

Thoughts from

Hanson Investment Management Inc.

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How do you say that in Japanese? . . .

THE FEDERAL RESERVE HAS JUST LOWERED interest rates again. This is the tenth cut in ten months. But it hasn't done much good. The economy is still weak and critics argue we are getting close to Japan, where short rates are just about zero and still no recovery.

Are we about to follow Japan now into an extended funk? I don't think so. Japan had two excesses in the 1980's, overvalued stocks and overvalued real estate. And they have been slow to deal with either one. When we had our real estate excess in the late 1980s we dealt with it swiftly and harshly. Banks were forced to foreclose, prices fell sharply and the economy got back to recovery in just a few years.

Japan is not a trap we are going to fall into but one we can learn from. Paul Krugman writing in the *New York Times* Sunday magazine section recently said that with short rates close to zero the Japanese should now target long-term rates. And if that doesn't work they can implement "inflation targeting" or print currency to generate a certain amount of stimulatory inflation. We can learn from their miscues.

The U.S. is not anywhere near needing these more dramatic measures yet. Fiscal and monetary policy combined with declining energy prices should be enough for us. Investors are overly worried now about falling into a Japanese "liquidity trap" of zero interest rates and no growth. We shouldn't be this concerned. Our situation is not as serious as theirs and we still have a lot of quivers in our bow. And most importantly we have shown we are not afraid to use them.

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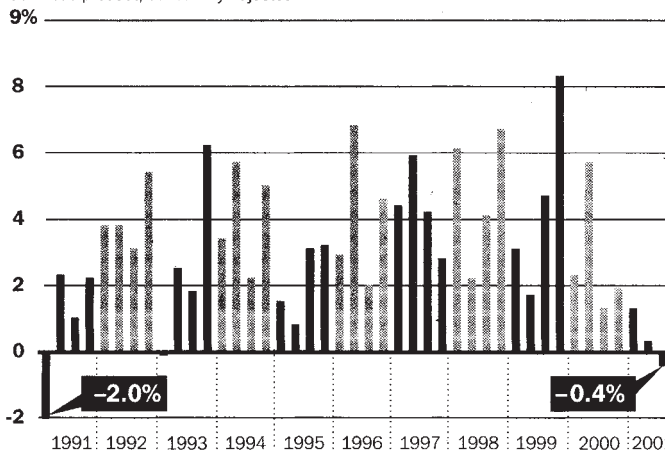
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Expansion May Be Over

The gross domestic product shrank in the period from July through September at a rate of -0.4 . This is the biggest drop in the total output of goods and services produced in the country since the first quarter of 1991 and could signal the end to the longest economic expansion in the country's history.

Annualized quarterly change of the real gross domestic product, seasonally adjusted



SOURCE: Department of Commerce

Source: The Christian Science Monitor

Investor behavior . . .

The individual investor is always on the wrong side of the market . . . right?

JOSEPH KENNEDY SUPPOSEDLY sold all his stocks before the 1929 crash when a shoeshine boy offered him a stock tip. When even shoeshine boys get interested in stocks, it has to be the time to sell. Conventional wisdom has it that individual investors are always wrong at major market turning points. But are they?

When the market re-opened on September 17, it was the professional investor, not the individual, who did the panic selling. Take a look at the chart at the bottom. The number of shares traded in blocks of at least 10,000 more than doubled the day the market re-opened compared to the day before the event. Shares of blocks of less than 10,000 shares did not pick up significantly until the end of September. Individuals are learning the lesson of long term investing. Stocks tend to go up six or seven years out of every ten and it is extremely difficult if not impossible to predict those three or four down years. Better to just stay the course and ride out the panic selling.

Professionals have been moving in the wrong direction on this one for a number of years. Institutions control 60% of all shares today and account for

approximately 80% of all trading. Take a look at the chart below. Turnover is at record levels now. Morgan Stanley estimates that the average holding period for a stock on the NASDAQ is 120 days and the turnover of all U.S. stocks is 160%. This means the average portfolio is turning over almost twice every year. When I first got into the business in 1971 institutional portfolios were averaging roughly 25% turnover per year.

editor at *Money Magazine*, has written a very interesting article on this in *Money* online. His point is that humans have an inbred tendency to look for patterns in things. We think we can figure things out even when there is no rhyme or reason to events. Two researchers at Dartmouth College, George Wolford and Michael Gazzaniga, set up an experiment with two lights in a laboratory. The lights flash in random sequence with one accounting for

Abnormal Returns = Abnormal Velocity?

Annual Turnover Rate				
	1991	1995	1999	2000
NYSE	48%	59%	78%	88%
NASDAQ	111%	179%	267%	316%
Estimated U.S. Turnover	65%	92%	131%	160%

Source: NYSE, Nasdaq, Morgan Stanley Research

Why all the frantic buying and selling? Well for one, portfolio managers are paid to keep up with the market and when they fall behind they do a lot of trading to try to catch up. Secondly, we are all overconfident in our abilities. We think we know a lot more about the future than we actually do and we trade on this.

And finally there is the issue of how our brains work. Jason Zweig, a senior

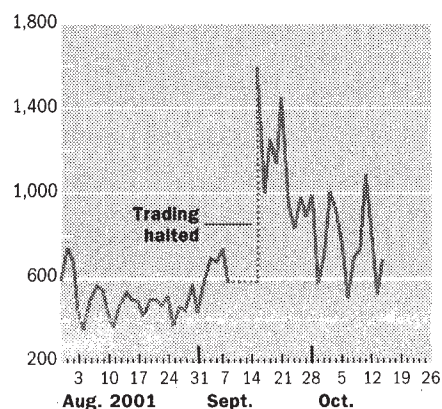
80% of the flashes and the other, 20%. The idea is you get a reward if you guess which light is going to flash next. Research animals invariably figure out the right response. They simply select the light that flashes 80% of the time. In this way they get the maximum possible reward.

Humans however are far more stubborn. Even when they are reminded that the lights flash randomly they try to figure out a pattern. Instead of getting 80% of the flashes right they get more like 65%.

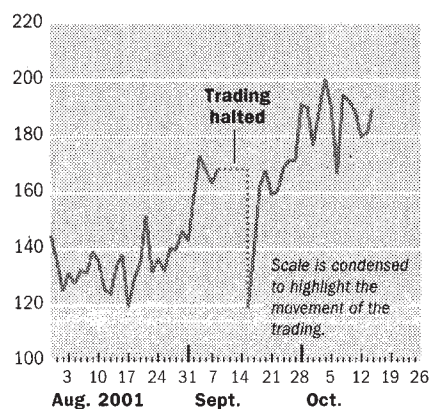
So what can investors learn from this? First, don't try to be too smart in a world that is characterized by randomness. Don't do more trading, do less. Instead of rapidly rearranging your portfolio, simply choose good quality companies with good prospects selling at reasonable prices and then hold them. And a second thing. If you are investing for the long term, try not to do it with someone who is turning your portfolio over two or three times a year. Like the humans in the light study you won't win. Exercise extreme sloth with your investments.

Small Investors Steady the Market

Shares traded in blocks of 10,000 shares or more, in millions



Shares traded in groups of less than 10,000 shares, in millions



Source: Wall Street Journal

The U.S. Scene . . .

The state of technology today . . .

THE AMERICAN ELECTRONICS ASSOCIATION has been bringing small to immediate size technology companies together with professional investors at the AeA Classic for over 25 years now. The big change at this year's conference is attendance was down 25%. I have been going for over 10 years now and can't recall a single decline. Quite significant.

The reason may be related to the second big change, which is that technology sales are down and down big time. It is not unusual to hear companies say sales are off 50% from a year ago. This is by far the worst high tech decline on record and tech is used to violent swings.

But the third big message is that technology still has a bright future. Of course you might expect companies to say that they have a bright future, but the

The Semiconductor Chip Cycle 300 mm Fabs Worldwide Growth

1999	3 New Plants
2000	5
2001	5
2002 (est.)	9
2003-2005 (est.)	25+

Source: Brooks Automation

numbers seem to back them up. Take a look at the chart on new semiconductor chip plants. The trend today is to pack more chips onto larger wafers. The 300-millimeter or 12 inch wafer is state of the art now. Some of the new proposed plants will be cancelled or pushed back but demand for chips is still growing and we will eventually need a lot of new capacity. And remember each plant costs a minimum of \$2 billion.

In the wireless or cell phone market it is estimated that at the end of the year 2000 there were about 625 million subscribers worldwide. It is expected that this will grow to 1.3 billion by 2006, an increase of 15% per year. So longer-term demand for high technology is still very vibrant.



The AeA Classic

Peter Lynch, formally of the Magellan Fund, likes to say when they yell gold rush don't buy gold, buy the companies that make the gold mining pans. This is what everyone has to have. In semiconductors it means companies that supply the chip making equipment and in cell phones it means the suppliers of base stations, repeaters, etc.

In the wireless area Allen Telecom supplies equipment for base stations and Datum makes the synchronization equipment that allows wireless phone calls to move seamlessly across the country. In semiconductor equipment Electro Scientific is into laser systems that trim circuitry and improve yields.

A rule of thumb we use here is to look for companies that have a dominant product and a solid balance sheet with little debt and lots of cash. You want companies that can survive the bad times. And finally you want companies that are cheap relative to book value (under 2X is a good starting point) and relative to sales (total market capitalization should be 1X sales or less).

The companies mentioned above meet most of these criteria. So do the following. Quantum makes tape storage products. Tape is a decidedly old technology but it is the cheapest and best way to back up huge volumes of data generated by the Internet. Avid makes equipment to edit films and videos. If you have seen a Hollywood movie recently you have seen Avid equipment at work. Infocus is the dominant supplier of projection systems that produce Power Point and other computer generated presentations. And finally there is Moldflow, which is a software company that helps plastic injection molding companies improve the productivity of their molding machines.

One of the biggest problems with the Internet today is that too few homes and small businesses are connected to high speed broadband. Fiber optic lines have blistering speed but they go only as far as phone company switching stations. The "last mile" over copper wire is at a snail's pace. Companies like ADC and Symmetricom are working on solutions here.

The caveat to this year's AeA conference is that some stocks have not declined as much as the fundamentals. What happens in the first half of 2002 if business doesn't bounce back as expected? Will stocks have to drop further? This is my big concern. So my best advice is, high tech at the AeA looks cheap but buy carefully, things could get cheaper still. Unfortunately life is always an awkward shade of gray.

Technology on Parade

	Recent Price	12-month range	Price/Sales	Price/Book	Debt/Total Capital	Cash per Share
Allen Telecom (ALN)	8	(24-7)	0.6x	1.0x	25%	\$0.23
Datum (DATM)	11	(34-9)	0.5x	1.0x	3%	\$0.84
Electric Scientific (ESIO)	28	(42-19)	1.3x	1.8x	0%	\$5.19
Quantum (DSS)	9	(16-7)	0.9x	1.0x	22%	\$2.28
AVID (Avid)	9	(22-6)	0.5x	1.8x	10%	\$2.95
Infocus (INFS)	21	(48-11)	0.9x	2.3x	0%	\$2.06
MoldFlow (MFLO)	10	(31-8)	2.5x	1.7x	0%	\$4.60
ADC (ADCT)	4	(27-3)	1.3x	1.5x	0%	\$0.18
Symmetricom (Symm)	6	(19-4)	0.9x	1.2x	6%	\$2.32

Source: William O'Neil & Co., Company Reports

The U.S. Economy . . .

Do you remember the old wag? . . .

AN ECONOMIST IS SOMEONE who knows tomorrow why things he predicted yesterday didn't happen. This seems to ring particularly true today as the latest downturn confounds even the most well respected economists. A recent study of the late 1990s by consulting firm McKinsey & Co. is helping shed some light on where the economy is headed.

During the last decade, many economists thought the U.S. had entered a period of unstoppable economic growth. Proponents of this New Economy believed that large investments in information technology were supporting sustained increases in the nation's productivity.

From 1975-1995, productivity in the U.S. increased at 1.4% per year. Then from 1995-2000, annual productivity gains almost doubled to 2.5% and economic growth surged to 4.1% per year. During this five-year period, consumers and businesses were investing in technology at an unprecedented rate. Between 1995 and 1999, investments in technology increased 16% a year, almost double the rate of 1987-1995. Many economists attributed the resurgence in productivity to increased spending on technology.

This conclusion is now being questioned. The McKinsey study found that only 6 of 59 sectors of the economy actually contributed to the late 1990s productivity gains. And importantly, the gains were driven not just by technology investment but by factors such as competition, deregulation and a strong business cycle. In retailing for example, Wal-Mart's move to larger stores and discount pricing fueled productivity gains throughout the industry. In semiconductors, Intel's transition to shorter product cycles improved efficiency while in the securities industry, larger trading volumes allowed for significant economies of scale. What is McKinsey's conclusion? Information technology may be a necessary ingredient to achieving productivity gains but it is not sufficient.

The study challenges the idea that technology spending is a primary driver of the nation's productivity. This is good news considering that as of the end of the second quarter, technology spending per employee was down nearly 10% from the previous year.

The study also provides some clues as to what to expect in the future. The authors argue that the high productivity rates experienced last decade are unsustainable and we are likely to see rates return to their long-term historical average of 2%. Getting this forecast right is important because small changes in productivity can lead to huge economic benefits. If, for example, productivity remains at 2.3% up from the 1% level achieved from 1987-1995 then, thanks to the magic of compounding, the economy will be 30% richer in 20 years. Stronger productivity leads to strong corporate

profits and this of course supports higher stock prices.

Over the short term, we suspect that falling corporate profits and increased spending on everything from security measures to insurance premiums will dampen productivity gains. But longer-term, productivity advances will likely surpass the anemic rate logged in earlier periods. Many industries are just beginning to reap the benefits of previous investments in automation, communication and data analysis and other factors such as increasing globalization, managerial innovation and deregulation are proving to be equally important in achieving efficiency gains. Longer-term, each of these areas should continue to support future productivity advances. This is good news for corporate profits and the stock market.

—Anne Williams Doremus

PRODUCTIVITY WINNERS, PAST...

Driven by info tech, economies of scale, and competitive pressures, six industries accounted for most of the jump in productivity growth in the second half of the 1990s.



DISCOUNTERS thrived

SHARE OF PRODUCTIVITY GROWTH
INCREASE 1995-1999

WHOLESALE TRADE	27.8%
RETAIL TRADE	25.6%
SECURITIES	18.8%
ELECTRICAL EQUIPMENT*	12.8%
INDUSTRIAL EQUIPMENT**	9.0%
TELECOM SERVICES	5.3%
OTHER	0.8%

*Mainly semiconductors **Mainly computers



TECH was a leader

... AND IN THE FUTURE

Industries with the potential to exploit information technology and economies of scale to obtain big jumps in productivity:

BANKING
CREDIT-CARD SERVICING
MEDIA
MORTGAGE BANKING
SOFTWARE



UTILITIES look like a good bet

Industries where regulatory changes could lead to more competition and a boost in productivity:

INSURANCE
PHARMACEUTICAL MANUFACTURING
UTILITIES

Data: McKinsey Global Institute
Source: Business Week