

Things We Just Don't Understand . . .

Everyone wishes they had loaded up on Google. The stock came public back in August, 2004 at \$85. Today the price is over \$500, a 5X increase in less than three years. Talk about "Wealth beyond the Dreams of Avarice"! But you know, we don't have any interest in Initial Public Offerings (IPOs).

Fortunately the research tends to support our position (*see chart below*). When you take all IPO's together, the return over the first five years is less than what the overall market would have earned. Why are investors often so enamored with IPO's? There are two reasons. The first is IPO's are a

little like lottery tickets. The returns are highly skewed meaning some IPO's do really great while others bomb, but for the individual investor it's the roll of the dice, a way to take that shot for the big payoff. And investors like to feel they are getting in on the ground floor of what might be the technology of the future.

A second reason IPO's are popular is selective memory. It is called Availability by Behavioral Finance researchers. The thing you remember is the thing that comes easiest to mind. When you say IPO, you don't think of the company that went bankrupt. You think of the success that is all over the front page – Google. So IPO's equal the Big Killing!

The reason we don't like IPO's has to do with the process. If you have been building your private company for up to 20 years and you have made a success of it, you are not going to let the business go for a fire sale price. In fact the only way you are going to let me get in on the action is at a really good if not blockbuster price – for you. Richard Zeckhauser, a Professor

of Political Economy at the John F. Kennedy School of Government at Harvard, likes to say you want to steer towards investments where there is limited competition, where the sellers are very eager to sell.

This is the exact opposite of IPO's. Here the buyers are the ones who are eager to do the transaction. Demand is often so intense that the sellers can name their price. The Value ideas we are attracted to are often in forgotten areas where the price is cheap relative to other investments and where there are very few others players competing. Warren Buffett plays here too but with much more sophistication. You don't see Buffett interested in IPO's. Instead you see him going into catastrophe insurance, for instance, right after a series of heavy storms where all the other big insurance carriers have exited with heavy losses. This leaves him alone in the market. He takes on some really big risks but he can charge an arm and a leg because of the lack of competition. Forget IPO's. Go elsewhere. Buy 'em when they are cold.

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

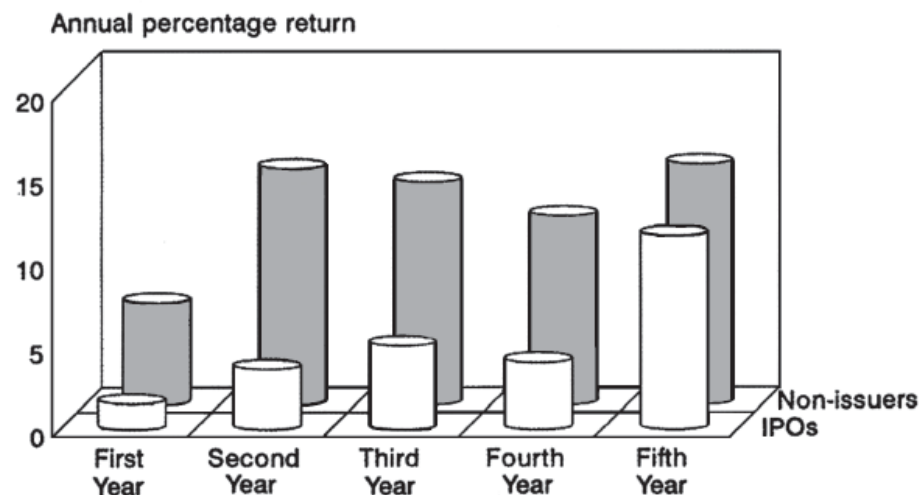


Julie Won, Eric Hanson, Anne Doremus

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.

©2007 Hanson Investment Management

The IPO Fizzle



SOURCE: Nicholas Barberis, Yale University

Buying Global Real Estate Securities

Singaporean industrial parks, German office buildings, and Hong Kong shopping malls have not traditionally been within the reach of small individual investors. However, as more real estate around the world becomes securitized through REITs – or real estate investment trusts – world real estate is becoming accessible to even small investors.

REITs own and manage income-producing properties and then distribute shares that trade like stock on public exchanges. The REIT structure makes it possible for small investors to participate in large-scale real estate projects like apartment complexes, office properties, shopping centers, storage centers, industrial parks, hotels and resorts, or health care facilities.

In the U.S., REITs got going in earnest in the early 1990s and boomed from the middle part of that decade. Japan introduced REITs in 2001, and earlier this year, both Germany and the U.K. approved REIT legislation. Asia has been particularly noted for its developing REIT markets. Australia actually has securitized more of its real estate than any other nation, and both Singapore and Hong Kong are positioning themselves as hubs for regional REITs with properties across South East Asian or Chinese borders. *The chart below left shows how much the real estate securities market already has grown.*

Why consider global REITs?

REITs are a total return product where income is an important component. Because REITs are required to pass through a high percentage of income to shareholders (90% in the U.S.), they provide investors with ongoing dividend income. They also provide capital appreciation potential.

Global REITs can also improve portfolio diversification. International real estate securities have a relatively low correlation with U.S. stocks of about 50%. *As the chart below shows,* that is much lower than the correlation between U.S. stocks and international stocks in the MSCI EAFE Index.

Finally, global REITs provide a good way to participate directly in the growth of local economies when you like the macroeconomic fundamentals of a particular market. REIT valuation is driven by rent and occupancy, and these in turn are a function of demographic factors, overall economic fundamentals, and the supply and demand of properties.

We know that the world is growing the fastest outside of the U.S. – especially in emerging markets, where we still are in the early stages of rising wealth driving rents and property values higher. Since we cannot buy properties on the outskirts of Shanghai, Mumbai, or any of the other of the world's most exciting cities, international real estate securities at least

provide a way to participate in the fastest growing regions of the world.

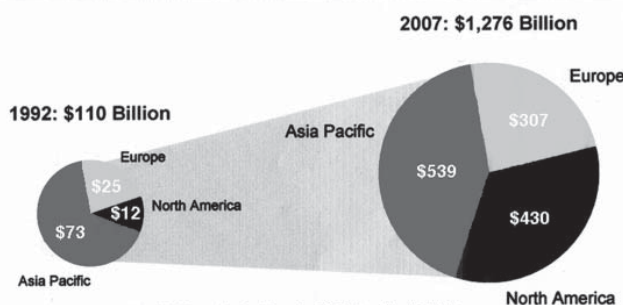
A few considerations

The prudent way for long-term investors to incorporate international REITs into their portfolios is to set an appropriate asset allocation for international real estate and to stick with it without worrying about market timing or the extent to which a REIT is trading at a discount or premium to its net asset value (NAV). While it is best to find REITs trading at low multiples of their future rental revenue streams, a long-term perspective is important – especially when looking at Asian markets.

And if there isn't a market that interests you in particular, there are funds that invest in diversified real estate securities and real estate operating companies. Real estate ETFs can provide a low-cost way to get diversified exposure to global real estate. State Street has the SPDR Dow Jones Wilshire International Real Estate Fund (RWX) with an expense ratio of 0.60%. Slightly less expensive is the just launched WisdomTree International Real Estate Fund (DRW), which invests in 224 real estate development and operating companies in Europe and Asia for an expense ratio of 0.58%. This index is fundamentally weighted toward the highest dividend payers in foreign markets.

Growth of the International Real Estate Securities Market

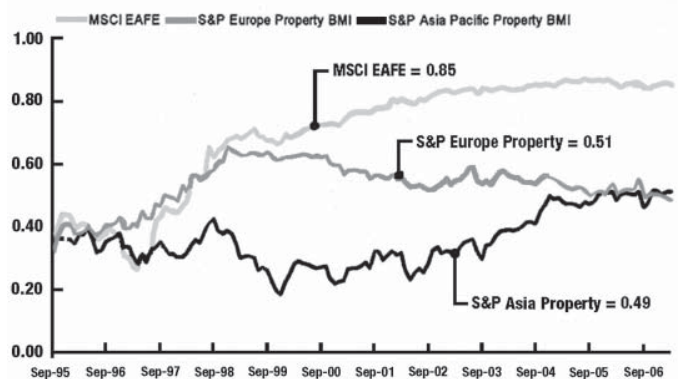
Market Capitalization



17 Source: S&P/ICJgroup World (ex-U.S.) Property Index at December 31, 1992 and March 31, 2007

Correlation to S&P 500

Rolling 5-year periods, monthly data September 1995 – March 2007



SOURCE: Charles Schwab Institutional

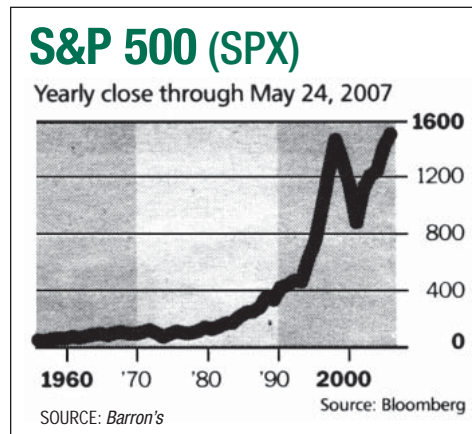
Seven Years Later . . .

The S&P 500 set a record last month breaking through the 1,527 high it established back in March, 2000. This current run-up has been pretty remarkable for both its duration and consistency. Historically, bull markets tend to run their course in 3-4 years. This one is coming up on its fifth year anniversary and the advance over that time has been pretty much straight up. Sure there have been periodic pullbacks but most have been fairly muted.

The reasons for these gains are not too hard to figure out. Over the last several years, markets around the globe have benefited from an ideal mix of low interest rates, tame inflation and strong profit growth. But coming into 2007, many economists worried that the slowing U.S. economy would put an end to the bull market's advance. So what happened? As is often the case, the market proved the professionals wrong and rose almost 8% from January to May.

The market's recent action illustrates two important points. First, it reminds us that short term market predictions are pretty hard to get right. The second point has to do with why most pundits got their forecasts wrong. Most expected corporate profit growth to stall out in the first quarter and here they were right. Economic growth slowed to a crawl in the first three months of this year. What they missed, however, was the extent to which strong foreign markets would boost U.S. multinationals' profits. Consider that as of 2005, S&P 500 companies generated 41% of their revenues outside the U.S. And first quarter earnings at companies such as Amazon, Microsoft and Boeing all came in above expectations thanks to strong international results.

Today, many investors are wondering whether the latest market hiccup is the beginning of another major correction. Those supporting this view think that slower corporate profit growth and weaker productivity gains will ultimately cause stocks to decline. But while corrections are always possible, I do not think we are



in for a major decline. The strongest argument for this case has to do with stock valuations. The last time the S&P 500 hit this level, stocks were on average trading at 33 times earnings. Today's price-to-earnings ratio of 17 is right in line with the long term historic average. The recent advance, rather than being concentrated in one sector, has been fairly broad based. This is generally a sign of a fairly healthy market. Finally, companies today are using their ample cash reserves to buy up shares. Buy-backs tend to support stock prices by spreading profits over a smaller number of shares.

Investors who want to see a real stock market bubble need look no further than China. *As the chart below shows,* the country's major Shanghai Index has more than quadrupled in value over the last two years. Strong economic

fundamentals are fueling these gains – growth is expected to top 11% this year, foreign investment continues to pour into the country, and exports and capital investment are booming. But recent market behavior suggests that stock prices have moved into “bubble” territory. Consider that the Shanghai index, which recently passed the 4,000 milestone, is up over 50% since the beginning of this year alone. Chinese investors, not immune to these gains, are opening an average of 100,000 personal trading accounts a day and, thanks to the tremendous demand for stocks, the average P/E ratio for companies traded on the Shanghai Exchange now exceeds 50.

Chinese authorities are not unaware of the dangers posed by collapsing stock prices. Mostly they fear the social unrest that could result if large numbers of new investors lose their hard earned savings in a stock market collapse. To avert this they have recently increased a standard trading tax, tightened credit and are now working on introducing stock futures to allow investors to bet on a fall in stocks. For long-term investors, this hot market still offers tremendous opportunity. But those going along for the ride should be ready for plenty more ups and downs along the way.

