Thoughts from
Hanson Investment Management Inc.

VOLUME 6, NUMBER 7 MARCH 2001

431 Pine Street
P.O. Box 819
Burlington, VT 05402
U.S.A.

Phone: 802-658-2668
Fax: 802-658-1027
E-mail: ehanson@juno.com

You May Have Noticed Some Changes . . .

WE ARE VERY FORTUNATE to have an excellent team here. We have worked together now for many years. In December however we had our first change. Marykay McCarthy has been the office manager since we started in 1995 and I have worked with her for a total of ten years. Her first grandchild was born in the fall and Marykay decided to move to Tucson to be closer to her family. She did a wonderful job here and we will miss her greatly.

Fortunately we were able to find an excellent replacement. Debbie Lalumiere has worked in financial services for a number of years, most recently with the Mutual Fund Strategist in Charlotte and the Geonomics Institute in Middlebury. Debbie will be taking over Marykay's function as office manager. Debbie graduated from Saint Michael's College and comes in most mornings by train from West Ferrisburgh where she lives with her husband and two children.

Kristen Audy has done just about everything here in the office since joining us four years ago. She will be assisting Debbie. Kristen's time is well spoken for. Her son Matthew is in the third grade at St. Joseph's School.

And Anne Doremus, who I have worked with for ten years, continues as chief cook and bottle washer. She does investment analysis, portfolio management and client reviews. Anne is very active in the financial management field. She is the incoming President this year of the Vermont Security Analysts Society. Anne lives in Jericho with her husband Greg and two sons, Jeff and Ted.

Back Row: Debbie Lalumiere, Kristen Audy. Front Row: 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.

©2001 Hanson Investment Management

The Global Scene . . .
Big Story . . . No Press

THE *NEW YORK TIMES SUNDAY BUSINESS* section ran a story on February 4 on global investing. The gist is don't bother with foreign stocks. This is pretty strong stuff since 50% of all stocks in the world trade outside the U.S.

The idea in investing is you try to produce the biggest return with the least possible risk. You want your cake and eat it too. One way to do this has been to add foreign stocks to a U.S. portfolio. Foreign markets often zig when we zag so when U.S. stocks are going down foreign ones are holding their own. Blending stocks of a number of different countries together lowers risk without sacrificing return.

But a problem has developed. Foreign markets have started moving more in unison. In 1993 the correlation between the U.S. and rest of the developed world was a low .145. A correlation of 1.0 means markets move in perfect sync and a correlation of 0 means there is no rhyme or reason to the movement. You are looking for movements close to zero.

By 2000 the correlation between the U.S. and other developed markets had risen to .787. The same increase is happening in Emerging markets. Why the convergence? For one thing capital moves much more freely today and investors are taking advantage of opportunities in many different global markets. But investors everywhere are looking at the same information so when consumer confidence drops in New York you feel the affect in Sao Paulo and London.

So what is an investor to do? Merrill Lynch decided to lower its recommended allocation to foreign stocks in individual investor portfolios from 35% to 5%. A pretty dramatic reduction. Other brokerages are also cutting recommended allocations *(see chart).*

So is this the end of global investing? Hardly. What seems to be happening is some investors are shifting their focus from country investing to industry investing. Research shows that when the semiconductor stocks move, a company like Intel goes up and so does Taiwan Semiconductor in Taiwan, STMicroelectronics in France and Chartered Semiconductor in Singapore. There is strong correlation between global companies in the same industry but little correlation between one industry and another. So instead of blending different countries together in a portfolio, portfolio managers are blending different global industries. A new twist on the old game of diversification if you will but this time on a global scale rather than a national one.

I still like to think that as markets such as China, Brazil and India develop, export focused companies may indeed trade more in line with their global counterparts but domestic focused companies (utilities, retailers, banks) will march to their own drum and trade differently from New York and other global centers. So I think there is still a place for country investing. But in the meantime the only developed market that marches to its own drum today and trades at its own pace is. . . Japan. More on this on page three.

Allocations Abroad

Recommended investment range in foreign stocks in the overall portfolio, including bonds, of an American investor.

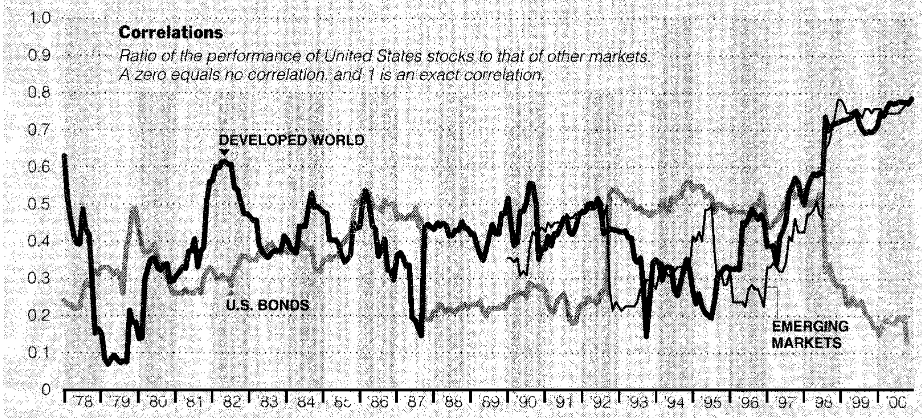
Goldman, Sachs	15% to 20%
J. P. Morgan	10% to 15%
Lehman Brothers	About 12%
Merrill Lynch	0% to 10%
Morgan Stanley Dean Witter	25% to 35%
United States Trust Company	8% to 11%
Wells Capital Management	About 15%

Sources: The companies

Source: The New York Times

A Different World

The correlation between American and foreign stock markets has risen sharply recently. This tendency to move in the same direction reduces the benefit of diversifying a portfolio into foreign stocks, even in emerging markets. The American bond market, however, is now far less correlated with American stocks, making it a better choice for diversification.



DEVELOPED WORLD Standard & Poor's 500 and the 400 biggest Nasdaq stocks vs. developed foreign stock markets; monthly data calculated on a three-year rolling basis.

EMERGING MARKETS Morgan Stanley Capital International's U.S. index vs. S.&P.'s Emerging Market Database; monthly data calculated on a five-year rolling basis.

U.S. BONDS M.S.C.I.'s U.S. index vs. Lehman Brothers aggregate bond index; monthly data on a five-year rolling basis.

Sources: Ibbotson Associates; Merrill Lynch

Source: The New York Times

The Scene in Asia . . .

What Are We To Do With The World's Second Largest Economy ?

IF THERE IS ANY CONSENSUS TODAY, it is that Japan is a mess. The economy has been reeling for a decade after the Nikkei stock average hit nearly 40,000 in 1990 *(see chart below)*. We talked up the Japanese market just before the jump in the Nikkei in May 1998 but the gain was short lived and we have now given back nearly all of the advance.

Consumer confidence is at rock bottom and no matter what the government does, lower interest rates, increase spending, whatever, the economy goes nowhere. And at the same time companies are very leveraged and the banks are loaded with bad loans. It isn't a pretty picture.

But as an investor, I think Japan has merit today. It is by far the cheapest developed equity market in the world now. Barton Biggs of Morgan Stanley Dean Witter says the Japanese market as a whole is at only a 35% premium to replacement book value. The U.S. even after its correction is at a 150% premium. As Mr. Biggs points out, the news from Japan doesn't have to turn good for stocks to rise, the news just has to be less bad than what is expected. And the expectations for the Japanese market now are zilch. The next surprise in Japan could be a good surprise.

Why? Because there are some fundamental changes going on now. Historically the individual has not amounted to much in Japan. The nail that sticks up gets pounded down. Faceless bureaucrats have tremendous power and well entrenched political parties are scared to take on any risks. Companies have offered lifetime employment in exchange for docile workers who won't make trouble. All this is starting to change.

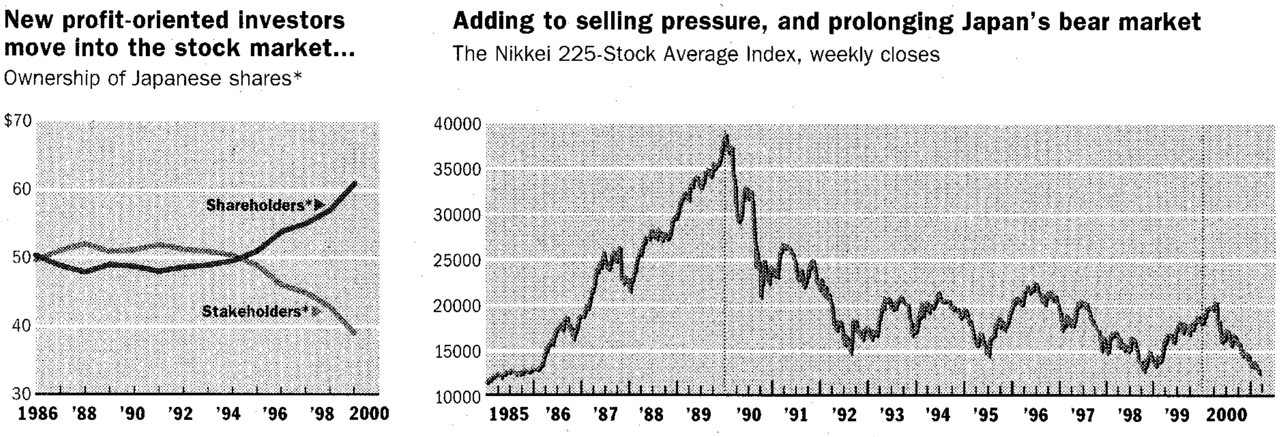
Lifetime employment is slowly going away as the economy worsens and the *International Herald Tribune* recently ran a story saying that a number of prefectures or municipalities in Japan are electing dissident governors who are saying no to the bureaucracy in Tokyo. They are nixing expensive infrastructure projects that will burden local areas with high taxes for years.

And individuals are starting to be more independent. The *Asia Wall Street Journal* reported that 2000 people last year took the qualifying exam to become U.S.-certified public accountants, up from 20 in 1994. Individuals are learning that their own skills are more important than the security of a big company and the promise of lifetime employment. Two years ago Matsushita Electric gave its employees the option of taking retirement benefits while still on the job rather than as a lump sum at 65. This works out better for employees who don't expect to stay their entire career at one company. More than 40% of new hires chose the current payment option, far exceeding what Matsushita expected.

Finally the severity of the crisis is bringing changes. Financial reforms enacted the past few years are forcing banks to finally mark bad loans to market and dump cross-share holdings *(see chart)*. This frees up capital for more rational investments.

The Japan market could be the big surprise of the next five years. The country is still world class in many technologies and manufacturing processes; it has enormous savings and a modern infrastructure. And the added kicker is their market is not highly correlated to ours. So if we go into a period of soft returns, the Japanese could just march to their own drum and that may mean higher stock prices.

The Unraveling of Japan Inc.



New profit-oriented investors move into the stock market...

Ownership of Japanese shares*

Adding to selling pressure, and prolonging Japan's bear market

The Nikkei 225-Stock Average Index, weekly closes

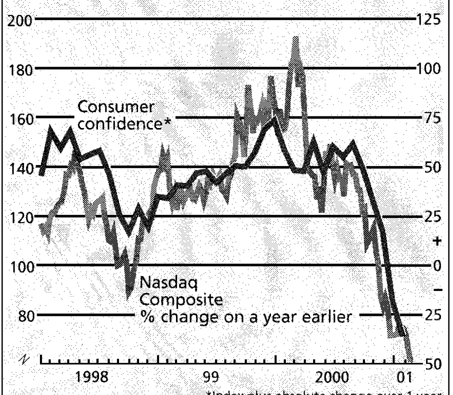
*Based on value of shares held in the FT-S&P Japan Index. Stakeholders hold shares for strategic reasons, rather than investment reasons; they are typically banks, insurers and corporations. Shareholders include individuals, pension funds, investment trusts and foreigners.

Source: The Wall Street Journal

The U.S. Scene . . .

Are We Talking Our Way into Recession Now? . . .

Stocks of confidence?



*Index plus absolute change over 1 year

Source: Thomson Financial Datastream

Source: The Economist

THE NUMBERS SHOW we are in a downturn. It may be a recession or it may be something less severe. Usually recessions are caused by excess demand that leads to high inflation. The Fed then steps in, puts on the brakes and raises interest rates. The resulting slowdown often overshoots and we end up in a full-scale decline.

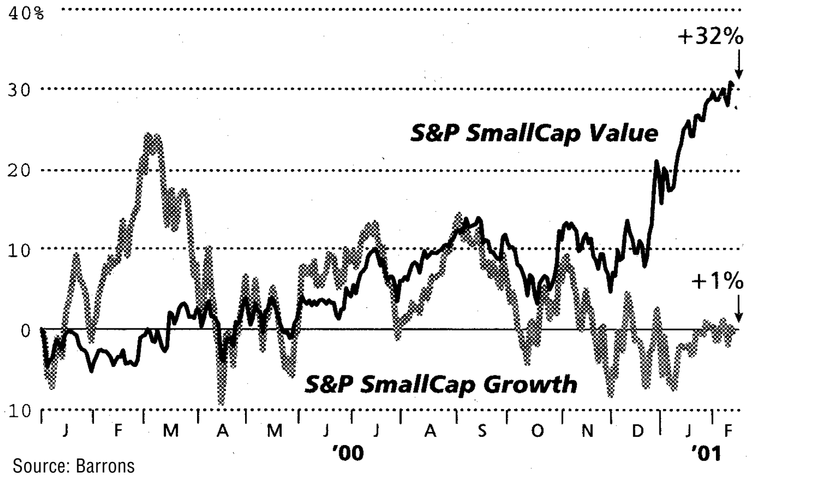
This time the lead-in is different. We haven't seen high inflation. What we have seen is a blow-off on the supply side. Cheap money, venture capital and the excitement of fast growing technologies have led to a boom in investment spending. We overspent and businesses are now cutting back rapidly on both employees and inventory to get rid of the excesses. This is scaring everyone.

The real key now is the consumer. If the consumer stops buying out of fear of job losses and a weakening economy, then we are in for real trouble. Remember consumer spending makes up nearly three quarters of the economy. Take a look at the chart in the upper right. As consumer confidence has come down so has the stock market. Or maybe it's the reverse, as the stock market has come down so has consumer confidence. In any case the consumer is in a fragile condition now. Last year saving turned negative for the first time since the 1930s and total consumer debt climbed to record levels in relation to income. So if the consumer now feels less wealthy after the stock market has given up $3.5 trillion in value, then the spending spigot could get turned off and we could see a full-scale collapse.

What's our thinking on this? We feel we are somewhere between economic slowdown and a recession. You don't need to call it any closer than this. If the consumer stays the course, then trimming excess inventory and cutting expenses won't take that long or be that severe. Only if the consumer heads for the hills are we worried. And so far this hasn't happened.

The extreme stock market weakness the past 12 months has been limited to one sector — technology. The NASDAQ Composite is down nearly 60% from its March 2000 high. The rest of the market has held up well on balance. Take a look at the chart at the bottom. Value stocks defined as those with lower price-to-earnings ratios and lower price-to-book value ratios have done well. They had the advantage of starting out at relatively low levels. They didn't get bid up to astronomic levels in 1998 and 1999 so didn't have as far to come down. And they also had real earnings and real sales. The Standard & Poor Small Cap Value Index has a price-to-earnings ratio today of 12 compared to the Small Cap Growth Index of 23. Large cap stocks follow the same story — that is, large cap value stocks have lower valuations and have done better than the large cap growth stocks.

SMALL VALUE TROUNCES GROWTH



Source: Barrons

This is the first Bear Market many investors have seen. We haven't had a 20% decline since 1990 and you have to go all the way back to the 1970s to find any mega-Bear Market lasting five years or more. So people are scared because this is so new.

But for us this is simply part of the cycle. We had an extra long recovery in the 1990s and now we are in the contraction phase. This has happened before and will happen again. The one thing we know is Bear markets give us plenty of solid companies at attractive prices. Of course you don't know it at the time because fear grips everyone and the last thing you are looking for is something to buy. We try to take as much emotion as we can out of the equation and if you do this you realize you don't have to run and hide in a Bear market. You simply take advantage of the good things it brings — like cheap stocks.