

Thoughts from

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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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And Then There Were Eight . . .

AS RECENTLY AS 1979 there were fifty-eight companies with a AAA bond rating by Moody's Investors Service. Today there are only eight. Last month Bristol Myers was dropped to AA status as its earnings came under pressure due to patent expiration of some of its blockbuster drugs and the questionable status of its new drug pipeline. The AAA survivors now are General Electric, UPS, AIG, Exxon-Mobil, Johnson & Johnson, Berkshire Hathaway, Pfizer and Merck. And there are even concerns about these last eight. GE bonds for instance are trading now as if they are AA not AAA. Investors are questioning the quality of GE earnings and the level of financial disclosure.

The only company to be added to the coveted AAA list recently is Warren Buffett's Berkshire Hathaway. Buffett has always prided himself on conservative financial reporting and maintaining a gilt-edged balance sheet. But there aren't many Warren Buffetts around anymore.

Why have so many AAA companies fallen by the wayside? One reason is that the added cost of letting your bond rating slip is not that significant. The difference between AAA and AA borrowing costs is small. In addition the economic expansion in the 1990s was so strong and lasted so long many companies got lulled into thinking that a more leveraged balance sheet with more debt was not that big a risk.

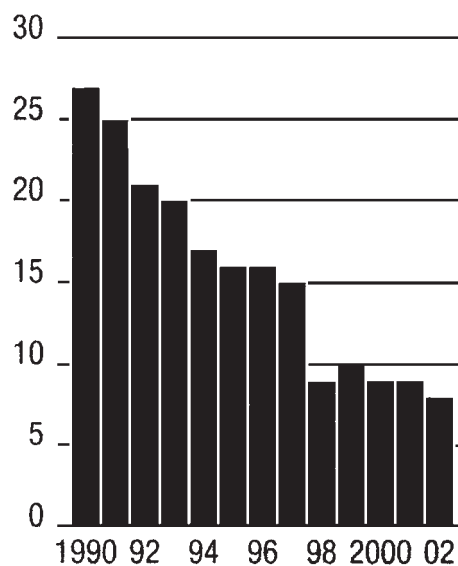
And debt is not necessarily a bad thing. Borrowing money is a justified way of growing a business

and recently the cost has been rather modest and stable. But the problem surfaces in the bad times when sales fall off but debt payments still have to be made. Then a more leveraged balance sheet becomes a very heavy yolk to bear. The New Economy telecommunications companies that built out enormous fiber optic networks only to see them lie idle now, are discovering this.

More conservative financial practices may be the wave of the future. Slower economic growth today and more stop and go expansions in the future will put the spotlight on high expenses and heavy debt loads. Companies will try to slim down. But don't expect this overnight. So far this year bond downgrades outnumber upgrades five to one.

US companies with AAA credit ratings

Number of companies



Source: Moody's

Source: Financial Times

The U.S. Scene . . .

Is This Really the Biggest Risk to the World Economy Today? . . .

THE INTERNATIONAL MONETARY FUND thinks so. It says America's rising current account deficit is a catastrophe waiting to happen. The current account consists primarily of imports and exports. When imports exceed exports the current account slips into deficit. Last year it grew to \$417 billion and is expected to go well over \$500 billion this year.

A current account deficit is not necessarily a bad thing. When foreigners sell us goods they take payment in dollars and if they are willing to hold these in U.S. stocks or dollar denominated bonds or in dollar bank accounts then everything is fine. But foreigners might get nervous about holding so

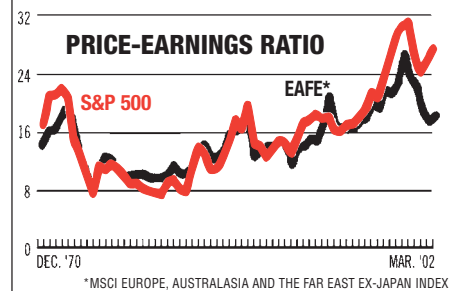
cost is declining profits and a possible fall in the stock market. So any solution to a high current account deficit, be it falling currency rates or slower economic growth has potential serious side effects.

The reason all this is important is our current account deficit is pushing up towards a crucial level. Historically it is very difficult for a country to maintain for very long a current account deficit above 5% of Gross Domestic Product. When you get there either your currency falls (10% to 20% is an average amount) or growth cools or you get a combination of the two. The U.S. current account deficit is now over 4% and will be 5% within twelve months. Morgan Stanley estimates it could reach 6% in 2003.

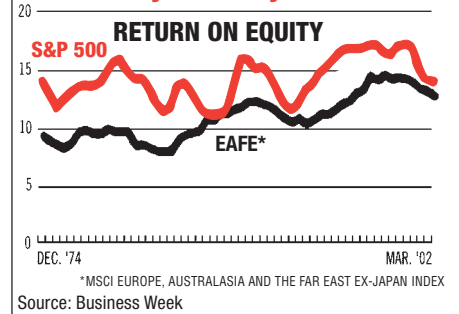
What's the flip side of this coin? Is there a way to play dollar weakness? Well one way is to buy foreign assets, which will appreciate (in dollar terms) when our currency falls. Foreign stocks today are cheaper than U.S. stocks (see chart) and foreign companies are nearly as profitable. This makes them a good hedge for U.S. portfolios.

The problem with this whole discussion is that Wall Street is littered with the remains of those who have bet against the dollar because of a rising

Foreign Companies Are Cheaper...



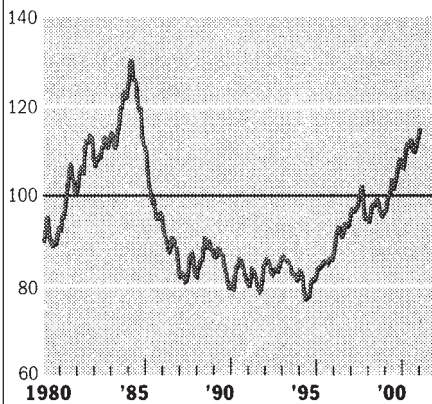
...And They're Nearly As Profitable



current account deficit. It seems that being right about the current account and also right about the direction of the dollar are two entirely different things. But the insurance today against a declining dollar — that is, foreign diversification — is a pretty cheap and easy strategy. I would do it.

ON THE RISE

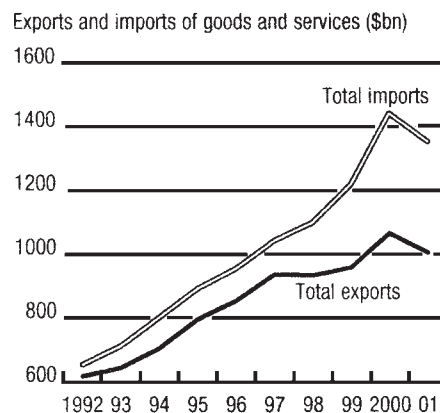
Inflation-adjusted index of the value of the dollar against a basket of other major currencies



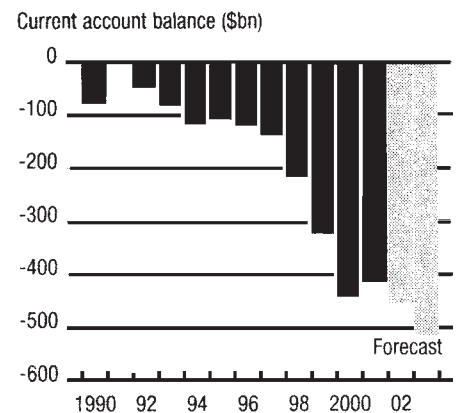
many dollars, and when they sell to buy Euros or Yen or whatever, the dollar falls. A falling dollar increases the cost of imports but also makes our exports more competitive. This is good for the current account but increasing the cost of imports increases inflation and sometimes this increase can be a lot.

Another way to rein in the current account deficit is through slower domestic growth. Here import demand cools and the deficit narrows but the

US ECONOMY



Sources: Thomson Financial Datastream; www.consensuseconomics.com



Source: Financial Times

Investing Trends . . .

Drug Stock Doldrums . . .

HISTORICALLY, PHARMACEUTICAL SHARES have served as a safe haven during times of market uncertainty. With clean balance sheets and steady, double digit earnings growth, these shares have always been a mainstay of most blue-chip portfolios. But after several decades of strong performance, drug shares began to significantly under perform last year.

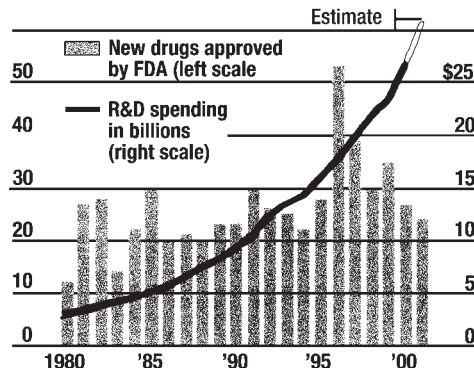
A number of trends can be blamed for this reversal of fortune. First, the rise of managed care and efforts to control prescription drug prices has significantly reduced the industry's pricing flexibility. As pricing pressures mounted, the costs of developing new drugs went through the roof. Recent data from Tufts University suggests that it currently costs over \$800 million to bring a new prescription drug to market. This level is up from \$231 million in 1987. In addition, the average time required to bring a drug to market increased from 9 to 11 years over the period. As a result, drug company research and development (R&D) budgets have soared. Worldwide, the pharmaceutical industry spent over \$30 billion on R&D last year alone.

Ironically, despite great technological advances in areas such as genomics and combinational chemistry, this increased spending has yielded disappointing results. Last year, the pharmaceutical industry launched a total of 31 new

PHARMACEUTICALS' PINCH

New Drugs Wane

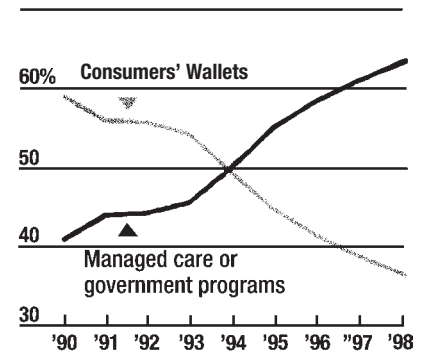
Companies spend more on research, but they're launching fewer drugs



Sources: Food and Drug Administration; PhRMA; Kaiser Family Foundation

As Buyers' Power Grows

Drug purchases, by type of payer



Source: Fortune

drugs — the lowest level in 3 decades. As recently as the late 1980s, the industry was launching 50-60 new drugs a year and spending less than half of what it does today on R&D. Many experts suspect that the industry's past successes may be behind these poor results. With fewer unexploited enzymes, scientists now have to look to new and often less productive approaches to drug development.

Finally, patent expirations on key products and a growing threat from generic drugs have dampened sales growth at many of the industry's largest firms. Rising R&D costs and slowing sales growth have depressed earnings across the industry.

While the drug industry is certainly suffering the blues, we are not willing to write off the entire sector just yet. The share prices of many of the industry's leaders have fallen significantly from their recent highs and now trade at relatively modest P/E multiples. More importantly, we think there may be reason to believe that earnings growth, while anemic now, may revive going forward.

Favorable demographics are probably the single strongest factor working in the industry's favor. People over age 65 use three to four times the prescription drugs that people in their 30s use and

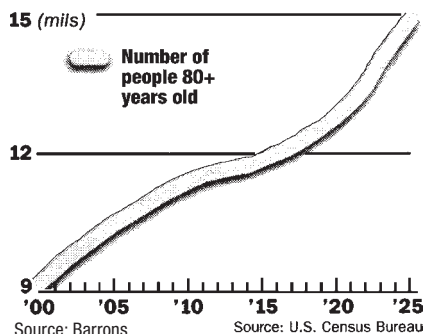
the world's population is aging. By 2010, the number of people over age 65 in the U.S. will expand by 17%. Healthcare spending will grow to \$2.8 billion or 17% of GDP over that time.

Exports will also represent a growing market for many pharmaceutical firms over the coming decades. Increasingly, it is becoming apparent that as emerging economies adopt "western lifestyles", the incidence of afflictions such as heart disease and high cholesterol rises. Consider the case of China where the number of heart attacks and strokes is rising sharply. According to recent research, 30% of adult Chinese have high blood pressure and one third suffer from elevated cholesterol levels. An estimated 26 million Chinese have diabetes compared to 16 million in the United States. Importantly, while more Chinese are developing these diseases, few receive treatment. Certainly, tapping into these markets will not be easy. While the demand for treatment is clear, the ability to pay may be limited. In addition, regulatory issues remain undefined in many export markets. Despite these hurdles, the opportunity to expand markets for existing, and already paid for, drugs could be an important source of growth for many pharmaceutical companies.

Anne Williams Doremus, CFA

Aging in America

The numbers of elderly are expected to rise 65% between 1999 and 2025, compared to a 25% increase in the population overall. And then come The Baby Boomers, who begin to turn 80 in 2026.



Source: Barrons

Source: U.S. Census Bureau