

Where To Invest In 2012...

Expectations for the economy are very low today. The worries are that Europe will continue to tiptoe precariously close to the edge of the cliff, China may have a housing bust and U.S. growth will look lethargic at best. With no one expecting much, our take is that the surprises may actually be more on the upside this year than the down.

Corporate profits have been strong since 2008 and although the

title of *the chart in the upper right* is "Losing Faith," corporate profits grew in 2011 and will continue to grow in 2012, maybe by 10%. The price to earnings ratio of the Standard & Poor 500 is now 12x versus an average of 15X.

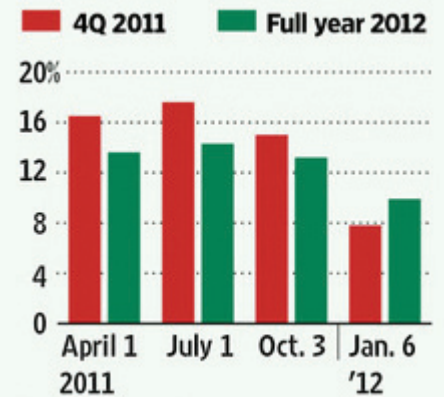
We are wary of bonds here. With the 10 year Treasury at 2% it is difficult to see how fixed income investors can make much money. Of course we said the same thing last year when interest rates were low. Long term Treasury bonds turned out to be the very best investment vehicle. But still, we think the game may be up for bonds now.

Inflation is not a problem today but we see the world economy getting better, not worse so inflation could be a problem down the line. *The chart at the bottom* shows how much we have benefitted from low or no inflation the past 15 years. This won't change tomorrow but we worry more about inflation in this economy than deflation.

Finally, emerging markets look interesting. They have low debt to GDP ratios which will allow them

Losing Faith

Consensus year-over-year earnings growth forecast for S&P 500



Source: Thomson Reuters; The Wall Street Journal

to stimulate their economies when needed. Also their populations are young and consumer spending is growing. Short term we realize there are lots of questions like, will China be able to avoid a housing bust but we remain positive especially since emerging markets performed so poorly last year.

On balance we think 2012 will be decent. We realize however how little we can actually know about the future. The best strategy is to simply buy the highest quality and cheapest Value ideas and let the future play itself out as it will.

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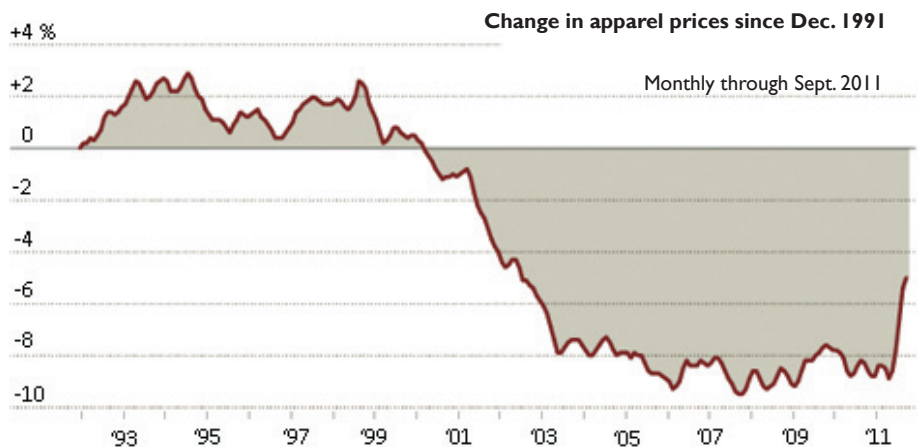
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Hanson & Doremus Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients. The firm also consults with individuals on financial planning and works with self-directed retirement plans on investment options.

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In apparel, inflation is back



Source: International Herald Tribune

Take Care of What You Can Take Care Of...

January is the month for Resolutions and Predictions. Let's start with Resolutions, specifically what we might do to become better investors.

The biggest impediment to investment success is not the complexity of markets and the plethora of information but our own irrational nature. Now, to be fair, we are rational most of the time but at crucial moments we just don't seem to keep it together.

Dalbar, a mutual fund research firm in Boston calculated that for the twenty year period ending December 2010 the average stock mutual fund investor had an annualized return of 3.8% compared to a 9.1% return for the Standard & Poor 500. Part of the reason might be we selected the wrong funds, but a bigger reason is that investors just don't stick to their guns at crucial times. We come up with a long-term strategy which makes sense for us but then we lose our nerve. We either buy when prices are at their highs or we sell when prices are down. Pogo had it right: we have met the enemy and he is us!

The chart in the upper right drives home the point that we need to learn how better to go sit quietly in our room. When you deviate from a long-term strategy and trade rapidly and try to time the market things

generally don't work out well.

The concept of reversion to the mean is a powerful one in the stock market. On balance, good quality undervalued assets do eventually show their color and recover and very expensive things eventually give in and decline. Of course I realize that sometimes cheap things deserve to be cheap and then just get cheaper. There are always exceptions to the rule but disregard reversion to the mean at your own risk.

Another interesting point is that men on balance suffer from the illusion of control and the propensity to trade more than women (*see chart at bottom*). I am sure a lot of women wonder why I am pointing this out since this is so self-evident to many! Again, the lesson here is to be careful: you don't know as much about the future as you think you do.

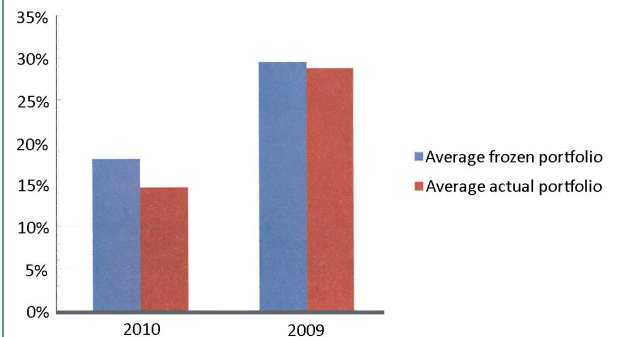
We have had it drilled into us that stocks return between 10% to 12% per year over the long-term, bonds do 5% and inflation, 3%. But over the past ten years stocks have gone nowhere, registering a zero percent

return. The reaction to this by many has been to move more money to bonds even with their anemic returns today. Also investors have made adjustments to give up on a buy and hold strategy and instead trade the market for every short term gain.

The metronome of reversion to the mean is a powerful force however and tells us that this is probably the wrong strategy. It would not surprise us if after a decade of bad returns we get a solid recovery of good buy and hold results. I realize, never ask your barber if you need a haircut, I am in the investment business and will tend to be optimistic and positive about investment results but still.

The best definition of Wall Street I have heard is, "the stock market is only indirectly related to economics. It is a function of human fear, greed and apprehension all overlaid on a business cycle." The markets are part finance and part emotions. Be very careful of the emotional side, this is where you get into trouble. The best advice going into 2012 is to stick to your long term strategy, give up on rapid trading and take not thyself too seriously – be confident but not too confident. The future is indeed uncertain.

The Virtues of Doing Nothing



The average newsletter editor would have made more money in each of the last two years if he had simply held for the entire year whatever he was recommending on New Year's Day.

Source: AAIL Journal

Love and Money

A growing body of research shows that there are distinct differences in how married men and women approach money and investing. Overconfidence, especially by men, can sometimes lead to bad decision making.

MEN

Tend to be overconfident, trading stocks and bonds more actively because they think they know what the next market movement will be. Less likely to listen to financial advice.

Result: Men incur various transaction costs associated with trading but don't pick assets any better than women.

WOMEN

Less confident than men about their financial abilities and will switch investments less often. More likely to listen to financial advice.

Result: Women generate risk adjusted returns superior to those of men.

BOTTOM LINE

Men may think they know what they are doing when it comes to investing but often do not.

Women may think they don't know what they are doing but often do.

Source: The Wall Street Journal

Is America Working?...

When you talk jobs in the U.S. today there seem to be two big issues. The first is, where are all the jobs anyway? And second, what can we say about the vast income disparity in the country?

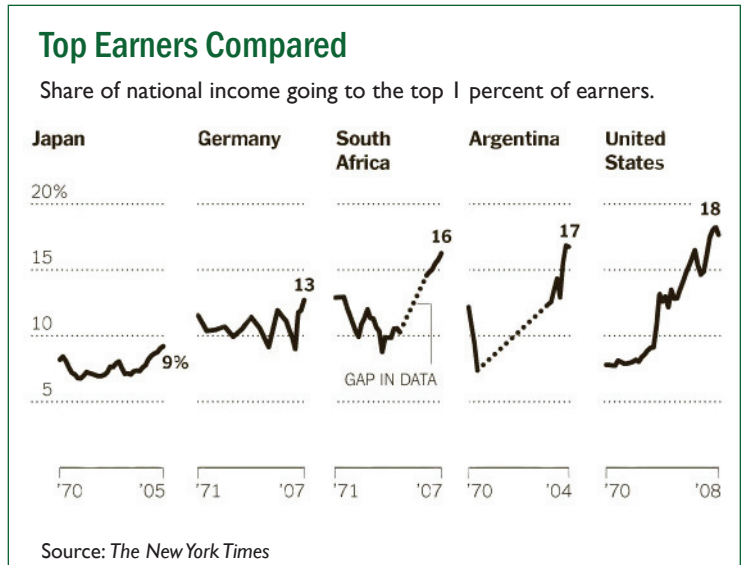
An article that caught my eye recently included data from the Commerce Department. U.S. multinationals have increased the number of people they employ worldwide the past ten years (1999 – 2009). The problem is the whole increase has come from outside the U.S. Multinationals have added 1.5 million workers in Asia and 477,500 in South America. At the same time they have cut their payroll here by 864,000.

Why the loss of jobs in the U.S.? The traditional reasons are technology and globalization. On the technology front companies are figuring out how to get more productivity out of the same number of workers. Even when demand picks up they are able to increase production without an increase in employees. Then you add in the issue of globalization. Manufacturing abroad is often cheaper than here in the U.S. and an equally important point is that companies want to manufacture closer to the end buyer.

Emerging markets have grown rapidly and U.S. multinationals are selling a lot there. It makes sense to be close to these buyers.

A third point is that the world has gotten a lot more competitive. The quality of education and the quality of the workforce has improved everywhere and young people are getting very adept at eating our lunch. This heightened competitiveness will only increase in the future.

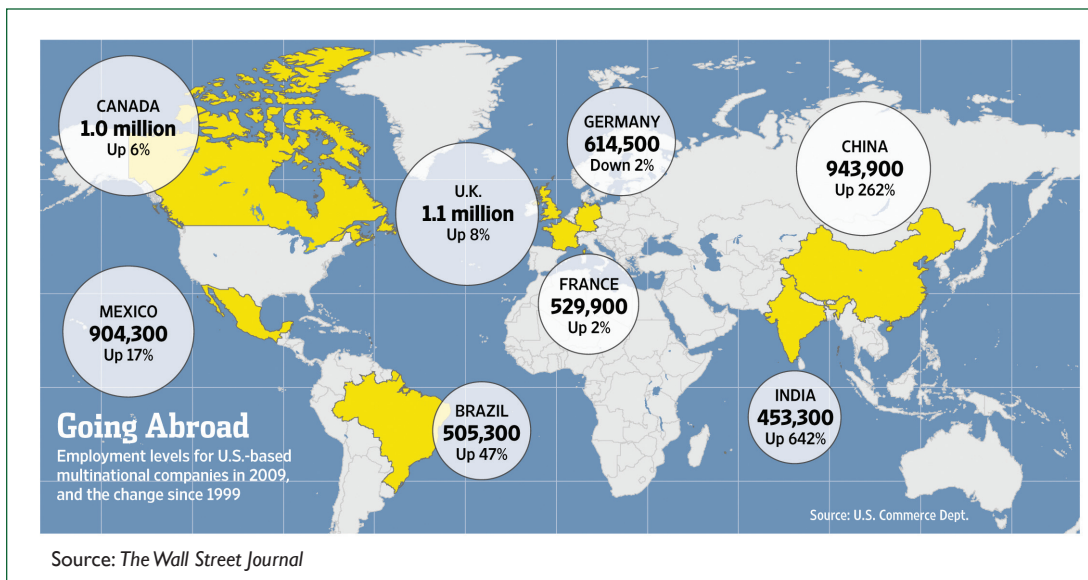
And what about income disparity? *The chart in the upper right* may surprise many. We don't think of ourselves as having a skewed income distribution but we do. The highest 1% of earners (with an average \$400,000 of income and median assets of \$4.5 million) control more national income than ever. Why? It is not completely clear but Thomas Friedman in his landmark book,



The Lexus and The Olive Tree (1999) noted that we have become more and more a “winner take all” society. If you are at the top of your game and very talented, then globalization could not be better for you but if you are lower down the totem pole you risk losing your job to other parts of the world.

We are probably not going back to the old days of more equal income distribution and rapid job gains anytime soon but the story is not all negative either. Costs are increasing fast in other parts of the world especially China and some manufacturing and services are moving back to the U.S. When

you factor in the cost of logistics and time delays in delivery, producing here is looking better. For instance, Honda is dramatically increasing the number of cars it produces here both for our market and for export to other parts of the world. General Electric which employs 133,000 people in the U.S. has announced plans to open sixteen new factories here increasing employment by 12,000.



The World's Evolving Energy Markets...

For most of the last fifty years, energy markets were pretty straightforward. Oil, the dominant global fuel source, was concentrated in the hands of a few largely Middle Eastern countries. Coal, abundant throughout the globe, ranked second and was the fuel of choice for much of the world's electricity generation. Economic growth and improving living standards meant an ever-increasing demand for energy and generally rising prices.

But a number of trends have emerged over the last several years to upset these long-standing industry dynamics. The changes may well upset the status quo and create new winners and losers across global markets.

Horizontal drilling technologies developed over the last decade are opening up vast, previously inaccessible natural gas reserves around the globe. The fuel has much to recommend it (see chart below). When burned, natural gas releases very small amounts of sulfur dioxide and nitrous oxide, virtually no ash particulate and lower levels of other carbons when compared to competing fossil fuels. As a result, energy giant Exxon predicts that natural gas will replace coal as the nation's number two fuel source by 2025. This transition is already underway. As of the third quarter of last year, coal accounted for 43% of U.S. electricity generation down from 51% as recently as 2003. And

many experts now predict that 10%-20% of U.S. coal-fired generating capacity will be eliminated by 2016.

The U.S. is perhaps furthest along in developing its natural gas deposits with onshore production up over 30% in the last 6 years. A number of energy companies are now hungrily eyeing export markets in Europe and Asia where natural gas prices are 3-5 times higher than at home.

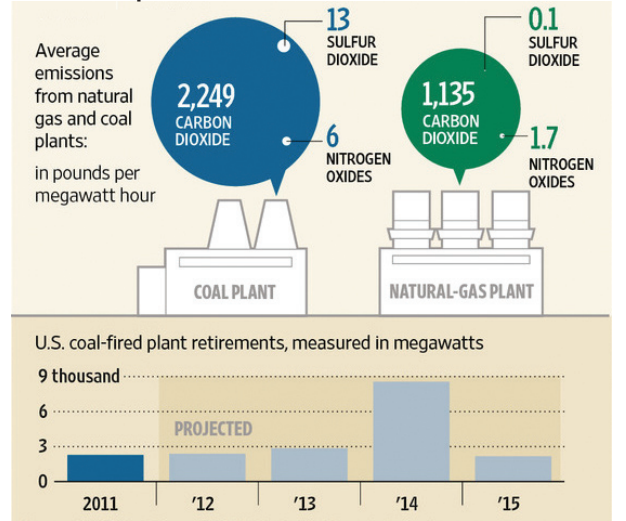
This trend helped the U.S. recently become, for the first time in 62 years, a net exporter of petroleum products such as gasoline and diesel.

This does not mean we are energy independent (the U.S. remains the world's largest importer of oil), but it does point out our growing role in the global energy supply chain. And China is not far behind. While natural gas plays a relatively limited role in the country's energy mix today, consumption of the fuel is expected to double over the next five years. In the near-term, most of this gas will be imported. But China will increasingly turn to their own reserves as the necessary energy infrastructure develops.

Over the next decade, rising living

Electricity's Byproducts

Pollution profile clouds coal's future



Source: The Wall Street Journal

deteriorating air quality will lead to a more global shift toward natural gas and cleaner renewable fuel use. Unfortunately, rising natural gas usage will not necessarily guarantee improved air quality. While it is true that natural gas burns cleaner, its lower cost could well fuel stronger economic growth and the pollution that comes with it.

Ultimately, finding cleaner and cheaper sources of energy will only be a part of solving the globe's energy puzzle. Technologies that improve energy efficiency will still play a role. The experience in the U.S. over the last several decades offers promise. Prior to 1970, the amount of energy consumed, measured in BTUs or British Thermal Units in the U.S. per dollar of gross domestic product (GDP) averaged around 15.41. But thanks to a wide range of efficiency initiatives, from "smart" appliances to intelligent lighting, this measure fell more than 50% to 7.41 by 2010. Efficiency gains will likely be much more rapid in the future as developing countries take advantage of already established technologies and processes. So be aware of these big trends: more natural gas which is cleaner than coal while at the same time conservation gaining real traction.

Pumping Up, Pricing Down

As onshore natural-gas production has risen....

...the price' per million BTUs has gone down.



*Monthly average settlement price on the continuous front-month contract

Source: The Wall Street Journal