Thoughts from
Hanson Investment Management Inc.

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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.

Life Is Really Simple . . .

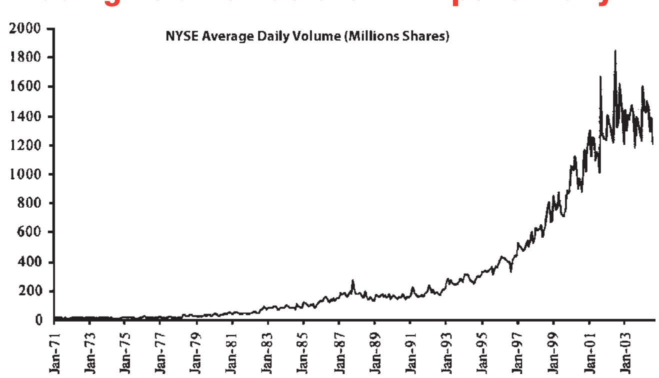
BUT WE INSIST ON making it complicated. Byron Wien, the portfolio strategist at Morgan Stanley, noted in a recent piece that program trading regularly accounts now for over 50% of total volume on the NYSE today. Program trading is computer generated trading of fifteen or more stocks with a total value of at least $1 million. A simple program trade might involve two companies in the same industry. When stock "A" gets out of whack with stock "B" the program calls for selling or shorting the more expensive stock and buying the less expensive one.

Charles Ellis, a consultant and one of the best-known observers on Wall Street, wrote recently in the *Financial Analysts Journal* (September/October 2004) that you could learn a lot about investing from golf. The challenge of golf is to control the most important variable – you. Tommy Armour, a legendary golf teacher, used to say "it is not solely the capacity to make great shots that makes great champions but the essential quality of making very few bad shots." Wall Street is the same. Program trading multiplies the number of decisions you have to make and accordingly multiplies your chance for error.

The best investors practice simplicity. They stay very focused and pick their spots carefully. Warren Buffett did not make his money through program trading. He patiently waits for good quality companies to sell at a fair price and then holds these investments for long periods of time. His turnover is negligible.

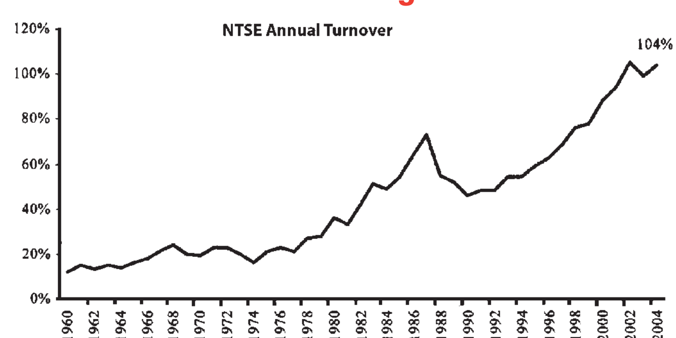
Peter Bernstein, the financial author, was recently asked in *Money* magazine (November 2004) the most important investment lesson he has learned about investing. He said it is that we do not and cannot know what the future holds. Every time we trade however we are in effect saying, I know something about the future. Why else would we trade? The 'smart' money today says buying and holding stocks is old hat. You have to be quantitative to be successful now and have your sophisticated algorithms to time the market. Don't buy it. A 100% turnover rate is a recipe for gambling returns, not investment returns.

Trading Volume Has Grown Exponentially



Source: Morgan Stanley Research

Turnover Rates Are Soaring



Year average, except for current year average through the end of August.
Source: 1960 through 2001 NYSE Fact Book

The World of Globalization . . .
The Only Norm Is Change . . .

GLOBALIZATION IS ABOUT bringing people together and also about tearing traditional economies and societies apart. But most of all globalization is about change and the incredible speed at which this is occurring. It is hard to keep up with globalization today. Here are three tidbits that caught my eye recently.

Outsourcing gets outsourced.

General Electric is one of the pioneers in shipping work off to India. Jack Welch, the former chairman of GE, calls it the 70:70:70 rule. Seventy percent of GE's internal processes are targeted for outsourcing, 70% of this outsourcing will be done offshore and 70% of this will land in India. This means conceivably that 1/3 of all GE's internal processes may one day end up on the Indian subcontinent. Over the years General Electric has built up a team of 12,000 people in four centers in India doing everything from call center work to the highest end research and development.

But now General Electric is selling its off shore unit for $500 million. Why? Because the bottom line is they can outsource their work in India to a third party at lower cost. General Electric has discovered that India does not come without problems. Employee turnover is running at over 50% there and salaries for young talent are jumping sharply as the popularity of outsourcing grows. Who would have thought that even off shoring can get outsourced!

The Big get bigger and the Small get smaller.

In the auto business the stock market has made its judgment. The market capitalization of Toyota Motor today is more than General Motors, Ford and Daimler Chrysler combined. That's right, on Wall Street Toyota is No. 1 and everyone else runs a distant second. And for good reason. Toyota is by far the most profitable automaker today and it is very close to taking the mantle of the company selling the most units in the world. Toyota intends to ramp up production to 8.5 million cars and trucks by 2006 from 6.7 million vehicles in 2003. General Motors last year sold 8.6 million. The passing of the baton from GM to the Japanese is not unexpected but symbolic nonetheless. The King is dead, long live the King.

At the same time that the big are getting bigger, the small are getting smaller. Tata Motors in India last year introduced the Indica car at $6,600. It has been quite a hit targeting the newly developing consumer class. The company is now working on a $2,200 compact, the world's cheapest car. The emerging world is the next big thing for consumer products. Taking expensive Western goods and selling them at lower price points without sacrificing quality will be everyone's challenge. India is leading the way in many products here. An important development to watch.

Russia rising? Russia falling?

In a report in 2004 Goldman Sachs identified the four Emerging Markets that will lead the world the next 20-50 years. They are: China, India, Brazil and Russia. No doubt about the dynamism of the first three. But Russia could be a problem. The political system there is suspect, crony capitalism might better be labeled criminal capitalism and *as the chart above shows* the country is in a state of population implosion today. Most Western countries and many emerging ones are experiencing a slowdown in the rate of population growth. In fact many western European countries will be losing population soon. But nothing along the lines of what Russia is experiencing. Analysts say the population of Russia could decline 20% by 2030. *The Economist* notes that Russia's death rate is beyond compare. Male life expectancy is lower now than it was forty years ago. The country has an enormous drinking problem and it incurs more heart disease, industrial and traffic accidents, and murder and suicides than any Western country. Tuberculosis is rife and AIDS is taking hold. Will we use the term "super power" for Russia thirty years from now? As I said the only constant with globalization is change.

Source: The Economist

The Indian Way: Inventive Yet Practical

Local entrepreneurs and companies are creating low-cost, high-quality products and services

TATA CAR
The Tata Motors $2,200 compact will be the world's cheapest car. A prototype of this motorbike-auto hybrid will be ready in 2005.

ARAVIND EYE-CARE SYSTEM
Thanks to assembly-line surgery, plus locally manufactured intraocular lenses, cataract operations go for as little as $50 each.

INDICA
A big success at $6,600

JAIPUR FOOT
The sturdy $30 prosthetic foot is made from the outer material of satellite rocket launchers made by the Indian Space Research Organization and is exported to developing markets.

ELECTRONIC VOTING MACHINE
This dust and tamper-proof $200 voting machine with an embedded microprocessor can be used by illiterates. The machine delivers election results in 24 hours—a time saving of 70%.

COMPUTER-AIDED LITERACY PROGRAM
Tata Consultancy Services devised a computer-aided program to teach India's 200 million illiterate adults to read using obsolete computers. Development cost: Just $100,000.

SECURITIZING MICROFINANCE LOANS
ICICI Bank is reducing the cost of its rural microfinance program and bringing more money into rural India by securitizing microfinance loans—much like mortgage-backed securities.

Data: Business Week

Source: Business Week

High Tech Score Card . . .

A Report from Monterey . . .

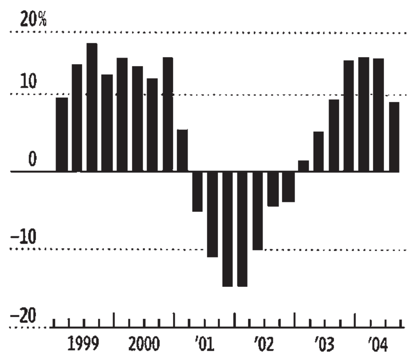
EACH YEAR I ATTEND THE American Electronics Association (AEA) Fall Classic in Monterey. I have been going for almost twenty years now. The Classic brings together smaller high tech companies and investment professionals. The mood this year was less than ebullient. High tech spending has slowed recently after a strong rebound in 2003. The reason is companies are squeezing more out of existing tech gear and when they do buy, they are being extremely stingy. Also there are few "killer applications" or must have products out there.

But the beauty of the AEA Classic is it showcases America's real strength in technology: we are still the leader in entrepreneurial innovation. The investment capital and deep markets required by small companies are all in place. We have the product developers and dreamers who come up with ideas and we have the nuts and bolts business pros to run the companies once they get going. In some years demand is strong and in some years (like 2004) demand is weaker but our system is still the envy of the world.

There were areas of strong demand at Monterey even considering the spending slowdown. The wireless sector is hot and some equipment suppliers are doing well. A trend to watch is the move towards "small mobile wearable devices." Also there was a lot of buzz about internet phone calling or Voice Over Internet (VOIP) protocol and also about broadband internet connection especially as it relates to wireless devices.

After the Bubble

Year-over-year percentage change in quarterly U.S. corporate spending on high-tech equipment and software



Source: Bureau of Economic Analysis via Commerce Department

Source: Wall Street Journal

<u>Three companies with interesting technology caught my eye at the Conference.</u> Two others might also be of interest even though they weren't at Monterey. They represent big trends in technology now.

UT Starcom is based in San Diego but virtually all its sales are outside the U.S. The company pioneered the PAS wireless network in China, an inexpensive alternative to traditional cell phones. The system has been a hit and the company is taking its products to the rest of the Emerging world. UTStarcom is an interesting way to play the growth in consumer spending in developing areas.

Kopin is a company I have seen a number of times at the AEA. It is a spin off from MIT's Labs. The company makes chips for cell phones. Well over half of all handsets have a Kopin chip in them. They are also pioneering very small aperture TV screens. They have a big share of the camcorder viewfinder market and are aggressively moving into small screens for cell phones. An interesting way to play the growth in wireless.

Finally Three D Systems is a maker of 3-D modeling and manufacturing equipment. Companies like Burton Snowboards in Burlington, Vermont use 3-D to design and create new snowboard and binding products. The unique feature of a 3-D system is you design your product right on the computer and then spit out the actual plastic version of the idea. No more waiting for mockups and molds. You go from idea to actual model in 48 hours. A real productivity breakthrough.

It was evident at Monterey that product manufacturing of everything designed in Silicon Valley is going to Asia and specifically China. Taiwan Semiconductor and Flextronics should benefit from this. Taiwan Semiconductor is the world's largest contract fabricator of chips. Only a few companies can afford the $4 billion cost of a new state of the art chip factory. All others use contractors like Taiwan Semi. Companies are also outsourcing more of the actual manufacture of their products. Flextronics for instance manufactures Xboxes for Microsoft and copiers for Xerox .

Tech stocks are on the expensive side today but that doesn't detract from the main message of the Monterey AEA conference: the U.S. is still a powerhouse in innovation.

High Tech Standouts

	Symbol	Recent Price	1 Year Range	Price/ Sales	Debt as % of Cap.	R&D ÷ Sales	Business
UTStarcom	UTSI	19	(42-13)	1.0x	30%	8%	Wireless Systems/Handsets
Kopin	KOPN	4	(8-3)	3.2x	0	18%	Cell Phone Chips/Miniature Screens
3D Systems	TDSC	17	(18-8)	0.8x	43%	8%	Three D Models
Taiwan Semiconductor	TSM	8	(10-6)	5.0x	8%	6%	Contract Chip Maker
Flextronics	FLEX	15	(19-10)	0.5x	27%	NA	Contract Manufacturer

Source: Hanson Investment Management

The Global Economy . . .
Dollar Doldrums . . .

AS ANYONE WHO HAS traveled to Europe recently knows, the dollar just doesn't buy what it used to. Last week, the dollar reached an all-time low against the euro, down 30% from 2001, and it is now at its lowest point in more than six months compared to the yen.

The nation's budget and trade deficits are largely behind the dollar's decline. Since 2001, the nation has gone from posting budget surpluses to record deficits. While experts will argue about the deficit's cause the reality is pretty staggering. According to *The Washington Post*, the federal government now pays more in annual interest payments on the debt than on education, homeland security, justice, law enforcement, veterans, international aid and space exploration combined.

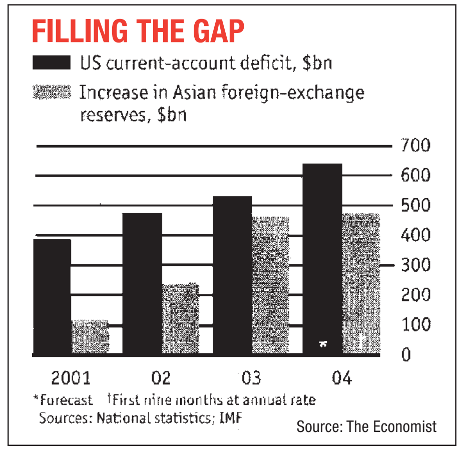
The current account deficit, a broad measure of the difference between our imports and exports, is also contributing to the dollar's swoon. Take a look at the chart to the right. The U.S. trade gap is projected to increase by almost a third this year to $630 billion or a staggering 6% of our total GDP. Trade with China continues to represent the biggest single source of the imbalance. This is no coincidence. China's policy of keeping their currency pegged at artificially low levels has led to a boom in exports from that country.

So what do these deficits have to do with the value of the dollar? Currencies are like any other commodity. Greater demand translates into higher prices and excess supply means lower prices. To fund its budget deficits, the federal government sells treasury securities. Foreign governments have become the primary purchasers of these IOUs. On the trade front, everyday foreigners must decide to accept in exchange for their exports abut $1.5 billion. The ability to finance both deficits depends on foreigner's willingness to hold treasury securities and dollars.

Recent economic data suggests that foreigner's appetite for greenbacks may be waning. A Treasury report released in October showed that net foreign purchases of U.S. bonds fell 45% in July while purchases by foreign central banks fell 76% to the lowest level in about a year. While this may be a short-term blip on the economic radar screen, other data suggests that many foreign purchasers are not anxious to add to their reserves.

So why aren't policymakers panicking? With the election now past, Washington seems to be taking the issue of rising budget deficits more seriously. But debate on the trade deficit continues. Many argue that the dollar can continue to decline as long as China and other Asian countries continue to buy our bonds. So far, it has been in their (and our) economic interest to do so. A falling dollar, after all, helps stimulate the U.S. economy as our exports become more competitive abroad.

But a continuing dollar decline has



other consequences as well. Principally, it hurts the economies of European countries with appreciating currencies. And at some point, foreign investors will be unwilling to hold U.S. assets (dollars or bonds) if they keep losing money on currency translation. This is not a trivial concern. In 2003, foreign investors owned 10% of all U.S. stocks and 17% of U.S. corporate bonds.

My guess is that the dollar will continue to depreciate for some time. While not great news for our friends in Europe, this will help solve two problems at home. It will help stimulate exports much to the delight of our beleagured manufacturing sector. It will also help bring the trade deficit back into line as exports increase and imports, which become more expensive, decline. This favorable outcome, however, is not without risks. Currencies are notoriously volatile and anything other than a slow, orderly decline could send international investors fleeing out of dollars in a hurry.

What is an investor to do given this uncertain outlook? In the current environment, we think owning international investments makes sense for several reasons. Economic growth rates in many emerging and Asian countries are accelerating and from a valuation standpoint, many of these markets look like bargains. Second, overseas investors will get an added boost from currency appreciation as foreign profits are exchanged back into weaker (more) U.S. dollars.

– Anne Williams Doremus, CFA