

## “It’s Only Money...”

Try this one on someone as a way to rationalize the recent financial meltdown and you might get the rejoinder, “Yea, but it’s my only money!” This has been one of the toughest times for almost all investors.

This page is not about the loss of money but about money itself. Something funny is happening to the stuff in your wallet today. *Take a look at the chart below.* Cash and currency in circulation has been increasing rapidly. Typically people don’t hold a lot of cash. It earns nothing and debit and credit cards and also checks have become more convenient to use.

There is \$845 billion of coin and currency in circulation today. This means every man, woman and child in America is walking around with about \$2,700 in his or her wallet. I don’t know about your friends but I don’t have many in this category. The fact is that a lot of U.S. currency is not in this country anymore. It’s estimated that up to three quarters of all greenbacks are circulating outside the U.S. Some countries have legislated the dollar as their official currency and many others such as Burma, Cambodia, Laos, etc. would rather accept dollars than their own local currency. Interestingly on my last trip to Southeast Asia I saw no interest among the locals in Euros. They only wanted dollars.

And then there is the underground and illicit economy. Who knows how many stacks of dollars are in shiny briefcases being passed from one drug or shady real estate deal to another.

A third reason for the demand for U.S. currency is that the alternatives earn so little today. With money market funds offering close to a 0% return, you are not losing much by just keeping your wallet stuffed.

The narrow definition of the money supply is cash in circulation

and checking accounts. This has been increasing rapidly recently, up 10% to 20% on an annual basis. Growth in the money supply often precedes an increase in inflation. When you have too much demand (cash and income) chasing too little supply (production) you get the fuel for the fire. The optimists say, don’t worry, the Fed has plenty of time to see this problem coming and they can withdraw funds as easily as they put them in. The naysayers respond, the next time the Fed achieves this high wire act of anticipating inflation, will be the first time. We all see the past perfectly clearly but the future is one big blur.

Our take is there is plenty of excess capacity in the economy now and inflation will be only a minor problem until this gets used up and producers get back some pricing power. Also the money supply may be growing rapidly but this doesn’t mean consumers have the will to spend. Unemployment is up, incomes are flat and the velocity of money (how fast the cash in your wallet turns over) will be slow to take off. Inflation doesn’t worry us right now but as I said earlier, the future is usually one big blur and we will be watching this issue closely.

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

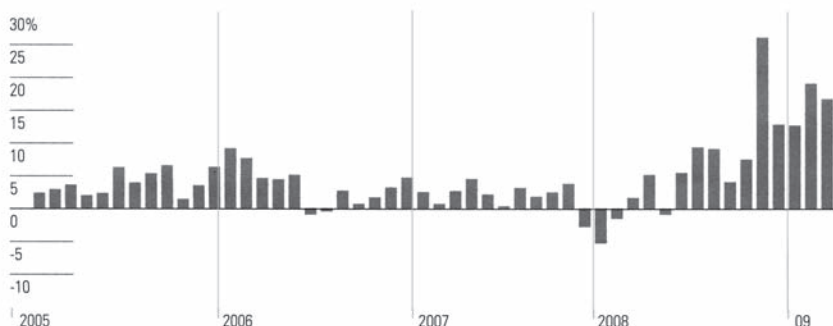


Anne Doremus & Eric Hanson

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.

©2009 Hanson Investment Management

### Annualized Monthly Growth in Currency Circulating Outside of Banks



Source: Morningstar StockInvestor

# Random Gleanings From The U.S...

*The Economist* is in my estimation the best single source of information and opinion on the global economy. They recently did an extended piece on Business in America (May 30, 2009). What came as a surprise is how optimistic they are about us.

Not all is roses however. America has shed 5 million jobs since 2007 and when the unemployed and underemployed are counted, 15% of

The challenges we face today are significant however. The first is health care (*see the bottom of the page*). We spend more on health care and get less good outcomes than most other developed countries. It is a big question as to how we are going to solve this. And then there is the issue of global warming and how to curb carbon dioxide emissions. Whatever is put in place here will be costly and there will be winners and losers. If things go badly we may have a less productive economy, not a more productive one.

Finally the financial sector bubble is deflating now. Finance will shrink in size relative to services and even manufacturing. This will come as a welcome relief to many!

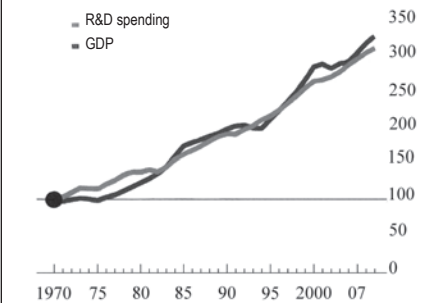
Gregory Mankiw an Economist at Harvard and a former member of the Bush Administration looked at teaching Econ 101 in a recent *Sunday New York Times* piece (May 24). How will his Economics course change with the recent financial developments?

On the one hand, not much will change. Supply and demand is still supply and demand and the importance of trade is still a concept very much intact.

But in four areas there will be revisions. Banks are necessary in the economy to grease the wheels of business but we can't ever again let them bring the whole economy to its knees as they did this time. More regulation may be the answer but an even better answer may be 'less bad

## A close match

US, 1970=100, real terms



Source: *The Economist*

regulation'. The zookeepers let us down this time. This needs to change.

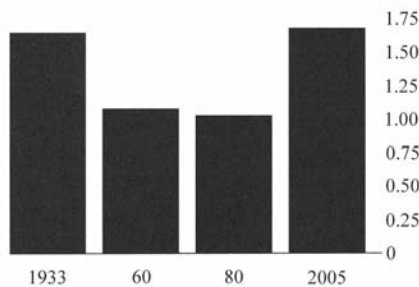
A second topic Econ 101 will focus on is leverage. When banks leverage themselves 20 to 1 and Wall Street firms 30 to 1, even small declines in asset values can bankrupt a firm. Risk needs to be better accounted for in the future. Third, Monetary Policy will need to be different. The Fed can raise or lower interest rates to either speed up the economy or slow it down. No one ever expected however that interest rates would fall to virtually zero as they did this time. The Fed will need to craft additional quivers for its bow.

And finally we need more humility in forecasting. The future is highly uncertain and Econ 101 needs to reinforce this. The quantitative models that precisely mapped who would default on sub prime loans and when, not only blew up but blew up big time.

How will America look in the future? Believe it or not, not much different than today, if you believe Raymond Fisman writing in *Foreign Policy* recently. Change in this world occurs in slow-moving shifts and this means the wealth and growth potential of the U.S. economy as detailed in *The Economist* piece will most probably continue. Good news to hear after the roller coaster ride of the past year.

## Overpaid? You bet

Wages in the US finance industry relative to the private sector



Source: *The Economist*

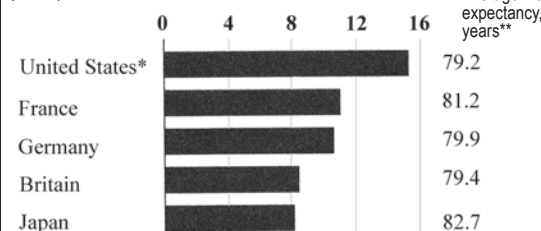
Americans today are jobless. A pretty big number.

But the Economist argues that even though many firms will die, others will pick themselves up, dust themselves off, and move on. We are still the best place in the world to do business. Our labor markets are the most flexible (the downside of course is that it is easy to get laid off) our entrepreneurial spirit is unmatched and we have an effective way of dealing with turmoil. We face up to it, take our lumps and move on.

The chart in the upper right shows the correlation between research and development spending and economic growth. U.S. firms continue to spend aggressively on R&D and with the vast majority of the world's top universities in the U.S. and with the close collaboration between universities and business, it's expected that R&D spending will continue to be strong. This bodes well for GDP growth.

## Unhealthy

Total health spending (public & private) as % of GDP, 2006



\*Differences in methodology

\*\*Latest

Source: *The Economist*

# If You Have To Ask The Price...

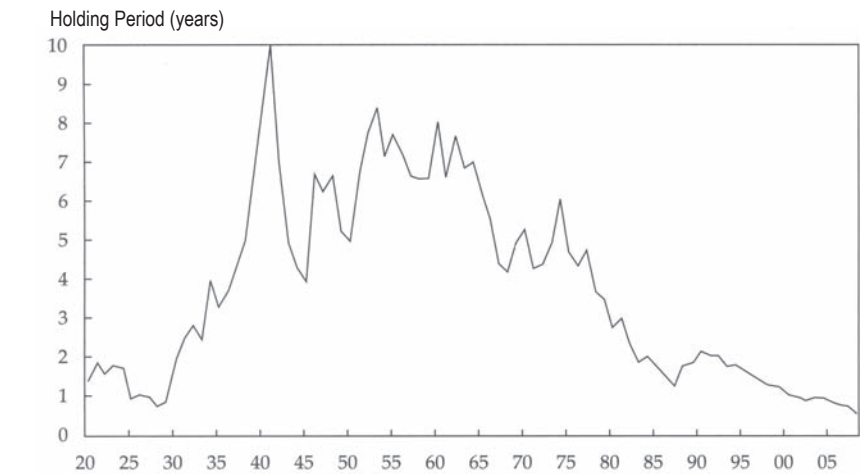
Well, you know the drill... You can't afford it. Seth Klarman's classic, *Margin of Safety, Risk Averse Investing Strategies for the Thoughtful Investor*, falls in this category. When the book was first published in 1991 it got some attention but not that much. Since then however it has taken on cult-like status. It has never been reprinted and today a used copy goes for between \$600 and \$1,000.

What's all the ruckus about? Klarman is a Boston based money manager, President of the Baupost Group. The firm manages money for a group of wealthy families. Klarman is seen by some as a younger Warren Buffett. He spoke recently in Boston and here are some of his ideas.

Klarman is a Value Investor who looks for securities selling significantly below intrinsic value. He wants to buy when there is a 'margin of safety' between the underlying business value and the current price. He focuses less on return (how much a security can go up) than on risk (how much it can go down). His mantra is that the world is uncertain so don't pay too much for it. Buy only when a security's tangible assets and business value are way below the current price.

Where do you look for values? Often it's where people are selling in a panic, or where things are ignored

## Average Holding Period of a Stock on the New York Stock Exchange, 1920-2008



Source: cfapubs.org

or areas that investors are unaware of. The bankruptcy of Lehman Brothers for instance, sent the corporate bond market into freefall (see the chart at the bottom and the increase in risk spreads). Baupost bought intermediate corporate bonds and mortgage backed securities from panicked sellers. Let the fear and greed of others play into your hands.

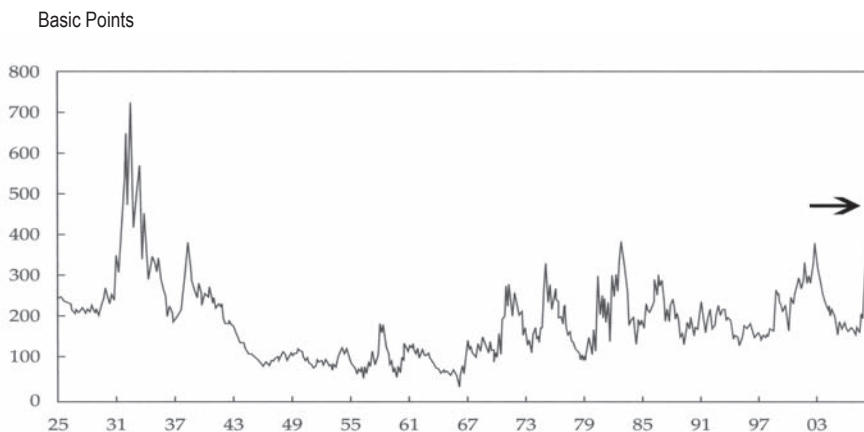
Klarman is not interested in the macro picture. He doesn't start with the overall economy and move down to sectors and then individual securities. He is entirely bottom up, focusing only on assets selling below intrinsic value. He also doesn't

understand the short term focus of many managers and their supposed long term clients, the endowments, pension plans and individuals. The chart at the top shows the average holding period for stocks. It has declined from eight years in the 1960's to under one year today. This is hardly long term investing.

It is important for clients to choose the right money manager. It is equally important for managers to choose the right clients. You are doing neither party a favor, if for instance a client is nervously worrying about the short term results of a long term manager while the long term manager is worrying constantly about what the client is thinking. Investment results will not be good here. An interesting point.

Andy Grove the former President of Intel titled his book, *Only the Paranoid Survive*. This is an apt description of Seth Klarman who has been described as a world class worrier. His focus on value, risk and the long term is very good advice today. And finally the best news. He intends to republish the book. The bad news however is, it won't be republished soon... just some day. So I guess you will still have to decide whether to pony up that \$600.

## Spread of BAA Bonds over U.S. Treasuries, 1925-2008



Source: cfapubs.org

# How Now the Dow?..

Talk about kicking someone when they are down! On June 8th, market icons General Motors and Citigroup were removed from the Dow Jones Industrial Average. While this may not seem like a big deal, changes in the vaunted Dow are remarkably rare. Only 121 companies have made it into the Dow's ranks over the last 112 years and *as the chart to the*

recognized index has always been a fairly good reflection of both the market and the U.S. economy. When Charles Dow first created the Average back in the spring of 1896, half of the 12 original firms came from the mining and agricultural sectors (*see table left.*) By the 1940s, over half of the now 30 components came from consumer and manufacturing sectors and today, technology and service-oriented firms dominate the index. The latest changes further illustrate Dow Jones' efforts to bring the index inline with the ever-changing economy. GM's elimination underscores the declining role of auto manufacturing in the economy and Citigroup's removal reflects the contraction in the banking industry last year.

## Changes in The Dow

Decade	Changes
1896-1900	9
1901-1910	9
1911-1920	12*
1921-1930	34**
1931-1940	15
1941-1950	0
1951-1960	5
1961-1970	0
1971-1980	3
1981-1990	5
1991-2000	11
2001-Nov. 2008	6

\*Increased number of components from 12 to 20 in 1916.      \*\*Increased number of components from 20 to 30 in 1928.

Source: [djavverages.com](http://djavverages.com)

### In 1896 the Average started with twelve.

COMPANY	WHAT BECAME OF IT
American Cotton Oil	Distant ancestor of Best Foods
American Sugar	Evolved into Amstar Holdings
American Tobacco	Broken up in 1911 antitrust
Chicago Gas	Absorbed by People Gas - 1897
Distilling & Cattle Feeding	Evolved into Millennium Chemical
General Electric	Still in the DJIA
Laciede Gas	Active, removed from DJIA - 1899
National Lead	NL Industries - removed in 1915
North American	Broken up in the 1940's
Tennessee Coal & Iron	Absorbed by US Steel - 1907
U.S. Leather (preferred)	Dissolved in 1952
U.S. Rubber	Became Uniroyal, now part of Michelin

Source: [djavverages.com](http://djavverages.com)

*right shows*, there have been only 30 changes over the last half century. In some ways, the folks who manage the Average at Dow Jones had little choice with these two latest moves. The Dow has always been composed of leading, "blue chip" firms. Bankrupt General Motors and reeling Citigroup (which is now 1/3 owned by the government) hardly fit this description today.

The Dow's changing composition is worth noting because the widely

Cisco and Travelers will replace GM and Citigroup this month. The decision to add Cisco clearly illustrates information technology's growing impact on the economy. And Travelers was added to augment the Average's much depleted financial service weighting.

Interestingly, the recent deletions will have little impact on the Dow's price performance. Because the Average is price-weighted, companies with high share prices have a greater impact on the Dow's movements than those with low share prices. GM and Citigroup shares declined dramatically last year and by the time they were both eliminated, the companies combined

had a less than 0.5% weighting in the index.

Many institutional investors complain that the Dow is not an effective barometer of the overall market because it is too small and too focused. And while it is certainly true that larger benchmarks, such as the S&P 500 or Russell 3000, probably do a better job, the Dow for its size and limited composition does pretty well. *As the chart below shows*, the Dow and the S&P 500 have tracked fairly closely over the long-term. In fact from 1986 to 2008, the returns on the Dow showed an almost 0.90 correlation with the returns from the S&P 500. A correlation of 1.0 would indicate that they move in exact lock-step.

The Dow does have its limitations. It under-weights small and mid-sized firms when compared to the broad U.S. market and as an "Industrial" average, it purposely excludes transportation and utility shares. But many investors like it because it is both familiar and easy to understand. And importantly, it has proved to be a reasonable indicator of the market's basic trend over time.

## The Dow and S&P 500 Over Time



Source: [yahoo.com](http://yahoo.com)