Thoughts from

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VOLUME 9, NUMBER 7 **MARCH 2004**

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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.

The Ugly American . . . Redux . . .

IF YOU HAVEN'T ALREADY HEARD OF BERNARD LEWIS, you probably will in the near future. He is the 87-year-old British-born retired Professor of Middle East history at Princeton who has come to exercise considerable sway in the Bush administration. Mr. Lewis was the focus of an excellent front page story in the *Wall Street Journal* February 2, 2004. After World War II George Kennan's doctrine of "containment" dominated U.S. policy. The objective was to cover the Soviet Union wherever it went. When they thrust, we parried. In the Middle East our policy was to promote stability at all costs, even if it meant supporting tyrants. Oil was just too important.

Bernard Lewis

Today the former Soviet Union is dead and the idea of containment has given way. The Lewis Doctrine posits that the Middle East is weak due to its own inadequacies. The region has had a chip on its shoulder since the 1600's when the Ottomans failed to sack Christian Vienna. The only way to deal with this is to bring the economies of the region into the twenty-first century and to do this you need democracy. We need to push harder in the area, not ease off. "Get tough or get out," Mr. Lewis says.

On the one hand this is pragmatic and defensible. It is difficult to point to a single successful Muslim economy the past 100 years. We need to build the job market and the economies in the region and democracy and capitalism are important tools here. On the other hand this policy smacks of unilateralism and imperialism. *The Economist* recently wrote a piece about Keith Reinhard, an American advertising executive who is worried about rising anti-Americanism. Foreigners have four main criticisms of America according to Business for Diplomatic Action, the group Reinhard has formed: first, American brands steamroller local under-financed products; second, America cares only about America; and third, American popular culture has forced itself everywhere. The fourth is that American foreign policy is unilateral and intrusive.

Someone once told me to be successful in business you need only listen three times as much as you speak. Maybe this should be included in our foreign policy. The Lewis Doctrine is quite a big stick and risks playing right into the hands of anti-Americanism. I think we need a softer touch or else get very used to the Ugly American tag.

The Wal-Mart Economy . . .
The Most Admired and the Most Hated . . .

CAN A COMPANY BE BOTH OF these? If it can it is Wal-Mart. Warren Buffett in his recent annual report sees the positives to the story, "for several years, I have given my vote to Wal-Mart in the balloting for *Fortune* magazine's "Most Admired" list". But there are plenty of negatives. A Federal Grand Jury is examining whether the company knowingly hired contractors who employed undocumented immigrants and charges of sexual discrimination in employment could soon precipitate the biggest civil rights class action in history.

PENNY-WISE

The cost of a typical basket of Wal-Mart goods fell roughly 3% in 2003, but that didn't spark strong enough sales gains. So this year, the retailer will ease the pressure on prices.

Source: Business Week

One thing for sure about Wal-Mart is that it is big, really big. This is a company with sales equal to the GDP of Sweden. It is the world's largest company with revenues 50 percent greater than that of Target, Costco Wholesale, Sears Roebuck and Kmart combined. It employs a total of 1.4 million people and it expects over the next four years to add 800,000 new positions including 47,000 management slots. Wal-Mart has taken size to a new level.

Wal-Mart is successful because of its low prices and because it executes so incredibly well. The company tracks sales and inventories better than anyone else in the business. This has allowed them to make the slogan, "Always low prices – Always", not just Madison Avenue speak but a reality. It is estimated that Wal-Mart saved U.S. customers $20 billion in 2003. A McKinsey & Co. report claims the company accounted for approximately 15% of all U.S. productivity gains in the late 1990s.

But the relentless push for low prices also has a price. And it is a steep one. The average wage of a Wal-Mart "associate" is $8.23 per hour or $13,861 a year (in 2001). The Federal poverty income for a family of three at that time was $14,630. The turnover rate at Wal-Mart last year was 44% meaning the company will need to hire 616,000 workers this year just to stay even. A turnover rate of 40%+ says a lot (or in this case a little) about job satisfaction and career opportunities at the company.

The pressure on suppliers to reduce costs means increased pressure to move jobs out of the United States. And once they are in low cost countries the pressure continues to reduce costs and wages even more. At some point the squeeze becomes destructive.

Wal-Mart may be reaching this point today. In the past the idea of price increases for suppliers was unheard of. But now some price increases are going through. The company is finding that price reductions, which averaged 3% across the full product line last year, are hurting gross sales. Same store sales increases are getting harder and harder to achieve. Allowing some price increases will boost sales while not driving off consumers who have come to expect lower prices. At least this is how Wal-Mart is betting.

King Kong in Diapers

WAL-MART dominates sales in a number of categories:

Disposable diapers	32%
Hair care	30%
Toothpaste	26%
Pet food	20%
Home textiles	13%

U.S. market share based on 2002 data; excludes Sam's Clubs
Data: A.C. Nielsen, Retail Forward, *Home Textiles Today*

Source: Business Week

Wal-Mart's advertising today is emphasizing more the human face of the company than just low prices. We don't think this means a radical change in the company's philosophy but any loosening of the squeeze on suppliers will allow corporate pricing power in the broader economy to improve. This means better profits for everyone but unfortunately it also means a possible earlier return of inflation, something Wal-Mart has been key in holding down.

Wal-Mart by the Numbers

The world's largest company generates some amazing statistics

30	44%	4	14%	82%	71%
Supermarkets closed since Wal-Mart **saturated** Oklahoma City	**Turnover rate** for Wal-Mart's hourly workers per year	Number of Wal-Marts in Vermont, the **fewest of any state**	How much **lower** average grocery prices are where Wal-Mart competes	Percentage of **U.S. households** that made a Wal-Mart purchase last year	**Price drop** for George jeans at Britain's Asda since Wal-Mart bought it in '99
Data: Retail Forward Inc.	**Data:** Wal-Mart Stores Inc.	**Data:** Wal-Mart Stores Inc.	**Data:** UBS Warburg	**Data:** Retail Forward Inc.	**Data:** Wal-Mart Stores Inc.

Source: Business Week

The U.S. Market . . .
Forget Delphi, Tis the Season to Look to Omaha . . .

THE ANNUAL REPORT OF Warren Buffett and Berkshire Hathaway was posted recently on the Internet. It is eagerly anticipated by many investors.

The issue of corporate governance takes up much of this year's report. CEO pay is the acid test of whether corporate governance is making headway. There are some companies doing good work here such as General Electric but not many others are following. Corporate governance of mutual funds is also making little headway. "Independent" mutual fund directors are far from showing much independence. Mutual funds are run by boards of directors who choose the management company to run the fund. Theoretically the board of a Fidelity fund could choose T. Rowe Price or Vanguard to run their fund. But you can guess how often this happens.

Buffett suggests a simple solution to mutual fund Board responsibility. Have each director affirm the following statement, "(1) we have looked at other management companies and believe the one we have retained for the upcoming year is among the better operations in the field; and (2) we have negotiated a fee with our managers comparable to what other clients with equivalent funds would negotiate." Typical Buffett wisdom – clear and to the point. We will see if it flies.

Buffett rarely speaks specifically about the level of the stock market. He is not terribly excited about stocks today, *as you can see from the quote below.* He did speak at length however about stock valuation in a piece in *Fortune* in 1999.

There are three factors that are most important in the stock market Buffett feels. The first is interest rates. When rates decline, cash flow from stocks look more attractive and prices usually rise. Conversely when rates go up, stocks come under pressure.

> *"We are neither enthusiastic nor negative about the portfolio we hold. …(but) if these stocks are fully priced now, you may wonder what I was thinking four years ago when their intrinsic value was lower and their prices far higher. So do I."* —*Warren Buffett*

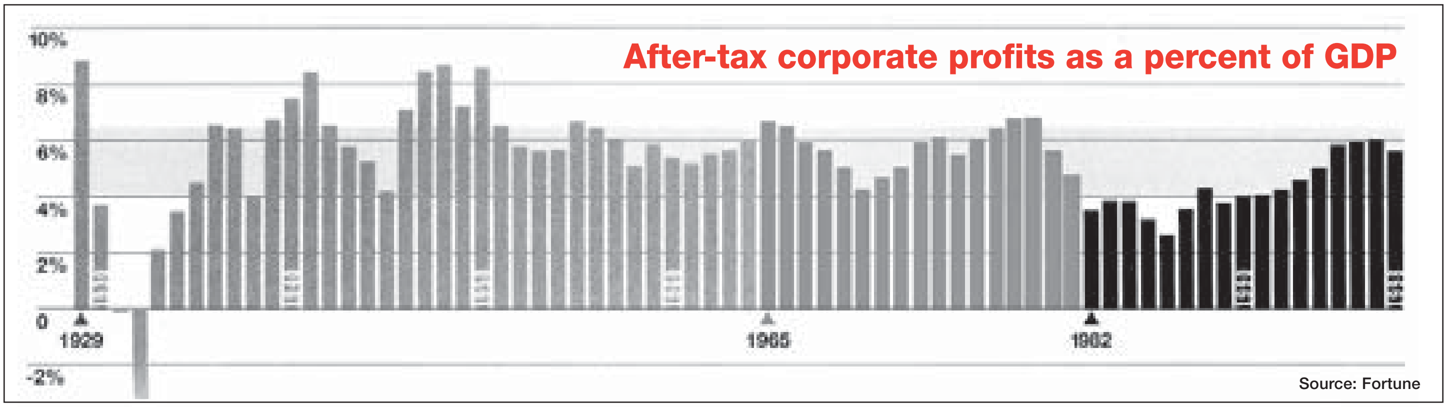
The second factor is corporate profitability. New economy or Old economy, corporate profits tend to range between 4% of GDP and 6%. When stocks were very cheap in the early 1980's corporate profitability was low. Today profits are at the high end of the range. Not much headroom for improvement here.

Buffett's third stock market factor is very human. Most investors see themselves as above average. They like to think that even if the market goes sideways or down they can spot the hot sector. This is fool's gold at best Buffett says. Today if interest rates aren't going down further and there is no room for profit margin expansion then the market is probably not a great bet.

But differences of opinion make a horse race. Jeremy Siegel, the Finance Professor at Wharton and the author of the popular book, *Stocks for the Long Run,* argues that the market should trade at a higher valuation today than in the past. One reason is the economy is more stable. Central bankers know more about the business cycle now and are doing more to keep the economy on an even keel.

Second, the market has far greater liquidity than in the past. Derivatives such as options and futures and various index products afford investors the ability to hedge extensively. Finally taxes are lower. The capital gains tax rate is 15%, the lowest rate in over fifty years and dividends are also taxed now at 15%. With these extra pluses stocks should trade closer to 20X today, rather than 15X as in the past.

Our take is a little bit of both Buffett and Siegel. The market has gone up more than 30% in a year and there are far fewer value ideas to be had. But still we are fully invested. The glass for us remains half full, not half empty.



Economic Trends . . .
Prices Headed Higher? . . .

WHAT A DIFFERENCE A YEAR makes! I just returned from Raymond James' 25th Annual Institutional Investors Conference where over 600 portfolio managers and analysts gathered to hear from more than 275 public companies. Last year, presenting firms were hunkering down, cutting costs and trying to wait out another year of soft orders and unused capacity. This year, talk was of growing backlogs, capacity additions and new market opportunities. But in the midst of all this good news were hints of the darker side of economic expansion. A number of firms reported rising input prices, in other words *inflation*.

For most of us, inflation has long seemed a thing of the past. *Take a look at the chart to the right.* For the past two decades, prices have been on a downward path. Over this period, a number of forces helped keep price increases at bay. Here at home, productivity gains allowed firms to produce more with fewer workers. With labor as most firms' largest cost, the absence of wage pressure proved significant in keeping prices low. Growing competition from low wage countries such as China and Mexico kept a lid on prices too. As recently as last November, when core consumer prices fell 0.1%, deflation seemed the greatest risk.

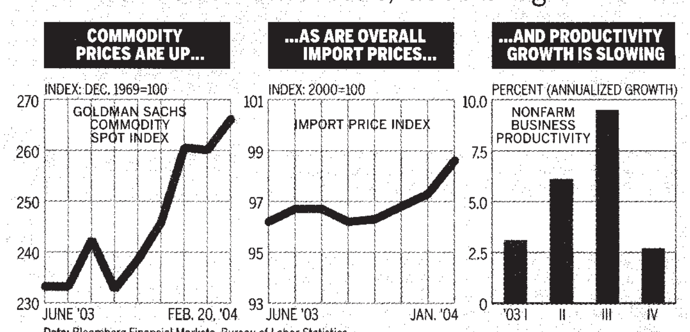
But the possibility of rising prices should not be dismissed. *As the chart shows*, our economy has periodically experienced inflationary periods. Remember the 1970s when sustained inflation produced Gerald Ford's spectacularly unsuccessful "Whip Inflation Now" campaign. The buttons are probably collectors' items now.

Beyond historical precedence, a growing number of economic forces suggest inflationary pressures may be building. First, the booming Chinese economy is fueling increased demand for basic materials. While a whole range of commodities have experienced price gains, steel has been hit perhaps the hardest. Last year China accounted for 36% of the world's consumption of steel and its growing appetite has pushed up scrap prices 35% since January alone. Tool manufacturer Black & Decker is feeling this pain as it tries to pass on most, but not all, of these price increases. As further evidence of China's growing role in world markets, bulk-shipping rates are up a staggering 350% over the last two years.

Here at home, stronger economic activity is translating into improved demand, capacity utilization and pricing power as well. In January, manufacturing plants were running at 74.6% of capacity, the highest level in more than two years. Specific industries, such as semiconductor manufacturing, are operating flat out and enjoying price gains not seen for years.

Simmering Inflation?

Chinese demand and the weak dollar are driving up prices of commodities and imports. And productivity growth, which has held down labor costs, is slackening



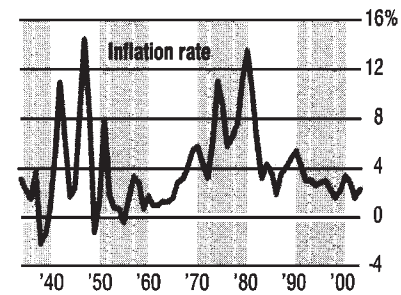
Data: Bloomberg Financial Markets, Bureau of Labor Statistics

Source: Business Week

A number of changes in the foreign currency front could also support higher inflation. Over the past two years, the dollar has fallen roughly 40% against the euro. Up until now, the weak global economy has prevented European manufacturers from raising prices to offset their currency losses. This will likely change as demand picks up. A possible revaluation of the Chinese yuan could also support higher prices. Historically, the Chinese yuan has been pegged to the U.S. dollar. If Beijing allows the yuan to appreciate relative to the dollar, as many hope, this would in effect raise prices for Chinese goods and allow other nations that compete with China to raise prices as well.

Rising prices

The New Deal nearly eliminated deflation. Since 1934, consumer prices have been rising steadily, with inflation sometimes topping 10%.



Note: Annual rate from 1934 through 2003.
Source: Bureau of Labor Statistics.
Source: Money

Finally, in all but 4 of the past 17 years, medical costs have outpaced general inflation rates. Behind these increases are rising drug development costs and new technologies and procedures. Our nation's aging population suggests these costs, which now represent 15% of gross domestic product, will only continue to increase.

A gradual increase in prices does not necessarily spell economic disaster. First, rising prices benefit borrowers who get to pay off fixed debts with ever depreciating dollars. It is also a boon to homeowners who typically see real estate values increase in times of rising prices. But prolonged or sharp price increases can spell trouble for the global economy. This is not what we see on the horizon as there is still a fair amount of unused capacity worldwide. But, a period of gradually increasing prices may be in the cards.

— Anne Williams Doremus, CFA