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.

Is This False Gold or the Real Thing? . . .

ARE WE DONE WITH THIS ECONOMIC SLOWDOWN? Or are we going into recession now? And what about the timing of the recovery? Everyone is looking for answers today. Unfortunately the tea leaves are pretty cloudy. Consumer spending continues to hold up well but layoffs are mounting and corporations continue to warn about future profits. The outlook is indeed murky.

But one signal — the yield curve — is giving an unequivocal positive signal. The yield curve compares short-term interest rates to long-term ones. The idea is that when short rates are high, investors sit tight in money market funds. But when short rates fall below long-term rates, investors start to move into bonds and also into stocks. Michael Sivy writing in *Money Magazine* has found that when long rates are half a percent above short rates, the yield curve is bullish. Now the spread is a whopping 2 full percentage points. The Fed has set the stage for a strong market recovery with its six rate cuts this year.

The big question is when will this recovery happen? Monetary policy generally operates with a time lag of six to twelve months so the kick in might be sometime in the second half. But stocks soared so much in this last cycle that the bounce back may take longer to develop. In any case the question is not if, but only when we get this recovery. So we are staying fully invested in good quality value ideas. They have done well this past year and we think they will continue to.

A Bullish Signal

When short-term rates are higher than long-term rates, the economy tends to slow. The sharp drop in short rates since January bodes well for stocks.

Source: Money Magazine

A Trip to South America. . .

Brazil, A Discovery Waiting to Happen . . .

MENTION BRAZIL AND MOST AMERICANS think of Rio and Carnival. After that it gets a bit fuzzy. Brazil is by far the biggest economy in South America. It is the eighth largest in the world, bigger than Russia, bigger than Mexico and bigger than Canada. But Americans know very little about it. Part of the problem is Brazil's own history of isolationism. Its markets are so big and its resources so bountiful it has not had to rely that much on outsiders for development. Until now and globalization.

Mara, Lillian and I traveled to Brazil recently. We wanted to see the sights and get a fix on a country so vast it has a border with every country in South America except two (Ecuador and Chile). If the emerging market story is going to play out, "the big four" will need to supply the muscle. These heavy lifters are China, India, Mexico and Brazil.

When the Portuguese arrived in Brazil 500 years ago, timber was the big prize (the country takes its name from the Pau Brasil tree). After that commercial interest turned to sugar, then gold, then rubber and more recently coffee and cocoa. In the last thirty years manufacturing has eclipsed natural resources as the principal money earner.

Since World War II development has come in fits and starts. The country has wrestled with a series of military governments, central economic plans gone awry and bouts of hyperinflation that have led to even more military governments and central plans. All this culminated in the "lost decade" of the 1980's when things got so bad that almost everyone agreed things had to change. Since 1990 popular elections have been reinstituted and the country has sustained three Presidential terms without collapse. And hyperinflation was extinguished in 1994.

A successful Brazil is very much in our interest. The United States is Brazil's largest trade partner. Brazil imports more from us than from anyone else and they export more to us than they do to any other country. And Brazil has a lot to offer U.S. investors. It has an enormous local economy and many world-class companies. Embraer is the leader in small regional jets and Aracruz Celulose is the low cost producer of softwood eucalyptus pulp used to make tissue and writing paper.

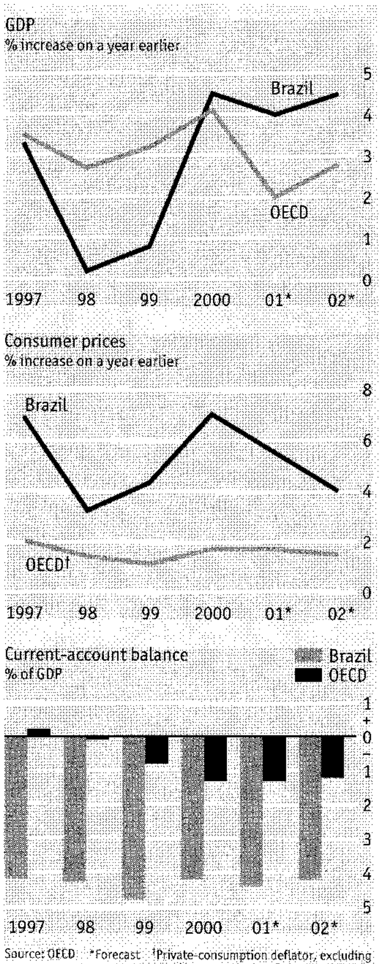
Brazil is a tough investment market now. The currency, the real, has slumped this year as problems in Argentina have scared investors off. The U.S. slowdown is affecting exports and a multi-year drought is playing havoc with the country's hydroelectric power supplies.

But I am an optimist. The key to any emerging market is keeping the ship afloat, keeping the economy stable and the government intact. This is crucial. Brazil has all the experience in the world at screwing things up. Now they have to learn the first lesson of globalization, to hold things together.

The Brazilian stock market is discounting just about the worst now. The Bovespa is down more than10% this year just about as much as Argentina, which is teetering on the edge of default. The hot Mexican market is up 22%. The Brazil Fund (symbol BZF) trades on the NYSE at a 20% discount to net asset value. The title at the top of this page was taken from a recent *Financial Times* article on Brazil. One of these days the discovery is going to happen. I think we are close.

Brazil

Economic reforms have enhanced Brazil's growth prospects, argues the OECD in its first survey of the country. But a big current-account deficit means that the economy is vulnerable to external shocks. The OECD calls for more tax and public-pension reforms. It also recommends that the central bank be made independent to keep inflation in check.



Source: The Economist

Source: The Economist

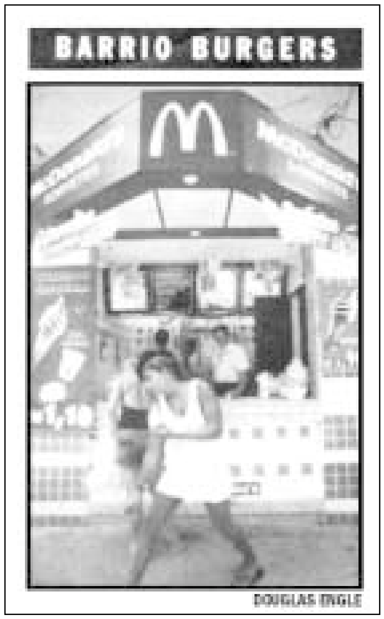
The Tough Nut to Crack . . .

IF YOU HAVE TO SINGLE OUT one problem in Brazil it is income inequality. The roots go back to the Portuguese and the large land owning classes and the 200-year history of slavery. Inequality is very entrenched now in Brazil. If you are born rich you will stay rich and if you born poor it is very difficult not to stay poor.

One of the common sights in Brazil is the favela. Favelas are shantytowns built on unoccupied land in big cities. Often you see them going down steep ravines or up mountain slopes, anywhere that traditional development can't get to.

On our trip to Brazil we visited the largest favela in Rio, Rocinha. Most locals wouldn't go there. Kind of like visiting the South Bronx. Rocinha has more than 100,000 residents now. The government initially tried to tear the favelas down and move everyone as far out of the city as possible.

In the early 1990's however an interesting change occurred. The government recognized Rocinha and legitimized the squatters' rights to their property including the right to transfer title. They also started supplying some



Source: Christian Science Monitor

basic services. These changes have unleashed tremendous development.

This is exactly what Hernado De Soto thought would happen. De Soto is a Peruvian who has written a very much talked about book, *The Mystery of Capital.* In it he argues that the poor are poor not because they don't have some capital or that they don't work hard. They have both of these. They are poor because they have to operate outside the legal system. They often have no title to the property they do control. By legitimizing Rocinha the Brazilian government unleashed the ability to make money. Now the poor can put small amounts into their houses and know they will be able to get their money back in rent or as a sale. Even the ultimate symbol of globalization, McDonalds has now set up right in Rocinha.

Instituting property rights in favelas will not solve all of Brazil's problems. Crime is still very evident. There were 9,000 murders in Sao Paulo last year compared to 600 in New York City. Uunderinvestment in education and the lack of basic services like health care and water and sewer will dog Brazil for a long time. But a visit to Rocinha gives a sense of optimism. When you are in Rio you will be warned about crime. Take the warnings seriously but not so seriously that you stay holed up in your five star hotel on Copacabana Beach. Get out and call Favela Tours and have your eyes opened to what development really means.

If You Go . . .

NO TRIP TO BRAZIL IS complete without a visit to Rio de Janeiro. It has beaches, views, beauty... the works. We stayed in Copacabana. It was great, but if you are looking for the hottest place it's probably Ipanema.

Iguacu Falls is also a must. Not only is it a spectacular sight but being there reinforces the importance of water in Brazil. It's estimated that one third of all the fresh water in the world flows through Brazil and the country generates 90% of its electricity needs from hydro. The Itaipu Dam, still the largest in the world, is located just north of Iguacu.

One of the real highlights of our trip was the Pantanal in Brazil's wild west. The Pantanal is a wetlands about half the size of France. Wetlands I thought meant swamp. It does but in fact the Pantanal is a low lying area that floods part of the year and then drains the rest. The movement from wet to dry brings in fish and animals and birds of all kinds. In fact you will probably see many more birds and animals in the Pantanal than in the much more densely forested Amazon. And the range is incredible. In five days in the Pantanal and the Amazon we saw nearly 150 different species of birds and animals. If you are lucky, you might see a jaguar and if you are unlucky, an anaconda. We missed both but we saw plenty of macaws, storks, anteaters, river porpoises and our favorite, the world's largest rodent, the capybara.

Symbol of the Pantanal: The Tuiuiu

Source: Insight Guide

If you find your way to the Pantanal, you have to continue north to the Amazon. The Amazon region is enormous, millions of square miles so there are unlimited ways to visit it. We chose an ecolodge on the Crystalino River in Mato Grosso State.

Finally we visited Salvador and the beaches of the Northeast. Salvador was the Portuguese capital of Brazil for two hundred years. It is still the home of Brazil's black culture. Try to attend a condomble service, the African-based cult practiced in Bahia.

Investing Trends . . .

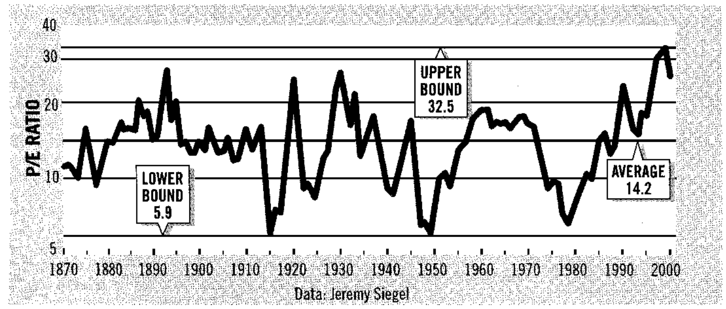
Value Verified . . .

MOST INVESTORS WOULD be quite happy to have avoided stocks altogeter last year. The list of stocks that have melted down in reaction to weak earnings announcements is long and keeps growing. Perhaps most surprising is the fact that much of the damage has been inflicted by the former “darlings” of Wall Street; stocks like Cisco, Nortel Networks and Sun Microsystems.

But closer inspection of the market’s recent performance shows a less gloomy picture. Take a look at the chart below. Since its peak in March of last year, the S&P 500-stock index has declined 19.8%. But this popular index is heavily influenced by the performance of large stocks. During the same period of time, the S&P Smallcap 600 Index posted a gain of 0.1% while the S&P Midcap 400 Index gained 1.6%.

The relative outperformance of small and mid-cap stocks has actually been going on for some time. Since March, 1999, the S&P 500 has fallen 5% while the small and mid cap indexes are both up close to 40%. So what exactly are small and mid cap stocks? While definitions have varied over time, today small-cap companies have a total market value below $1.5 billion while mid-cap companies have values between $1.5 billion and $7.5 billion.

A Historical Look at Stock Market Valuation



Source: Business Week

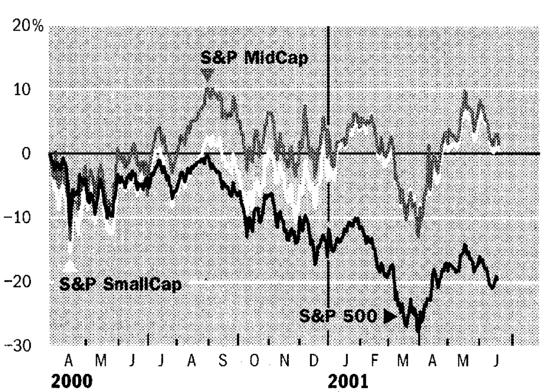
Now, most investors want to know what sectors of the market will perform well next. One valuation measure, the price-to-earnings (P/E) ratio, may provide a clue. The P/E ratio tells us how much an investor is willing to pay for $1 worth of earnings. As the chart above illustrates, the market’s P/E ratio over the last 130 years has averaged around 14. From this point of view, today’s P/E of slightly over 25 looks expensive.

But this statistic doesn’t tell the whole story. Slightly over a year ago, the median P/E on the 20 largest market capitalization companies in the S&P 500 was 42. After the recent market sell-off, this measure is a still rich 31. But the remaining 480 smaller companies trade at a more reasonable P/E of 18.

A recent study by David L. Babson illustrates the danger of investing in such high P/E stocks. Each year the folks at Babson track the performance of the New York Stock Exchange’s most popular stocks. In this work, the most popular stocks are defined as those having the highest P/E ratios. Since 1982, when the study began, if an investor each year bought the most popular stock and held it up to today, the 19 stocks together would have earned a cumulative return of 133%. If the same investor had alternatively taken his money and invested it in an S&P 500-index fund on the same dates, his return would have been 315%. Further, only 2 of the 19 stocks outperformed the S&P 500 from the dates of their peak popularity to today while 13 of the 17 under performed by 50% or more.

Small is Beautiful Again

Since its March 24, 2000, peak, the large-stock Standard & Poor’s 500-stock index has declined 19.8%, while the S&P SmallCap 600 index and the S&P MidCap 400 index have posted gains of 0.1% and 1.6%, respectively.



Source: Thomson Financial/Datastream Source: The Wall Street Journal

So why do these high P/E stocks almost always perform poorly? One reason has to do with the unsustainable nature of competitive advantage. In the early stages of a company’s life cycle, earnings growth soars as new markets are tapped. But competitive threats and technological advancements eventually enter in and earnings growth slows. Investors rarely anticipate this transition and unload the shares at the first sign of an earnings slow-down. Another important reason popular stocks under perform has to do with investor psychology. Most investors would rather be associated with winners than losers. In their enthusiasm, they push the prices of “winning” stocks up to levels that cannot be justified given the individual company’s earning potential.

So how can an investor avoid being caught up in the market’s latest popularity contest? Start by recognizing that businesses experience defined periods of popularity. In the 1970’s, energy stocks had their day in the sun and in the late 1990s it was technology. But these periods of popularity go in and out of favor. Second, focus your investment efforts on the low P/E, undiscovered sectors of the market. Finally, identify high quality companies that are attractively priced and give these investments sufficient time to work out. These steps remain at the heart of successful value investing.

— Anne Williams Doremus