

Thoughts from

# Hanson Investment Management Inc.

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## A Major Shift in the Wind? . . .



**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.**

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**W**E MAY BE AT THE END of a wonderful era today. In 1979 Paul Volker was named Chairman of the Fed and in the early 1980's he broke the back of inflation by pushing short term interest rates to ultra high levels. Since then we have been in a period of declining interest rates both short and long. This has spurred a long economic advance with only mild recessions. It also fueled one of the great Bull Markets ever in stocks. Remember, in 1982 the Dow Jones was under 800! Yes, that's right, 800.

*The chart here from the Fall of 2005* shows that short term interest rates in the U.S. bottomed in 2004 and have been rising continuously. Rates also look like they have bottomed worldwide. We may be at the end of the line for easy money in this cycle. The Bank of Japan recently announced that it was abandoning its "super-easy" monetary policy and it wouldn't surprise me if rates rise in Europe as well.

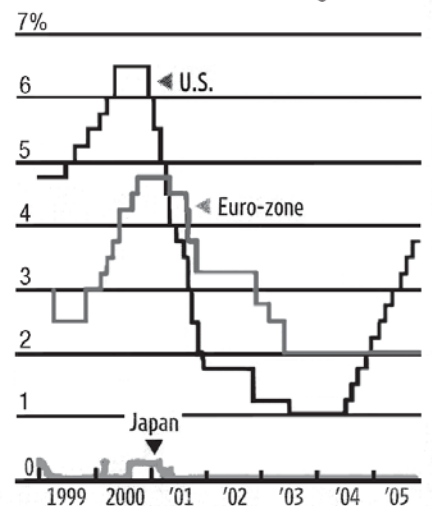
The big question now is, how will this affect economic growth and world markets? Typically rising rates slow economic growth and also put pressure on corporate profits and accordingly on investment markets.

The good news is, rising rates have not affected things adversely so far. Globalization may have changed many of the past assumptions. Rising rates often imply rising inflation. But today as Stephen Roach the global economist at Morgan Stanley notes, the internet and globalization are holding inflation down, regardless of what interest rates do. Today 25% of world GDP is accounted for by trade and this percentage is growing. The intense price pressure of trade has kept prices tightly in check. And the price pressure in trade is rapidly moving from manufacturing to the even bigger market of services. So even though we are in the midst of the strongest four year spurt in growth since the early 1970s, inflation is only modest worldwide.

Robert Samuleson, the columnist in *Newsweek*, notes that the central legacy of Alan Greenspan at the Fed will be that he suppressed inflation expectations. People don't expect inflation anymore so they don't act accordingly. This is an important inflation dampener. Our take is rising short term rates is a good sign today not a bad one. It indicates central banks are confident enough in global growth that they think the system can take a strong dose of medicine without collapsing. We don't think rising rates by themselves will threaten either the global advance or global investment markets.

### Shifting Views

After a period of very low interest rates, central banks are raising them, or preparing to. Central-bank interest rate targets:



Source: Thomson Datastream

Source: Wall Street Journal

# A Good Read . . . Putting Things in Perspective . . .

ON A FULL FLIGHT BACK from Europe in coach it is important to first, stay as relaxed as you possibly can (which is not very) and second, bring along plenty of reading material. This past trip I brought Jeremy Siegel's new book and it turns out to be gem. Siegel is certainly not an unknown. Back in 1994 he wrote the popular, *Stocks For The Long Run* in which he argued that over the long term stocks are a far better bet than bonds or short term investments and they need to be at the core of every investor's portfolio. In this

Index (see total descendants portfolio in the chart below on the left of this page).

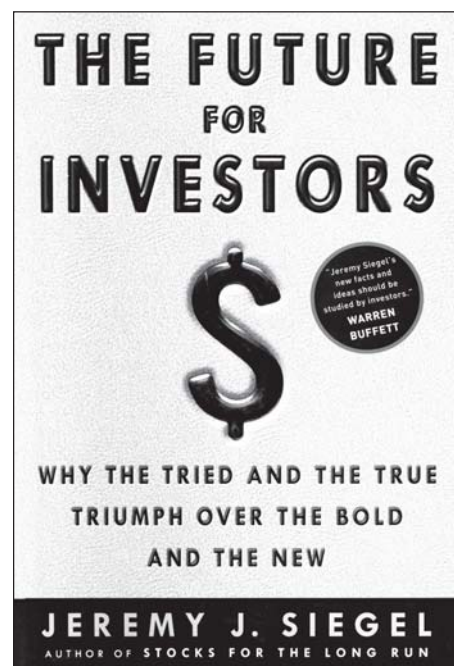
Since 1957 there have been over 900 changes to the S&P 500. The S&P adds "leading companies in leading industries of the economy" and deletes those it considers less important. How can a portfolio that includes none of the new fast growing companies do so well? The answer is that all those new companies come with a price tag. The shares already reflect the expected good results. The key to investing for Siegel (and for us here) is to buy good quality companies

but only when they are cheap, when expectations are low and valuations are modest.

It's amazing that this works so well. Three of the biggest sectors of the S&P 500 today are finance, healthcare and technology. They make up one half of the overall value of the index. Back in 1957 these three sectors were

virtually non-existent in the S&P. There were no banks at all in the original 500. So you could have missed all three of these exciting, growing sectors and still your return would have been greater than the constantly rejiggered index. Wow.

Now you might think, I am just going to be an investment Luddite and avoid anything new and hold only the old. Wrong. You don't want a portfolio of



buggy whips, slide rules and vacuum tubes. What Siegel argues is, buy the new but just be very careful you don't pay too much for it. Take a look at the chart at the top of page 3. If you simply avoid the highest price to earnings ratio stocks and buy the lowest you consistently outperform the S&P 500.

The question that goes begging here, is if this all there is, why don't more people do it and beat the market? Warren Buffett supplies the answer, "I have seen no trend toward value invest-

**TABLE 2.2: PERFORMANCE OF ORIGINAL S&P 500 PORTFOLIOS AND INDEX**

Portfolio	Accumulation Based on \$1,000 Invested	Annual Return	Risk
Survivors Portfolio	\$151,261	11.31%	15.72%
Direct Descendants	\$153,799	11.35%	15.93%
Total Descendants	\$157,029	11.40%	16.08%
S&P 500	\$124,522	10.85%	17.02%

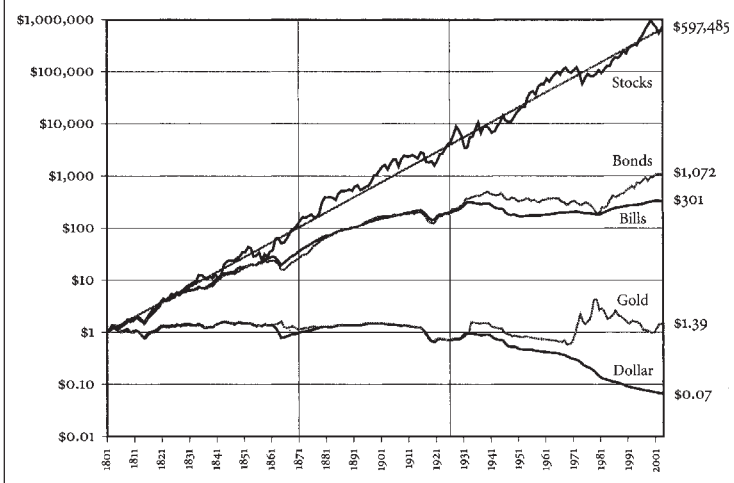
*The shares of the original S&P 500 firms have, on average, outperformed the nearly 1,000 new firms that have been added to the index over the subsequent half century.*

new book the Wharton School economist sets out to answer two questions:

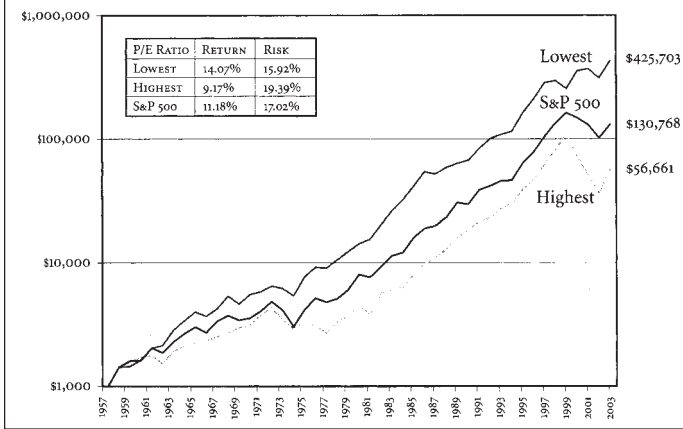
1. If stocks are such a good investment then which stocks should I buy?
2. What happens when the Baby Boomers retire and want to sell off all their stock? Won't the market collapse?

Investors are always worried about missing the next big thing on Wall Street. Siegel has reassuring advice here – don't worry. What if you had bought the original 500 stocks in the Standard & Poor 500 when it was first introduced in 1957 and then done nothing. You would continue to hold all the spin offs and you would continue to hold all the new shares of merged companies. How would you have done? The answer is you would have earned a return higher than if you had followed the constantly revised S&P

**FIGURE 12.1: TOTAL REAL RETURN INDEXES 1802–2003**



**FIGURE 3.1: CUMULATIVE RETURNS TO S&P 500, SORTED BY P/E RATIOS (SOURCE: COMPUSTAT®)**



says the most important single graph he has done on investments is the one at the bottom of page 2. It shows that the real rate of return for stocks for long periods of time has averaged 6½ % to 7% per year. No matter whether you look at the early part of the period say 1802 to 1870 or the middle

much more we will age by 2050. The developing world on the other hand still has a powerful youthful profile.

If growth continues in China, India and other countries at 5% to 10% per year, consumption and income will increase dramatically. Siegel thinks these Emerging market investors will be able and willing to buy our assets (stocks and real estate) if we decide to sell. Of course this raises the thorny issue, do we mind eating our seed corn so to speak, selling our assets to keep our retirements in place. Britain has been doing this for 100 years now and we could also. I am not sure we have to settle for this however. Our economy is growing now, productivity is strong and we continue to increase our real standard of living. I don't see any reason we can't continue to. Equity markets do not have to succumb to the aging Baby Boomers. We will either sell to the next generation or if Siegel is right, to Emerging Market buyers. In any case I do not see demographics as the biggest hurdle for equity markets.

I put Siegel's book right up there with Burton Malkiel's *Random Walk Down Wall Street* as a Classic for individual investors. Both authors are academics but we will forgive them. They write rigorously but also very readably, and they take all of the buzz words out of the equation. This is a great addition to any library.

All the charts shown on these pages are from *The Future for Investors*, by Jeremy J. Siegel.

ing in the 35 years I have practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult." It is not that the logic of this strategy is that difficult it is our emotions get in the way. There is no excitement to buying the down and out. But there is great excitement to buying Google at \$360 even if it is at 70 plus times earnings. Everyone knows search is the name of the game in the Internet today and Google is, and will continue to be, the King of Search. Enough said. Buy the stock. But for Siegel this is not the road to riches. It is simply the road to below average results.

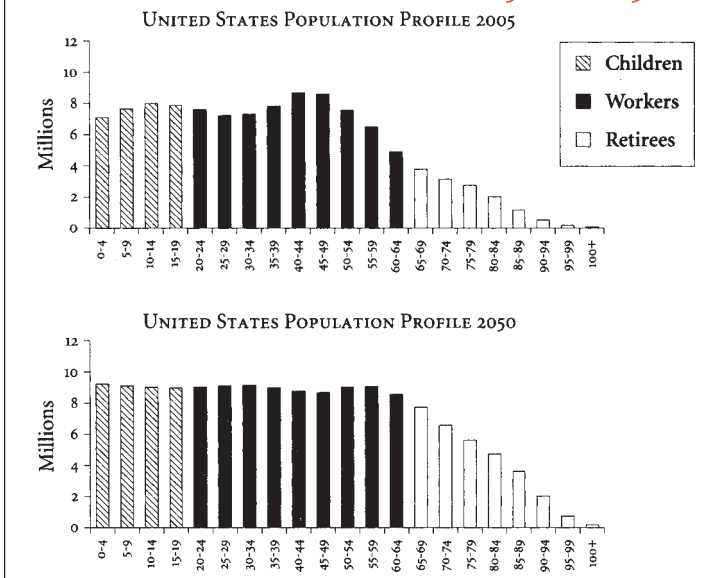
Investors are very nervous today. There are mega problems on the horizon: the twin deficits, outsourcing, higher interest rates, nuclear proliferation, terrorism. You can add your five. The temptation is to just get out of the market and sit on the sidelines. Siegel

1926, the return has been very consistent, 6½% to 7% per year. Going forward many pundits worry that returns will be less than this. They could be right, but my advice is don't lose sight of the long term. A chart like Siegel's implies that positive high returns are stable and likely to stay that way.

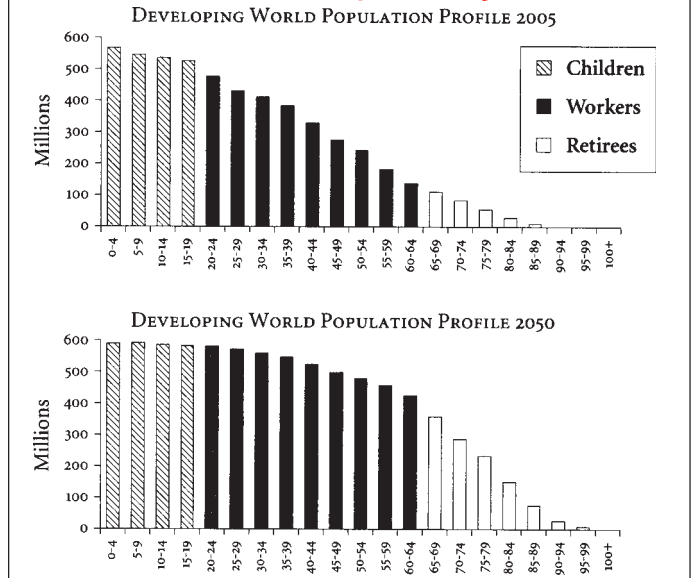
The first of the Baby Boomers turn 60 this year. Will we become more conservative with our investments and move from stocks to bonds? And if we do, who are we going to sell to?

There are many uncertain things in the world today but demographics is not one of them. We know what the demographics look like today (see charts below) and we have a pretty good idea of what demographics will look like in 2050. Birth rates will change somewhat and immigration rates will also as will death rates. But still we know the U.S. is aging today and we know about how

**FIGURE 13.2: POPULATION PROFILE FOR THE UNITED STATES IN 2005 AND 2050**



**FIGURE 15.1: DEVELOPING WORLD POPULATION PROFILE 2005 AND 2050**



# Investment Trends . . .

## The State of Manufacturing Today . . .

I JUST RETURNED FROM attending Citigroup's 19<sup>th</sup> Annual Global Industrial Manufacturing Conference in New York. At this event, CEOs from almost 100 different firms discussed their company's future growth prospects. These events always provide great insights and this one proved no exception. Here are some of my observations on the state of global manufacturing today.

### American Manufacturing: Going But Not Gone

I was surprised to hear many firms comment on their plans to maintain some manufacturing presence here in the U.S. The rationale for doing this is pretty straightforward. First, the U.S. is still a big consumer of industrial machinery and in many cases, the advantages of manufacturing close to your customer can still outweigh the labor savings achieved abroad. Second, many manufacturers have responded to the labor cost disadvantage by replacing workers with highly automated processes. Using advanced robotics, for example, allows American Axle to avoid high priced union labor, boost efficiency and improve quality.

### Emerging Markets: Go Where the Growth Is

Emerging markets offer great opportunities for many manufacturers. True, much of the world's most sophisticated equipment can be found outside our borders. But, until now, a lack of funding has kept many countries from upgrading antiquated production techniques. Joy Global, a manufacturer of mining equipment, is seeing strong demand from China as they upgrade mining processes and Agco, which makes Massey Ferguson tractors, is positioning itself to take advantage of strong Eastern European demand.

Staying competitive today also means developing a global manufacturing "footprint." Having production facilities around the globe allows firms to maintain a low cost basis while tailoring

design and production to their clients' unique needs. Many heavily unionized manufacturers are also using this diverse capability as leverage to negotiate more competitive "second tier" labor contracts here at home.

### Mergers & Acquisitions: The Game Continues

Accessing global markets sounds like a great idea but can be quite difficult in practice. Entering new markets takes time and money that smaller firms can often ill afford. The challenge of "going global" is driving a good deal of acquisition activity today. Several smaller water filtration companies, for example, have been bought up over the last year by larger international firms interested in capitalizing on the growing global demand for clean water. Consolidation will continue to change the competitive landscape in many manufacturing sectors going forward.

### 19th Annual Global Industrial Manufacturing Conference



### Operating Efficiency: More is Not Enough

"Continuous re-engineering", "lean manufacturing" and "Six Sigma" have become the watch words of the manufacturing world today. These terms all refer to the process of continuously taking costs out of your product. Outsourcing functions to lower cost countries remains an important part of this overall process. For many manufacturers, this means shipping low skilled jobs offshore while maintaining higher skilled design and marketing jobs here at home. Successful firms no longer focus on keeping jobs at home, but instead look at how best to leverage their global pool of talent.

### Margin Squeeze: Are We Done Yet?

Strong global demand drove big increases in many raw material costs last year. But thanks to strong end markets,

### Who's No. 1?

The World Economic Forum's competitive index, based on economic indicators and surveys of executives:

1 Finland	9 Norway
2 USA	10 Australia
3 Sweden	11 Netherlands
4 Denmark	12 Japan
5 Taiwan	13 United Kingdom
6 Singapore	14 Canada
7 Iceland	15 Germany
8 Switzerland	

Source: Wall Street Journal

most manufacturers have been able to pass through these higher costs in the way of price increases. Most companies I spoke with see raw material prices moderating this year and their margins, as a result, stabilizing.

### One Group, Many Sectors

As the chart at the top of the page shows, my assessment is that U.S. manufacturers are doing fairly well today. Most are staying flexible and adapting to the rapidly changing global economy. This means keeping costs down, while focusing on meeting customers' needs through product innovation and superior service. But it is important to keep in mind that manufacturers are a diverse group and each sector has its own unique supply and demand conditions. Companies manufacturing equipment for the energy and defense industries, for example, have had an unbelievably strong 2-3 years and their share prices generally reflect these positive conditions. The stocks of auto parts suppliers, particularly those with heavy exposure to GM, Ford and Chrysler, are priced as if they are going out of business. As always, our approach is to carefully evaluate these industry dynamics and identify companies with strong competitive positions and capable management teams whose stock prices are low relative to the earnings and asset values.

— Anne Williams Doremus, CFA