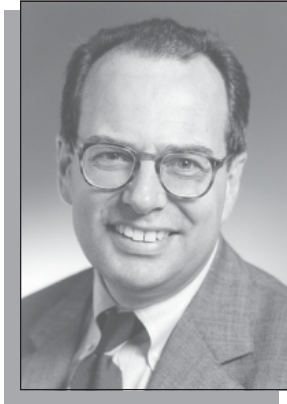


Thoughts from

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.

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The Passing of the Baton . . .

THE THIRTY-YEAR TREASURY bond has always been the benchmark for the fixed income market. It was big and it was liquid. But the Treasury stopped issuing thirty-year bonds in 2001.

As the Treasury market declined the mortgage market soared. Back in 1996 the mortgage market was approximately one half the size of Treasuries. Now it is 125%. The mortgage market started to take off in the 1970s. Prior to then when interest rates rose depositors pulled money out of Banks and invested in higher yielding Treasury Bills. Loanable funds dried up and the housing market died. Now Fannie Mae and Freddie Mac can step in, buy mortgages and package them as mortgage securities for sale to long-term investors, like life insurance companies and pensions. Instant liquidity for the housing market.

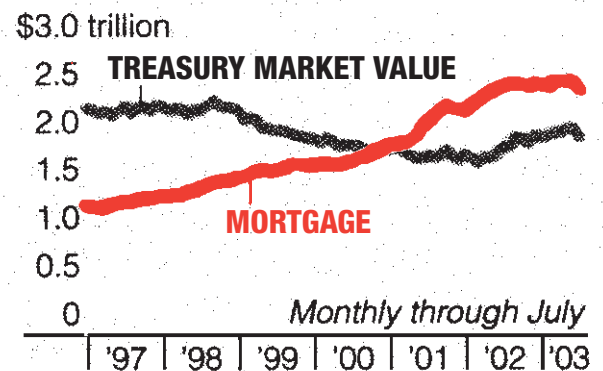
Fannie and Freddie are very focused today on matching what they earn (from mortgages) with what they pay (on the bonds they issue to finance the deals). When interest rates declined in the 1990s refinancings soared. This reduced the mortgage pools and created a mismatch on the balance sheet. Fannie/Freddie countered by buying Treasuries to make up for the lost earnings. Bond prices rose and interest rates fell further.

But this summer the Federal Reserve announced it would keep rates as low as necessary to stimulate the economy. The bond market smelled inflation and investors sold Treasuries pushing rates higher. Refinancings fell off and Fannie/Freddie were forced to sell Treasuries to keep their matches in sync. This added fuel to the selling fire and rates rose even further.

The moral of the story is the mortgage market has now become the tail that wags the dog. Buying and selling of Treasuries by Fannie Mae and Freddie Mac to keep their balance sheets in sync and the writing of sophisticated derivatives on the bond market by all mortgage players means a much more volatile market in the future. The days of a staid and steady Bond market may be over. Long live mortgage backed securities.

Role Reversal

The mortgage market has surpassed the Treasury market in size.



Source: Bianco Research

Source: New York Times

The U.S. Workplace . . .

So you have a job . . .

THAT IS THE GOOD NEWS. The bad news is the U.S. workplace is fast becoming the overworked-place. We are now logging more hours on the job than we have since the 1920's. And when we take vacations we take less of them. The *Los Angeles Times* recently reported that Americans take an average of fourteen days vacation a year. In Europe, Italians get 42 paid days of holidays, the French, 37 and the Germans, 35. We are the only industrialized nation in the world with no minimum paid-leave law.

The upside of this is we earn more money. The charts at the bottom show that our GDP per capita is among the highest in the world and a big reason is longer hours. When the French and Germans are on the job their productivity is about equal to ours.

So why do Americans work so hard? Maybe it's taxes. They are lower here and this means more money in our pockets. Or maybe it's that we are scared. As long as we are at our desk reading reports and answering phones, we are needed. As soon as we are away we suddenly fear we are less indispensable. And there is also the idea of shame. With corporate downsizing, fewer workers are handling more work. When bodies are away it

means more work for even fewer people.

A lot is being written today about work, money and happiness. If we are working to earn more money, then money must lead to happiness. But study after study has shown that once you get to a middle class income and this could be as low as \$10,000 a year, additional money does not lead to more happiness.

So let's try again, why are we working so hard? Michael Elliott recently noted in *Time*, that our brand of Christianity "comes packaged with the stern message that hard work is good for the soul." This could be. Or it could be that we like "things" more than Europeans and we like keeping up with (and ahead of) the Jones'. A recent study at Harvard University asked a group whether it would prefer (A) \$50,000 a year while others got half that amount or (B) \$100,000 a year while others got twice as much. The majority chose A. We often work harder to feel wealthier than others. But alas, the sad fact is there will always be others making even more than us, so the treadmill just keeps going faster.



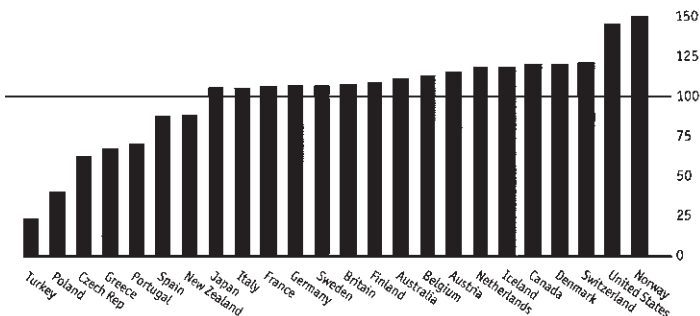
Source: New Yorker

What are the ramifications of all this? We could suddenly decide like the Europeans to take more vacation. This could happen but for some reason I doubt it. More likely, I am afraid, is we are becoming the test kitchen for the overworked, overstressed society. Maybe pharmaceutical sales (*see page 3*) isn't such a bad career choice.

GDP per person

Living standards, measured by GDP per head, vary widely even within the OECD group of 30 countries. Within the European Union, most countries are clustered just above the OECD average; the main difference is between poorer southern and richer northern countries. The comparisons use purchasing-power-parity exchange rates to strip out cost-of-living differences and avoid sharp fluctuations in market exchange rates.

At purchasing-power parity, 2002, OECD=100

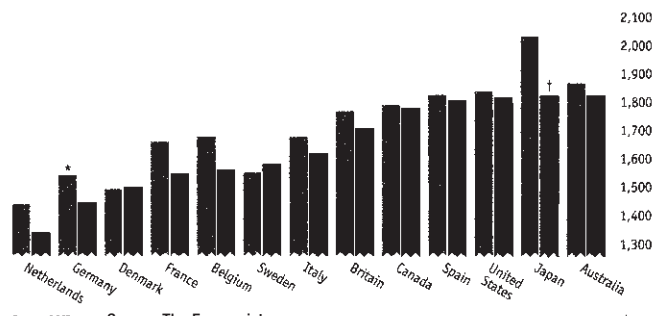


Source: The Economist

Working hours

Since 1990 average working hours have dropped sharply in Japan and in most European countries, but have scarcely fallen in America. The gap in work effort is now the single biggest reason why GDP per head is lower in the European Union than in the United States. By contrast, lower productivity is the main reason why other OECD countries are less prosperous than America.

Average annual hours worked per person in employment



Source: OECD

Source: The Economist

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The U.S. Economy . . . Can we have recovery without jobs? . . .

THIS IS THE BIG QUESTION today. *Take a look at the chart at the bottom.* As soon as most recessions end job creation picks up. This is quite logical. Businesses start hiring when the orders pickup. But not this time. We have lost nearly 3 million jobs since the stock market peaked in March 2000 and we are still losing jobs, 600,000 since January.

The pessimists say this is the downside to globalization. Everyone is cutting costs and moving jobs to Mexico, India and China. The optimists say foreign competition is not the problem; instead it is the relentless increase in productivity. Productivity is the increase in output per hour worked. Higher productivity means fewer people needed to do a given amount of work. But eventually higher productivity leads to sharply higher corporate profits and these profits get reinvested in new products and eventually new employment.

This is the hope at least. The problem is getting from here to there. As someone once said, tides have to go out before they rise. How many jobs do we have to lose and how high does the unemployment rate have to get before the benefits of higher productivity kick in? Donald Straszheim, the head of Straszheim Global Advisors, believes that job losses to overseas competition will be the issue of the next decade.

Where do we stand on all this? First we think the economic recovery, which began in late 2001 and which has been gaining steam of late is for real. It is the reason the stock market rallied in March and a sustained recovery means further gains in stock prices. The Hartford Mutual Fund group recently noted that 6 mega-economic trends are lining up to kick start the economy now: the third

largest tax cut in history, record government spending this year, no tax increases even in the face of a war, a weak dollar which will help exports, thirteen consecutive rate reductions and finally record mortgage refinancings.

But we don't want to downplay the problems of global job shifting. Someone once said when you lose your job it is a recession and when I lose my job it is a depression. The job losers today are very articulate and very angry. There will be calls soon for the traditional defenses against the threat: renegotiate NAFTA, toughen environmental and labor provisions in foreign trade and increase tariffs. Protectionism still lives.

The irony however is that traditional policies may make little difference this time. As Thomas Friedman noted in *The Lexus and The Olive Tree*, the problem with globalization is no one is in control. The forces are so strong and so global that we may just have to wait for the natural adjustments to run their course. But in the meantime the job picture may not be as bleak as portrayed. There are attractive jobs and careers available now (*see chart*) and many jobs are going begging, in nursing for instance.

The long, long picture is even more attractive. We may be facing a serious worker shortage not job shortage the next twenty years. The Bureau of Labor Statistics projects that between 2010 and 2020 the number of workers in the prime

Hot Jobs

The highest-paying jobs that are hot now and should remain in demand for the next five to 10 years.

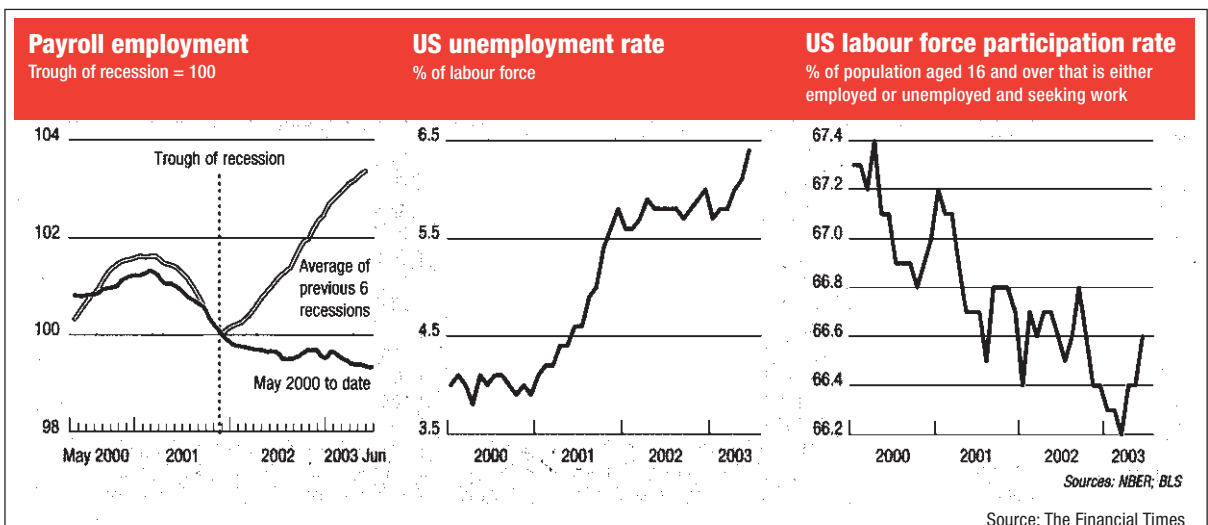
JOB	SALARY
Chief privacy officer	\$122,360
Actuary	122,000
Business continuity director	118,423
Real estate sales	108,565
Manager, wireless infrastructure	100,000
Pharmaceutical sales	100,000

Note: Salary data is median for top 10% of earners, where available, in 2002 or 2003.

Source: Challenger Gray & Christmas

Source: Money Magazine

age years of 25-54 will stay absolutely flat. In a growing economy this spells disaster. Either existing workers will have to postpone retirement or immigration will have to increase or both. But this is the long term. In the meantime the global job shift continues. As Walter Kirn put it in the *New York Times Magazine* recently, shifting jobs to increase competitiveness may kill the goose that lays the golden egg. "At what point does remaining competitive dry up and dissipate the disposable incomes being competed for?" Good question.



Investment Strategy . . .

Saying No to Mo' . . .

INVESTORS ARE AN EMOTIONAL lot. They fall in love with shares that have treated them well and hate those that have disappointed. If you doubt this, just ask any Krispy Kreme shareholder why they currently hold this latest Wall Street star. Most will gush on about the chain's piping hot doughnuts and history of rapid earnings growth and share price appreciation.

While all of these comments would be true, they only address Krispy Kreme's past performance and provide little insight into the share's outlook going forward. Since the company has been a winner in the past, the thinking goes, it will be successful in the future.

Investors have a long history of pouring into Wall Street's latest hot stock. Remember the Nifty Fifty stocks in the 1970s, biotech in the 1980s and the most recent dot-com craze. In each of these cases, investors inspired by a history of rapidly rising sales or earnings, piled into stocks only to be hit with falling share prices as reality failed to meet high expectations.

So why do investors fall prey to this form of "momentum" investing again and again. The answer, in part, is psychological. Buying into rising stocks feels good. You are on the winning side and, after all,

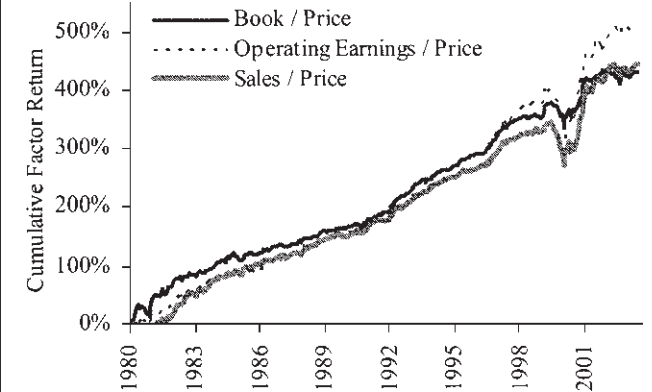
nothing succeeds like success. But there are a number of reasons why corporations have a tough time sustaining profit growth.

First, most companies that identify a winning product or service are bound to face growing competition. If the business is a good one, other firms will be attracted to the possibility of above average returns. Second, the larger a company gets, the more difficult it becomes to maintain high growth rates. A 2001 study by the National Bureau of Economic Research illustrates this point. In researching 1,833 companies from 1951-1997, NBER found that only 67 or 3.6% of them were able to sustain operating income growth rates above the market's median level for five consecutive years. Just 4 out of the 1,833 managed to sustain above average rates for ten years. Interestingly, Krispy Kreme is in its fourth year of posting above average rates of operating income growth.

While all stocks can become overvalued, consumer shares have been particularly vulnerable to this kind of "momentum meltdown." Consider the case of Home Depot. Throughout the 1980s and 1990s, HD enjoyed explosive sales and earnings growth as it steadily expanded across the country. But by 2000, the company was exhausting its store expansion opportunities and competitor Lowes was starting to come on strong. Early that year, Home Depot's sales growth started to slump. Then in October, a disappointing earnings announcement sent HD's shares, then trading at a P/E of over 50, down 28% in one day. Ultimately, the shares fell from a high of \$70 to \$20 this year.

Certainly, momentum investors would

Boring Old Valuation Works Over the Long Haul



Source: Morgan Stanley Research. Cumulative return of portfolio rebalanced monthly, long the quintile of stocks with the cheapest valuation on these metrics, short the most expensive quintile. Source: Morgan Stanley

argue, there are profits to be made in high-flying stocks if you sell before the meltdown. This sounds like a reasonable strategy particularly considering evidence suggesting that strong stocks continue to perform well over the short term. But historically, individual investors have had terrible timing buying only after the stock has gone up and selling after its decline. High transaction costs also offset momentum-investing profits. *Take a look at the chart to the left.* In a recent study, Wharton School Professor Donald Keim found that because of their impact on stock prices, momentum investors incur transaction costs three times greater than other investors.

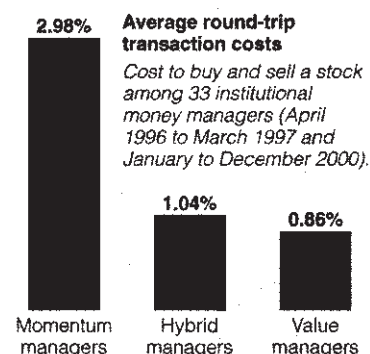
Work by Steve Galbraith of Morgan Stanley supports an alternative investment approach. In examining the returns of stocks over the last 20 years, Steve found that systematically buying the cheapest quintile of stocks and simultaneously selling the most expensive produced market beating returns over the period.

The temptation to "jump on the bandwagon" of high-flying stocks still exists today. Think Starbucks, Bed Bath & Beyond and Coach. But avoiding the stars while seeking out neglected, high-quality shares selling at a discount to perceived value is the key to investment success.

—Anne Williams Doremus, CFA

Paying for Momentum

Money managers who use momentum strategies incur higher transaction costs than do other types of managers, a recent study shows.



Source: Professor Donald B. Keim, Wharton School of the University of Pennsylvania

Source: The New York Times