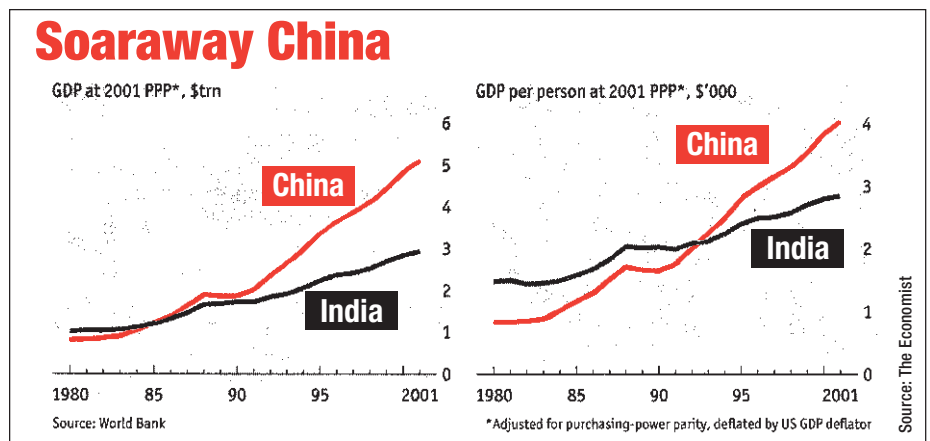
## Will It Be One, or the Other or Both? . . .

**C**HINA AND INDIA ARE BY FAR the two most important Emerging markets today. They are over 40% of the world's population. Twenty-five years ago the standard of living of the two countries was roughly the same. Today China is almost twice as wealthy as its sub-continent rival (see chart).

Since the early 1980's the Chinese have been loosening the reins of their centrally planned economy and spurring growth. They have been remarkably successful and have attracted mammoth amounts of foreign investment. This year China will pass the United States as the biggest single recipient of Foreign Direct Investment (FDI).

But the story is not an unqualified success. The experiments in change have been mostly limited to the economy. Political power is still tightly controlled by Beijing. State owned companies (SOES) are bleeding red ink at an alarming rate. The government can't close them down without throwing millions out of work. But the banks are in a quandary. As many as 50% of all bank loans (most of them to SOES) are in technical default. The high wire act is to hope the private sector and foreign companies can create enough new jobs to absorb new workers and those being laid off by the SOES. A daunting task. On top of all this, the rule of law, property rights and the judicial system are still in their infancy.

Many in India however would love to have China's problems. India started liberalizing in 1991 and many critics say it has blown its opportunities. The "Hindhu rate of growth" is the way many decry India's slow ponderous advance.



The economy is characterized by political infighting, a grinding bureaucracy that ties up even the best of intentions and a judiciary that is creaky and often corrupt. The "world's largest democracy" is both a blessing and a curse. The proof of the pudding the critics argue is the fact that China attracted \$44 billion of FDI in 2001 to India's meager \$3 billion.

But now a new article has come along in *Foreign Policy* by Yasheng Huang of MIT and Tarun Khanna of the Harvard Business School. The authors claim that the race may indeed go to the tortoise not the hare. Yes, India has lagged so far but this is both because China had a 10 year headstart and it has taken time for India to nurture its entrepreneurs. The Chinese model emphasizes attracting foreign direct investment. India on the other hand has emphasized home grown talent. Investors are hard pressed to name even a single Chinese company which has grown from its domestic base and created a global brand.

India on the other hand has many examples. In computer software alone there is Infosys, Wipro and Satyam and in

pharmaceuticals, Ranbaxy and Dr. Reddy's are serious global players. India has made life easier for local entrepreneurs, the authors contend, while China has done the opposite.

I see Huang and Khanna's point that India's growth will pick up as more private sector companies succeed. But I don't think it will come at the expense of China. The next wave in the Middle Kingdom will be when private firms move from supplying multinationals to selling under their own name. They know how to do quality and volume now, next is branding and global markets. Deng Xiao-Ping liked to say, "it doesn't matter if a cat is black or white, as long as it catches mice." The Chinese are, above all, pragmatic and this will start to show shortly in global markets. But the biggest concern for us is not whether China wins or India wins but what the effect on our economy is. Continued development of the two largest emerging markets will put ever increasing pressure on our high paying, high value added jobs (see *Anne's discussion on page 4*). The pressures of Globalization continue.

## Competing Giants

	Population (2002)	Population Growth Rate (2002)	Infant Mortality (2002)	Average Annual Real GDP Growth Rate (1990-2000)	Foreign Direct Investment (2001)	Population in Poverty (2002)	Labor Force (1999)	Fixed Lines and Mobile Phones (2001)	Size of Diaspora
<b>China</b>	1.28 billion	0.87 percent	27 (per 1,000 live births)	9.6 percent	\$44.2 billion	10 percent	706 million	247.7 (per 1000 people)	55 million
<b>India</b>	1.05 billion	1.51 percent	61 (per 1,000 live births)	5.5 percent	\$3.4 billion	25 percent	406 million	43.8 (per 1000 people)	20 million

Source: Foreign Policy

# The U.S. Market . . .

## This Rally Is For Real, Right? . . .

**T**HE DOW JONES INDUSTRIAL Average has shot up nearly 25% since March 11. Everyone is now wondering, is this just another sucker's rally in a continuing Bear Market or a legitimate upturn?

We don't know but the conventional wisdom says the second half of the year will be solid for the economy. Corporate profits are picking up, interest rates remain low, inflation is very much under control and fiscal stimulus both on the spending side and tax cuts, will add fuel to the fire. The decline in capital spending has finally run its course. Spending is starting to pick up.

But don't get too enamored with your own press releases, the Bears say. Corporate earnings are sluggish at best, the market's valuation is still high and the whole run in the market is liquidity driven and quite speculative, not based on fundamentals.

Where do we stand? We feel the recent market move is more justified

### The Debt Drag

►Despite record stimulus, economic growth remains weak, a phenomenon only seen two other times: following 1929 in the U.S. and 1989 in Japan. High debt levels may explain it. With debt steadily growing since 1933 to nearly \$32 trillion today, the amount of growth produced in gross domestic product has been diminishing.

Date	Debt (bil)	% Gain	GDP (bil)	% Gain
1933	\$146.6	-	\$56.4	-
1962	887.6	505%	594.4	954%
1981	5,269.4	494	3,203.1	439
2002	31,702.2	502	10,588.8	231

12/31/02 Debt = \$31.702 Trillion  
12/31/02 GDP = \$10.589 Trillion = 299.4%



Quarterly Data 12/31/1922 - 12/31/2002

Source: Barrons

Source: Ned Davis Research

### A BULL WITHIN A BEAR?

For now, the bull market has enough going for it to post a good year . . .

■ **CORPORATE PROFITS** for the second half of the year look relatively strong

■ **FISCAL STIMULUS** will help stocks this year and possibly next year, too

■ **LOW INTEREST RATES** make stocks a better value than bonds

■ **THE ECONOMY** is starting to pick up steam in some areas

■ **WAR WORRIES** have abated with the ending of the Iraq conflict

. . . But the big, brutal bear hasn't yet gone into full hibernation

■ **THE ECONOMY** may remain in a deflationary mode

■ **CONSUMERS** are considerably overleveraged, and their spending could drop off

■ **CORPORATE SPENDING** could take some time to revive

■ **INTEREST RATES** have fallen so much, they're more likely to rise over the next few years

■ **TERRORISM WORRIES** continue to hang over the market

Source: Business Week

than not. There are plenty of problems out there but the economy is improving. The tax cuts especially will have a bigger effect on the economy than most think. Also we are not believers in the deflation scenario. Some sectors, principally manufacturing, are seeing deflation and will continue to. We spoke recently to an Fortune 500 durable goods maker which sells hardware to the likes of Lowes and Home Depot. They say the big boxes simply demand price reductions every year. Period. And there is no end in sight here. Pricing power is just not there in many businesses.

But the service sector is another story. The *New Yorker* recently pointed out that "Baumol's cost disease" is still alive and well. William Baumol the economist at NYU noted many years ago that most service industries have very little productivity growth. Their costs go up year in and year out. He used the example of a string quartet, where it takes just as many musicians today and just as much time to play a piece as it did 250 years ago. Education, insurance, health care and most government services are in the same boat. Costs go up because produc-

tivity gains are so hard or impossible to achieve. Since 70% or more of the economy is services, I don't see overall prices falling anytime soon.

There are two problems however, that do worry me today. The first is debt. Take a look at the growth in debt in *the chart in the lower left*. We haven't had to pay the price for this yet because interest rates have fallen and debt service is very manageable. When rates rise however, debt will be a longer-term drag on GDP.

The second issue is jobs, or more specifically the lack there of. We have lost 2.5 million jobs this cycle and many of these are not coming back (*see page 2 on China and India*). In the near term we may have a bump in the economy but as Sung Won Sohn, economist of Wells Fargo wonders, "can we have economic growth without new jobs?" This is a good question and a problem that may come back to haunt us later.

But as a friend of mine says, as he signs off his phone calls, "enjoy your youth." For now the second half looks solid and we are still believers that the rally has legs and we remain 100% invested.

# The U.S. Economy . . .

## The Changing Face of Labor . . .

**M**OST ECONOMISTS TODAY agree that the U.S. is slowly emerging from recession. Real gross domestic product, a common measure of economic activity, has gradually advanced over the last year and corporate profits are recovering. But if things are getting better, why do so many Americans feel worse?

The answer is in the job picture. Unemployment, which hit a low point of 3.8% in April 2000, has crept up to 6.4%. And as *the chart to the right shows*, these job losses have fallen disproportionately on higher level, managerial workers.

Certainly, job losses are to be expected during times of economic weakness. But persistent losses in the face of an improving economy suggest something more is at work here. Forces including technological innovation, deregulation, trade liberalization and demographics are converging to fundamentally alter U.S. job markets. Consider the following trends.

### The New Blue Collar Worker

The ongoing drive to improve productivity has transformed manufacturing today. Modern machine shops involve highly automated processes. Meeting just-in-time inventory delivery schedules means a faster pace of work. To

be successful in this environment, employees must be highly trained, flexible and capable of handling complex tasks.

### Welcome to Bangalore

U.S. manufacturers have long turned to inexpensive, Asian countries for production work. The U.S. service sector, once thought immune from international competition, is now embracing this process of "offshoring" too. Bangalore, India, where wage rates can be as much as 80% below U.S. levels, is a booming offshoring center with an English speaking workforce capable of handling tasks ranging from call-center services to financial analysis and radiology screening. Over the next 15 years, consultant Forrester Research predicts that 3.3 million service jobs will move abroad.

### Delayed Retirement

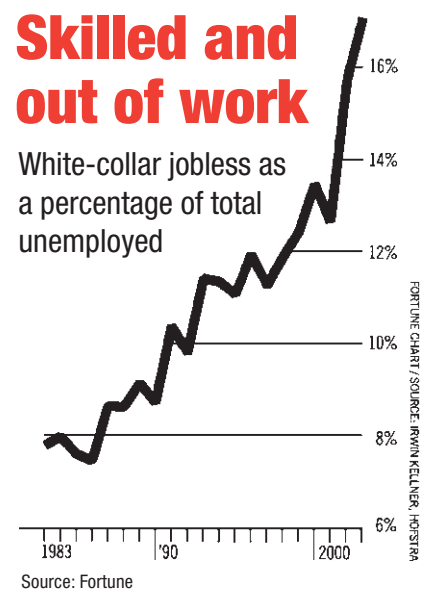
Two forces will keep US workers in the job market longer. First, people living longer, healthier lives are able to stay in the job market. Second, stingier corporate pensions, changes in social security and weak financial markets mean individuals must work longer to support themselves. The shift to an older workforce is impacting workplace rules. More flexible work options are starting to emerge. New employees are finding their career paths blocked as older employees hold onto jobs longer. While improved stock market conditions may reverse this trend somewhat, my guess is that most Americans will be bringing home the bacon well into their late 60s.

### A Growing Immigrant Workforce

Immigrants have long played a powerful role in our economy filling lower skilled service sector jobs. But over the past three decades, foreign-born workers have been filling an increasing number of higher paid jobs. Manufacturers, impressed by immigrant's motivation and work habits, have been increasingly tapping into this labor pool. Immigrants, a growing percentage

## Skilled and out of work

White-collar jobless as a percentage of total unemployed



of PhD awards from U.S. universities, will also continue to contribute to basic research and development efforts.

### The Big Cost Shift

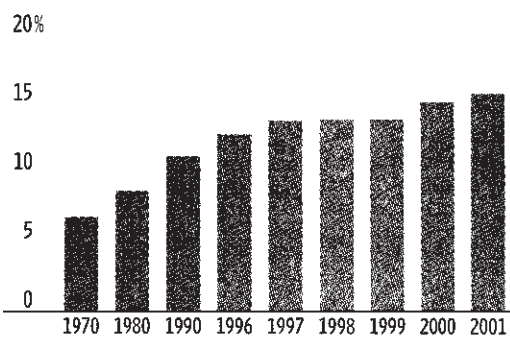
U.S. firms are often at a disadvantage when competing against foreign rivals whose retirement and healthcare costs are picked up by their taxpayers. This economic reality is placing pressure on big firms such as Xerox, Kodak and Boeing to shift rapidly rising benefit expenses onto workers. Efforts to move from defined benefit to defined contribution plans and eliminate company matches for 401-k plans are recent examples of this growing phenomenon.

My guess is that these forces are unlikely to reverse when economic conditions improve. Adjusting to these changes will require a workforce that is willing to adapt through education rather than stagnate. Yes, we will continue to lose low-skill jobs to foreign competitors. And it is also likely that increasingly educated workforces abroad will pose a growing threat. But the U.S. is still home to the largest college-educated population on the planet. Sustaining that competitive advantage will determine our success in the global market place for years to come.

– Anne Williams Doremus, CFA

## Importing Talent

The percentage of immigrants in the manufacturing work force has risen in the past three decades.



Source: 1970, 1980 and 1990 decennial Census; tabulations by Center for Labor Market Studies; 1996 to 2001 figures from Bureau of Labor Statistics Current Population Survey

Source: Wall Street Journal