Thoughts from
Hanson Investment Management Inc.

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We Are Definitely In Control...

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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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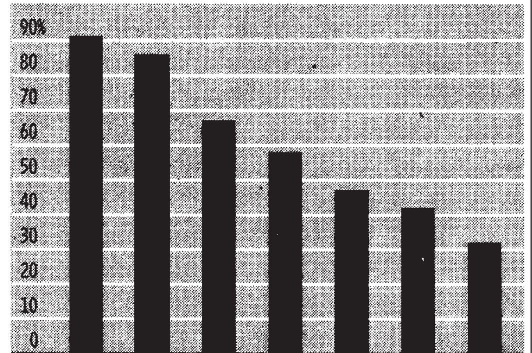
RIGHT? I AM TALKING about us as shareholders of corporations. As *the chart at the bottom shows* we are supposed to be in charge. We elect the Board and the Board supervises Management. But amazingly it doesn't work like this. First, there is virtually no avenue for shareholders to nominate directors to most corporate Boards. Instead management nominates and we rubber stamp. A recent SEC proposal to change this has been dropped.

Once a director is nominated, shareholders vote either "for" or they "withhold" their vote. There is no place to vote "no"! A director can actually be elected with just one share voting in favor since all the "withheld" votes are simply dropped.

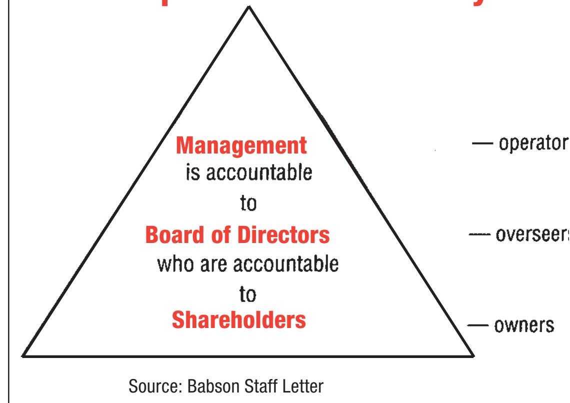
Some changes may finally be in the works however. Pfizer for instance now says that if a majority of shareholders withhold their votes for a nominee that person must offer his or her resignation from the board. But even here shareholders do not have the final say. The Board of Directors can reject the nominee's resignation request.



Source: Federal Reserve Board; Bogle Financial Markets Research Center
Source: The Wall Street Journal

John Bogle, who has been a thorn in the side of institutional investors for decades, has a new book out, "The Battle for the Soul of Capitalism." In it he notes the decline of the individual shareholders. Direct ownership of U.S. stocks by individuals has fallen from 90% in 1950 to 30% today. The ownership of securities has shifted to mutual funds and pension managers who are far more likely to vote with management than against. Remember, institutional investors compete for investment management business from 401-K Plans and Pensions. They don't want to tick off management with a lot of "No" votes on proxies.

Here at Hanson Investment Management we vote our proxies in favor of all shareholder rights amendments. This includes the right to nominate members to the Board and the right to vote an individual Director up or down.



Source: Babson Staff Letter

Zhongguo (China) . . .
Still Very Much a Mystery . . .

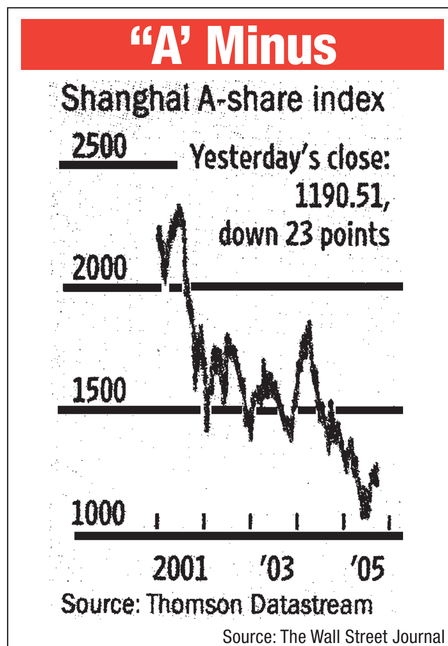
OH SURE, WE KNOW WE GET our clothes and toys and stuff from China but what is this country anyway, friend or foe? And if China gets wealthier, does that mean we get poorer?

The changes Deng Xiao Ping initiated in 1979 have been breathtaking. When he exclaimed a quarter century ago, "to get rich is glorious," the masses did just that. China has pulled more people out of poverty the past twenty-five years than any country has ever done anytime in history. The Organization for Economic Cooperation and Development says that China will be the 4th largest economy by 2010 and the world's biggest exporter.

I was recently in China on a group tour visiting Chinese and foreign software companies. The trip had a narrow focus but it was still broad enough for me to get some common themes. Here are six:

Source: Business Week

1. **Relationships ("Guanxi") matter, really matter.** Every company attributed a major part of its success to "good relations" with city, state and federal officials. Good relations can mean anything from a good working relationship to cash payments to officials to helping arrange foreign trips or helping the children of higher ups get into college abroad. Many U.S. companies use "agents" to interface with customers so they in effect, hear no evil, see no evil.



Source: The Wall Street Journal

2. **Labor is not as cheap as you think.** Oh sure, there are a billion people and tech companies can hire young engineers for between $5,000 and $12,000 a year. But it is not easy to find experienced mid level staff and very difficult to find senior level ones. Wages for talented workers are going up 5% to 20% a year and turnover is high. Nurturing and keeping good employees is Job One for companies in China.

3. **The rule of man trumps the rule of law.** Chinese laws are vague and rules interpreting them are rarely written down. Much is left to the individual officials, i.e. guanxi. And corporate Presidents in China are emperors in miniature, as someone explained to me. They make their own rules. Corporate governance is very much in its infancy.

4. **The Chinese do not like economic road blocks, like the power of foreign patents.** Intellectual property is not something the Chinese value highly or at least not yet, until their own companies develop it. It is estimated that 95% of desktop software (read: Microsoft Windows and Office) is pirated. The Chinese are doing just enough to counter this to keep the U.S. and the WTO at bay. Every software company I spoke to, both Chinese and foreign, takes evasive action to protect their source code like selling over the internet where material is more difficult to duplicate and steal.

5. **Is anyone making money in China?** Seventy percent of foreign companies say they are, according to one study, but there are skeptics. Demand for everything is growing rapidly in China but supply is growing just as fast if not faster. China is probably the most competitive, cutthroat capitalist economy in the world today. To compound the problem the inefficient Banking system makes trade finance difficult for many Chinese companies. If A can't pay B then B can't pay C. This is a big issue for many companies.

6. **Forget traditional strategic planning.** Think speed and flexibility. China is a

very fast changing market and to succeed *(see Key Lessons below)* you need to nurture a local staff, design products that are particularly suited to the Chinese market and then be willing to change on a dime.

So can investors make money in China? Yes, but not the traditional way of buying Chinese stocks on Chinese exchanges. The markets in Shanghai and Shenzhen so far have been a disaster *(see chart)*. There are almost 1,400 listed companies but only 1/3 of total shares are available for trading. The rest is owned by the government or state owned companies. Whenever there is a whiff that these shares will be released the averages plummet. In addition almost all listed companies were once state owned and strange things still happen here. For instance, China has four phone companies, two for land lines and two for cellular. These are all shareholder owned and traded in New York. Last year, to shake the sector up, the government announced that each company would exchange Presidents. Kind of like the President of SBC suddenly becoming the President of Verizon and vice versa. Bizarre but that's China.

There are two effective ways to play China now. One is to own the Index fund for Shanghai/Shenzhen (FXI on the New York Exchange) and also for Taiwan (EWT) and Hong Kong (EWH). This is not the most elegant strategy but it effectively covers the region. The other way is to own shares of companies doing business in China. There are many candidates here perhaps 3,000 or more. For instance, Proctor & Gamble has a long history in China and has developed one of the best supply chains of anyone. Citibank is the first bank to allow Chinese citizens with Chinese currency bank accounts to withdraw funds from ATMs outside of China. General Motors surprisingly, is one the most successful car companies in China, first with the Buick Regal and now with a full range of cars including the $5,700 Spark.

The northern city of Dalian is becoming a center for outsourcing back office tasks from Tokyo and Seoul. The Indian company Infosys is planning to increase its Chinese employment by 6,000 to do overflow outsourcing from India and to service the Chinese and Japanese/Korean markets. Real estate is going to be a big winner if China continues to grow. Many Hong Kong listed property players are working now in China. *And as the chart above shows*, environmental clean up is going to be a very big issue in the future. The list goes on.

The *Christian Science Monitor* recently asked, "Is China Japan all over again?" The big risk to the China story is that it will all fizzle just like Japan did in the 1990s. Both countries have been export focused and each protected 'strategic industries.' But whereas Japan was always inward looking China has welcomed foreign investment. And China has a reserve of low cost labor and educated young people that Japan never had.

The two things I worry most about are one, a major military or economic confrontation between the U.S. and China and two, internal political and social chaos. The former would be absolutely destructive to both countries. The latter is the nightmare for every Communist official. The way China carefully weighs all decisions to avoid internal unrest leads me to believe this economic miracle still has a long way to go.

Breathtaking Damage

China's industrial development is taking its toll on the nation's air, water, and economy:

- Six of the world's 10 most polluted cities are in China
- Acid rain falls on one-third of the mainland
- 80% of China's sewage flows untreated into its waterways
- Contaminated water kills more than 30,000 children annually
- Pollution costs China more than $54 billion a year

Source: Business Week

Key Lessons for U.S. Corporate Investors

Connections, or *guanxi*, still rule	China is not just an export platform	Look for new expansion opportunities
Cultivate **Chinese partners, key regulators, and big customers,** especially in still highly regulated industries like telecom and autos.	Increasingly successful companies do **R&D in China** and set ambitious sourcing targets.	Go beyond joint ventures and greenfield investments. Smart companies often **buy out** Chinese partners and rivals.
EXAMPLE GM's relationship with Shanghai Automotive Industry Group has been key to its expansion.	EXAMPLE Delphi has opened a new R&D center, which will grow from 300 engineers now to 1,500 by 2010.	EXAMPLE Caterpillar and Anheuser-Busch are both using M&A to expand in a cost-effective way.
Nurture your local talent	**Avoid a one-size-fits-all mentality**	**Be creative in seeking opportunities**
The caliber of China's manager class is improving rapidly, so **train** locals rather than rely on expats.	Understand China's **consumers** and markets. Experiment with new China products, sales outlets, and pricing models.	Accept that expanding your business in China may require **new business models** or partners.
EXAMPLE Beijing-based Motorola University trains managers among its 9,000 China employees.	EXAMPLE P&G offers simpler versions of popular products like Olay moisturizing cream at cheaper prices.	EXAMPLE Cendant is moving from business hotels to chains of motels in China.

Source: Business Week

Investment Trends . . .

On the Hunt for Value. . .

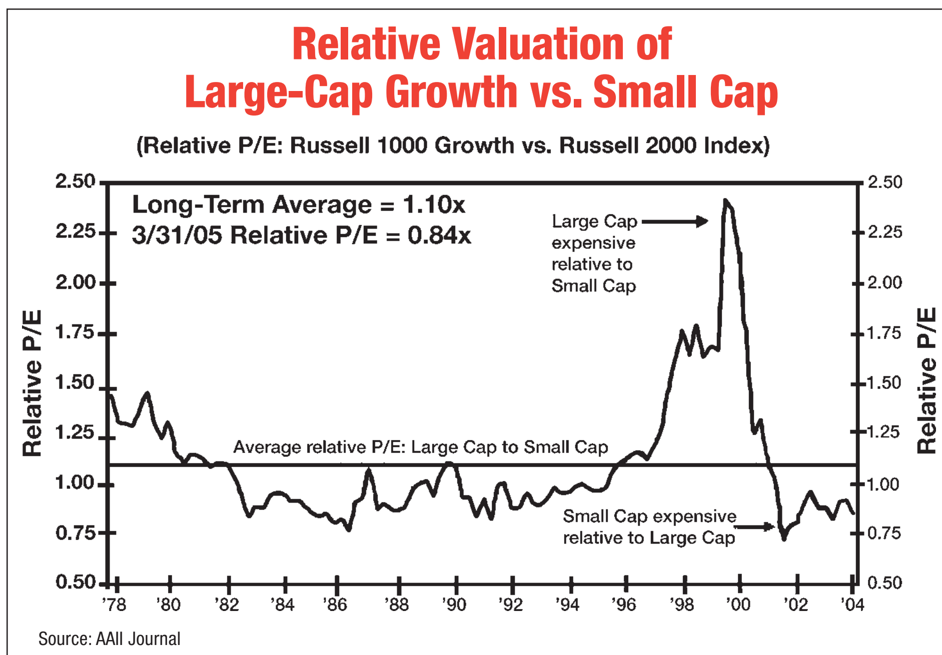
AS VALUE INVESTORS, WE ARE used to buying the under-followed, unknown and unloved. But a strange thing has happened over the last several months. Many of the market's traditional darlings are turning up as prospective buy candidates. Stocks I frankly never thought I would own, like Coke, General Electric and IBM, are starting to look attractive.

Historically, we have avoided these market leaders because we felt they were simply too expensive. Sure they were good companies, but their lofty valuations meant they were not necessarily good stocks. But *as the chart to the right shows*, this group underperformed the market for much of the last 5 years. Brokerage firm Smith Barney points out that the forward price-to-earnings (P/E) ratio of the 25 largest S&P 500 companies is now at 90% of the overall S&P 500 multiple. And while many of these firms sport below average valuations, their growth prospects are better than average.

Part of this underperformance makes sense. In the early stages of an economic recovery, smaller stocks and value oriented cyclical companies tend to outperform large companies. This is exactly what happened from March 1999 to December 2004. Over that almost 6 year period, small cap stocks outperformed large caps by an annualized rate of 18%. Many investors also avoided large stocks on the theory that their fundamental growth prospects had diminished. How, they argued, can a firm the size of IBM or GE continue to grow earnings 10% a year?

But large cap stocks deserve a second look now. The solid brand franchises of companies such as Coke and IBM produce impressive cash flows. Cash flow is the life blood of every company and with it many of these big boys are investing in research & development and international expansion, paying down debt, growing dividends and buying back shares.

Further, Henry McVey of Morgan Stanley makes an interesting case for large cap stocks now. As baby-boomers migrate into retirement, he reasons, they will increasingly seek out shares of companies that offer both growth and yield. Many large caps provide just this combination. Even if he is only partly correct in his thesis, the increased demand could have a big impact on the shares of firms that meet this criteria. Over the next 5 years, baby boomers will be transferring massive amounts of cash from 401-(k)s to IRA Rollover accounts as they retire.



Source: AAII Journal

General Electric probably best illustrates the case for considering large stocks today. In the 4 years that new CEO Jeffrey Immelt has been with GE, its stock has underperformed the market by an average of 7.4% a year. But this underperformance came while the company was growing earnings in excess of 6% a year and paying out a 2.5% dividend yield.

Immelt's plan for rectifying the situation is fairly straightforward. To grow earnings, he is focusing on several great global growth opportunities. Developing economies, he reasons, will grow faster than developed ones. And these economies will struggle to provide basic services such as water, transportation and energy in an environmentally sustainable way. China alone, for example, is slated to spend an estimated $85 billion on environmental clean-up through 2008. In total, analysts expect 40% of GE's revenue growth over the next 5 years to come from emerging markets.

GE also expects to double the revenues it derives from green businesses by 2010. Water purity and reduction of carbon dioxide emissions factor greatly into this goal. This year alone, GE expects to sell $2 billion worth of water filtration systems, chemicals and services. To reduce carbon dioxide emissions, the company is focusing on coal degasification, a process that strips out most coal produced pollution, and wind technology. GE is now the second largest manufacturer of wind turbines worldwide.

Because of its industrial past, GE will probably never serve as a poster child for the environmental movement. But its strategy of meeting the demand for environmentally sound technologies makes good sense both as a business and a global citizen.

— Anne Williams Doremus, CFA