

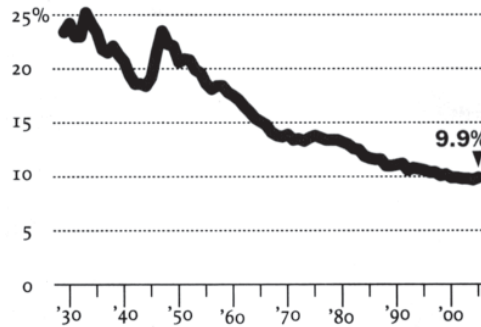
From the Hard to Believe Department . . .

According to the World Health Organization, there are now more overweight people in the world than hungry ones. What? We grew up being told to finish everything on our plate because of the starving people in (fill in one of fifty countries). Now they tell us we have the opposite problem.

Obviously there still are a lot of hungry people in the world but food has gotten ever more affordable in most countries. Food today in the U.S. is recreation, not a life and death proposition as it once was. The Chinese not too long ago used to greet each other with, "Have you eaten?" Today the Chinese and other

CHEAP EATS

Percentage of disposable income Americans spend on food



Source: Department of Agriculture SOURCE: New York Times

emerging market countries are getting a lot wealthier and this is reflected in their diets. It is estimated that 70% of Americans have a weight problem. In China the figure is only 30% and in India 15% but the overweight population in those countries is increasing rapidly.

A big part of cheap food has to do with government policy. The Farm Bill has historically subsidized five main crops – corn, wheat, soybeans, rice and cotton. Food prices will reflect what the Farm Bill spends on. Adam Drewnowski, a researcher at the University of Washington, found that a dollar will buy 1,200 calories of cookies and potato chips (from subsidized crops) but only 250 calories of carrots (not subsidized). A dollar buys 875 calories of soda laced with high fructose corn syrup but only 170 calories of orange juice. The best predictor of obesity in the U.S. today is wealth. The less money you have, generally speaking, the more you shop for the most calories per dollar which means more "junk" food.

The Farm Bill is up for renewal in 2007. It gets little attention outside the very interested constituent states. I guess most people feel it is just too complicated and in any case why pay attention when food gets

more affordable every year. Not many people ask: Why don't they subsidize things that are good for us like fresh vegetables and fruits?

A recent book by Gina Kolata, *Rethinking Thin*, argues that weight problems have more to do with genes than government policy. Dieting has very little positive effect on most fat people. This is probably the case for some but it doesn't explain the explosion in weight the last thirty years in people who were not chronically overweight to start with. Cheap food and subsidies have to be part of the problem. So what should each of us do now with our lives? A first step would be to pay closer attention to the Farm Bill. Secondly we need to be realistic about ourselves. Stop beating yourself up about weight and appearance. Oh sure, we should try to shape up that body and eat a better diet but when it comes right down to it, we need to make peace with what we've got. Happiness is not the dial on the scale.

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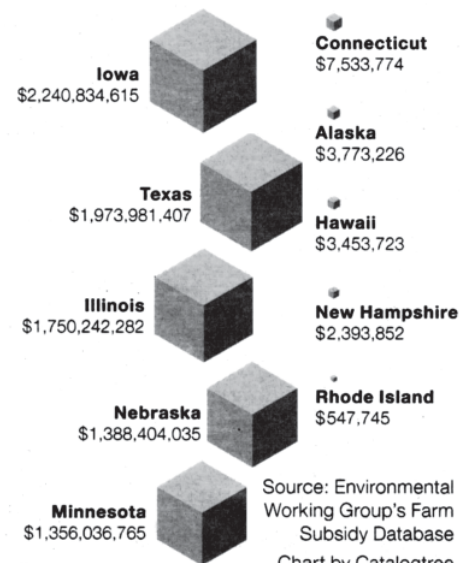
Julie Won, Eric Hanson, Anne Doremus

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FARM AID

States that received the most and the least in U.S.D.A. subsidies in 2005.



SOURCE: Time

Source: Environmental Working Group's Farm Subsidy Database
Chart by Catalogtree

It's Eastward Ho for the World Economy . . .

The center of the world economy is shifting. The accumulators of new money are not the traditional powers of Europe and the U.S. It's now the Middle East and Asia, especially China, which are seeing an embarrassment of wealth. China has \$1,200 billion of official reserves now. So far they have been content to plow this into U.S. Treasury securities. They are the second largest owner in this category after Japan (see chart). China's willingness and the willingness of others to buy Treasuries may have kept U.S. interest rates as much as 2% below where they would otherwise be.

Now China is diversifying. They recently announced the creation of a new state investment agency to be funded with \$200 billion to buy assets other than US Treasuries. It is not inconceivable that this fund will grow \$200- \$300 billion a year, that's how wealthy China is becoming. Other countries have big Investment Agencies also. One of the oldest is Temasek in Singapore but Abu Dhabi, Saudi Arabia and Norway also have big pools. But China will dwarf everything if current assumptions are correct.

Brad Perry, the former head of David L. Babson and one of his former associates, Paul Davis, have written about this potentially major shift in investment power. What are the implications of China's move?

One is that US interest rates may rise as China pulls back. We just don't know how this will play out. Will China sell some of what they already have or just cut back on new purchases? And will other investors quickly fill this void? I am always suspicious about "conspiracy theorist" writing on subjects like this. They see China's pullback as the beginning of a collapse in our bond markets. It's just like the debate about what happens to stocks when the Baby Boomers decide it is time to sell in order to fund retirement. I don't see a disaster in our stock market just like I don't see calamity in the US Treasury market. Buyers will be there.

A second possibility is that China's move is very Bullish for world stock markets. China might first look for

Cash to Burn				
High oil prices have helped fill the coffers of many countries, which are seeking to diversify away from investments in government bonds.				
Country	Fund	Size* (bil)	Year Begun	Source Of Funds
UAE	Abu Dhabi Invest. Authority	\$875	1976	Oil
Singapore	Govt. Investment Corp	330	1981	Other
Norway	Govt. Pension Fund	312	1996	Oil
China	State Investment Corp	300	2007	Other
Saudi Arabia	Various Funds	300	NA	Oil
Singapore	Temasek Holdings	100	1974	Other
Kuwait	Kuwait Investment Authority	70	1953	Oil
Australia	Australian Future Fund	40	2004	Other
Alaska (US)	Permanent Fund Corp	35	1976	Oil
Russia	Future Generations Fund	32	2007	Oil
Total All Countries		\$2,510		

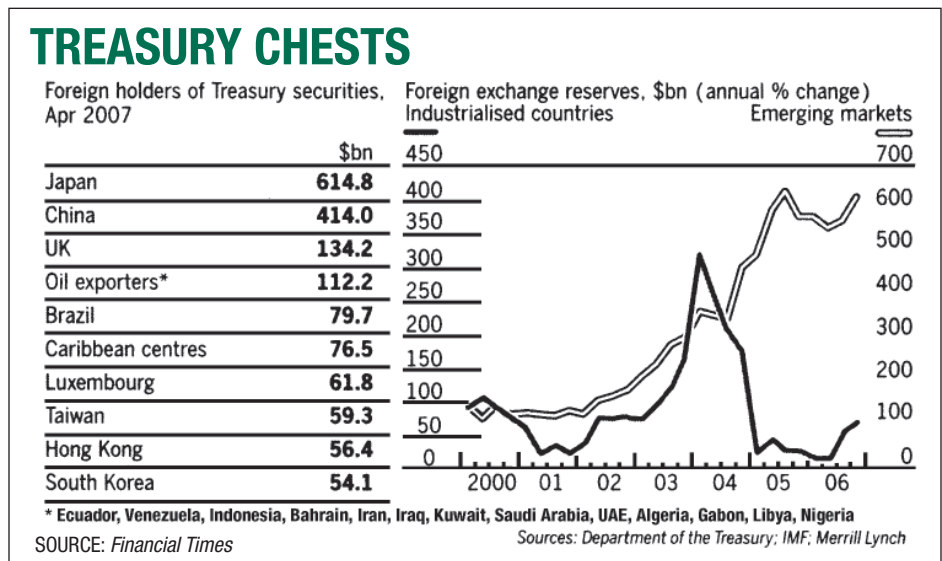
*Estimate SOURCE: Barron's Source: Morgan Stanley

Martin Kozlowski for Barron's

assets that are of strategic interest – like oil or metals or even water. This means rising asset values. And then when they look in the area of publicly traded companies this also means higher prices. They have already committed \$3 billion to buy 10% of Blackstone, a private equity group. Private equity firms look to buy companies, fix them up and then refloat them to the public. But to get these companies they have to pay a premium in the market.

A third (pessimistic) implication might be that China's move signals the long term decline for the U.S. When they start seriously buying our hard

assets, there go the family jewels. This is exactly what has happened in Britain the last 100 years. They have been in "graceful decline" selling their assets and giving in to the New Economic order. I doubt we are in this same predicament however. The real test of an economy is competitiveness and here we are still a leader, either measured by productivity or how we lead in most all new technologies. China's rise is not our fall, either in terms of the US Treasury market or in terms of our standard of living. But it is certainly a sign that the economic center is shifting East.



Fear of (Stock Market) Heights

There seems to be a great deal of fretting and fussing over whether the stock market is overstretched or still has legs. On the one hand, it certainly has been a high-spirited market. The Dow Jones Industrial Average has set a series of multiple record closes this year, and the S&P 500 reached an all-time high in early June – exceeding the previous peak in March 2000 during the height of the internet boom. On the other hand, this strong performance is exactly what makes some worry that today’s bull market is four years old and that cheap shares are getting harder to find.

By the key traditional measure of stock valuation, price to earnings ratio or P/E, the market actually isn’t overpriced. The average P/E multiple for S&P 500 stocks recently has hovered in the neighborhood of 17 to 18 based on trailing earnings (see chart below). This is slightly above the long-term P/E average of 16, from 1927 to the present, but far below the 29.4 multiple at the market’s previous peak in March 2000 – or the 46.5 P/E multiple in late 2001 when the market was really coming undone.

Since stock prices don’t seem to be terribly out of line relative to current earnings, it also is worth mentioning that there is no reason to expect a collapse in earnings either. First quarter earnings this year came in better than

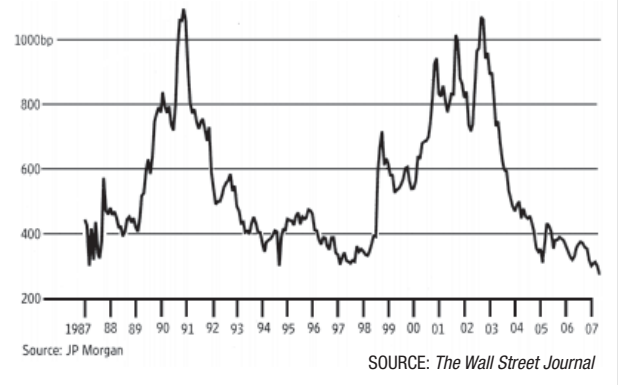
expected, and Standard & Poor’s estimates operating earnings for the S&P 500 will grow by over 7% for 2007. That may seem low relative to 14 consecutive quarters of double-digit profit growth, but it is hardly cause for valuation concerns.

It may be a relief to know that stock market valuations are nowhere near where they were in 2000. But one thing that has been troubling stock pickers recently is P/E compression – meaning that there is not as much of a difference as there used to be between the high-P/E Googles of the world and the low-P/E stocks that no one wants to touch, at least usually. As P/E’s of once unpopular stocks have moved closer to the market’s mean P/E, finding cheap stock ideas has been getting harder. We’ve been feeling this pressure too.

But what may be most vexing to cautious market-watchers is the notion that risk is not being properly priced. This is best reflected in the spread between U.S. Treasuries and junk bonds, now at a historic low (see 2nd chart). Credit is cheap, and lending standards are low – or as Bill Gross of PIMCO says, “What was chaste and AAA

CHEAP MONEY

Spread between lower credit bonds and U.S. Treasuries, 1987-2007, in basis points



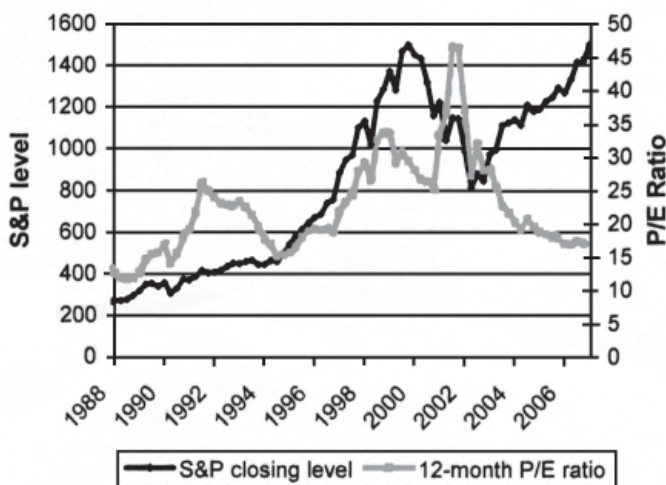
acquirers to comfortably cover the cost of debt incurred in a takeover without necessarily improving a company’s profitability. That is giving the buyout boom just a whiff of “bubble-ness” to it.

Other asset markets around the world with a hint of bubble to them – art, wine, Chinese stocks, Spanish real estate – also may be making us nervous. When a single painting sells for \$72 million, as Andy Warhol’s “Green Car Crash” did this past spring, it does make you wonder what could happen if we get into a real credit crunch and risk comes back into the market.

The good news for now is that the U.S. stock market isn’t in bubble territory. Nevertheless, it does seem perfectly realistic to expect more volatility in the coming months – especially as we see how inflation pressures and long-term interest rates play out. Rising interest rates generally aren’t a good sign for stocks. Even though we are in for reasonable economic growth and supportive market conditions this year – there may be some bumps along the road.

Finally, it also is worth remembering that we care much more about assessing individual stocks than valuation of the overall market. As value investors, our job is to find the lowest-priced quality stock ideas out there – regardless of whether popular sentiment calls the overall market “too high,” “too low,” or “fairly valued.”

S&P 500 and P/E Ratios, 1988-2007



Source: Hanson Investment Management; data from Standard & Poor’s

years ago may not be the case today.” Ample credit means that even high-risk borrowers are getting great deals on loans. It also means that private equity players are able to take on ever larger, ever riskier buyouts that bid up equity prices. Borrowing costs are low enough for private equity

Taking Some of the Uncertainty out of an Uncertain World . . .

Many people would argue that making decisions in the face of uncertainty is what business is all about. Virtually every decision a manager faces, be it forecasting sales or developing new products, must be made in an uncertain economic, regulatory, and political climate.

Historically, decision makers polled experts, commissioned studies, and convened focus groups to improve their chances of making good decisions. Now, a whole new set of tools – Prediction Markets – are being used to improve forecasts.

Prediction markets, first pioneered in the late 1980s by researchers at the University of Iowa, are speculative markets created for the purpose of making predictions. This is how they work: let's say you think the Democrats will win the 2008 Presidential election. You can bet on this outcome through electronic prediction markets such as the Iowa Electronic Market (www.biz.uiowa.edu/iem) or Intrade (www.intrade.com). Each contract you hold for the party winning the Presidential race will pay you \$1 on Election Day. If you hold a contract

for the losing party, you get nothing. Today, for example, it costs you slightly more than \$0.61 to place a bet that the Democrats will win. If they do, you get \$1 and if they lose, you get nothing. Because these markets aggregate the opinions of many participants, the prevailing price can be interpreted as the probability of the particular event (e.g. the Democrats win) actually occurring.

Betting on elections is probably one of the most popular (and oldest) uses for these markets. But if you take a look at some of the trading sites you will see markets for a wide range of events. Real time betting on sport events are common but you can also bet on the possibility of a U.S. recession in 2007, Osama bin Laden's capture by year-end, and the location of the 2016 Summer Olympics. Placing a bet today that the U.S. will have a confirmed case of bird flu by year-end will cost you \$0.13, for a possible \$1 payoff while the probability of the U.S. or Israel executing an air strike against Iran by year end is now 15%. If you think this sounds like gambling, you are right. Most of the sites that involve betting with real money are domiciled offshore to avoid state

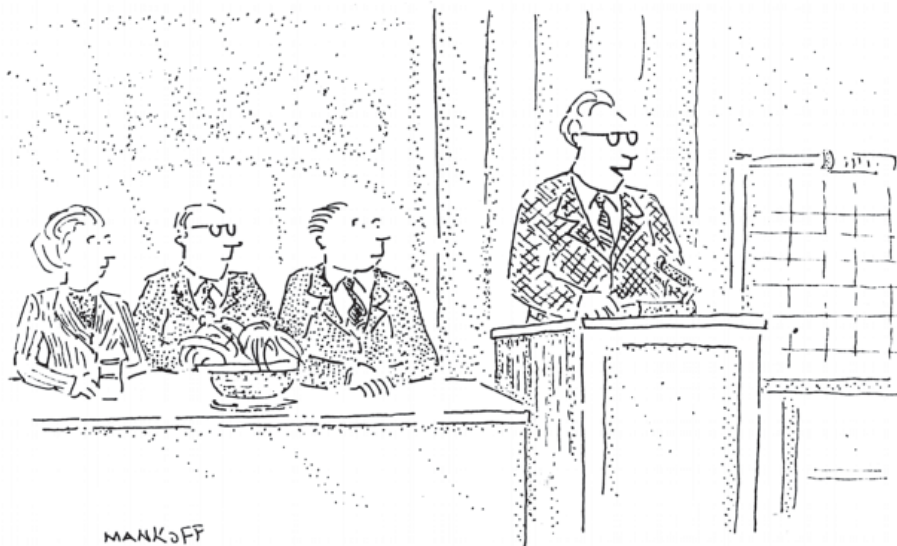
and federal regulations. The Iowa Market, one of the original and more established sites, has been granted a special academic exemption.

These markets may seem like just another way for computer geeks to entertain themselves. But I think they are worth paying attention to. Research has shown that prediction markets produce more accurate forecasts than traditional opinion polls. The reason for this is fairly intuitive. Focus groups can suffer from "group-think" where participants are swayed by the loudest member and, therefore, often gravitate toward consensus. Individuals participating in prediction markets, alternatively, act independently and have a monetary incentive to seek out better information.

The enhanced accuracy of prediction markets is not lost on business. Hewlett Packard has been using them to forecast sales for years. Intel is using them to manage manufacturing capacity and GE to generate new business ideas. As each of these cases reveal, they are particularly useful in environments characterized by rapid change and where, as a result, you need to adapt quickly or get left behind.

The possible applications for investors are intriguing too. Institutional investors are using prediction markets to better understand what consensus opinions are incorporated into stock prices. Does the average investor, for example, expect real estate prices to rise or fall next year? If the consensus expects real estate prices to fall further and IF you feel they will rise, then you can take advantage of this difference of opinion by purchasing real estate stocks.

Prediction markets remain fairly new. Over the next several years, private sector users and academics will continue to innovate and create new uses for the technology. Today, they are enhancing efforts to gauge public opinion.



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"And so, while the end-of-the-world scenario will be rife with unimaginable horrors, we believe that the pre-end period will be filled with unprecedented opportunities for profit."

SOURCE: *New Yorker*