

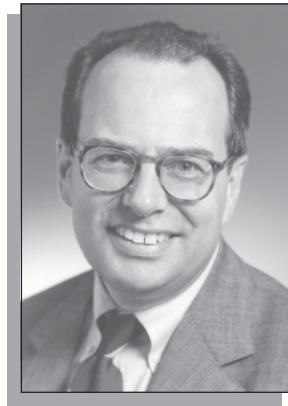
Thoughts from

Hanson Investment Management Inc.

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This is One Confusing World...



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THE ECONOMIST IN A lead piece on the Global Economy in early October lists four risks to the 2005 World outlook: higher oil prices, a slowdown in consumer spending in the U.S., a global housing bust and a hard landing for China. We review two of these in this letter, oil prices on page 3 and Anne on the housing market on page 4.

Managers and investors are all over the board today about the outlook for 2005. In the October 11 edition of *Barron's* Alan Abelson reported that the Business Council made up of CEOs of Fortune 500 companies is bearish on the immediate future. Seventy percent of CEOs expect the economy to grow only 0% to 2% in 2005 versus 3% to 4% now. But in the same edition a poll of

700 economic development specialists in fifty states comes to a more positive conclusion. Seventy-two percent of respondents rate economic conditions as very good or somewhat good compared to only 46% last year. So go figure.

We come down on the positive side of this debate. *Like the chart below* we look for slow but steady progress in a number areas. For the most part inflation will remain under control and interest rates, although likely to rise will not cause major problems. The price of oil could slip if the current "terrorist premium" dissipates. Finally the economy will grow steadily next year probably closer to 3% than 1% to 2%. With fingers and toes firmly crossed we are looking for a decent year in 2005.

A Brighter 2005

You can separate the real issues from the background noise by imagining yourself a year from now looking back at today. The good news is that by then the key economic indicators should be signaling the continuation of a moderate recovery.



THE ECONOMY

GDP has been up for 12 straight quarters. Growth may slow slightly in 2005, but the recovery won't end.

GDP growth

Fall 2004: 3.2%

Fall 2005: 2.8%



UNEMPLOYMENT

A small reduction in unemployment should help consumers without igniting wage inflation.

Unemployment

Fall 2004: 5.5%

Fall 2005: 5.3%



PRICE OF OIL

The current spike in oil prices is likely to dissipate as the "terrorist premium" eases.

Oil price per barrel

Fall 2004: \$44

Fall 2005: \$35



INFLATION

There's no sign yet of an upturn in inflation, so the economic expansion could be long-lasting.

Inflation

Fall 2004: 3.0%

Fall 2005: 2.5%



INTEREST RATES

Normally, interest rates rise as a recovery continues, but stocks should easily be able to absorb a small increase.

Long-term interest rates

Fall 2004: 4.4%

Fall 2005: 5.4%

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.

The U.S. Market . . . What is Value? . . .

THE ANSWER IS THERE IS NO one definition. Value is in the eye of the beholder. To us Value means buying securities that are cheap relative to earnings and assets. Our selections are usually out of favor with the market and the stock price is steeply discounted. Expectations are generally low and sentiment is negative. The biggest risk in Value investing is losing faith. No strategy is right all of the time. The

Graham liked companies selling below book value or the amount a company could be liquidated for. Jeremy Grantham, the founder of GMO, a Boston investment manager and one of the sharpest investment minds today, agrees. The problem is there

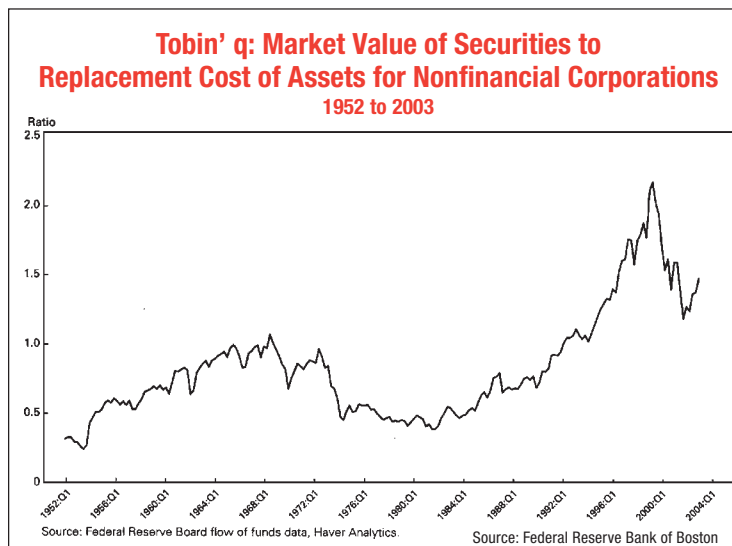
aren't a lot of low price to book candidates. The average stock trades at almost three times book. Grantham follows the Tobin's q Ratio, which measures the market value of all securities relative to the replacement cost of the assets. Because stocks are selling significantly above what you could theoretically replace them for Grantham expects U.S. large cap stocks to decline 1% per year on average the next seven years. Warren Buffet, one of the most famous Value investors, also thinks the market is expensive. He is looking for a total return the next five to ten years of 6% versus the historic average of 10% to 12% per year.

We are a bit more optimistic. We are looking for a total return of 8% in this market. But with valuations stretched the choice of investments is more limited. In the overlooked and unloved

category we own both Kodak and Merck today. We also are attracted to companies that are retooling their business. Newell Rubbermaid in the consumer area is one and Unum in finance is another. And we like companies that pay big dividends. The more return we can get upfront the more is our margin of safety.

U.S. stocks are more expensive today than European companies and European issues are in turn more expensive than Emerging Markets. So we are attracted to issues trading in the faster growing parts of the world. TelMex, the Mexican phone company with operations in a number of South American countries, is attractive.

The stock market outlook is never clear. There are always clouds. Today is no exception but we still see opportunity in the Value sector of the market.



Overseas Values

Based on some popular market yardsticks, foreign stocks are less expensive than U.S. shares.

	PRICE-TO-BOOK VALUE	PRICE-TO-EARNINGS RATIO	DIVIDEND YIELD
United States	2.9	19.4	1.8%
Europe	2.1	16.0	3.0
Pacific	1.8	25.7	1.6
Emerging markets	1.8	12.7	2.9

Note: Data as of Aug. 25, 2004

Source: Morgan Stanley Capital International

Source: Wall St. Journal

temptation is to jump ship to a brighter light right at the wrong time – remember the high-flying and absurdly expensive tech stocks of the 1990s. They attracted many converts very late in the game.

Benjamin Graham, the father of security analysis, was a Value investor. He wasn't very interested in figuring out exactly how a company was going to perform in the future. He was more interested in choosing solid companies selling at such low prices that there was a significant built-in "margin of safety". If his analysis was off, even by a lot, he could still make money.

Value Revisited

	Recent price	52-week range	Current PE	Price/book	Debt as a % of capital	Yield	Business
Eastman Kodak	34	34-22	13x	3.0	47%	1.5%	Photography
Merck	31	50-30	12x	4.0	30%	4.9%	Pharmaceuticals
Newell Rubbermaid	20	26-20	13x	2.9	60%	4.2%	Consumer products
UNUM Provident	15	17-13	8x	0.7	33%	2.0%	Disability insurance
Telmex	32	36-30	10x	2.6	40%	3.6%	Telecom

Source: Hanson Investment, Value Line, Yahoo Finance

The Oil Card . . . Nothing Has Changed . . .

... **L**ET US SET as our national goal . . . that by the end of this decade we will have developed the potential to meet our own energy needs without depending on any foreign energy source". John Kerry? George W. Bush? . . . No, Richard Nixon. As far back as the first energy crisis of 1973 we were declaring Energy Independence as Job One. But not much has been done on this the past thirty years. We are now more dependent on foreign oil than ever. We are pumping less crude today than in 1982 but using more refined product.

The energy issue involves two questions. The first is, how badly will \$50 a barrel oil affect the economy? Stephen Roach, the Chief Economist at Morgan

We realize there is little room for error here as *the chart to right* shows.

The primary reason for the jump in crude prices is an increase in consumption. This increase is coming in places that are very inefficient in the use of oil. It takes China for instance twice as much oil to produce a dollar of GDP as compared to developed countries. It takes India 2.5 times as much.

Longer term, is U.S. energy independence really a possibility? Our Presidential candidates say it is. The Republicans favor increasing supply. The Democrats want to reduce demand. The problem on the supply side is many of the most attractive new drilling areas in the U.S. are in environ-

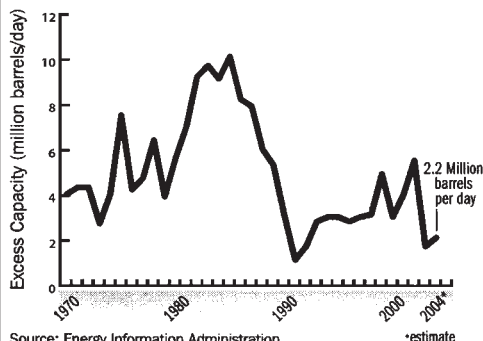
mentally sensitive areas. Increasing wind generation has proven to be politically difficult and the pay off from hydrogen is years if not decades away.

An immediate step that could save us significant oil is conservation. Sixty-eight percent of our total energy use (*see chart*

below) is accounted for by transportation. We haven't updated our fuel efficiency standards in almost twenty years and a lack of prodding on standards and cheap gas has led to an explosion of gas guzzling cars and SUVs. Tighter energy

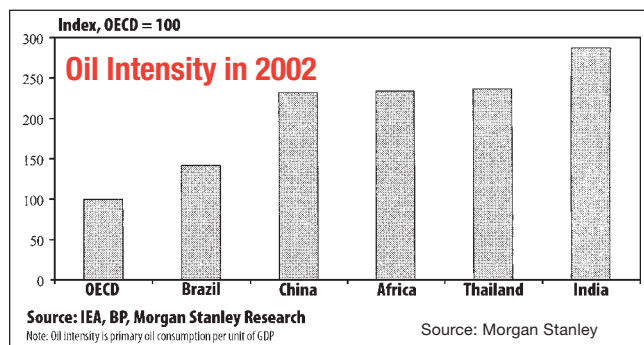
World's spare oil-production capacity

The ability to produce more oil on short notice is at a level comparable to the low point when Iraq invaded Kuwait in 1990. This doesn't necessarily affect prices, but suggests the market has little margin for unforeseen interruptions.



efficiency standards could save as much as a million barrels a day in demand or two thirds of what we import now from Saudi Arabia. Higher gas prices would also help reduce consumption and would have the added benefit of making oil shale and heavy oil, things we have a lot of, more economically viable.

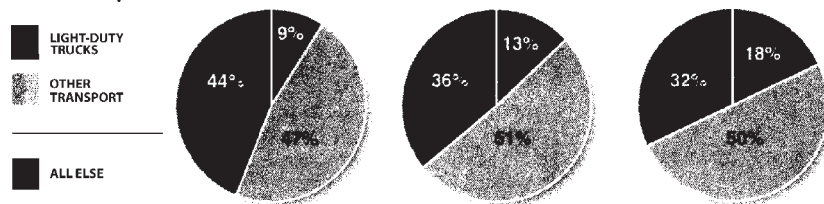
The oil issue can be solved. But the solution requires the pain of higher prices. The fact is we are consuming more and are producing less. We have to import the difference and these imports are often coming from politically unstable areas. Democracies have never been all that good making painful choices before problems reach crisis stage. Let's hope this time is different.



Stanley, notes that each of the three previous oil shocks in 1973, 1979-1980 and 1990 was followed by a recession. Can we avoid the R word this time? We are betting we can, that a combination of some increase in production and a decline in the "terrorist premium" (as much as \$5 to \$10 a barrel) will push crude prices lower. A decline in oil prices will take a lot of pressure off the world economy.

More Transportation . . .

Percent of all oil consumption

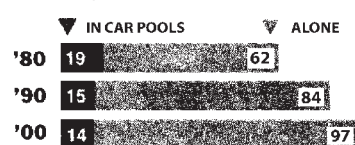


* One B.T.U., or British thermal unit, is the amount of heat required to raise the temperature of one pound of liquid water by 1 degree Fahrenheit at its maximum density, which occurs at a temperature of 39.1 degrees Fahrenheit.

Sources: Energy Information Administration, Department of Energy's Transportation Energy Data Book

. . . Less Conservation

People driving to work in private vehicles, in millions



Miles driven by vehicles, per capita



Source: New York Times

The Global Economy . . .

The Making of (Another) Asset Bubble . . .

PERIODICALLY, OTHERWISE rational people make bad investment decisions based on the lure of extraordinary financial gain. When enough investors holding exaggerated expectations bid up prices, a bubble is formed. Unfortunately, bubbles tend to expand far beyond what is sensible and ultimately, for one reason or another, everyone rushes for the door. Of course, because not everyone can get out, most investors are left with substantial losses. The recent meltdown in technology stocks is a sad reminder of bubble behavior. But, another asset bubble may now be forming in the wake of this recent painful experience.

Low interest rates and easy access to credit have fueled a boom in housing. Since the mid-1990s, housing prices have increased more than two times as fast as in the 1970s or 1980s. And so far, there is no sign of prices abating. In the second quarter, house price appreciation over the previous year was at the fastest pace since 1979. The volume of house sales, a good indicator of speculative fever, also continues to rise. This year home sales are running at 7.9 million units or at a rate 50% higher than the pace established in the mid-1990s. And this phenomenon is not limited to the U.S. Research by

Morgan Stanley economist Steve Roach shows that housing bubbles exist in about 25% of the global economy.

Debate now centers on whether house prices are in bubble territory. Many in the real estate business claim that the price increases are justified given the current low level of interest rates, lack of available land and increased demand for housing from new immigrants.

Unfortunately, it is not so easy to determine the "fair" value for any given house. Multiple factors such as location, school systems, and prevailing interest rates come into play. But looking at prices relative to incomes and rents over time sheds some light on their current valuation. Intuitively, the price of a home should be connected to the income of the people living in it. The more income an owner has, the more house he can afford. Rents, or the earnings your house would generate if you decided to lease it out, also influence prices.

As the chart to the left shows, these two measures have been on an upward trajectory for the past 5-10 years. Today's price to

personal income rate of 3.4 is 21% higher than the long-term average established between 1975-2000 while the ratio of house prices to rents (15.2) stands at the highest level in 20 years.

So what is the outlook for housing prices? Historically, we know that since World War II there has never been a year when average real estate prices in the U.S. have

State of Play in World Housing Markets

	Bubbles	Bubble Watch	No Bubble
	Australia	US	Japan
	UK	Canada	Euroland
	China	France	Germany
	Korea	Sweden	ASEAN
	Spain	Italy	India
	Netherlands	Hong Kong	Latin America
	South Africa	Thailand	
		Russia	
		Argentina	
Share of World GDP	25%	40%	35%

Source: Morgan Stanley Research

lost value. But the experience of individual markets has been quite different. In the early 1990s, home prices fell 26% in Los Angeles, 13% in Boston and 11% in San Francisco.

Today, it appears that average prices are probably not too out of line. But specific markets definitely appear frothy. Housing markets on the two coasts present the biggest area of risk. Over the last 5 years, for example, home prices are up 103% in San Diego, 100% in Salinas, 105% in parts of Cape Cod and 87% in Providence.

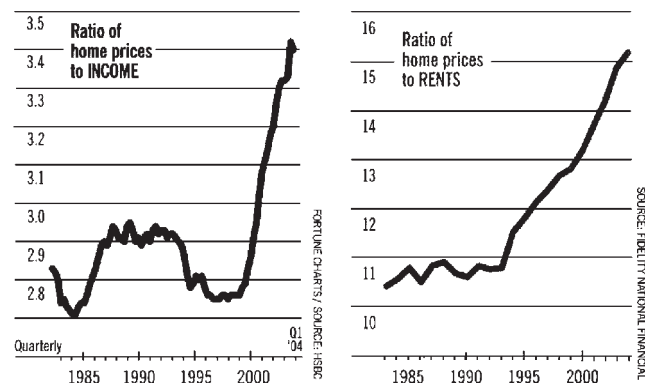
What could set off a drop in prices? Rising interest rates probably represent the most likely and greatest threat to the housing market. This is especially true given the recent increased use of adjustable rate mortgages. A weaker economy and continued deterioration on the job front would also reduce the pool of willing buyers and depress prices. Finally, rising property taxes present a subtle but growing risk.

Fortunately, a number of factors tend to support house prices. In weak markets, homeowners are reluctant to mark down prices and when mortgage rates increase, people who have locked in prefer to stay put. I don't think a broad price decline is in the cards. But future returns on homes won't begin to approach the outsized gains of the last five years and those looking to earn a quick buck should take heed.

— Anne Williams Doremus, CFA

Reality Check

Home prices have leapt far beyond historical norms when measured against both personal incomes and rents.



Source: Fortune