

Thoughts from

Hanson Investment Management Inc.

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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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Some Good Summer Cheer . . .

THERE ARE PLENTY OF BIG things to worry about out there today. Oil prices have soared, there is political and military turmoil in the Gulf and big imbalances – the U.S. is pumped up on fiscal and monetary steroids while the rest of the world is still trying to find traction – threaten the global recovery. All this has stalled the U.S. stock market.

But there are reasons to be optimistic. Martin Wolf is the Associate Editor and Chief Economics Commentator of the *Financial Times* in London and writes often about the global economy. He is no pushover on globalization. He sees both the positives and the negatives. Today Wolf is quite optimistic.

First, productivity in the U.S. is strong (*more on this on page 3*). A growing U.S. economy, the largest in the world, is essential to spur Europe, Japan and the Emerging world. Second, rich countries and the poor continue to

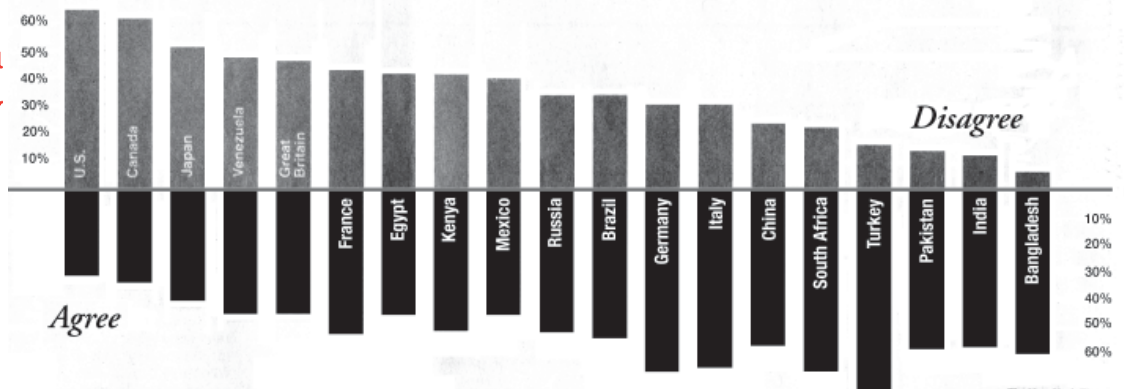
converge. Back in the early 19th Century, Asia generated 60% of world output measured at purchasing power parity. By 1950 this had fallen 20%. Now it is back to 38% and growing. The catch up of the China's and India's of the world will lead to better conditions for all and a faster growing global economy.

A third force at work is continued economic integration. World trade has increased forty-three fold since 1950 while total world manufacturing is up ten fold. Developed countries and emerging countries alike benefit when world trade is encouraged and economies are more integrated.

Americans are an incredibly optimistic and positive lot (*see chart below*). When we see opportunity we grab it. Today the combination of our optimistic bent and a favorable world economic tailwind makes for a refreshing Summer message.

'Success in life is pretty much determined by forces outside our control.'

— A Pew Center poll in 2002 of 38,000 people in 44 countries. Americans, more than any other respondents, disagreed.



The New York Times

Investor Psychology . . . Read 'em and Weep . . .

BARRON'S HAD AN ARTICLE recently on a book making the rounds of Wall Street – *Bringing Down the House*, an account of a scheme by some MIT students to win millions at blackjack.

Gambling and Wall Street have had a long association. Cynics say the stock market is nothing more than one big casino. Like the roulette wheel there appears to be no rhyme or reason to the short-term movement of stocks. Companies may report higher earnings and the stock goes down. They report disastrous results and the price sometimes goes up. Go figure.

There are indeed similarities between Wall Street and gambling but there are also big differences. You should be aware of these. Gambling is basically a loser's game. Play long enough and you will leave the table with an empty wallet. It has to be this way because the tables are rigged in favor of the house (blackjack and maybe poker are the only exceptions).

The stock market on the other hand is a winner's game. If you "play" long enough, that is are invested in a broadly diversified list of stocks for a long period of time, you will win. The reason is stock prices move in lockstep with corporate earnings and dividends. And corporate profits go up on average somewhere between 5% and 7% a year, decade in and decade out. From 1950 through 2003 the stock market averaged a total return including price appreciation and dividend income of 11.4% per year (see chart at the bottom).

The problem is most investors don't earn this return. And this gets to a feature of gambling that is also very important in investing. David Sklansky, the author of *The Theory of Poker*, notes that "serious gamblers bet only when they have the best of it; when they have the worst of it they pass." In effect they are disciplined. They take the emotion out of the action.

The best investors do the same thing. Warren Buffett insists that there be a "margin of safety" in any stock he buys.

The intrinsic value has to be sufficiently above the market price so that even if something goes wrong the investment will work out. Otherwise he passes. Most investors are not so cool and collected. They buy and sell based on the headlines of the day. This means piling in as

"The real truth with the world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable but not quite. It looks just a little more mathematical and regular than it is... its wildness lies in wait."

—G.K. Chesterton

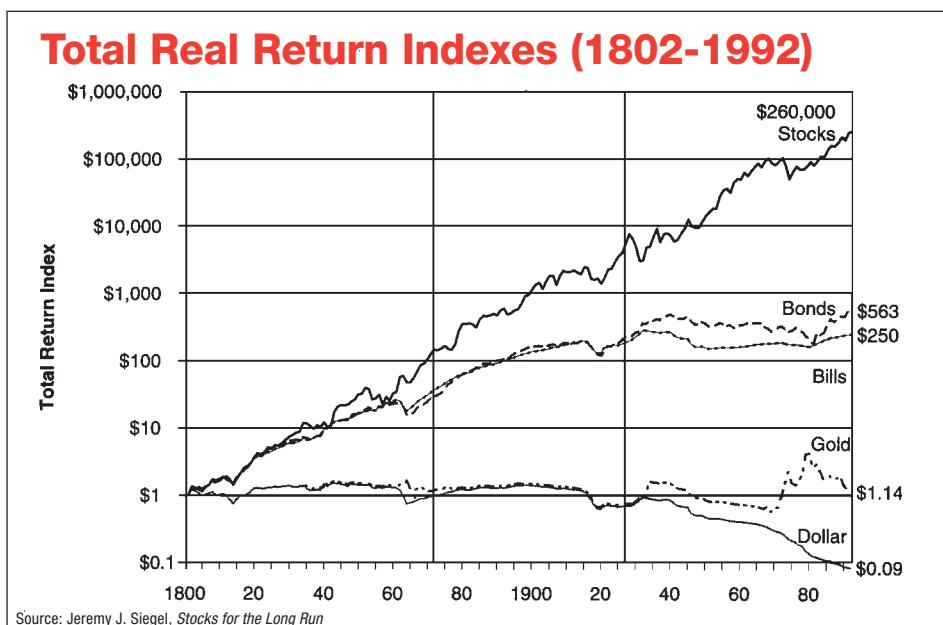
euphoria carries stocks to unrealistic highs and then selling when despair grips the land.

David Sklansky notes, again in *The Theory of Poker*, "it doesn't take long for pool players or golfers to realize they are outclassed and demand to be handicapped, but losers in poker return to the table over and over again donating their money and blaming their losses on bad

luck, not bad play." Many observers feel that on Wall Street individual investors are the "suckers". But I disagree. Unlike gambling, it is actually the "knowledgeable" pros, the managers of mutual funds and pensions who are at the disadvantage. Why? Pros have a tough time just like you and me figuring out which way the market is going (see quote to the left). But they are paid to do so. So, as Richard Geist, the editor of *Strategic Investing* notes, "if your job depends on beating the S&P 500 and you are evaluated every quarter you can't very well worry about the value of your holdings three years from now. If you underperform in the short term you won't have a job three years from now."

So you do everything you can to avoid short-term underperformance. You trade like crazy and you time the market, in essence you do everything that is antithetical to long-term investment success. Individual investors on the other hand are not burdened by relative performance measurement. They can take the long view and find the Buffett style ideas that work out over time.

Gambling and Wall Street may be friends but they are not family. Keep firmly in mind which one is the loser's game and which one is the winner's.



The U.S. Economy . . . Onwards and Upwards? . . .

A YEAR AGO CRITICS SAID George W. Bush would have the dubious distinction of being the first President since Herbert Hoover to experience over all job loss during his tenure. Now that statement is far from certain. The economy has been on a job-creating tear the last nine months.

But what kind of jobs are being created? *The chart at the bottom* shows that lower wage jobs, those paying less than the national average of \$15.35 per hour, are proliferating while higher paying jobs are lagging. Areas such as food service, nursing, residential care facilities, building materials and garden supply stores are seeing strong job growth. But these are generally low wage sectors.

Long-term trends in the economy are very difficult to spot ahead of time. Back in the 1980's we were pretty certain that the Japanese economic model was just a few years away from destroying us. Now we can't remember what we were worried about. Today the worry is globalization and the threat of low wage countries. Emerging areas such as China and Mexico have done a good job taking manufacturing employment away from us and jobs we never thought we would lose, in high tech for instance, are moving to places like India. A pessimist will look at this and say, definitely the U.S. has peaked and the best we can hope for the next 100 years is a graceful decline a la the British. The next generation will not live better than we do.

But there is another side to this coin as someone once said, you have never made money betting against the U.S. The fact is the rest of the world has always been stealing our jobs. But the beauty of the U.S. is we keep re-inventing ourselves. Old companies fail but new ones spring up with even better mousetraps. The only constant is change and America has forced itself to adapt to this well.

The measure of all this is

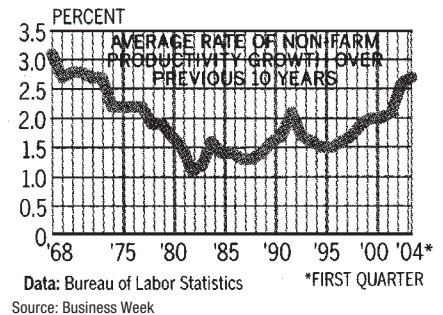
productivity or how much more per hour a worker produces each year. If it is going up a lot we are successful and have the best of all worlds. Companies can increase both wages and profits while holding the line on price increases. The holy grail of business! Recently, *as the chart here shows*, productivity has been surging. It has increased 4.5% a year versus a fifty-year average of 2.2%. A survey of experts by *Business Week* found that the expected future growth in productivity is 2.8% well above the long-term average. If we get this - new industries, new products, rising productivity - then we are in for a healthy economy and more high value added jobs.

But this is a big if. Pushing productivity up 3% or more per year will require using all the new technologies, risking more venture capital and demanding more brainpower from our work force. We live in the lap of luxury today and it is easy to be complacent. Slipping just a little will let the rest of the world rush in. And this time the competition is a lot more highly educated. It will be tough to stay on top.

Harvard University recently completed its first major review of the undergraduate curriculum in almost thirty years. It asked the question, what does it mean to be an educated person in the 21st Century? The report concluded

THE BIG PICTURE

Economists look at 10-year averages to smooth out business cycle distortions and see productivity trends more clearly



that students today need a wider range of knowledge, a deeper understanding of science and a far better grasp of international affairs. Students need a "global component". Harvard intends to put greater emphasis at the undergraduate level on foreign language skills and studying abroad. I say, "Here, here!"

We live a global world today. No matter what industry we are in we all are part of a global supply chain. Some of what we do or make comes from here, some from far away. We need to better understand other peoples and their markets if we hope to identify and take advantage of opportunities, which will lead to higher productivity and higher paying jobs.

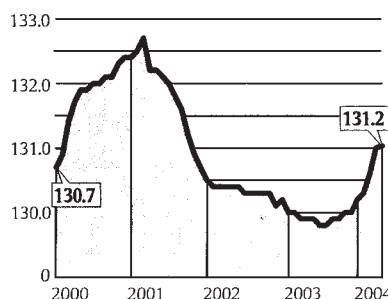
Jobs: Lower-wage outpace higher-wage

U.S. employers have created jobs for nine straight months, leading to the addition of more than 1.4 million jobs. Although both higher-wage and lower-wage jobs are increasing, lower-wage jobs are rising at a faster pace. Economy.com defined lower-wage

jobs as those in industries with hourly earnings below the national median, \$15.35 in 2003, while higher-wage jobs are those in industries that pay more. The median is the point at which half the numbers fall below and half fall above.

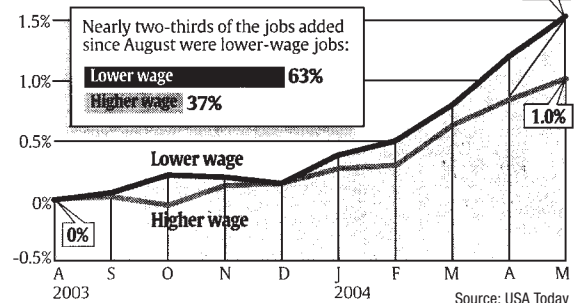
U.S. added 1.4 million jobs overall

Total employees outside agriculture (in millions):



More lower-wage jobs added

Percentage change in number of lower- and higher-wage jobs using August 2003 as the base.



The U.S. Economy . . .

Maintaining Our Competitive Edge . . .

MUCH HAS BEEN WRITTEN on the declining fortunes of the U.S. economy. First, it was the manufacturing sector that year after year lost jobs to lower cost competitors abroad. Then more recently, service firms began outsourcing higher skilled technology jobs to India. These developments have left economists and politicians wondering exactly how the U.S. will maintain its competitive edge.

But looking behind the headlines, one sector of the economy offers hope. As the chart below shows, over the last 20 years, research and development (R&D) spending in relation to sales has been increasing fairly steadily. Growth in this important barometer is an encouraging sign. R&D spending is what allows U.S. companies to continually develop new products, services and delivery methods.

Fostering and exploiting innovation, however, is not so easy. To excel at innovation, economies must first develop and attract people with the drive and skills needed to produce strong basic research. While the U.S. has had mixed results developing talent domestically, our highly respected system of higher education successfully attracts foreign students to PhD programs in science, medicine and engineering. Maintaining our competitive edge will require that we continue to invest in all aspects of our educational system.

Inexpensive access to financing is critical to bringing innovative ideas from

the concept stage to commercialization. Raising money, whether from venture capital networks or public markets, is relatively easy (perhaps too easy) here in the U.S. Finally, a political environment free of heavy-handed regulation is also necessary. While striking the right balance between oversight and free reign can be tricky, clear and consistent policies can go a long way to encouraging innovation.

Today, the path to survival for many companies lies not in just developing new technologies but in figuring out the best way to combine old ones.

Consider the popular MapQuest application. Hardly a summer vacation is planned today without downloading travel directions from this online digital mapping service. But this seemingly simple tool evolved only after the development and integration of such varied technologies as space photography, global positioning systems, mobile phones and the internet. As this example illustrates, the ability to meld different skills and technologies is the core skill behind many new developments.

Historically, the U.S. has led the world in corporate R&D expenditures. According to the National Science Foundation, we spent \$276 billion on research in 2002 or 2.7 times more than second ranked Japan. Industry funded 65% of the work with the information technology and healthcare sectors spending the most. But technological innovation is occurring across the economy. The retail industry, for example, is handily exploiting

INVESTING IN THE FUTURE			
During the past 12 months these U.S.-listed companies spent the most money on research and development			
COMPANY	R&D SPENDING (LATEST 12 MOS)		
	(\$BIL)	AS % OF SALES	AS % OF MARKET CAP
Pfizer	\$7.6	15.4%	2.7%
DaimlerChrysler	6.7	4.0	14.0
Microsoft	6.1	17.3	2.1
Siemens	6.1	6.8	9.2
IBM	5.2	5.7	3.5
GlaxoSmithkline	5.1	13.2	4.1
Nokia	4.7	13.1	7.0
Intel	4.5	14.4	2.4
Honda Motor	4.0	5.5	9.2
Novartis	3.9	15.0	3.4

Source: Reuters Fundamentals via FactSet Research Systems. Source: Forbes

opportunities provided by the internet. This year consumers will spend more than \$120 billion on-line for everything from cars to cartoons. The advent of voice-over internet protocol (i.e., making phone calls over the internet) is likely to also transform the telecommunications industry over the next decade. And in the biotech field, regenerative medicine is making possible new therapies to treat a wide range of diseases.

From an investment standpoint, it makes good sense to pay attention to R&D spending. Allan Eberhart, an associate professor at Georgetown University, studied the R&D spending patterns of 8,000 companies over a 50-year period. His results showed that companies that increased R&D spending had both improved operating performance and superior stock returns.

Clearly, corporate profit growth is not solely determined by how much money is spent in labs. History is full of examples of companies who spent lavishly on research but were never quite able to turn their good ideas into profits. But when considering alternative investments in the same industry it never hurts to keep a close eye on how much management is investing in their best and brightest ideas.

– Anne W. Doremus, CFA

