

Thoughts from

# Hanson Investment Management Inc.

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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.**

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## All power to the people ...

**A**S RECENTLY AS TEN YEARS AGO if you uncovered an interesting stock idea and wanted to find out more, you had some real legwork ahead of you. First you located the annual report and then you called the Chief Financial Officer or CEO and hoped they would call you back to fill in the details. Sometimes they would and sometimes they wouldn't.

One of the wonderful developments the past decade is the emergence of the conference call. These group calls take place right after the release of quarterly earnings. They usually last an hour and include details of the last quarter and then thirty or forty minutes of questions. Originally the calls were quite restricted. Wall Street analysts and large institutional investors were welcome, but the press and individual investors were excluded.

Now things have changed. A recent conference call of AOL-Time Warner drew 1300 participants. The *Financial Times* reported that in 1998 only about one quarter of companies opened their calls to individuals. By the spring of 1999 the number was 84%. And companies are beginning to post conference calls on their web sites. You can listen in live or wait until the evening and listen to the replay or transcript.

Conference calls are particularly good for the questions. You can find out quickly what Wall Street is worried about and the areas where management is particularly sensitive.

SEC Regulation FD ("Fair Disclosure") has influenced the growth of conference calls. Reg FD forbids public companies from giving "material information" to securities analysts before disseminating it to the public. A public conference call avoids all these problems. The real winners in the conference call growth are smaller money managers and individual investors who now have access to the same playing field as Fidelity and JP Morgan. And at a very cheap price.

### Listening in



#### Most popular company conference calls

Cisco Systems

AOL-Time Warner

Microsoft

Intel

Dell Computer

Lucent Technologies

Oracle

Sun Microsystems

Yahoo!

EMC

Graphic by Graham Lever

Source: Financial Times

# Economics 101 . . .

## A trade surplus is good and a trade deficit is bad . . . Right? . . .

**T**HAT'S WHAT OUR GUT tells us. Trade deficits imply weakness. You are not able to produce the best product at the cheapest price, so you import it and on the other side, no one wants to buy what you produce.

The pessimists say that when you run a trade deficit of \$1 billion a day (yes that's what ours is now!) foreigners have to take our dollars and stash them in banks and other investments. Eventually they lose confidence in the dollar and start dumping it. Then watch out for the drop in the currency.

Well there is another side to this coin. IBM, Caterpillar and General Electric export a lot today, but they also manufacture in foreign countries and they do a lot of it. Foreign-affiliate sales, that is what U.S. corporations produce abroad, totaled \$2.4 trillion in 1998, the latest year figures are available. This is almost 3X the \$933 billion of goods we exported.

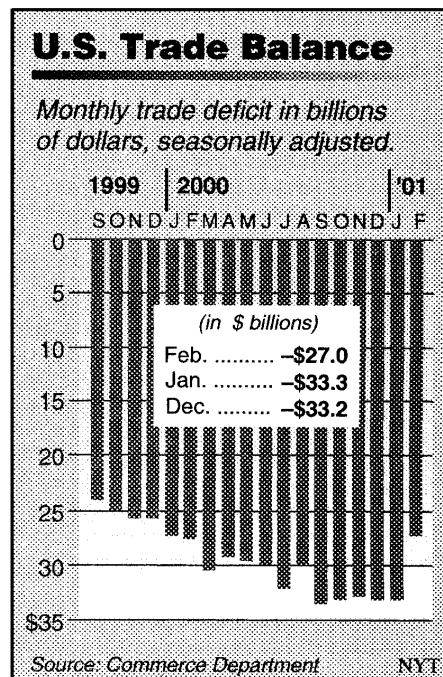
Where does all this foreign produc-

tion go? The standard thinking is we produce abroad to get the lowest possible labor cost and then import these cheap goods back to the U.S. Well the fact is that two thirds of U.S. foreign-affiliate sales are sold to customers in the host nation. This means the computers IBM makes in Japan and the earth-moving equipment Caterpillar makes in Brazil are sold mostly in Japan and Brazil. Only 10% of overall U.S. foreign-affiliate sales make it back to the U.S. A full 90% of U.S. overseas production gets sold somewhere else.

So what does this say about U.S. companies' motivation to invest abroad? Well first that it is not primarily low labor costs they are looking for. Sure low labor costs are important, but the number one reason companies invest abroad is to get closer to their markets. Coca-Cola's recent new mantra "think local, act local" could be the mantra for any number of multinationals. Joseph Quinlan and Marc Chandler have

written an excellent piece in *Foreign Affairs* on this (May/June 2001). Quinlan, an economist at Morgan Stanley Dean Witter, has trumpeted the importance of foreign production by U.S. corporations for many years.

What are the implications of their work? The most important is that policy makers need to focus less on the trade deficit today and more on Foreign Direct Investment (FDI). FDI is the lifeblood of U.S. foreign-affiliate sales. How much you invest today determines how big your sales will be



tomorrow. Policy changes that help the trade deficit may work against FDI. For instance a weaker dollar now may make the trade deficit look better, but it also will make it more expensive for U.S. companies to invest abroad. This is not what we want.

Policy makers have been working hard recently to get Japan to take more of our exports. This is a good thing, but it might be better to focus more on opening Japan to FDI. In this way U.S. service sector providers like banks, insurers and brokerages could get a bigger piece of the Japanese market and build U.S. foreign-affiliate sales there. Already American companies produce more in Japan than they export there.

The trade deficit is scary today and it may cause the dollar to decline. But longer term it makes more sense to focus on U.S. foreign-affiliate sales. This is where the really big money is and remember eventually all these foreign-affiliate sales get translated into profits and "imported" back to the U.S.

**U.S. Exports vs. U.S. Foreign-Affiliate Sales, 1998**  
(IN BILLIONS OF U.S. DOLLARS)

Country	Exports to	Affiliate Sales from
U.K.	\$39.1	\$224.0
Germany	\$26.7	\$163.1
Canada	\$156.6	\$209.5
Japan	\$57.8	\$77.2
Brazil	\$15.1	\$52.9

Source: U.S. Department of Commerce  
Note: Figures are for goods only.

Source: Foreign Affairs

# The U.S. Market . . .

## How we see things today . . .

**T**HE U.S. MARKET STAGED an impressive rally in April one of the best thirty-day periods on record. But we may not be out of the woods quite yet. The economic outlook is still very uncertain and stocks are still expensive by historical standards. The chart in the upper right shows that at bear market lows the market trades below fifteen times earnings. And often far below. Depending on how you do your math the market PE today is between 20 and 25.

So how do we look at things today? We are 100% invested. Truth in advertising however requires us to say we are 100% invested all the time. Our strategy is to choose quality value stocks, hold them until they become expensive and then look for something that is cheaper.

When you get down to it there are really only three styles of investing. There is growth stock investing which entails looking for very high quality companies, which can produce rapidly growing earnings with great consistency.

Investors are willing to pay a pretty penny for these "certain" results.

The second school of investing is momentum. Here investors don't want to be confused with the details. Don't tell me what a company does. If it is going up I want to own it and if it is going down I want to sell it. Sounds easy but you can count on your fingers the number of investors who have been successful at this over a longer period of time.

The third school is value investing. Here you are trying to buy the fallen angels of the world and other companies that have simply slipped between the cracks and are selling at cheap prices relative to earnings and assets. You can find good solid value ideas today at anywhere between 5 and 15 times earnings.

Why do we favor value stocks? For two big reasons. The first is that true growth stocks are few and far between. A new study by Louis Chan, Jason Karceski and Josef Lakonishok analyzed the performance of all active American public companies from 1951 to 1997. Over a forty-six year period only one firm in ten was able to grow its profits by 18% or more per year over a ten-year period. But investors today act as if it is easy to find consistent 15-20% growers.

A second reason for value is that predictions about companies require an idea of the future and accurate ideas about the

future are hard to come by. David Dreman in his excellent book, *Contrarian Investment Strategies*, did a study with Michael Barry of James Madison University looking at all analysts' forecasts for quarterly earnings between 1973 and 1991. Analysts were allowed to change their quarterly estimate up to two weeks before the end of the reporting period. After looking at over 94,000 different forecasts the authors found that the average error rate for the twenty-three year period was between 40 and 50%. So if analysts can't predict earnings up to two weeks before the end of a quarter how can they say anything intelligent about the next 5 or 10 years?

Our solution is to look for stocks in areas where expectations are very low. Here there is no premium built in for future results. Warren Buffett likes to say he would much rather step over a 1-foot hurdle than try to jump a 7-foot fence. This is what value investing is all about. Investors don't like to be associated with losers and if they own them they dump them to avoid the feeling of regret. This is when we get interested.

Is the economic outlook uncertain today? You bet. Is the broad market still overvalued? Very possibly. But we will stick to our knitting, buy good quality out of favor value ideas and let the economy and the market averages take care of themselves.

### S&P 500 Bear Market Bottoms

Date	P/E	10-Yr. Yield	Trailing Yield Gap	Bull/Bear Ratio*	12 Mo. Fwd. EPS Growth
06/26/62	13.8	3.9%	0.0%		
10/07/66	12.7	4.7%	3.1%	33%	
05/26/70	12.4	6.9%	1.1%	34%	
10/03/74	7.1	7.2%	6.9%	36%	
03/27/80	6.7	12.9%	2.0%	29%	
08/12/82	6.8	13.5%	1.1%	43%	
07/24/84	9.7	13.3%	-3.0%	45%	
10/11/90	13.8	8.9%	-1.7%	37%	13.6
12/08/94	16.3	7.8%	-1.7%	36%	18.6
10/08/98	24.5	4.6%	-0.5%	47%	15.8
03/23/01	24.2	4.8%	-0.7%	63%	7.4

\* Among investment advisors.

Source: MSCI, Datastream, Investors Intelligence, IBES

Source: Morgan Stanley Dean Witter

### All Growth Stocks vs All Value Stocks

Year-End 1927 = \$1.00



Source: SBBI 2001 Yearbook

# The U.S. Economy . . . A Consumer Crunch?

UP UNTIL NOW, the economic downturn has largely been a corporate phenomenon. Those firms that grew fastest during the 1990s, namely manufacturers of electronic and other high-tech gear, have been the hardest hit. These businesses have responded quickly to the fall off in demand by cutting production levels and overhead costs.

Stock market activity has always served as a good predictor of economic trends and this downturn has proved no exception. The most recent sell-off began last March while economists were still scratching their heads over the latest employment statistics. The falling stock market and deteriorating economic news did not go unnoticed by the nation's consumers. As the chart below shows, consumer confidence began to decline last fall reaching a 4-year low in February.

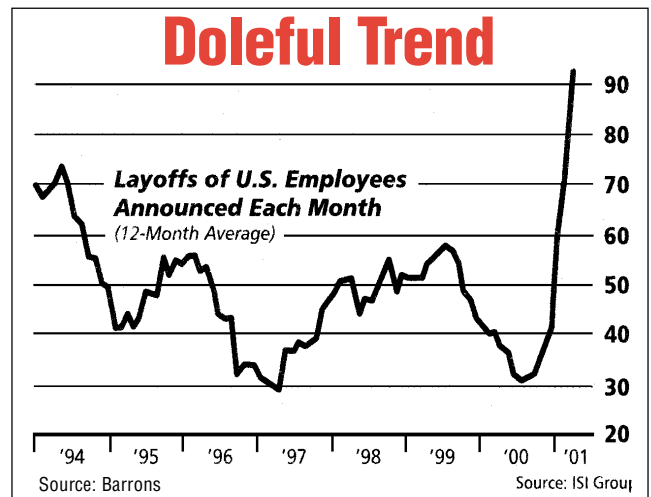
But despite their gloomy perspective, consumers have remained the one bright spot in the economy. They are still spending freely thanks in large part to the Federal Reserve's aggressive policy of lowering interest rates. Since January, the Fed has lowered interest rates 4 times by a total of 2 percentage points. This policy has fueled strong demand for homes, cars and other big-ticket items.

Americans bought 4.1 million cars in the first three months of this year, the second best quarter for car sales in history. Housing data is also booming. New home sales reached an all time peak in March and mortgage refinancings are at record levels.

How can consumers remain so buoyant in the face of deteriorating economic fundamentals? Recent studies on past

spending behavior suggest that consumers have been twice as likely to spend out of gains in the value of their homes as out of gains derived from share appreciation. The recent strong housing and spending statistics seem to bear this out. Last year, the value of owner occupied property rose by over 10%, the biggest gain since 1985. This increase raised household wealth by over \$1.1 trillion dollars. While this was half the loss created by falling share prices, it still represents a significant boost to consumer balance sheets.

So with all this good news, what is there to worry about? As you can see in the above chart, corporate layoffs are picking up steam. In April, the U.S. economy lost more jobs than at any time during the last ten years and the unemployment rate rose to 4.5%, the highest in two and a half years. To date, the tight labor market made companies reluctant to lay-off workers. Now, this seems to be changing at a time when consumers can least afford it.



Throughout the 1990s, consumers spent more and saved less. In 1990, the savings rate hovered around 8%. By the end of January, it had dropped to a minus 1%, meaning that savings were being liquidated to finance consumption. The negative savings rate is particularly significant given that consumers are also carrying record levels of household debt. Clearly, if unemployment rates climb further consumers will have a difficult time maintaining spending levels.

Consumers account for approximately two-thirds of our nation's economic activity so any change in their behavior will have a significant impact. But don't count them out just yet. First, the Federal Reserve remains poised to lower interest rates if economic conditions weaken further and a tax cut now appears likely. While these policies may have a delayed impact, they will stimulate spending by putting cash directly back into consumer's pockets. In addition, consumers appear to be working down debt levels. In April, total growth in consumer credit slowed to its lowest pace since October 1999. Employment trends will be the important thing to watch now. Overall unemployment rates remain historically low, but given the recent layoffs, we expect we will see higher rates before the downturn is over. Higher unemployment is the thing that could bring consumer spending to an end quickly.

—Anne Williams Doremus

