Thoughts from
Hanson Investment Management Inc.

VOLUME 10, NUMBER 7 **MARCH 2005**

We Don't Remember All the Words . . .

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.

BUT WE CAN HUM A FEW bars. A recent study showed that 99% of investors recognize the Dow Jones Industrial Average but only 30% have an idea of how it is figured. The Dow is by far the most quoted measure of U.S. stock prices so a tutorial is in order.

The original Dow was the brainchild of journalist Charles Dow. In 1884 the Index consisted of nine railroads and two other transportation companies, the leading companies of the day. By 1928 the Index had morphed into 30 names and this is where it has stayed. The only survivor of the original 30 is General Electric.

The Dow is price-weighted meaning the higher the price of the stock, the greater the weighting. Most indexes are capitalization-weighted, meaning you multiply the price of a stock by the number of shares to get a market value and then weight by this number. Critics say the Dow is an anachronism both because it is price-weighted and because it is only 30 stocks trying to represent an economy of over ten thousand publicly traded issues.

The fact is the Dow tracks remarkably well against other major market averages including the most accepted professional measure, the Standard & Poor 500. The 30 names in the Dow are tweaked periodically by the editors of the *Wall Street Journal* to reflect changes in the economy. The most recent change was in 2004 when AT&T, Eastman Kodak and International Paper were dropped and American International Group, Pfizer and Verizon were added.

The Dow has been around one hundred and twenty years now. It is nice in this age of products du jour such as hedge funds, derivatives and options and futures that a trusted old friend is still at it.

Current Dow Components with Weightings

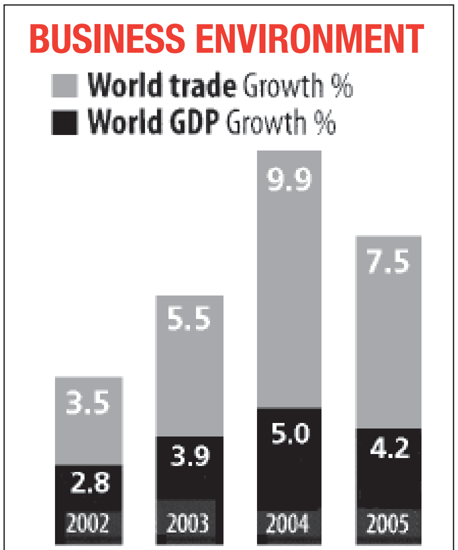
Caterpillar	6.9%	Honeywell	2.6%
United Technologies	6.8%	JP Morgan Chase	2.5%
IBM	6.1%	Verizon	2.5%
3M	5.9%	General Electric	2.4%
Johnson & Johnson	4.6%	General Motors	2.3%
Altria	4.4%	McDonalds	2.3%
AIG	4.4%	Alcoa	2.1%
Exxon	4.3%	Merck	2.1%
Boeing	3.9%	Walt Disney	2.0%
American Express	3.7%	Pfizer	1.8%
DuPont	3.6%	Microsoft	1.7%
Proctor & Gamble	3.6%	Intel	1.7%
Wal-Mart	3.5%	SBC	1.6%
Citigroup	3.3%	Hewlett Packard	1.4%
Coca-Cola	2.9%		100%
Home Depot	2.7%		

Source: Dow Jones

Emerging Markets . . .
On the Move But Difficult to Play . . .

MARC FABER IS THE HONG Kong editor of *The Gloom, Boom & Doom Report* and a long time observer of Asia. He was recently in Montreal for a speech. Marc is quite negative on the U.S. today. He thinks our markets are still very over-valued. Asia on the other hand is the long-term positive story. Here are some of his thoughts.

First, the big idea. Asia and the Indian subcontinent will be a much bigger part of the global economy in the next 25 years. Today the U.S. economy is the world's largest. We account for 20-25% of total world GDP. Tomorrow Asia might take that mantle. And yet all emerging stock markets together comprise only 5% of the world's total now. The U.S. is still over 50% of the world's stock markets. Investors need to dramatically shift their focus from slower growing developed markets to faster growing emerging ones.



Source: Economist Intelligence Unit

Where are the most attractive areas? Number one for Marc is real estate. The place to be is the outskirts of fast growing towns in China and India. Buy all the real estate you can there. (Unfortunately this is not the most practical idea for individual U.S. investors). A second theme is tourism, not the inbound variety, but the outbound. Only about 24 million Chinese travel abroad today out of a population of more than a billion. Airlines, hotels and tourist destinations catering to emerging market visitors will benefit. Right now anything with a casino is popular with the Chinese. Another theme is infrastructure or companies involved in building roads, generating electricity, supplying clean water and modernizing airports. There will be strong demand here.

A final theme is resources. Commodity prices have soared recently reflecting strong demand from China and other emerging countries. China consumes 1.7 barrels of oil per person per year. Mexico consumes 7 barrels. If China simply went to Mexico's consumption level they would consume nearly 30% of the world's total oil output. Don't expect $20 a barrel oil anytime soon.

The problem with all this is it is not easy to play. The Chinese stock market for instance is populated mostly with quasi state-owned companies with opaque financial reports and poor investor protection laws. The most frustrating thing in emerging markets is translating exciting growth into productive investment ideas. Marc agrees.

An alternative is to look in our own back yard at the multinational companies serving new markets. World trade today typically grows at twice the rate of world output. Multinationals are right in the middle of this market. General Electric recently said they expect 60% of their revenue growth the next decade to come from emerging countries compared to 20% the past decade. And GE is not the only one focusing on these exciting areas. Toyota gets 75% of its sales from outside of Japan and much of this is in emerging countries. Citigroup also earns approximately two thirds of its income outside the U.S. and at Coca-Cola it is an even higher number, over 80%.

Every investor needs a strategy to take advantage of the growth in Emerging markets. We are using a combination of closed end mutual funds (the Brazil Fund, the India Fund), ETFs or Exchange Traded Funds which are index type investments for emerging countries and individual stocks from Asia and South America which trade here as American Depository Receipts (ADRs). We will tweak this as new attractive investments come along. And don't forget U.S and European multinationals. They will benefit more than many assume.

MSCI All-Country Stock Market Weights December 31, 2003

United States – 52%

U.K. – 10%

Japan – 9%

France – 5%

Germany 5%

Emerging Markets 5%	
Korea	0.83%
South Africa	0.62%
Taiwan	0.55%
Brazil	0.42%
China	0.36%
Mexico	0.29%
India	0.26%
Russia	0.22%
Malaysia	0.21%
Israel	0.15%
Thailand	0.15%
Chile	0.09%
Turkey	0.07%
Indonesia	0.07%
Poland	0.06%
Hungary	0.05%
Argentina	0.03%
Peru	0.03%
Czech Republic	0.02%
Philippines	0.02%
Egypt	0.01%
Morocco	0.01%
Pakistan	0.01%
Jordan	0.01%
Venezuela	0.01%
Columbia	0.00%

Source: Fisher Investments, Marc Faber Ltd.

The U.S. Market . . .
The Pendulum Swings . . .

THIS MONTH MARKS THE fifth anniversary of the peak of the NASDAQ Composite on March 10, 2000 at 5,048. The Index is still down nearly 60% and don't bet on it getting back to its former high anytime soon. The blow off in stock prices in the late 1990's will probably go down as the biggest market hysteria of our lifetime. Certainly nothing like this has happened in my thirty plus years in the business.

The chart to the upper right shows how far the High Tech "New Paradigm" went. In March 2000 Cisco was the most valuable stock in the world at $550 billion. The price to earnings ratio was an eye-popping 213. You could have bought twenty-five old-line American companies lock, stock and barrel for the price of this one networking company. Amazing.

Today Exxon has become the new most valuable company and Cisco barely makes the top twenty. But the market is like a big pendulum swinging continuously from overvalued to undervalued and back. It is not a straight line and it takes varying amounts of time but almost always what goes around does indeed come around. Cisco was the poster child for the excesses of the 1990's. Today lo and behold Cisco is being talked up as an overlooked gem, rich in value and low in valuation. Who would have thought it?

The company still dominates the networking and router business with a worldwide market share of close to 70%. And there are new markets where its products are well positioned. This includes Voice over Internet Protocol (VoIP) the fancy new procedure for transmitting phone calls over the Internet and avoiding all those high cost landlines. Cisco is a supplier of equipment in this new area. The stock's PE is 18X about the same as Microsoft and Intel and very close to the market's average.

We are not touting Cisco here, we don't yet own the stock but we are looking. The purpose of this is to highlight how the market is constantly moving back and forth between extreme popularity and extreme disregard and how investors would do well to pay attention when prices get to the disregard level. *The chart in the lower left* looks at mutual funds that are losing the most investors versus those that are gaining the most. Today the hot funds are in the commodity area and energy and foreign bonds. But the record shows that immediately after getting all this new money, funds underperform those that just lost the most investors. How come?

Because by definition popularity means high prices and high prices is not where you look for out performance. What you want are areas and stocks where the stuffing has been kicked out, where the expectations are low and where the only investors involved are the true believers. Then the only surprise that will affect prices is a positive surprise and this will start the process of bringing back the trend followers. It all sounds pretty easy – buy the unpopular – but it is not. No one knows how long the unloved will stay unloved or how high the popular ideas will rise before turning down (think Cisco in the 1990s).

Which categories today are experiencing the most withdrawals and could be a prime candidates for out-performance? According to Morningstar the most unloved include utilities, financials and you guessed it, technology. In this business it pays to lean against the breeze, to buy when others are selling and to be ultra suspicious when everyone is jumping in. And it even pays to look at Cisco today.

THE NEW ECONOMY

3/23/00 Market

Company	Ticker	Cap ($B)
Cisco	CSCO	550
Total		**550.00**
Price/Sales		**36.00**
Price/Earnings		**213.00**

THE OLD ECONOMY

3/23/00 Market

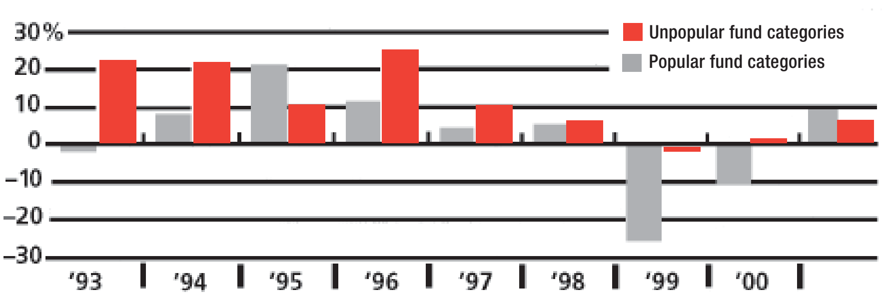
Company	Ticker	Cap ($B)
Ford	F	53.75
Texaco	TX	27.70
Merrill Lynch	MER	39.56
DuPont	DD	57.36
Aetna	AET	8.24
International Paper	IP	16.08
Sara Lee	SLE	16.42
Raytheon-Class B	RTN.B	6.34
Caterpillar	CAT	14.19
AMR	AMR	4.71
FedEx	FDX	11.53
Minnesota Mining & Mfg	MMM	35.03
McDonald's	MCD	47.64
Archer-Daniels-Midland	ADM	6.52
Goodyear Tire & Rubber	GT	3.67
Morgan (JP)	JPM	23.80
Anheuser-Busch	BUD	28.14
Lilly	LLY	70.20
Staples	SPLS	9.74
Fox Entertainment	FOX	18.74
Consolidated Edison	ED	7.02
Apple Computer	AAPL	22.73
Maytag	MYG	2.66
Hilton Hotels	HLT	2.81
Dow Jones	DJ	6.66
Total		**541.24**
Price/Sales		**1.01**
Price/Earnings		**14.82**

Source: Ned Davis Research

Source: Morgan Stanley Dean Witter

Against the grain

Stock-fund categories with the highest annual investment outflows* tend to outperform categories with the highest inflows over the subsequent three years.



*as a percentage of total assets

Source: Morningstar

Industry Trends . . .

Words of Wisdom from Warren ...

EVERY YEAR INVESTORS eagerly await the release of Warren Buffett's annual letter to shareholders. In this report, Buffett spells out how his firm, insurance and investment company, Berkshire Hathaway, performed last year. But the real draw of the document is his insightful and down-to-earth observations on the state of the investing world.

I figure anyone who has made an estimated $30 billion largely through solid, long-term investing is probably worth listening to. I am not alone on this. In late April, approximately 19,500 Berkshire Hathaway shareholders will show up in Omaha to be indoctrinated into the "Buffett Way." While I don't plan on attending, I did read his annual report to better understand this man's incredible record of success.

My first observation is that Buffett is an exceptional manager. Berkshire Hathaway owns over twenty businesses spread across a wide range of sectors. But despite this diversity, he has a unique ability to understand the fundamental economics of each business without getting bogged down in the details. This clear understanding of what matters allows him to take a very disciplined management approach. He knows what matters (profitability, not market share, for example) and is willing to suffer short-term setbacks to achieve long-term ends.

Importantly, he also knows how to identify like-minded managers and is not afraid to then let them "run-the-ship." He asks each of these managers to run their business as if "...it was the only asset your family will own over the next 100 years." Many managers are former owners of businesses Berkshire Hathaway has bought and he has obviously made it worth their while to stick around.

Finally, Buffett sets realistic expectations. He understands that above average returns can only be achieved by taking on greater risk and he favors satisfactory returns over the long-haul. As has often been noted, he only buys what he understands and prefers "..stories with a simple proposition." If he doesn't understand it, he doesn't buy it.

But much of Berkshire Hathaway's success has come from its stellar investment record as well. Over the last 25 years, the investment portfolio of Berkshire's insurance subsidiary GEICO earned a 20.3% average annual return. Over the same time period, the S&P 500 gained 13.5% annually. These superior results have come from investing in large, somewhat boring stocks. Consider that American Express, Coca-Cola, Gillette and Wells Fargo have long been the firm's four biggest investments. So what is his take on the market now?

Buffett sees few bargains in the stock market today. Because of his dedication to not overpaying, Berkshire's cash balance has built up to a record $43 billion. The current high level of market valuations also supports his belief that future stock market returns will be lower than those seen historically.

But Buffett continues to see opportunity to make money in the currency markets. Two years ago, Buffett made headlines by investing in foreign exchange contracts. In essence, these investments were a bet that the dollar would fall in value relative to a basket of foreign currencies. Last year Berkshire made over $1.8 billion on these contracts. Buffett is sticking to this strategy because he believes that deep-rooted, structural problems will cause America to continue to run huge trade deficits and these will depress the dollar further.

Finally, if you are still wondering whether or not to listen to this old guy from Nebraska, consider the following. In his 1993 annual letter to shareholders, Buffett criticized Corporate America's practice of issuing vast amounts of stock options without recording the compensation as an expense. His reasoning here was simple. "If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go?" After more than a decade of debate and fierce opposition, option expensing is now scheduled to become mandatory on June 15th.

—Anne Williams Doremus, CFA

Source: *The New Yorker*