



And the Message Is? . . .

USUALLY WHEN A RECESSION ENDS and the economy turns up the market goes on a tear. Actually scratch “usually” and substitute “always.” This is the only time in over 75 years the market hasn’t turned with the economy. Check out the chart at the bottom. What gives? Either the market is pretty dumb and this is the buying opportunity of the cycle or the recovery isn’t as sure a thing as we think.

The standard definition of a recession is two consecutive quarters of declining gross domestic product. Technically we didn’t get there last year. The third quarter was the only down period in 2001. The Business Cycle Dating Committee of the National Bureau of Economic Research however says the two-quarter definition of recession is too simple. They use a more

involved four-factor model including employment, industrial production, personal income and wholesale and retail prices. When these four start down a recession has begun. When they bottom out and start to rise again then the recovery is on.

Three of the four indicators today (industrial production, personal income and wholesale and retail prices) are back to previous peak levels. Employment however is still struggling now. The economy lost 1.8 million jobs between March 2001 and today and payrolls are growing only sluggishly. What the market is saying is this recovery is still iffy. The key to stocks now may be trust issues like Enron, etc. but it probably is more the state of those monthly economic reports. Watch employment closely. It’s still the economy stupid!

**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**

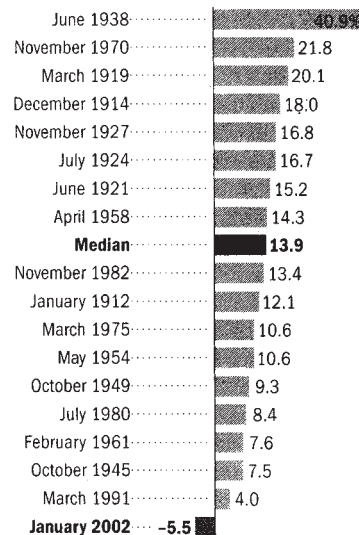
Hanson Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.

Stocks and Recovery: the Road Not Taken

Many economists are saying that the economy hit bottom in January and is on the road to recovery. But stock-market investors have other ideas.

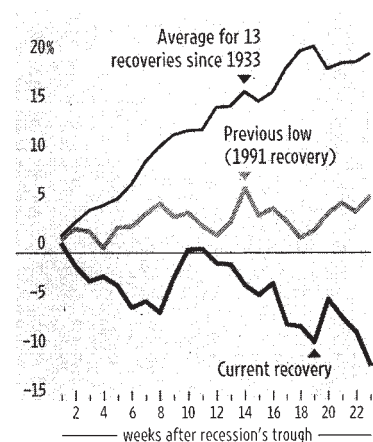
Dow Jones Industrial Average

Performance of the average slightly more than five months after each recession’s trough



S&P 500 Stock Index

Historically, the S&P 500 has risen around 20% on average in the 23 weeks after the recession trough



Note: 1933 recovery of DJIA after Great Depression not included because of extraordinary scale of the rise and fall.

Sources: Raw data from Economy.com; recession dating from the National Bureau of Economic Research

Behavioral Finance . . .

Shall I Tell You Why You Feel So Bad? . . .

ECONOMISTS WOULD HAVE US believe we act rationally all the time. Well I don't buy it. We are all rational, meaning we do things that are best for us economically, most of the time but not all the time. We are irrational or emotionally wacko a lot more of the time than we think. Ray DeVoe, a long time market commentator, says, "The stock market is only indirectly related to economics. It is a function of human fear, greed and apprehension all overlaid on a business cycle".

The chart to the right shows we have had a very sharp downturn in stock prices since March 24, 2000. Only the market decline of 1973 and 1974 was worse. And there is an interesting behavioral thing to these market setbacks. Psychologists tell us we should be indifferent to equal amounts of gain and loss. That is, the pleasure we feel from a dollar of gain should be equal to

the pain from a dollar of loss. But studies show that we actually feel twice as much pain when we lose money as pleasure when we make money. This helps explain the market today. We have lost money today and this is a real thing but our emotions are magnifying this economic loss and making us feel even worse. Understanding the human foible of feeling worse about losses than gains can make down cycles a lot less traumatic.

The market decline is exposing other emotional quirks also. We see a lot of investors today show us tech heavy portfolios that are down more than the averages. Our advice is usually to reduce the exposure and diversify more widely. But the advice is difficult to take. The reasons are due more to emotional quirks than capital losses. Investors feel "regret" at having bought losing positions but until they sell they don't have to face up to the painful feelings. So they hold on.

Other investors have an "anchoring" problem. If you bought a stock at \$100 this becomes your anchor or value point. When the price gets down to \$5 the company must be extremely cheap. Right? And finally there is the "endowment" effect. When we own a stock we usually endow it with more value than it actually has. So it is more difficult to sell a position especially one that is way down in price.

A final problem with the market is that most investors' biggest single asset today is

Growl of the bear

The current bear market is the worst in nearly 30 years.

| S&P 500 index, % change | |
|-------------------------|-------|
| HIGH / LOW | |
| Jan. 11, '73 | -48.2 |
| Oct. 3, '74 | |
| ----- | |
| Sept. 21, '76 | -19.4 |
| Mar. 6, '78 | |
| ----- | |
| Nov. 28, '80 | -27.1 |
| Aug. 12, '82 | |
| ----- | |
| Aug. 25, '87 | -33.5 |
| Dec. 4, '87 | |
| ----- | |
| July 16, '90 | -19.9 |
| Oct. 11, '90 | |
| ----- | |
| Mar. 24, '00 | -36.2 |
| Thursday* | |

*The low was Sept. 21, '01

SOURCE: Bloomberg Financial Markets

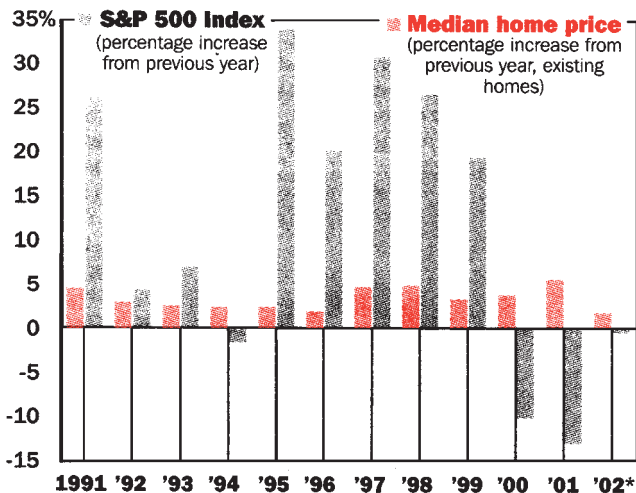
Source: International Herald Tribune

their home. As the chart to the left shows home prices have held rock steady this cycle, and actually gone up, while Wall Street has swooned. Stock investors are asking, is this roller coaster ride really worth it? You may get a bit higher return from stocks, 8-12% long term versus 4-6% for real estate but the aggravation seems too much.

I can assure you that just when you are about to throw in the towel on stocks is just the time that prices are most attractive. Warren Buffett is rich because he has been able to separate so well the investment decision from the emotional side. As he often says, "be fearful when others are greedy and greedy only when others are fearful." This looks like a time to start being greedy. I can't tell you where the bottom is or whether we still have another 25% to go but timing is always impossible in this game. The only thing you need to know is the best time to buy is the time it is most difficult to buy. We are close now.

Slow and steady vs. wild and woolly

Investors who don't like the volatility of stocks might consider moving more dollars into real estate. Gains aren't as dramatic, but median home prices continue to rise each year. In fact, home prices have risen 47 percent from 1991 to 2001, according to government data. Despite the stock market's slump, the S&P 500 Index, a measure of 500 large companies, has risen 175 percent during that same period.



Source: HUD, Standard & Poor's, National Association of Realtors *through March

Source: Christian Science Monitor

The Global Scene . . .

Will Education Save the World? . . .

THE STANDARD OF EDUCATION excellence in financial analysis and portfolio management is the Chartered Financial Analyst® designation (CFA). This is a three-year professional exam that has been offered since 1963 by the Association of Investment Management and Research (AIMR) and its predecessor organizations. It has gained increasing prestige over the years, to the point where many firms and jobs require a CFA.

The CFA tests candidates in eleven topic areas including ethics, financial statement analysis, economics, portfolio management and asset valuation. When I started in the business the majority of candidates were institutional analysts and portfolio managers working for mutual funds, pensions, large trust departments and life insurance companies. The majority of CFA charter holders still are institutional investors.

But over the years a number of changes have occurred. The first is the increase in the number of candidates in the U.S. When I completed my third exam in 1978 I was charter number 5453. I thought I was late to the party.

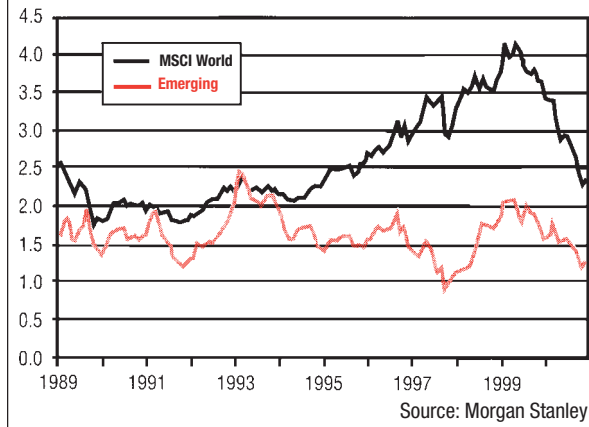
But today as the chart at the bottom shows there are over 49,000 total charter holders and over 101,000 individuals signed up to take one of the three exams this year. I certainly know because I was one of the 700+ CFA graders in Charlottesville, Va. last month helping to grade the 32,000 Level 2 and 3 exams.

A second change is that more CFA charter holders now deal directly with individual investors as Anne and I do here at Hanson Investment Management. It is estimated that 30-40% of CFA's now do both professional money management and client contact work. This is up significantly from 20 years ago. Finally and maybe the biggest single change in the CFA program is the global acceptance of the designation. Almost one half of the total number of candidates sitting for the exam this year were from outside the U.S. and Canada.

This is significant for a couple of reasons. First it puts ethics and professional standards of financial analysis closer to the top of the list for global portfolio management. Many family owned businesses in Asia for instance have followed rather cavalier standards of financial disclosure and minority shareholder rights. This will start to change as newly minted CFA charter holders put pressure on companies to follow a higher standard of corporate governance.

Second it may mean we are getting closer to a uniform standard for global financial reporting. Historically different countries and regions have reported in different ways. Here in the U.S. our GAAP standards (Generally Accepted Accounting Principles) are set by the Financial Accounting Standards

PRICE/BOOK



Board (FASB). Internationally standards are set by the International Accounting Standards Board (IASB). The FASB and IASB are talking to each other more today about common reporting standards. We won't get to a one world standard anytime soon but the fact that 101,000 analysts from all over the world are taking the same exam is a help. The Enron scandal raises interesting questions about whether U.S. reporting standards or International ones are the way to go but maybe recognizing that each system has flaws leaves more room for compromise.

Fifty percent of all stocks by market value trade outside the U.S. And this is where the value is today (see chart in upper right). The CFA program and its international popularity is doing its part to raise the bar on financial reporting standards and to tie the world's markets more closely together. All a good thing!

Chartered Financial Analyst (CFA) Profile

| | |
|--|---------|
| Total No. of Charters Issued (2001) | 49,266 |
| No. of Candidates Taking Exam (2002) .. | 101,000 |
| Level 1: | 62,000 |
| Level 2: | 28,000 |
| Level 3: | 11,000 |
| Candidate Breakdown by Nationality | |
| U.S. | 41% |
| Canada | 11% |
| Rest of World | 48% |
| Total | 100% |
| Percentage of CFA candidates who end up earning their charter: | |
| 1990 | 25% |
| 1997 | 20% |

Source: AIMR

CFA PROGRAM

Total Enrollment

| | |
|------------|---------|
| 1983 | 4,393 |
| 1987 | 7,664 |
| 1991 | 13,126 |
| 1995 | 28,150 |
| 1998 | 50,051 |
| 2002 | 101,000 |

Source: AIMR

The Investing Scene . . .

“You only find out who is swimming naked when the tide goes out.” **Warren Buffett**

LIKE MOST OF AMERICA, the daily revelations of ethical “lapses” in the corporate world have me scratching my head. Don’t get me wrong. I am not at all surprised by the existence of fraudulent activity in corporate suites but I am curious about the timing of these latest developments. If you believe as I do that basic human nature does not change, why the sudden tidal wave of bad executive behavior?

A short review of history suggests that this trend is not new. The rise of Robber Barons in the late 19th century produced a populist backlash and new regulation in the form of the Sherman Antitrust Act. Less than thirty years later, the financial run-up and subsequent crash of 1929 led to a wide range of financial reforms including the establishment of the Securities and Exchange Commission. And who can forget the “greed is good” decade of the 1980s that was punctuated by indictments of such financial luminaries as Michael Milken and Ivan Boesky.

Throughout history, financial scandals have followed prolonged periods of market speculation. The most recent market run-up certainly qualifies as a one of history’s most speculative periods. From 1996 to 2000, the Dow Jones Industrial Average doubled as Americans poured \$1.1 trillion dollars into stock mutual funds. During this period, cheap money and a wave of new technologies gave rise to investor’s obsession with earnings growth. Companies across a wide range of industries began to promise 15%-20% annual earnings gains. This goal represented quite a stretch considering that corporate profits have historically increased at a 7% average annual rate.

Corporate America, through the greatly expanded use of stock options, was well rewarded for playing this earnings game. Originally stock options, which give the owner the right to purchase shares at a fixed price for a set period of time, made a lot of sense. Management and shareholders alike benefited as earnings growth fueled share price gains. But what was a good idea in theory proved to be not so good in practice. With millions on the line, managements had a strong motivation to show ever rising profits. In stretching to meet their expanded earnings goals, the fine line between right and wrong, legal and illegal became murky. Recent disclosures of accounting fraud at Enron, WorldCom and Global Crossings sadly illustrate how far companies were willing to go in order to meet their earnings targets.

The growing list of corporate scandals has shaken investor confidence

both here and abroad. Rebuilding this confidence will require that we first understand the scope of these financial abuses. While the jury is still clearly out on this, one study by Credit Suisse First Boston has found that so far only 10% of the companies in the Standard & Poors 500 Index have had questions raised about their accounting. Further, consider that more than 100 companies in the Index are up by more than 50% since the market’s peak in March of 2000 while the index is down 38%. The list below of some of these companies is interesting. Most of the top performers are Old Economy companies operating in easy to understand businesses run by little known CEOs.

Finally, while there have certainly been some fine examples of out and out fraud, most of the recent headlines involve regulators calling into question aggressive but technically legal accounting practices. My guess is that we will see greater scrutiny of questionable accounting practices as current standards are revised.

To be successful, future regulatory efforts will need to both prevent out and out fraud and redefine, clarify and enforce appropriate accounting standards. Current regulatory proposals include the establishment of a new accounting oversight board, separation of research and underwriting activities and stiff new penalties for corporate fraud. This is a step in the right direction. Ultimately, increased oversight from both the private and public sector and the market’s own punishing response will once again help restore investor confidence in the market.

— Anne Williams Doremus

Top-performing companies and their CEOs

Not every company has hit hard times since the S&P 500 index peaked in March 2000, 38% above where it is today. The top performers are likely Old Economy companies with little-known CEOs running easy-to-understand businesses.

| Company | CEO | Wednesday close | Change |
|-------------------------------|-------------------|-----------------|--------|
| AmerisourceBergen | R. David Yost | \$69.62 | 364.1% |
| Lockheed Martin | Vance Coffman | \$69.26 | 238.9% |
| Pepsi Bottling | John Cahill | \$31.09 | 210.9% |
| Apollo Group | Todd Nelson | \$38.38 | 206.4% |
| UnitedHealth Group | William McGuire | \$90.20 | 202.6% |
| Reebok | Martin Coles | \$27.96 | 202.3% |
| St. Jude Medical | Terry Shepherd | \$35.40 | 174.2% |
| SLM | Albert Lord | \$90.17 | 170.7% |
| AutoZone | Steve Odland | \$73.68 | 165.5% |
| International Game Technology | G. Thomas Baker | \$56.25 | 159.4% |
| Pactiv | Richard Wambold | \$22.45 | 158.4% |
| Concord EFS | Dan Palmer | \$29.26 | 155.1% |
| Pulte Homes | Mark O'Brien | \$53.13 | 154.5% |
| Ball Corp. | R. David Hoover | \$42.49 | 145.9% |
| KB Home | Bruce Karatz | \$50.20 | 134.2% |
| Centex | Laurence Hirsch | \$55.13 | 131.5% |
| Harrah's Entertainment | Philip Satre | \$42.18 | 127.2% |
| Northrop Grumman | Kent Kresa | \$119.40 | 125.5% |
| WellPoint | Leonard Schaeffer | \$77.53 | 121.9% |
| Health Network | | | |
| Progressive | Glenn Renwick | \$55.00 | 116.9% |

Sources: Standard & Poor's; USA TODAY research

Source: USA Today