

Thoughts from

# Hanson Investment Management Inc.

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## Even The Rallies Make Us Nervous . . .

**B**EFORE THE IRAQ WAR the market was unsettled and we were glum. Now after a sharp 14% jump since mid March we seem equally glum. Everything seems to worry us. Is this a sucker rally or is this the real thing backed by a strong economy and a safer world?

We can certainly have big rallies in Bear markets. The chart at the bottom shows that between 1930 and 1932 we had double digit rallies a third of the time while the market was falling sharply. The proof of the pudding for this rally is the economy. If we are making sustained headway in GDP then the rally can be believed. And I think we are making headway. The evidence I see is anecdotal but encouraging. At the very local level in Vermont for instance, truck traffic at Highgate Springs to and from Canada is up solidly since October. Container volume at the port of Montreal is strong and container rates across the Atlantic have increased. Also the world's largest semiconductor foundry, Taiwan Semiconductor is seeing strong order flows and expects 20% growth this quarter. This is important since TSM produces for many companies who don't own their own "fabs" but who represent a wide range of chip activities. We think the lows of last October (7286 on the Dow) will hold. The rally now won't go on forever but the economy is more likely to gain strength than lose it and as long as this is the case, stocks are on sound footing.

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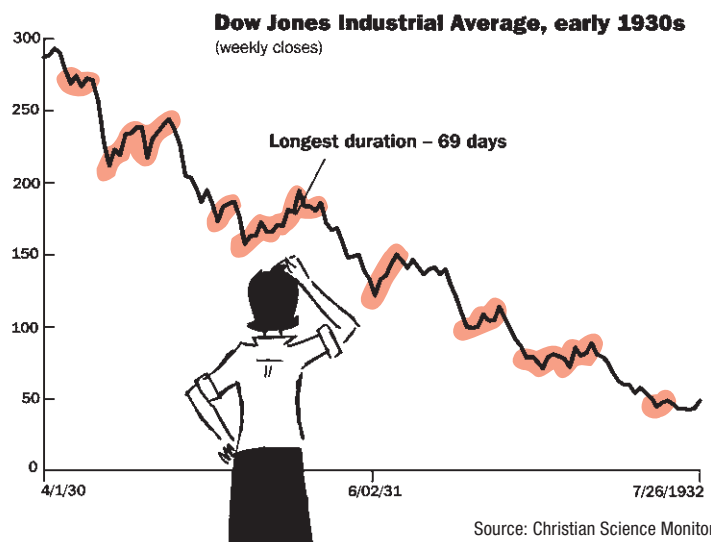
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**Hanson Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.**

### False Positives

Call them sucker's rallies. Even during the Great Depression's stock-market nose dive, the Dow Jones Industrial Average showed successive weekly surges. For the period April 1930 to July 1932, the market was in double-digit rally mode more than a third of the time (yellow highlights), according to an analysis by Elliott Wave International, a market forecasting firm, with the average rally hitting 24 percent and lasting 40 days. For the period overall, however, the Dow shed 86 percent of its value.



# Investing Strategies . . .

## The News from Academia . . .

**W**E GOT A LOT OF CALLS in the fourth quarter last year about Iraq. Many clients had big amounts of money to invest but were reluctant what with the possibility of war looming. And who was I to disagree? The world certainly did look uncertain and what could be wrong with sitting and waiting? Well the answer is this is not the way to make money on Wall Street.

Mark Hulbert, the editor of the *Hulbert Financial Digest* which tracks investment newsletters, has gone back and looked at how markets perform in the face of big news events. Mark studied thirty-six major world stories since World War II including the Japanese attack on Pearl Harbor, the Cuban Missile Crisis and President Nixon's resignation in 1974.

Before many of these events (and before the Iraq War) the market had declined. So the question was, is it likely the market will continue to go down after a big news event? This would justify a wait and see investment strategy? Hulbert's conclusion (*see chart*) is it is a coin toss. Fifty percent of the time the market twelve months after the momentous event had moved in the same direction as before the event and 50% of the time it had moved in the opposite direction.

What I take from this is that market timing even in the face of big, big events

### No clear direction

Direction of the Dow Jones industrials 12 months before vs. 12 months after . . .

. . . Momentous news events 1941-87



. . . All other days 1896-2003



Source: The Hulbert Financial Digest NYT

is a fool's errand. The odds are not in your favor. It is much better to bet on the long-term outlook than the scary news of the day. The odds here are in your favor. Stocks will track corporate profits over the longer term and markets tend to go up 6 or 7 years out of every ten. Market timing will only get you out of stocks at the most emotional (low) time and back in when the world looks rosy which usually is after prices have fully recovered.

Another recent study deals with earnings persistence. Do companies that show rapid earnings in the past have rapid earnings in the future? Two

professors at Illinois and one at Florida found that it is very difficult to even find companies with earnings growing above the median growth rate. Only 3% of all firms can manage to increase their earnings faster than the median for at least five years. Wow, this is a pretty low number. And finding these companies ex post (after the fact) is a lot easier than ex ante (before the fact).

The chart at the bottom is from James O'Shaughnessy's *What Works on Wall Street* published in 1996. He found that in every decade since 1950 low PE stocks outperformed high PE ones. His work confirms what Chan, Karceski and Lakonishok find now. If fast growing companies are few and far between and if it is difficult to find them before the fact, then many growth stock investors are going to be disappointed chasing high PE stocks.

Better to keep a value focus and search for reasonable growth at a reasonable price. I realize of course this is self-serving since we are value investors. I also realize you can find some study or some person to support almost any case. But still Hulbert's work and the conclusion of Chan, Karceski and Lakonishok is persuasive. Beware of market timing and beware of chasing unrealistic growth estimates. You would think that the dot.com blow off would have taught us something.

### Compound annual rates of return by decade.

Portfolio	1950s*	1960s	1970s	1980s	1990s**
Large Stocks	15.33%	8.99%	6.99%	16.89%	8.53%
50 high PE from Large Stocks	14.77%	10.94%	0.93%	14.11%	5.98%
50 low PE from Large Stocks	16.12%	11.14%	12.64%	16.19%	10.28%
All Stocks	19.22%	11.09%	8.53%	15.85%	9.09%
50 high PE from All Stocks	19.27%	10.96%	2.26%	7.99%	4.30%
50 low PE from All Stocks	21.84%	13.96%	8.89%	7.56%	7.15%

\* Returns for 1952-1959.

\*\* Returns for 1990-1994.

Source: James O'Shaughnessy, *What Works on Wall Street*

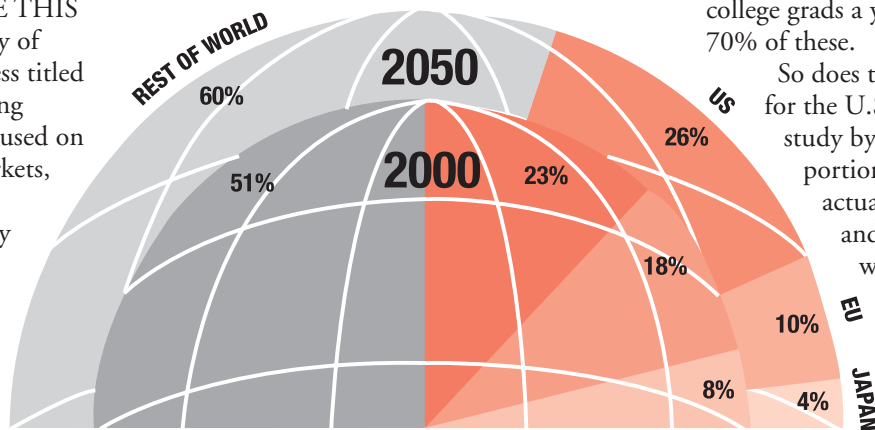
# The U.S. Economy . . . Is the Going Still Good? . . .

I TAUGHT A COURSE THIS Spring at the University of Vermont School of Business titled Globalization and Emerging Financial Markets. We focused on the big four emerging markets, China, India, Brazil and Mexico. The subject is very exciting but can also be very depressing. Let me explain.

The U.S. is 4% of the world's population today and 23% of the world's Gross Domestic Product (see chart to the right). The rest of the world is eyeing this pie and getting a lot savvier about how to grab

it. Early on it was Japan and the Four Tigers (South Korea, Taiwan, Hong Kong and Singapore) who ate our lunch in the manufacturing area. More recently China has become the workshop of the world.

But the high paying service sector jobs were always our trump card. No one was going to take these. Well, never say never. India is coming on strong today as are other emerging markets. From a standing start twenty years ago India has built an incredible high tech service sector. Take a look at the chart at the bottom. GE and GE Capital have over 19,000 employees in India now up from zero 20 years ago. Nineteen thousand is over 5% of GE's total worldwide employment. At first GE did low-end things in India like programming and code crunching. Then they moved on to call centers and disaster



## Shifting economic powerhouses

In the next 50 years, the United States' share of the world's output of goods and services will grow marginally, while Europe's and Japan's share will shrink dramatically, according to a new EU study. Source: Christian Science Monitor

backup facilities. Now they have gone all the way to research and development. GE has sunk more \$80 million into its largest research center outside of the United States where over 1,600 employees work today.

This trend is just going to continue. Financial analysis, regulatory reporting, reading CAT scans, dunning for overdue bills and graphic design are all candidates for emerging market workers in India, China, the Philippines, the Czech Republic, Mexico and other places. Karnataka state alone, which includes the Indian high tech center Bangalore, pumps out 36,000 fresh engineering graduates a year. They start at around \$5,500 a year. The U.S. can't compete with these costs. Outsourcing and "offshoring" (what GE does in India) could send 3.3 million American jobs overseas by 2015. India with 2 million

college grads a year is expected to get 70% of these.

So does this mean a steady decline for the U.S.? Not necessarily. A new study by the EU says the U.S. portion of world GDP will actually grow between now and 2050. The big losers will be the EU and Japan. Part of this is due to heavy regulation and structural rigidities in their system. But a bigger problem is the expected drop in population in both areas. The U.S. with a more stable fertility rate, more liberal

immigration policies and solid productivity should stay strong over the long term.

But we are going to have to work a lot harder and smarter to keep our lead. Those employees best able to compete in the world economy will do fine. But those with more marginal skills whose jobs are targeted by emerging markets will fall back. It is going to be a "have" and "have not" economy I fear. The U.S. will probably maintain its lead as the chart at the top shows but income inequality will grow. The challenge will be to keep productivity growing and technical skills improving enough to keep everyone moving ahead. We don't have to worry about the top end but the middle of the work force and the bottom need real attention. Otherwise the benefits of globalization will flow to just the few. Is the going still good? Yes, but...

## INTELLECTUAL CAPITAL

In India, GE leads a push into outsourcing research and development

<b>LATE 1980S</b> Former General Electric CEO Jack Welch visits India	<b>1990</b> GE and Wipro launch medical equipment joint venture	<b>1993</b> India, along with China and Mexico, becomes a priority country for GE	<b>1994</b> GE links up with four key software suppliers	<b>1997</b> GE Capital starts call-centre operations	<b>1998</b> GE renews software-supplier agreement	<b>LATE 2000</b> Inauguration of the John F. Welch Technology Centre in Bangalore
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Source: Far Eastern Economic Review

# Investing 101 . . .

## “The More You Pay, The Less You Earn”

—John Bogle

**T**HE MUTUAL FUND BUSINESS has exploded over the last 20 years. Back in 1985 just 562 individual stock funds were publicly available. Today, investors face a dizzying array of over 4,750 funds of every size and style. And mutual fund companies have successfully peddled their wares. Half of all U.S. households now own mutual funds – up from 10% back in 1982. So what accounts for this tremendous growth?

Without a doubt, mutual funds were clearly a good idea at a good time. They offered the growing ranks of baby boomers the opportunity to invest their savings in professionally managed, fully diversified funds. But these benefits have come at a significant cost. *Take a look at the chart to the right. Mutual fund expenses, which directly offset returns, have been steadily rising.* John Bogle, founder of the Vanguard funds, is a vocal proponent of controlling fund charges. Back in 1950, when Bogle first started in the business, operating expenses averaged 0.75% of fund assets. Today, despite the tremendous growth in assets under management, operating expenses now average 1.6%.

Fund operating expenses include

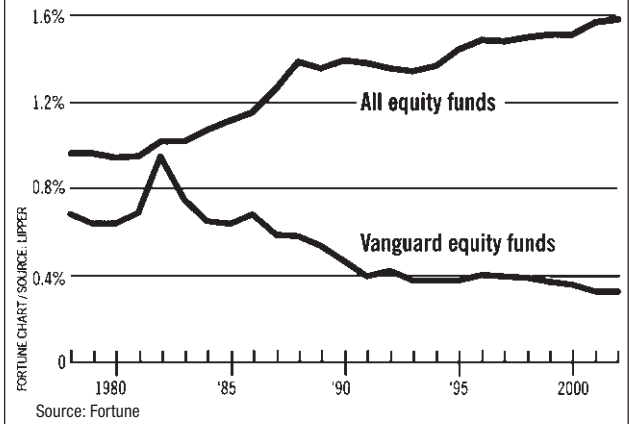
investment advisor fees, administrative charges and, often, distribution costs called 12b-1 fees. While most investors know they are paying sales commissions and operating expenses, few are aware of the other fees paid by mutual funds. These charges, while reflected in total return numbers, are not individually disclosed. Trading commissions, or the cost of buying and selling individual holdings, represent the most significant of these “invisible fees.” The chart below illustrates why these costs are increasing. Portfolio turnover, or the percent of a fund’s assets that change every year, has increased dramatically over the last forty years. Today, the average mutual fund has a turnover rate of almost 100%. This means that the average fund manager is holding the average security for only one year. High turnover translates into high commission costs and often greater capital gains distributions to shareholders.

For funds following a high-turnover strategy, these undisclosed commission costs can easily exceed their reported operating expenses. Consider the following example from the *New York Times*. In 2002, the RS Midcap Opportunities Fund spent a whopping \$3.2 million or 1.80% of assets on trading costs while its reported operating expenses totaled just 1.47%. This fund, therefore, needed to earn 3.27% last year before it could return one dollar to its shareholders.

And the fee tally does not end there. When a large fund goes into the market to establish a new position, its buying can drive up the share’s price. This “market impact” cost can be significant for large funds or when trading in small, illiquid securities. Ron Ross, author of “The Unbeatable Market,” estimates that

### FUND COSTS KEEP RISING

Total fund expenses as a percent of assets.



commission, market impact and other related transaction costs can add 2% to the average fund’s expenses.

A recent Morningstar study illustrates why investors should pay close attention to fund costs. In studying the returns of 5,200 mutual funds, Morningstar found that high turnover funds underperformed those with low turnover by 5.9% and 1.5% annually over the recent three and five year periods.

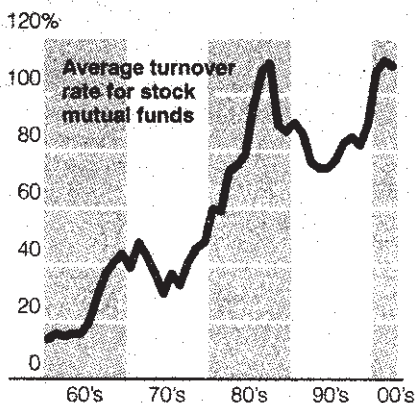
But there is good news too. My guess is that the growth rate of mutual fund costs may be slowing. For much of the last 20 years, investors earning double-digit stock returns saw little reason to be concerned about fund expenses. But in today’s weak market, fund expenses are having a greater percentage impact on returns and cost control is finally getting the attention of investors and regulators.

So what is an investor to do in the meantime? Our approach is pretty straightforward. Fees are nothing short of a drag on profits so we pay close attention to fund costs of all types. We also avoid excessive trading, both in the accounts that we manage and the funds that we purchase. Good investment ideas take time to work out. Patience, it turns out, is as much a virtue in the investing world as it is in life itself.

— Anne Williams Doremus, CFA

### Buy, Sell, Repeat

The portfolio turnover rate for stock mutual funds has risen since the 1960’s.



Source: Bogle Financial Markets Research Center  
The New York Times