

Thoughts from

# Hanson Investment Management Inc.

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## Cash, Cash Everywhere . . .



**C**ORPORATE BALANCE sheets are in their best shape in decades. S&P 500 companies have reported double digit earnings increases for twelve quarters now, a record run.

What are companies doing with all these earnings and cash? Two things among others, neither of which is that great for shareholders. First, they are buying back shares. This sounds good on paper since buy backs, all things being equal, push up the share price. But what companies are also doing is turning around and issuing more shares under generous stock option plans. So total shares outstanding have not come down. Companies are simply using shareholder profits to finance more executive compensation.

Companies are also starting to do acquisitions again. Mergers can make a

lot of sense but on balance research shows that mergers destroy more value than they create. Richard Bliss at Babson and Richard Rosen of Indiana University have looked at all bank mergers between 1986 and 1995 and found that what happens almost without exception is that executive compensation goes up after the merger. Sometimes shareholders benefit from the new union and sometimes they don't but in all cases managers come out ahead. Oh, and did I mention investment bankers do well also.

We are not ruling out all mergers or all stock option plans but if management wants to do something that is really shareholder friendly they should increase the dividend. This is a vote of confidence in the business and it also lets the real owners of companies decide how to spend the spoils of a successful operation.

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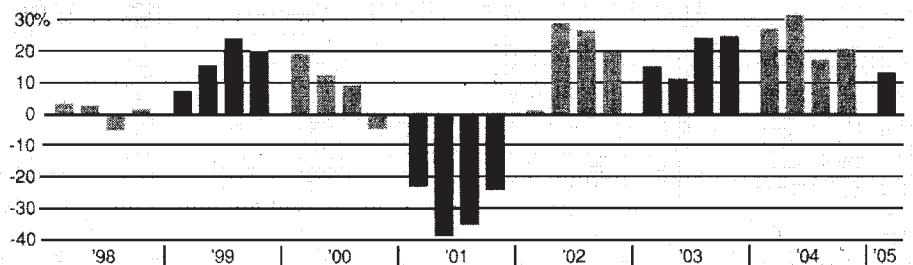
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**Hanson Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.**

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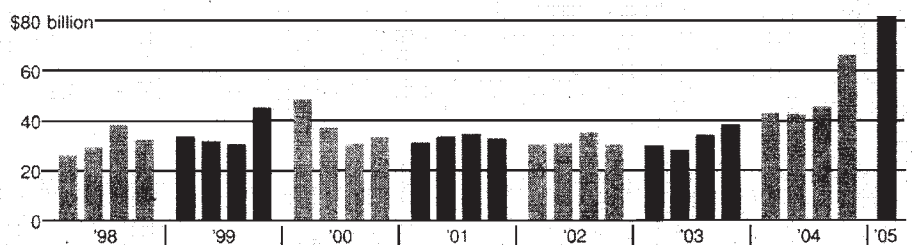
### American companies see sustained profit gains . . .

Percent change in quarterly operating profits of companies in S&P 500, compared to same quarter a year earlier.



### . . . and they spend the money on their own stock.

Quarterly share repurchases by companies in S&P 500.



Source: Standard & Poor's

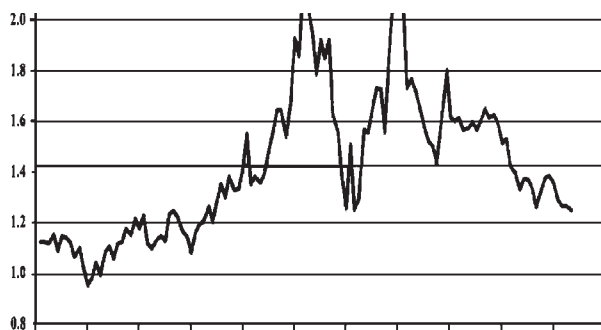
Source: Christian Science Monitor

# The U.S. Market . . . The Way The World Works (We Think) . . .

**WE ARE VALUE INVESTORS.** We look for securities selling cheap relative to earnings and assets. Our strategy is the reverse of growth investing where you look for earnings and sales momentum and where you are willing to pay a much higher price for your selections.

Research shows that value investing outperforms growth. One explanation offered by academics is that value stocks are riskier than growth stocks and you need to be paid a premium for the greater uncertainty. We are not entirely convinced by this argument. Another explanation comes from behavioral finance. Investors don't like to be associated with losers and they feel the pain of a loss more acutely than the pleasure of gains. So they often drive the price of losing stocks to a level lower than it should actually be. This offers opportunities for value buyers.

**S&P 500 Information Technology Sector Rolling 12-month Forward P/E Relative to the S&P 500**



Source: Merrill Lynch Quantitative Strategy, Thomson Financial

A new explanation has come along that is kind of obvious but also kind of ingenious. Robert Arnott writing in *The Financial Analyst Journal* in March-April notes that by definition it is more likely that a larger cap stock is overvalued than a smaller cap issue. Market capitalization is defined as the number of shares outstanding times the current market price. So to be a larger capitalization stock means the price has run up which

implies the greater likelihood of overvaluation.

We don't discriminate here between large, medium and small cap value ideas. We think they all have merit. Today we continue to look for out of favor sectors that have acceptable quality and a cheap price. We have to admit it is not as easy to find them as in the past. There isn't a wide range between the cheap and the expensive today.

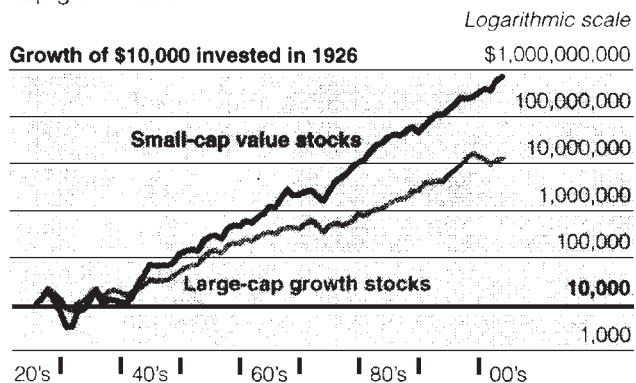
But there are exceptions. One area is technology. *Note the chart to the left.* Technology is now trading at a below average price to earnings ratio relative to the S&P 500. The blow

off of the 1990's has been given back. Also take a look at biotechnology. This group has been losing relative strength for five years. Biotech is notoriously difficult to handicap. Most companies have hitched their wagon to one or two or three promising

formulations. If the FDA doesn't approve them it can be an entire wipe out. We don't think we are smart enough or lucky enough to pick the exact winners. The way to play the sector is through the exchange traded iShares Nasdaq Biotechnology Index Fund (New York Stock Exchange: IBB).

## Smaller and More Rewarding

Since 1926, the average small-cap value stock has significantly outperformed the average large-cap growth stock.



Source: Eugene S. Fama, Kenneth R. French

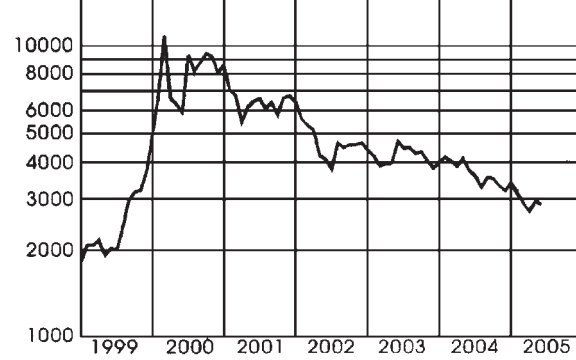
Source: The New York Times

This fund gives you the full run of the biotech sector.

The stock market does not perform like a perfect metronome. You don't get a reversion to the mean just because we think things are under priced or overpriced. Alan Greenspan talked about "irrational exuberance" in 1996, four years before the peak in technology prices. But the way to play the game is to look for the out of favor and avoid the already exploited. You could do a lot worse than to follow the mantra, "buy failure and sell success."

## Biotechnology

**RELATIVE STRENGTH (Ratio of Industry to Value Line Comp.)**



Source: Value Line

Index: June, 1967 = 100

# The U.S. Scene . . .

## “That’s The American Dream . . . Things Get Better . . .”

THE ABOVE QUOTE IS FROM A *Christian Science Monitor* story on the mood of mid-America. Scratch most Americans and they will tell you it is not inherited privilege that matters but merit. Work hard and opportunities will be there. Horatio Alger lives.

The *New York Times* just finished a ten-part series recently and the *Wall Street Journal* a seven-part one on social mobility in America. The conclusion is that moving up in society is getting more difficult. Where you are born foretells a lot about where you will end up.

Globalization is leveling the playing field as Thomas Friedman’s new book, *The World is Flat* highlights. One of the effects is the rest of the world is getting more successful at eating our lunch and stealing our high value added ideas and pay.

Editorializing, I see the United States in a long term gradual decline. Today we are 4% of the world’s population and 25% of the world’s output. Fifty years from now we will still be 4% of the world’s population but probably 15% of the world’s output, or less. The rest of

the world and especially the emerging nations like China and India will move up faster.

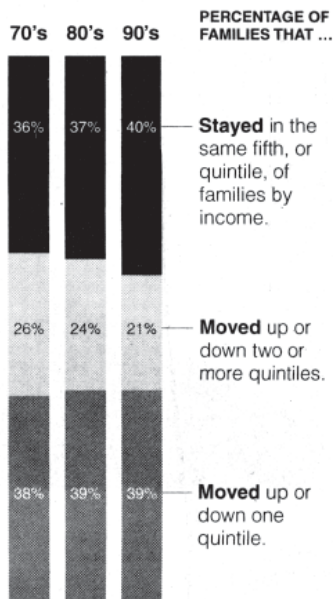
Our decline will be “graceful” however, perhaps like Britain between 1900 and 2000. No one mistakes the UK today for an emerging economy. The two charts here highlight the ongoing arguments in this debate. *The chart in the lower left* implies it will be more difficult for lower income people to move up to middle class or upper class.

A recent *Business Week* story (see *chart on the right*) however takes a different tack. The important thing here *Business Week* contends is not whether we are moving up or down relative to our peers but whether everybody is getting wealthier. And on this they claim victory. Over the past decade virtually every disadvantaged group has made gains in absolute terms.

Where you stand in this debate definitely depends on where you sit. I worry that the U.S. is becoming more class stratified. Paul Krugman points out in *The New York Times* that income adjusted for inflation for the median family increased only 22% from 1973 to 2003. At the same time the average income of the top 1% of Americans doubled.

Who cares if we are becoming more stratified? Well, democracy depends on an electorate working cooperatively to achieve common goals. If there are fewer chances to move up, the system risks breaking down. Benjamin Friedman, a professor of economics at Harvard, wrote an interesting article in *The Atlantic Monthly* recently. He points out that in periods of sustained economic slowdown (like the U.S. in the late 1800s) we move more quickly towards isolationist economic policies or aggressive foreign policy ones, race relations deteriorate and debate in general becomes more shrill. When living standards are rising we are more

### MOBILITY LOSING STEAM

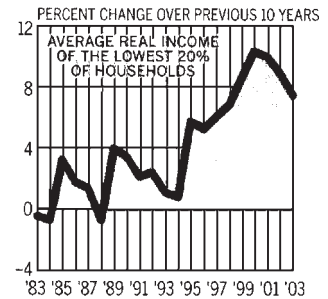


Source: The New York Times

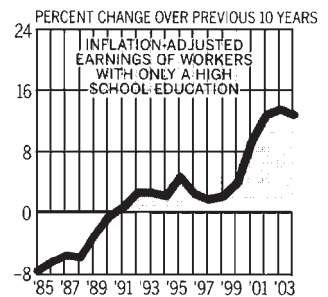
### UPWARD BOUND

Over the past decade, living standards have risen for many of the least privileged groups in the U.S. economy

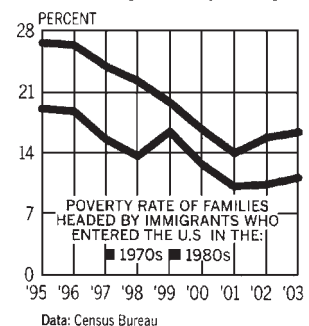
#### Low-income households have gained ground...



#### ...earnings of high school grads have risen...



#### ...and many immigrants are climbing out of poverty



Source: Business Week

trusting, more inclusive and more open to change and we view our future with more confidence. Economic growth in one respect is the well spring of Democracy and a civil society.

Globalization may be moving us towards tougher economic gains and wider income stratification. Something to watch out for.

# Economic Trends . . .

## “Hi-Ho, Hi-Ho, It’s Off to Work We Go . . .”

**R**ETIREMENT PLANNING seems to be the hot topic in the financial press these days and it is no wonder. This month the first of the nation’s 78 million baby boomers turns 59½ or the age at which they can make penalty-free withdrawals from their retirement accounts.

But don’t expect a rush to the workforce exits. True, a decade or so ago people in their late 50s were busy preparing for an extended period of volunteer work and travel. But a number of demographic, social and financial trends are now combining to fundamentally transform retirement.

Increased longevity is probably the most powerful force behind this change. In 1900, the average American could expect a retirement lasting 1.2 years. Basically, you worked and then you died. By 1980, the average worker enjoyed 13.6 years of retirement and today with life spans approaching 80, retirement can last 20 years or more. The good news here is that you can expect to live longer but the bad news is you may outlive your retirement funds.

Americans traditionally counted on a combination of Social Security, defined benefit pension plans and private savings to fund their retirement. But this model has eroded over the last several decades. Twenty years ago, 80% of workers at medium and large US companies were covered by defined benefit plans that provided a fixed payout regardless of the actual return earned on plan assets. By 1997, that number had dropped to 50% and today just 21% of workers at all private companies are covered by these plans. In most cases, Corporate America has replaced traditional pensions with 401-(k) plans. While these plans have many benefits, most principally a matching allowance provided by the employer, they require employees to bear all of the risk. Payouts depend entirely upon each worker’s investment acumen and willingness to participate. Employees do not have a great record here. According to a recent study by John Hancock

Financial Services, after adjusting for inflation the average retirement plan is only 3% higher today than it was in 1993.

And private savings are unlikely to take up the slack. Over the last several decades, the national savings rate has consistently declined and today stands at less than 1% of disposable household income. Further, almost half of respondents to a recent *New York Times* study said they had saved less than 5% of their income in the last 12 months and 68% felt they had difficulty meeting their monthly bills and saving for retirement.

OK, what about Social Security? Anyone who has read the press is familiar with the outlook here. By 2030, spending on Social Security, Medicare and Medicaid is projected to almost double as a share of national income. This growth rate is simply unsustainable. According to economist Paul Samuelson, if you assume that federal spending as a percent of national income stays constant, this increase would require an almost 50% cut in spending for all non-retirement government programs or a 30% increase in taxes.

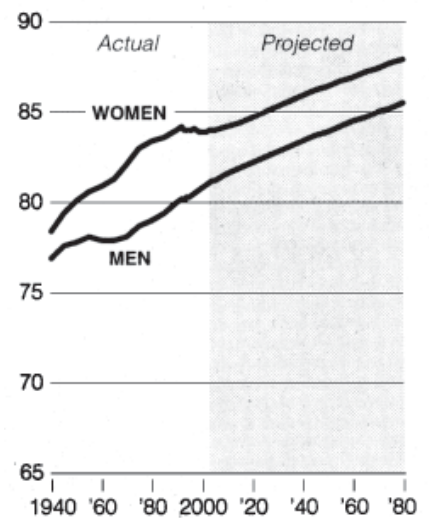
Interestingly, most Americans underestimate the role that Social Security plays in retirement plans. Today, Social Security is the major source of income for two-thirds of retirees. This statistic tells me that the current program will be fixed although exactly how remains open to debate. Recent polls suggest that most Americans support raising the cap on income subject to payroll taxes and decreasing the rate at which benefits accumulate for upper income earners. Increasing the age of eligibility and raising payroll taxes, however, are concepts enjoying much less popular support.

Whatever solution is ultimately arrived at will likely include a reduction in the level of benefits. So, with private pensions disappearing and personal savings weak, what is a retiree to do? Increasingly, the answer to this question is some form of work. According to

### Living Longer, Retiring Earlier

Not only are Americans living longer, but they are increasingly retiring at earlier ages.

#### Life expectancy at age 65



#### Age at which men first began drawing Social Security retirement benefits

YEAR	62	63-64	65	66 OR OLDER	
1965	17%	17	27	39	
1975	29%	28	36	9	
2001	54%		22	21	4

Source: Social Security Administration (life expectancy); "Saving Social Security: A Balanced Approach," by Peter A. Diamond and Peter R. Orszag, drawing from Social Security Administration data (retirement ages)

Source: The New York Times

employment firm Challenger, Gray & Christmas, people age 55 and older account for 16% of the total workforce and 30% of self-employed consultants and entrepreneurs. While working may be a financial necessity for many retirees, some will find a mixture of work and leisure just the recipe for a successful and prolonged retirement.

—Anne W. Doremus, CFA