

Thoughts from

Hanson Investment Management Inc.

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WE ARE GROWING IN numbers again. If you haven't spoken to us in a while we are up to six people today. Don't worry though, we do not intend to grow so big that we lose our small firm character.

We have been in business now a little over ten years. In 1995 there were just two of us, Marykay McCarthy and me. Marykay decided to move to Arizona five years ago to be closer to her children and grandchildren. We were very fortunate to find Debbie Healey to replace her. Debbie is our office manager and the one you are most likely to talk to when you call. Debbie knows where everything is. She can probably answer 80% of your questions. Kristen Audy assists Debbie and recently Mike Reynolds joined us from Charles Schwab. He rounds out the administration team.

Anne Doremus and I have worked together for over 15 years and she is the second person on the investment and client contact front. Julie Won, our most recent addition, will help in both these areas. Julie was formally with Citibank



Julie

in their Foreign Currency operation. Before that she was at Stanford earning an MBA and a Masters in Asian Studies. She is getting up to speed now and prepping for the Chartered Financial Analyst (CFA) exam.

I am awfully proud of everyone on our staff. They are all very talented and very hard working. Call any of us when you have questions. Our present size should carry us through the next couple

of years. We are getting bigger but we will be careful with our growth. Size doesn't necessarily mean quality. We will work hard to keep our service level up (and hopefully make it even better) as we grow.

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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.

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Anne Mike Eric Kristen Debbie

The U.S. Scene . . . High Tech in America . . .

EVERY FALL THE AMERICAN Electronics Association (AEA) brings 200+ small to intermediate size high tech companies to San Diego to present to institutional investors. I saw twenty companies in two and a half days and my conclusion is high tech is alive and well in the U.S. Here are some of the themes I saw and some of the most interesting companies.



1. Technology still means growth.

The chart in the upper right shows forecasted growth in the disk drive business. The print is small and I apologize. The point is that demand for computer memory is growing dynamically today. The same thing can be said for many other areas of high tech. Personal computers were an early driver of tech growth. More recently wireless devices have taken off and technology in industrial areas is also growing such as the increased use of computers in cars. The newest area is growth in consumer electronics (iPods for instance) and gaming devices.

MKS (symbol MKSI) makes equipment to build semiconductors and is benefiting from the increase in chip

demand. Other companies are developing brand new technologies. **Nanophase** (NANX) is manipulating individual atoms and molecules. For instance, they are putting nanoparticles in plastics in children's furniture to make surfaces more germ resistant.

2. What you see is not always what you get.

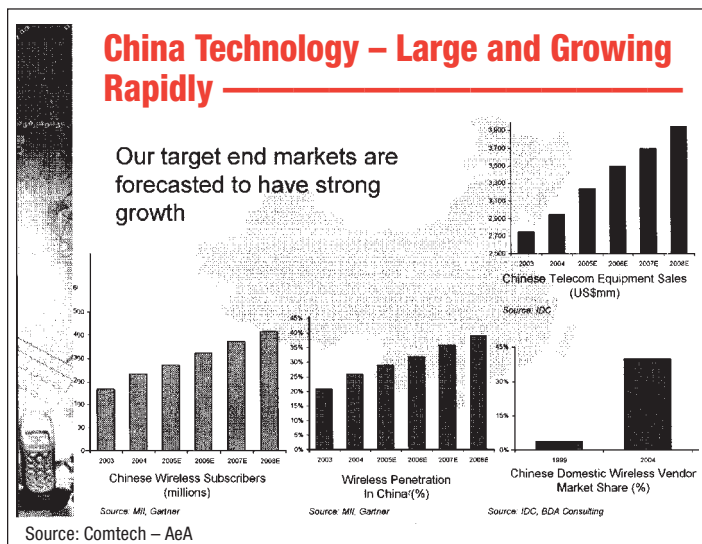
Technology often starts out in one market and

then morphs into totally new ones. **Plantronics** (PLT) began life making headphones for airline pilots. Then the call center business evolved and products were developed here. More recently headphones have gone wireless and you can now buy a single PLT product to answer your cell phone and listen to stereo iPod or MP3 players. **Kopin** (KOPN) makes very small TV displays the size of your thumb nail. The initial market was screens for camcorders but now the same technology is being used in eyewear to project DVDs onto your own personal theater screen. The military is adapting Kopin's cyber displays for use on the battle field.

3. Outsourcing is now investable.

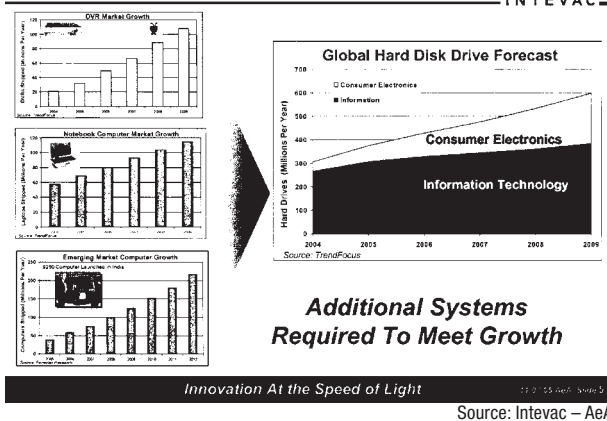
A significant amount of U.S. technology manufacturing has moved to Asia.

This is not new. The change is that companies specializing in outsourcing are now available to investors. **Comtech** (COGO), a Chinese company listed in the U.S., does design outsourcing for telecommunications and consumer electronics. A company wanting to make cell phones in



Equipment Products Business

Growing End Market for Hard Drives Requires Additional Systems | INTEVAC



China for instance, can buy a Comtech module customized to their specific need. **Peoplesupport** (PSPT) in the Philippines does business process outsourcing (BPO). They operate call centers and help desks for U.S. companies. Philippine costs are slightly higher than India but, the company argues, physical infrastructure is better in the Philippines and Philippine English has less of an accent than English in India.

4. Five star finances.

Don't look for bonds in the high tech sector. You won't find many. Balance sheets are almost always gilt edged. You read plenty today about bankruptcies in the airlines and even at mighty General Motors but smaller high tech firms are awash in cash and have virtually no debt. High tech may have rock'n roll product cycles but finances are very much in order.

5. The devil is in the details.

After Enron, Tyco and WorldCom, Congress has come down hard on corporate fraud. The solution, Sarbanes Oxley legislation (SOX), is not without its costs however. The typical high tech firm at AEA says the cost of complying with SOX in the first year will be an average of \$1 to \$3 million and ongoing costs will be 50-80% of this. This is a lot of moulah. Increased regulatory costs are as much as one third to one half of net earnings for many smaller companies.

Investment Strategy . . . To Fight or Flee?

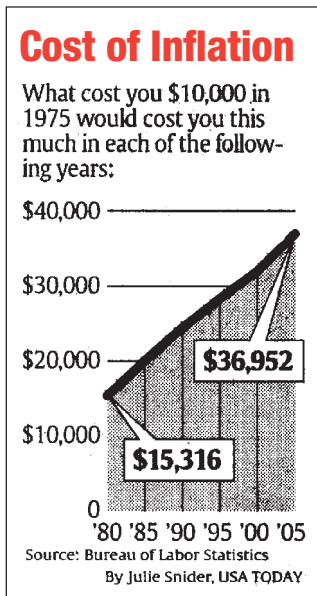
THE STOCK MARKET HAS been pretty dull. After a lot of back and forth, most of the major averages are trading near where they began the year. *As the chart to the right shows*, this is nothing new. Stocks have made little headway over the last five years, underperforming every other major asset class including cash.

These dismal results have investors scratching their heads looking for more exciting places to park their money. This reaction is pretty typical. Many people today came of investing age during the 1980s and 1990s when 20% average annual returns were not uncommon. But the current tendency to “reach for return” can get investors into trouble. So, if you are thinking about selling stocks and putting money into the latest hot investment, consider the following points.

Know Your History.

Since 1926, stocks have produced 10%-12% average annual returns. But as *Wall Street Journal* columnist Jonathan Clements points out, this is far from the “typical” annual experience. It turns out that the S&P 500 produced annual returns between 6% and 16% in only 3 of the past 20 years. Of the remaining 17 years, 9 saw returns of 20% or more, while in 4 years the index lost money.

The point here is that stock returns are volatile. Stocks remain one of the only asset classes that keep pace with inflation, but your chances of getting



this “average” return in any year are not high.

Maintain Realistic Expectations.

A number of factors suggest that future stock returns will be below the long-term average. Valuation levels, while better than they were 5 years ago, are still not cheap. And my hunch is that rising interest rates, increasing debt burdens and the aging baby boom generation will all put a damper on corporate profit growth. So what is an investor to do in this kind of environment? One defensive approach is to reduce your dependence on capital gains by seeking out stocks that offer above average dividend yields.

Watch Out for Hidden Risk.

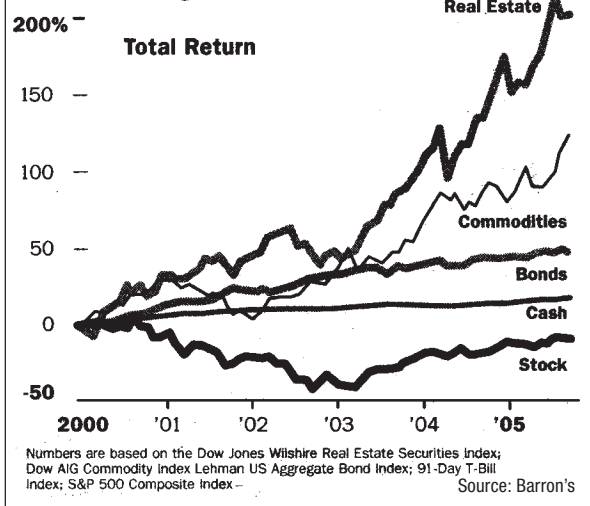
A recent Vanguard survey found that investors think there is a 51% chance that U.S. stocks will lose a third of their value in any given year. But according to Vanguard’s calculations, the real risk of this kind of sell-off occurring is only about 2%. This irrational fear of large market losses is what keeps many investors on the sidelines in cash. But this “safe” investment strategy is actually quite risky. *As the chart to the left shows*, the slow, eroding impact of inflation (and taxes) can wreak havoc on your nest egg.

Keep Tabs on Your Anxiety.

Buy low, sell high sounds like a great idea. But this strategy is actually extraordinarily difficult to put into practice. To avoid the pain associated with loss, most investors naturally want to bail out of stocks after they have fallen and are only comfortable getting back in stocks once prices have recovered and the market appears “ok.” But making money in the stock market requires keeping your cool while those around you head for the exits. To avoid falling prey to your

Reversal of Fortune?

The performance of various assets from December 1999 through September of this year. Jim Paulsen views the worst performer—stocks—as attractive now, even with short-term interest rates rising.



emotions, develop a long-term investment strategy based upon your risk tolerance and return goals. Then stick to it regardless of all the market’s short term “noise.”

Keep A Close Eye on Fees.

Paying 2% in annual operating costs for a mutual fund that is earning 20% a year is no big deal. But if that fund is only growing 6% a year, then paying 2% or 1/3 of your annual return to fund managers can really hurt. If we are indeed entering a period of lower returns, then keeping a close eye on investment costs will also be key to achieving above average results.

Hold A Diversified Portfolio.

Thousands of factors influence investment returns and most of these cannot be predicted over short periods of time. A diversified investment strategy is an investor’s best defense against this investment reality. Holding a wide range of assets whose returns are not highly linked to one another will smooth out returns. And within a stock portfolio, holding a large number of issues spread across different economic sectors will also help you sleep at night.

—Anne Williams Doremus, CFA

The World Economy . . .

“Necessity is the Mother of Invention.” Plato

IT'S BEEN QUITE A YEAR. Over the last twelve months, we have had news of the devastating Tsunami that hit Asia killing over 100,000 people. Since then, there have been earthquakes in Pakistan, flooding in Guatemala and multiple hurricanes in the southeastern U.S. And just when it seemed safe to go back in the water, we now have news of a possible global outbreak of bird flu.

Interestingly, the current H5N1 strain of bird flu is not new. For the last eight years the virus has been incubating in East Asia, where it has been responsible for killing close to 140 million birds. But two facts are now making public health officials sit up and take notice of the disease. First, it turns out that the H5N1 virus is extremely lethal. Of the 140 people infected with the disease so far, 68 or almost 50% have died. Second, for the first time, the virus has expanded its range and is now showing up in flocks in northern China, Russia and Eastern Europe.

Fortunately, the bird flu in its current state poses little risk to humans. The only way you can contract the disease is through close contact with infected birds. Afflicted individuals, for example, have typically been involved with feeding, cleaning up after or slaughtering birds. The real concern is what might happen if the virus mutates into a form that can be transmitted between humans. If this happens, experts predict an influenza pandemic that could kill between 2 and 7.4 million people worldwide.

The spread of the disease would likely have far reaching economic consequences too. A review of the SARs epidemic that struck East Asia in 2003 gives us some sense of the likely impact. According to the World Health Organization, a total of 8,097 people contracted SARs and of these, 776 died. This relatively “limited” outbreak is estimated to have cost between \$30 and \$50 billion. Unless contained quickly, a bird flu outbreak could prove much more costly.

Bird Flu Migrates West

Turkey and Romania have recently confirmed cases of avian flu in birds, indicating that the virus has moved from Southeast Asia toward the West. So far, human cases of avian flu have occurred in only four Asian countries.



Source: The Washington Post

A whole range of organizations are now gearing up to prepare for a possible pandemic. Efforts are focusing on two fronts. First, epidemiologists are working

with national and local governments to track the disease. Private and public sector entities are also developing vaccines to prevent infection and drugs to combat the flu once contracted. Currently, two drugs, Tamiflu and Relenza, can help relieve bird flu symptoms. But current supplies of the drugs and manufacturing capacity are too limited to meet demand if the rate of infection really takes off.

Developing a vaccine against the disease is not easy. The current virus has not yet mutated into a form that can be transmitted between humans. While this is good news, it means that scientists must develop a vaccine against a virus that does not yet exist. And vaccine manufacturing capacity needs to be improved. Today vaccine production, a process that involves incubating virus material in chicken eggs, can take up to 6 months.

Just thinking about the bird flu is enough to send most investors to the phone with sell orders. But there are reasons for optimism as well. Consider what the Bill & Melinda Gates Foundation is accomplishing in Africa. After years of little progress, a vaccine was developed last year that offered partial protection against malaria, a disease that kills about 1 million people every year.

The threat of a major bird flu pandemic is now spurring a number of innovations. Scientists across the globe are collaborating to develop an additive to boost the effectiveness of current treatments. Swiss drug firm Sanofi is working to create a vaccine by growing the virus in cell cultures, and a small British company called PowerMed is focusing on making vaccines using DNA. PowerMed's approach would dramatically reduce the cost and time needed to develop drugs. Whether these efforts will produce the needed results in time for the next flu outbreak remains to be seen. But amazing things can happen when money and a sense of urgency are brought together.

— Anne Williams Doremus, CFA