

Thoughts from

# Hanson Investment Management Inc.

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## How Are You Feeling Today? . . .



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**I**F YOU SAY *NERVOUS*, I understand. *As the chart below shows,* individual investors are less and less Bullish today. The most current data (done since this chart was published) shows only about one in three investors is outright positive. It is not difficult to see why. We are facing one mega-problem after another. Inflation is moving up and interest rates will likely follow. The fiscal deficit is yawning, the trade deficit is still a problem and the dollar could crash. Should I go on?

Traditional theory says investors are “rational” meaning they look at the expected return from an investment, compare it to the risk and make a reasoned decision. The problem is, as Meir Statman, a Professor of Finance at Santa Clara University points out, that we are not as rational as we are “normal.”

And normal means we bring a lot of behavioral baggage to the table. For instance we feel the pain of losses about twice as acutely as we experience the pleasure of gains.

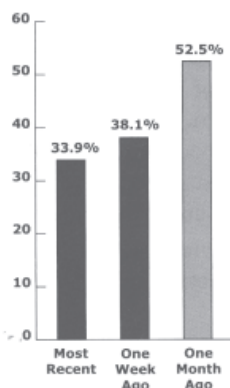
The final exam of successful investing is how well we stay the course in tough times. Our tendency is always to sell in weak periods to avoid the pain of loss. Then we buy back but only after stocks have risen significantly. I am not trying to minimize our current problems but I think the wisdom of Warren Buffett is very apt now – you have to be greedy when others are fearful and only fearful when others are greedy. The time to have been fearful was 2000 when the “new paradigm” had the beanstalk growing to the sky. History tells us that today is more likely to be the time of bargains.

**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.**

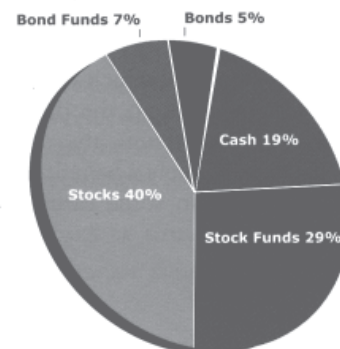
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## AAll Investor Surveys As of January 12, 2005

### Bullish Sentiment



### Asset Allocation



Source: American Association of Individual Investors Journal

# The China Scene . . . A Great Market, Right? . . . Wrong!

**C**HINA HAS GROWN AN astounding 9% per year the last twenty-five years. This is the fastest growth rate of any major economy in recorded history. Average income in the country has quadrupled and 300 million people have been lifted out of poverty. An incredible achievement.

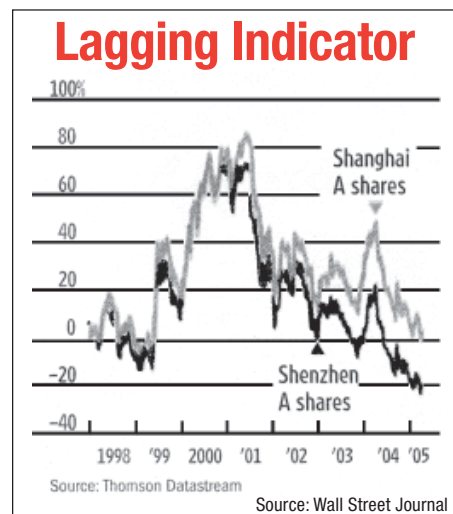
You would assume that the stock market has been on an absolute tear. If you had you are wrong. *Take a look at the chart to the right.* The Shanghai and Shenzhen Stock Markets, the two big equity markets are at six-year lows today. The total market capitalization of China is about \$150 billion, the same size as Denmark. China has been wonderful as a low cost manufacturer and exporter. U.S. companies have benefited from cost savings on the production side and U.S. consumers have benefited from cheap imports.

But investors have not benefited nearly as much. What explains the dismal market performance in China? First the Chinese government still controls two thirds of all stock. If the government privatizes these shares there will be a flood of new issues, which might drive prices even lower. Second, there are fundamental problems like the late disclosure of market-moving information and faulty financial statements. China

could definitely use Mr. Sarbanes and Mr. Oxley. Third there are the macro problems of loan losses in the banking sector and income inequality between the wealthy coast and the less wealthy interior. Finally there is the issue of who really owns companies in China. Haier is one of the best-known Chinese companies making a wide range of white goods. Some shares are traded in Hong Kong and Shanghai but the company is still technically a “collective” owned by the employees. But as the President says, “the company belongs to the employees but no one knows who owns how much”.

To invest in China today you need to go beyond the mainland and include the Greater China region of Taiwan and Hong Kong. Taiwan has been an incredible success story. Early on it was a low cost producer of consumer goods and electronics. But as it became wealthier, costs rose and manufacturing fled to lower cost destinations like mainland China. Taiwan has countered by going upscale, turning to the design of new products and concentrating on delivering better performance. The move has been a success. It is estimated that Taiwanese companies control an astounding 40% to 80% of all information and communication technology products coming out of China (*see chart below*).

The same goes for Hong Kong but in a different way. The biggest Hong Kong companies have a long history in real estate development. Li Ka Shing the wealthiest man in Hong Kong has used his two companies, Hutchison Whampoa and Cheung Kong to move aggressively into China to take advantage of real estate and



shipping opportunities. Hong Kong manufacturers specialize in textiles and they have moved production to Guangdong Province just like the Taiwanese producers have moved their electronics production.

We are using ETFs or exchange traded funds traded in New York as a proxy for the region. ETFs are basically index funds. The FTSE/Xinhua China 25 Index (symbol FXI) tracks the twenty-five most liquid companies in the mainland market. The largest holdings now are China Mobile (cell phones) PetroChina and BOC Hong Kong (banking). We also use the exchange traded funds for Hong Kong (EWH) and Taiwan (EWT). The largest holdings in the Hong Kong fund are, Hutchison Whampoa (shipping, port operations and real estate), Cheung Kong (real estate) and Sun Hung Kai Properties. The Taiwan market is much more high tech. The largest positions here are Taiwan Semiconductor the biggest merchant maker of chips in the world, Hon Hai Precision (a contract manufacturer) and United Micro Electronics, the principal world competitor to Taiwan Semi. All three funds have moderate expense ratios of approximately 0.7%.

China has been a no brainer for every multinational looking for low cost manufacturing. But China has been anything but a no brainer for investors. This approach may give you a leg up.

## Taiwan's Tech Clout

**Where the Island's Industries RANK Globally**

**#1** Provider of chip foundry services, with **70%** of the market worth **\$8.9 BILLION**

**#2** In servers, with **33%** of the market, worth **\$1.8 BILLION**

Taiwanese companies, from chip foundry TSMC to laptop maker Quanta, manufacture thousands of items essential to the global digital economy. Most appear under someone else's name—and most are made in mainland China.

**#1** Producer of notebook PCs, with **72%** of the market, worth **\$22 BILLION**

**#2** Producer of digital still cameras, with **34%** of the market, worth **\$2 BILLION**

**#1** Provider of LCD monitors, with **68%** of the market, worth **\$14 BILLION**

**#1** Producer of PDAs, with **79%** of the market, worth **\$1.8 BILLION**

Data: Market Intelligence Center, Industrial Technology Research Institute

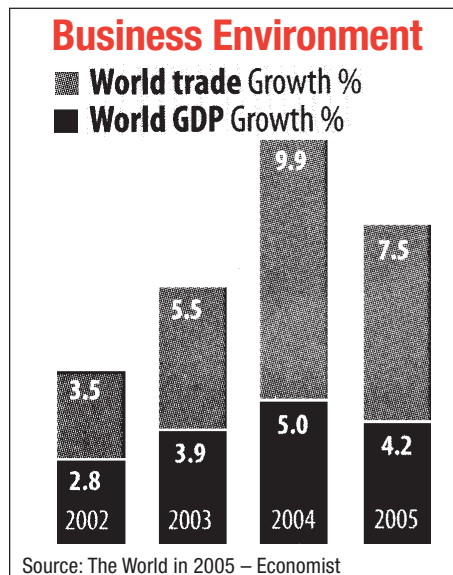
Source: Business Week

# Global Investing . . .

## Stocks For All Seasons? . . .

**W**E HAVE BEEN ASKED a lot recently, how do you invest in a world where the dollar might continue to decline? The standard answer is look at foreign securities or foreign bonds, which will strengthen if the dollar weakens. But we have another idea, which may surprise you: buy U.S. multinationals (and foreign multinationals too).

Peter Drucker, the writer and teacher, had a recent article in *The National Interest* (Spring 2005). In it he says that there are four world economies emerging today. One is the world of multinationals. Multinationals have historically been



considered domestic U.S. companies with foreign subsidiaries, companies like Coca Cola with a global reach. Today however things are changing with multinationals. First they are not just American anymore. In 1969 there were 7,258 multinationals world wide. By 2000 there were 63,000. Only 40% of the largest multinationals are headquartered in the U.S. And a surprising fact is most multinationals are not large, they are small. Drucker uses as an example a German manufacturer of specialized surgical instruments with sales of \$20 million but with 60% of revenue outside of Germany. There are plenty of U.S. firms which fit this bill too.

Another difference is multinationals today are not just hub and spoke

businesses with a domestic headquarters and foreign subsidiaries. They are now more integrated operations. Toyota for instance is starting to view the world as a single market. Going forward they will introduce products simultaneously in a number of countries, manufacturing parts in one part of the world for assembly in another.

Most multinationals are pretty currency neutral. Their treasury departments hedge both revenues and profits to such an extent that it basically doesn't matter that much if the dollar is weak or strong. No matter which way the wind blows these companies are able to adjust. And a final point, multinationals are in the sweet spot of the world economy. *As the chart to the left shows world trade is increasing about twice as fast as total world GDP.*

*Wired* magazine is a very interesting high tech focused publication. If you haven't seen a copy you should. Each year *Wired* puts together a list of the 40 most exciting companies. As the editors say, "These are the masters of technology and innovation. They're global thinkers driven by strategic vision. They're nimbler than Martha Stewart's PR team." The 2005 list is shown to the right. There are 34 repeaters and six new companies (marked with an asterisk). This is a pretty good starting point to identify companies who will lead their industry and who also will be able to deal with a volatile dollar and a volatile world economy. Some of the names are too pricey for us but others are right up our alley. Eight that look solid now include (in no particular order) Toyota, IBM, Flextronics, Jet Blue, Costco, Pfizer and Taiwan Semiconductor.

A key to good stock selection is to find companies with unique products and delivery systems, and where this uniqueness can be protected and extended for some time. Then if the price is cheap enough relative to earnings and assets, jump on and enjoy the ride. Happy hunting!

### The 2005 Wired 40

- 01 Apple
  - 02 Google
  - 03 Samsung
  - 04 Amazon.com
  - 05 Yahoo!
  - 06 Electronic Arts
  - 07 Genentech
  - 08 Toyota
  - 09 Infosys
  - 10 eBay
  - 11 SAP
  - 12 Pixar
  - 13 Cisco
  - 14 IBM
  - 15 Netflix
  - 16 Dell
  - \*17 General Electric
  - \*18 Medtronic
  - 19 Intel
  - \*20 Salesforce.com
  - 21 Vodafone
  - 22 Flextronics
  - 23 EMC
  - 24 Nvidia
  - \*25 JetBlue
  - 26 FedEx
  - 27 Monsanto
  - 28 Microsoft
  - 29 Nokia
  - 30 Costco
  - 31 Comcast
  - 32 Pfizer
  - \*33 Li & Fung
  - 34 TSMC
  - 35 Gen-Probe
  - 36 Citigroup
  - 37 L-3 Communications
  - 38 Ameritrade
  - \*39 Exelon
  - 40 BP
- \* New this year

Source: Wired

# The New World of Drug Discovery . . .

## “The Dose Makes the Poison.” Paracelsus

**D**RUG STOCKS, ONCE market darlings, have been in a slump for over three years. Reasons for their underperformance are not hard to find. Competition from generic drugs is on the rise. Legislative efforts to curtail healthcare costs are crimping pricing power. Patents on a whole range of blockbuster drugs are expiring and new drug discovery rates are down despite record R&D spending levels.

The pharmaceutical industry is undoubtedly experiencing a sea change. For years, major drug firms made money by developing therapies that could be marketed to wide portions of the population. Think Pfizer’s Lipitor for treating cholesterol, Schering’s allergy medicine Claritin and yes, Merck’s now-infamous pain reliever Vioxx. While these drugs were costly to develop, patent protection and intense sales efforts ensured that they were highly profitable. A recent study by Boston Consulting Group, for example, estimates that 80% of the growth for the 10 biggest drug firms over the last decade came from the approximately 8 big drugs launched a year during the 1990s.

But sometime in the last several years, major drug breakthroughs dried up. Some experts speculate that the industry’s past success was the reason for the slowdown. Scientists, they claim, have fewer unexploited enzymes to work with and this means they must rely on newer and less proven approaches to drug development. But I think the industry’s structure is also partly to blame. During this period, many companies discovered that

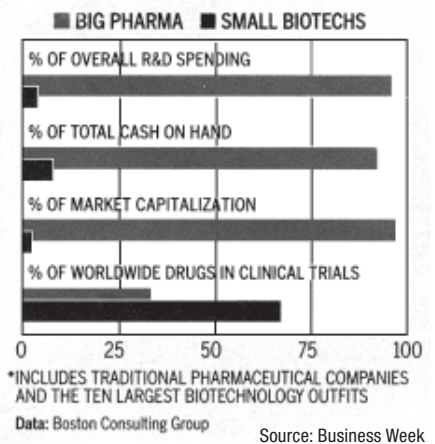
it was far more profitable to push existing drugs (or slightly altered versions of them) than to come up with new ones. According to Business Week columnist Shawn Henry, approximately 50% of blockbusters are knock-offs that offer little benefit from others in their class.

Interestingly, the biotech sector is now having the greatest development success. *Take a look at the chart to the right.* Smaller biotech firms are contributing a tiny fraction of overall R&D spending but are accounting for almost 70% of drugs now in clinical trials. Rather than targeting huge markets, many of these drugs are aiming at smaller population segments. Biotech giant Genentech, for example, is developing a breast cancer drug that targets only the 25% to 30% of patients carrying a particular genetic flaw.

This more “personalized” approach to medicine is having a profound effect on the economics of drug research. Historically it has taken 10-15 years for an experimental drug to make it onto pharmacists’ shelves and it is estimated that out of 5,000 proposed therapies only 5 will make it to the clinical trial stage. But many of the new targeted trials require improved patient pre-screening. This focus should lead to higher success rates and faster FDA approval. Further, the risks associated with large, expensive drug withdrawals should be lower because the new targeted therapies reduced the risk of broad unintended side-effects. And the chance of a drug being pulled entirely is lower when there are few competitive treatment alternatives available.

### LOSING THE EDGE

Big Pharma\* has big bucks but lags smaller biotechs in promising new drug development:



But this new world of drug discovery has some drawbacks as well. Instead of focusing on one or two big blockbusters, firms must now churn out many more small successful therapies. For this reason, firms that put a priority on science over the size of their sales force will have a distinct competitive advantage.

Large pharmaceutical firms are beginning to adapt to the new drug development environment. Many are tackling their bloated cost structures, entering into licensing agreements with small biotech outfits and pumping up their own R&D spending.

Adapting to these challenges will not be easy for most firms in the sector. But demographic trends should provide a measure of support. Consider the fact that people over 65 use three to four times the number of prescription drugs that people in their 30s use and the world’s population is rapidly aging. And there are other reasons to reconsider pharmaceutical stocks. After three-plus down years, many of them are trading at historically low valuations. Most carry little debt, are flush with cash and offer above average dividend yields.

—Anne Williams Doremus, CFA

### DRG Pharmaceutical Index

