



Deflation? . . . I'm not betting on it . . .

EVERYBODY IS TALKING ABOUT DEFLATION today. The Japanese have been wrestling with this for the better part of ten years now and officials seem to be powerless to do anything about it.

Deflation means falling prices. We are quite familiar with inflation and more recently, disinflation, which is the decline in the rate of price increases. But we haven't had a serious bout of deflation since the Depression. Now falling prices are showing up in many manufacturing areas. *Take a look at the chart below.* TV sets, toys, clothing, sporting goods and new cars are all down from a year ago. There is too much production of almost everything out there. But in services which is the biggest part of the economy we have not seen price declines. Cable TV, rents, car insurance, dining out, they are all still going up. Stephen Roach at Morgan Stanley who has been right on the economy so far thinks services is the next area for deflation. Look at software. India and more recently China have done a lot of work for us at cheap prices in software outsourcing and this has gone well beyond writing code, to include manning e-mail help desks, doing production layout design, logistics tracking and telemarketing. So we may see deflation in areas previously immune to foreign competition.

But remember there are two kinds of deflation. The first is the Japanese strain caused by a fall in demand. This is dangerous. But deflation can also be driven by productivity gains. In this case prices decline but profits and output actually increase as worker output per hour improves. This may be us today. Productivity has held up very well in this cycle. As long as this is the case I am betting against deflation or any kind of Japanese stalled economy.

**431 Pine Street
P.O. Box 819
Burlington, VT 05402
U.S.A.**

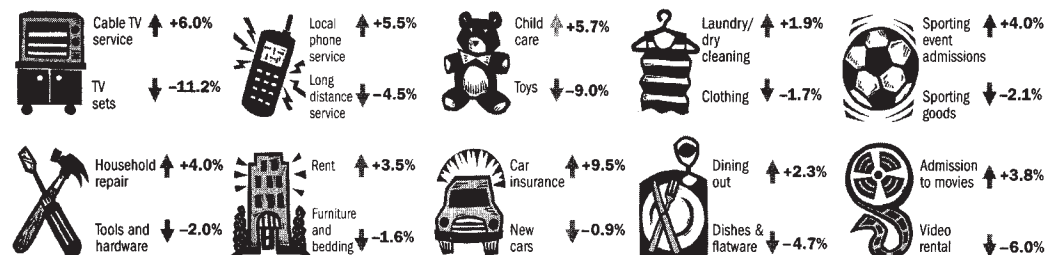
**Phone: 802-658-2668
Fax: 802-658-1027**

**E-mail:
ehanson@hansoninvestment.com**

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.

A Pricing Seesaw

The tug of war between inflation and deflation touches almost every facet of your life. Overall prices for services are up 3.2% from a year ago, while prices for goods (excluding the volatile food and energy sectors) are down 1.1% from a year earlier.



Other things getting cheaper...

EXAMPLES OF DEFLATION	% CHANGE YEAR AGO	EXAMPLES OF DEFLATION	% CHANGE YEAR AGO
Personal computers	-21.0%	Watches	-3.3%
Computer software	-8.1	Appliances	-2.8
Airline fare	-5.2	Coffee	-2.5

...and more costly

EXAMPLES OF INFLATION	% CHANGE YEAR AGO	EXAMPLES OF INFLATION	% CHANGE YEAR AGO
Cigarettes	+9.8%	Educational books	+5.9%
Hospital services	+9.0	Prescription drugs	+4.7
College tuition and fees	+7.2	Legal services	+4.5

Note: All percent changes are through September 2002; Source: Economy.com

High Tech Investing . . . Rest in Peace? Hardly . . .

For over twenty-five years now the American Electronics Association has hosted a meeting in November bringing together smaller high tech companies and investors. This year 180 companies were in San Diego to make presentations to over 750 attendees.

What were some of the themes of this year's conference? Well first, much of high tech growth is based on unexpected breakthroughs which fuel the "killer applications" which in turn drive the cycles. As the chart below shows, different products have driven the market at different times. Personal



The AeA Classic

to provide wireless office computer networks, or maybe cheap sensors to track commerce, machines etc. Another breakthrough could emerge if legal wrangling gets resolved over computerizing movies. And then there is the whole explosion in videogaming which the Koreans are out in front on. Until the next "must have" comes along and until the excess of past tech spending gets worked off, conditions will be soft.

A second theme at AeA this year was "survival." Everyone is interested in how much cash is on the books and how high debt is. A related theme is the incredible competitiveness of the business. Price cutting is a fact of life. Infocus, the maker of projection systems for computer presentations, introduced an incredibly small two-pound box that sits in the palm of your hand and is virtually noiseless. They priced it at \$3,800. But they expect to reduce prices 5% a quarter to keep the competition at bay. And this is if they are lucky. Otherwise bigger price cuts.

A final theme in San Diego this year was outsourcing. High tech production

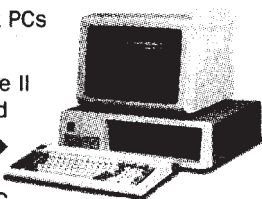
in the Silicon Valley is going away fast. Asyst, a maker of semiconductor equipment, estimates that fully loaded labor costs for high tech production in California is \$100 an hour. Moving production to a contract manufacturer in Singapore cuts the price to \$16 an hour and there are lower places still (*see page 3 on China*). In the future high tech in America will mean product design, research and development (part of this may also go) and marketing. Most all production will be offshore.

So things sound pretty bleak for technology, right? Hardly. Yes it is true there are few killer applications now and business is slow but breakthroughs of all sorts continue and this is fueling a lot of growth. And stock prices are finally cheap again. Take a look at the list of four below. Each is down more than 75% from its high in 2000. And each sells for less than 1.5 times book value and with little debt. Infocus is coming up with ever better projection systems, Kopin chips are used in 25% of all cell phones worldwide and they make incredible small screen displays for camcorders and eventually wireless phones. MapInfo in Albany, New York does detailed mapping and software and Moldflow develops software to improve the design and efficiency of the injection molding process. Buy'em when they are cold as they say. Based on this year's AeA, high tech is alive and well... and cheap to boot.

Tech Momentum

Innovations have repeatedly driven tech out of the doldrums.

- 1975 First PCs on sale
- 1978 Apple II introduced
- 1981 IBM unveils its first PC
- 1986 Microsoft IPO
- 1991 World-Wide Web created
- 1993 Mosaic browser released
- 1995 Netscape IPO
- 1997 Amazon.com goes public
- 2000 Nasdaq tops 5000



Source: Wall Street Journal

computers were introduced in the late 1970's, then the more powerful desktop computers or workstations of Sun Microsystems. The seemingly simple mouse fueled mainstream acceptance of the PC and then in the early 1990's the killer application was e-mail followed by the development of the World Wide Web in 1991 (yes, the Internet in commercial form is just a little over ten years old!). Finally the browser developed by Netscape (IPO in 1995) fueled the explosion of the Internet.

The problem today is there are no obvious killer applications. Some are betting on Wi-Fi, the standard created

AeA High Tech on Parade Survivors in the Wreckage

Stock (symbol)	Recent Price (\$)	Decline from 2000 High	(\$mm) Sales	Price/Book	Debt as a % of capital	Business
Infocus (INFS)	6.30	(88%)	630	0.6x	0	Projection Products
Kopin (KOPN)	4.50	(91%)	80	1.2x	0	Advanced Semiconductor Materials
Mapinfo (MAPS)	6.95	(86%)	93	1.2x	15%	Mapping Software
Moldflow (MFLO)	6.35	(78%)	35	1.1x	0	Automation Software - Plastics

SOURCE: William O'Neil + Company and Hanson Investment Management

China Trends . . .

Still the Biggest Story We Know . . .

ITEM: This year China is expected to overtake the United States as the world's leading destination for foreign direct investment. Inflows will top \$55 billion.

ITEM: China is the world's fourth largest industrial base today in terms of value of goods produced — just behind the U.S., Japan and Germany. China makes 50% of the cameras sold in the world, 30% of the air conditioners, 25% of the washing machines and 20% of the refrigerators.

ITEM: Taiwanese-owned firms produce three quarters of the world's mother-

chain. Companies are finding that they can produce ever more sophisticated products in China and even do research and development. Chinese universities granted 465,000 Science and Engineering degrees last year approaching the total for the U.S. India has carved out a more important market in high tech exports (primarily software) but the Chinese are targeting this area now and their resources are many.

The last stage up the value chain is when China companies move from the "back end," making products for others for export, to the "front end" of designing homegrown products selling under their own label. This is starting to happen. Haier is a producer of small refrigerators sold here in the U.S. and Huawei Technologies is competing against Cisco in the world router market. Huawei's prices undercut Cisco's by as much as 40%.

China is not a slam dunk however. Although the southern part of the country is booming, China's employment appetite is immense. It must create more jobs just to avoid the possibility of social unrest. The *Financial Times* estimates that China will create 8 million jobs annually at a GDP growth rate of 7%. But 20 million urban residents per year will be seeking jobs

WHY CHINA IS SPOOKING SILICON VALLEY

PRECEDENTS Chinese manufacturers have successfully made the leap from electronic toys to chips, telecom, and software

SILICON Their progress has been especially rapid in semiconductors, which are the building blocks for all other tech products

PARTNERSHIPS To play in China's huge domestic market, Western companies must partner with Chinese players, speeding their advance up the tech ladder

HUMAN CAPITAL China boasts a huge pool of bright techies who work at a fraction of what their counterparts in Silicon Valley are paid

SPIRIT Shanghai, in particular, boasts entrepreneurial energy, fine universities, and increasingly, an international climate—just like the Valley Source: Business Week

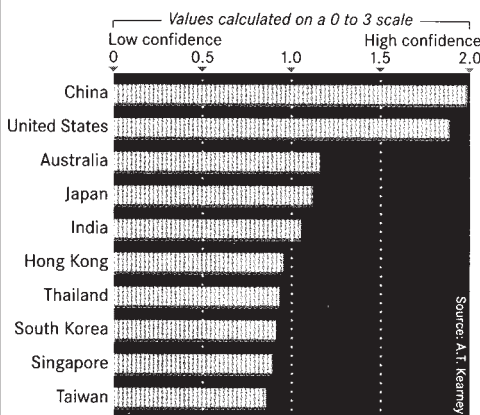
over the next half-decade.

China also is facing an impending banking crisis. Forty-five percent of the urban workforce is still employed by state companies. Most of these are profitless and many are technically bankrupt. The funds necessary to prop up these firms have come from the state banks which show non-performing loans of 20-40% of the total loan portfolio. How do you fix the banks without causing massive layoffs?

We are keeping a close eye on China today. It is a huge investment opportunity but at the same time a difficult one. Many of the most attractive private companies are just that, private and not publicly traded or traded as "A" shares available only to Chinese. But stay tuned, we will be back on this one.

THE BIG BET

More executives say they want to put their foreign direct investments in China



boards and mice, 70% of the keyboards and 60% of the LCD monitors. In the span of just over five years in the mid-1990's most of Taiwan's peripheral companies uprooted themselves and moved to China.

Traditionally foreign direct investment targeted China's local market. It would be a home run if just one in two or even one in five Chinese bought our products. That market is still large but the boom is now on to use China as an exporting platform. The cost advantages are great. Manufacturing wages start at \$0.20 to \$0.60 an hour. These are threatening not just Japan and the United States but also the emerging tigers like Taiwan, Malaysia and Singapore.

And China is also moving up the food

The China Contingent

Chinese companies like those below target the U.S. market with their own brands.

Company	Product	Sales 2001 (\$mil)	% of sales from U.S.	Target for % of sales from U.S.
Haier Group	household appliances	\$7,300	3%	10%+
Huawei Technologies	telecom equipment	3,100	1 ¹	NA
Wanxiang Group China	auto parts	1,100	9	23
Kelon Group	household appliances	1,000	5	15
Konka Group	televisions	860	3	8+
Pearl River Piano	pianos, band instruments	87	10	20

¹Less than 1% of sales.

Source: Forbes

Personal Finance . . .

Home Sweet Home . . .

THE LATEST MARKET DOWNTURN has been tough on everyone. But for those in or nearing retirement, the sell-off has been particularly disheartening. And Mr. Greenspan has not made things any easier. Not only are retirees' equity portfolios down in value but their interest income has dwindled as rates hit their lowest level in over 40 years. The combination of falling portfolio values and rising living expenses is putting many seniors in a financial bind.

Fortunately, real estate values have been the one bright spot in this otherwise gloomy financial picture. Home prices, on average, have increased 51% since 1995 and in many areas of the country are up far more than that. Today, many seniors are house wealthy but cash flow poor.

Up until now, there were only two ways to unlock the equity in your home. First, you could sell. A poor choice for those who want to stay put. Second, you could refinance your home. While millions of Americans have recently done this, it isn't a terribly attractive option for seniors who may not want to be saddled with monthly mortgage payments again.

Reverse mortgages represent a third interesting alternative for senior citizens looking to augment their income. These loans, for those 62 and older, allow you to tap into the equity built up in your home. Unlike the original versions of these loans introduced in the 1980s, reverse mortgages are now non-recourse. This means that the lender bases the loan only on the value of the home and cannot look to your income or other assets for repayment. Payments are not made until the borrower dies, the house is sold or is vacated for a 12-month period of time. During the life of the loan, the borrower retains title to the property and must continue to pay property taxes and insurance.

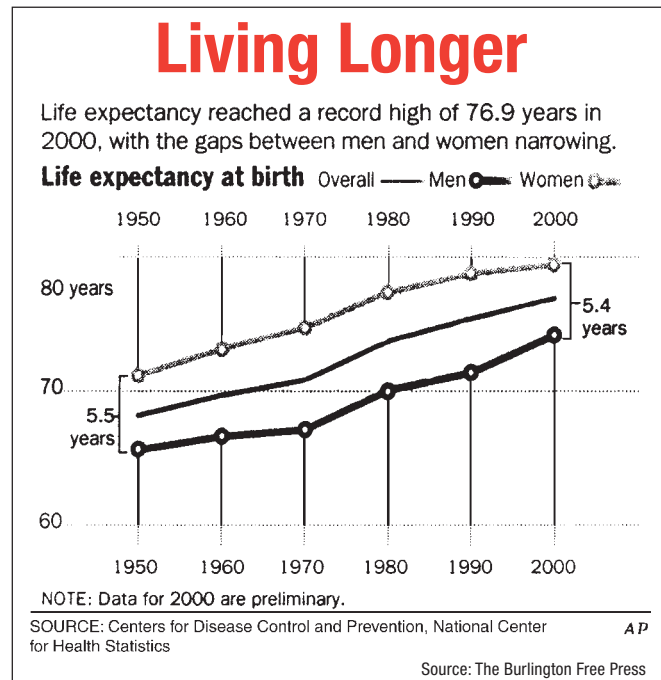
So how much can you borrow? There

are three different types of reverse mortgage loans now offered. Two of these are insured by federal agencies (HUD and Fannie Mae) and private institutions offer the third form. While the maximum loan amount differs under these programs, they are generally based on the borrower's age, the house's appraised value, the value of homes in the surrounding county and the level of interest rates. In Chittenden County here in

Vermont, for instance, HUD's maximum lending limit is \$155,325. A reverse mortgage borrower in his mid-70s might be able to borrow up to 50% of that or \$77,500 while someone in their 80's might be able to borrow closer to 75% or \$116,250. Borrowers may receive cash in the form of a series of payments, as a lump sum or as a line of credit.

As Americans live longer these products are going to become more popular. *Take a look at the chart above.* With the average American now living to almost 77, the chances of you outliving your assets has increased. In general, reverse mortgages make sense for individuals who have most of their wealth tied up in their home. For these folks, the extra cash can be used to pay off a primary mortgage, offset living expenses or help send a grandchild to college.

Seniors facing major medical expenses are also good reverse mortgage candidates. Cash from reverse mortgages can help pay for home care costs or allow a surviving spouse to stay in the family



home. Finally, for seniors with ample financial resources, reverse mortgages can play a very interesting role in minimizing estate taxes

Of course, there are no free lunches. This is particularly true in the world of financial products and reverse mortgages do come with some drawbacks. Administrative costs, especially on loans offered by private institutions, can be high when compared to home equity or first mortgage loans. The second and perhaps more significant negative is psychological. Most Americans spend the majority of their adult life paying off their home. The idea of "spending away" this hard won asset and not passing it on to your heirs can be difficult.

Despite these drawbacks, I believe that reverse mortgages are a product whose time has come. By having access to extra cash, retirees can avoid liquidating portfolios in the midst of a down market. Reverse mortgages are not the right answer for everyone, but they can represent one of many sound choices for negotiating your financial future.

— Anne Williams Doremus, CFA