

## The Way The World Works...

**T**he chart below is very interesting. It breaks out the major component suppliers of the new Blackberry Torch Smartphone. I am using the chart to make two points: the first is that money follows brains and the second is that money often follows brands.

We are constantly bemoaning the fact that all manufacturing seems to have moved to low cost emerging countries, especially China. Foxconn the large maker of iPhones for Apple and others employs an incredible 900,000 people in China. The fact is however that Foxconn and the Chinese workers get only a small piece of the pie. It is estimated that

for both the Blackberry and the iPhone, less than 5% of the total cost of the devices goes to the assemblers. The big bucks go to the companies supplying the high value added features (the brainy stuff).

The second point is that the brand owners are the really big winners. If you go to Best Buy for an iPhone the full retail price is \$600. The components total about \$185. There is a lot of profit in the final price for Apple, for the marketing firms that create the buzz and the retailers and logistics folks who sell the phone. And not much for those who sweat putting it all together.

This says something about our economy and also about China. Here in the U.S. the creative employees who come up with the next must have high tech gizmo will be the big winners in the income game. Also those who create the brand

image, develop the advertising and add the sizzle to the steak will be handsomely rewarded. But there will not be a lot of room in the middle for those who do the actual manufacturing. Brains are winning over brawn.

The Chinese also recognize this. They want to be the brand creators of the future. Companies like Lenovo (which purchased IBM's laptop business) Haier (small refrigerators and other white goods), Huawei (a competitor of Cisco in computer networking) and Li Ning (former Olympic gymnast whose eponymous company competes with Adidas and Nike in shoes/athletic wear) have big aspirations. China will eventually have winners but it will take time. One conclusion is don't discount the value of the great western brands today. It's still where the money is.

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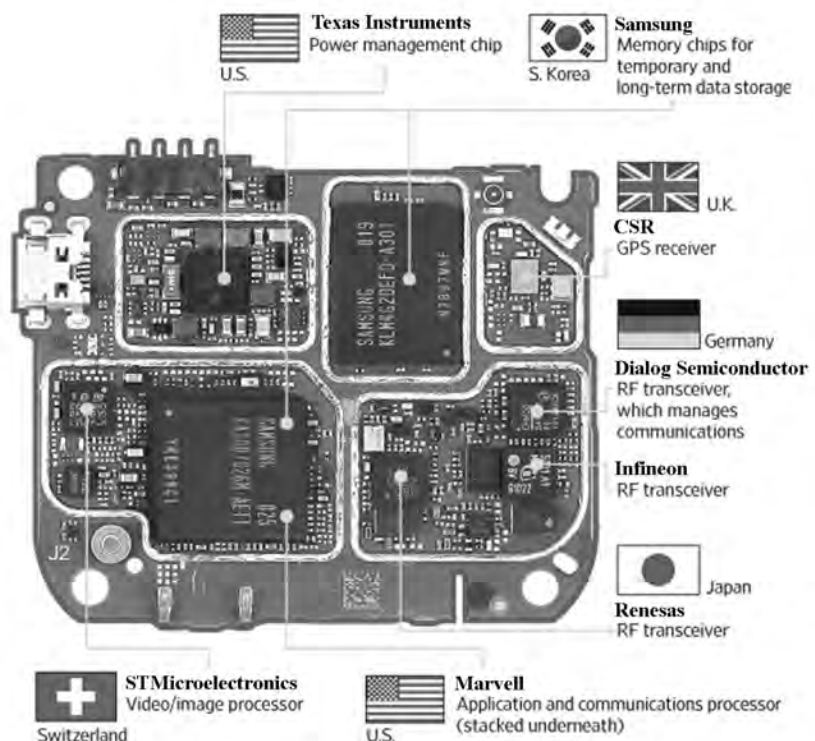


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### Piece by Piece: The Making of the Blackberry Torch

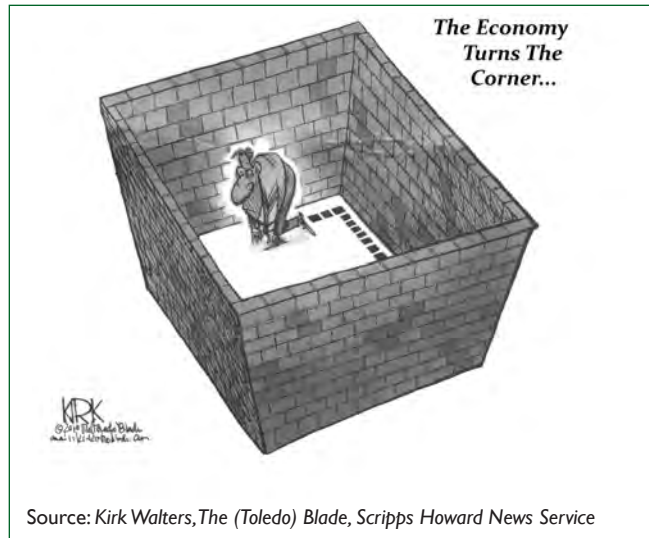


Source: *The Wall Street Journal*

# “This Time is Different...”

**Who was it that said these are the four most dangerous words in the English language?** We are always thinking things are “new:” it’s either a new era, a new paradigm, a new market or a new something. But the core things in life and on Wall Street don’t change that often. For instance the same things that have driven stock prices in the past will probably drive things in the future. If companies increase their earnings and dividends over long periods of time and if bonds yields stay moderate, then stocks will most probably move higher.

The spanner in the gears I realize is the price investors are willing to pay for a company’s earnings and dividends. This is the price to earnings ratio. PEs can be notoriously fickle over even fairly long time spans. PEs can soar when investors get giddy with anticipation and then when the mood is glum, PEs can sink to unbelievably low levels. The metronome moves back and forth from an approximate low of about 8x earnings to a high of 25x earnings or higher. An important question is, when do stocks do better, when PEs are high or when they are low? *The*



*chart at the bottom* is fairly clear. When expectations are low and PEs have sunk, this is when investors should keep the faith and stick with stocks. And after stocks have been bid up to sky high PEs, this is when investors can expect lower returns. The good news today is that the market is trading much closer to the low PE than the high. Based on next year’s earnings, PEs are close to 13-14x. This implies a much better decade going forward.

But another question is, do we have to sink all the way back to 8x earnings before we see a turn in this cycle? We don’t think so. Our best guess is the economy is forming a long slow saucer bottom here. There

will be no great short term improvement in employment or housing but the economy will still see progress. We think we are far closer to a stock market bottom here than to any kind of top.

Brad Perry the very perceptive Boston investment manager and newsletter writer makes an interesting point about investor sentiment today. Microsoft, Wal-Mart, IBM and Johnson & Johnson are four legitimate Blue Chips. They are each currently selling at a low PE. In fact

they are selling at either their all time low PE or at a PE that is their lowest in 50 years. Pretty incredible. There is certainly a lot of worry and negative sentiment out there. The best advise we have is, use fear to your advantage now.

One final comment. The sluggish economy today is compounded by the decidedly negative mood of the country. American “exceptionalism” and confidence has given way to uncertainty and a feeling of we are not in control anymore. Remember this when analyzing our situation. The economy may be weak but it is probably not as weak as our pessimistic mindset is painting it.

## S&P 500 10-Year Normalized P/E Ratio & Subsequent 10-Year Compound Annual return

10-Yr. Normalized P/E Ratio	Below 12	12 to 16	16 to 20	Above 20
Average 10-Yr. Compound Return	14.88%	12.91%	8.50%	4.33%
Range of Historical Outcomes:				
75th %	17.11%	16.50%	10.00%	7.40%
50th %	15.59%	13.11%	8.42%	4.00%
25th %	14.32%	9.33%	6.63%	0.92%
Number of 10-Yr. Periods	26	16	17	16
Average Equity Risk Premium*	8.25%	7.94%	4.14%	-1.30%

\*For any given 10-year period, the Equity Risk Premium is the compound annual return on the S&P 500 (with dividends reinvested) minus the compound annual return on Long-Term Government Bonds. Calculated using data from Ibbotson Associates and Morningstar. Data from 1926 through 2009.

Source: Gibson Capital, LLC 2010. Compiled using data from Robert Shiller and Ibbotson Associates.

# Just Give Me Something Safe!..

The bond market has been performing extremely well, and as such, money continues to pour into bond funds. Whether or not the performance is sustainable, blue-chip equities are also looking relatively attractive.

Trying to find decent yield these days without sacrificing safety has become very challenging. As the government continues to keep interest rates low, it is encouraging investors to search out either lower credit quality bonds or bonds with longer-dated maturities in order to pick up some yield, each avenue resulting in a slightly riskier investment profile. This feels similar to characteristics that investors faced back in 2002-2003, which ultimately didn't help anyone heading into the financial crisis. The rally in the junk bond market is an example of that, coupled with declining default rates, as just recently, prices on high-yield bonds were at their highest level since 2007.

Companies with lower credit-ratings are aware of the investor appetite and as a result, year to date, have sold \$172 billion in junk bond debt, already an annual record, according to data from Dealogic. However, this time is a

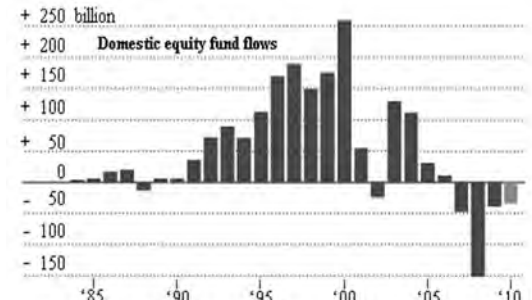
little different, the amount of leverage in the business environment is lower than it was heading into the financial crisis, and a lot of highly unstable companies were wiped out during the crisis, theoretically leaving a universe of stronger capitalized companies.

As many investors have noticed the relative outperformance and safety in the bond market, many have been pulling money out of their equity funds and allocating a larger percentage of their savings into bond funds. This is evidenced in the chart to the right, which shows historical fund flows for both equity funds and bond funds. In the first seven months of this year, investors have taken close to \$35 billion out of equity funds, while at the same time putting over \$185 billion into bond mutual funds. Many economists believe it is forming a bubble in the fixed income markets and while that remains to be seen what is true is that investors continue to pay up for earning record low yields on their typical bond fund investments.

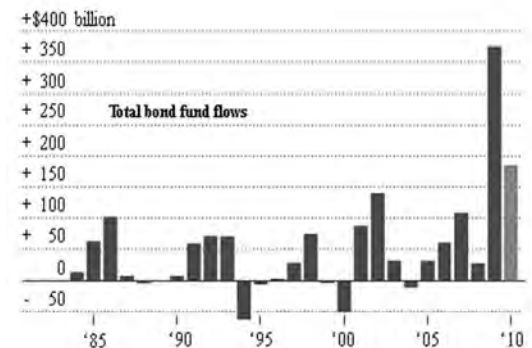
While many investors have been shifting to bonds and/or bond funds for safety, many large-cap, blue chip companies have been seeing record amounts of cash flow, and as a result are sitting on record amounts of cash, which is translating into increases in stock dividend payouts. For S&P

## Flight to Safety

In the last few years, investors have been pulling their money out of stocks...



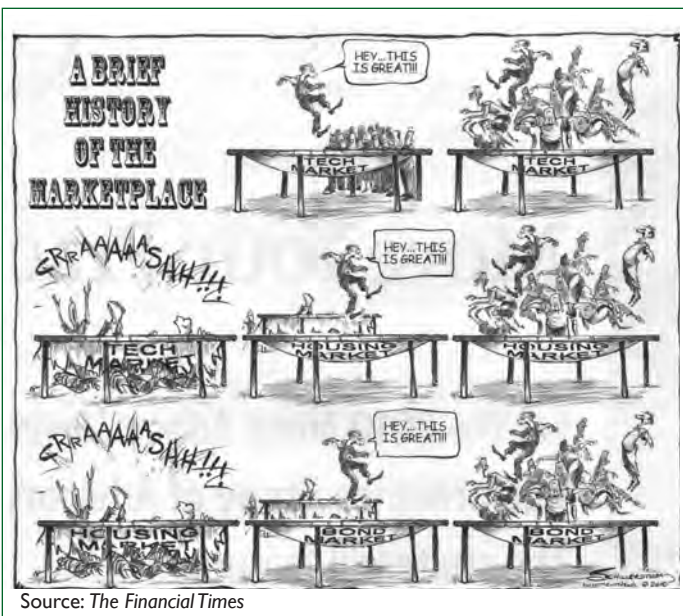
...and putting more in the relative safety of bonds.



Source: The New York Times; Investment Company Institute

500 companies, cash balances have risen to approximately \$825 billion in the second quarter of 2010 according to Bloomberg. Couple this with the languishing stock performance and the resulting dividend yields for many U.S. blue chip stocks are at the highest level relative to corporate bonds than any other time in the past 15 years.

According to Bloomberg data, there are currently 68 companies in the S&P 500 with payouts that are greater than the average bond yield in the credit market of 3.8%. True, the bond markets have outperformed equities over the past decade and represent a valid asset allocation for relative safety in a portfolio. But we are at an interesting point where the last time 68 companies in the S&P 500 were paying dividends above the corporate bond rate was March 2003; the was just after the start of a bull market in which the equity index more than doubled over the ensuing five years.



# Where Will the Best and the Brightest Go?..

The U.S. has long been home to the world's most well-regarded institutions of higher education. Mention that you graduated from Harvard, Stanford or Princeton and, in much of the world, doors swing open. A wide range of global rankings of top universities show U.S. institutions right at the top. As a result, higher education remains one of our country's most successful "export" industries. According to the U.S. Department of Commerce, international students contribute \$17.8 billion to our economy. These extra dollars are proving particularly important today when soaring tuition costs threaten to reduce the pool of eligible U.S. students.

As the chart below shows, foreign students have been flocking to the U.S. in increasing numbers. In the 2008-2009 year, the latest for which data is available, almost 672,000 students attended institutions here, up 8% from the year before. Over 40% of this total came from India, China and South Korea. This trend has been a huge benefit to U.S. and foreign students who can both benefit from a more diverse learning experience.

American universities, however, should not rest on their laurels. In a period when financial support for U.S. colleges is under pressure, many foreign governments are working hard to improve the academic reputations of their leading institutions. Most of the efforts to date have focused on investing in new campuses and attracting top academic talent with higher salaries, lighter teaching loads and subsidized housing. The just released *QS Top Universities Ranking* shows that while Asian universities accounted for only about 10% of the top 100 institutions in 2005, their ranks have grown 50% to 15 today. Another prominent ranking by the Shanghai-based Center for World Class Universities produced similar results. This ranking system, which places the most value on research quality, showed the U.S. still dominating the list with 8 schools in the top 10 and 54 in the top 100. But countries such as China, Saudi Arabia and Turkey are making significant progress. Not surprisingly, in the rankings of top universities by subject fields, Chinese institutions were second only to the

## National Pride: Top Institutions Of Each Country Represented In The Top 200

Country	Number of Institutions	Best Institutions
US	72	Harvard University
UK	29	University of Oxford and University of Cambridge
Germany	14	University of Gottingen
Netherlands	10	Eindhoven University of Technology
Canada	9	University of Toronto
Australia	7	University of Melbourne
Switzerland	6	Swiss Federal Institute of Technology, Zurich
China	6	Peking University
Sweden	6	Karolinska Institute
Japan	5	University of Tokyo
Hong Kong	4	University of Hong Kong
South Korea	4	Pohang University of Science and Technology
France	4	Ecole Polytechnique, Paris
Taiwan	4	National Tsing Hua University
Denmark	3	Technical University of Denmark
Singapore	2	National University of Singapore

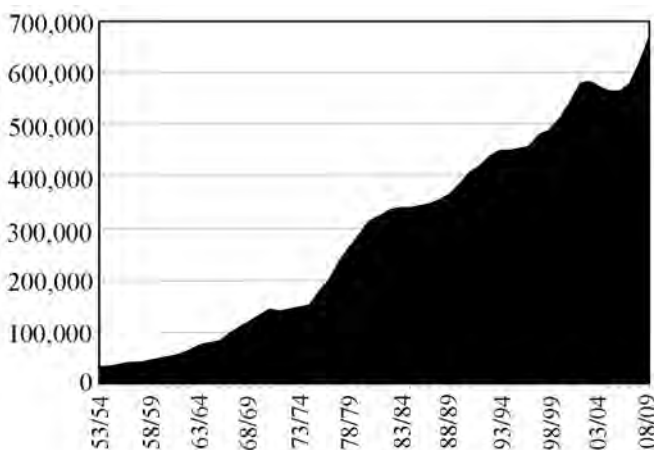
Source: [timeshighereducation.co.uk](http://timeshighereducation.co.uk)

U.S. in engineering and computer science.

As international institutions improve, the lure of studying abroad for many foreign students is waning. This trend is particularly evident among graduate students. While the number of undergraduates coming to the U.S. continues to rise at a double digit pace, graduate student enrollment in the 2008-2009 year increased only 2%. This is particularly concerning given that foreign students make up approximately 10% of the country's total graduate school population. The impact is even greater in specific subject areas, such as math and engineering, where more than 50% of the Ph.Ds awarded go to non-resident aliens.

In a global economy increasingly driven by knowledge and ideas, the importance of our nation's top academic institutions should not be dismissed. Innovation in this country has always been linked to the free flow of ideas encouraged in our top schools. While this trait remains their strongest competitive advantage, we would be foolish to think that it cannot be replicated elsewhere. Well funded, foreign competitors are working hard to do just that.

**International Student Trends**  
The number of international students in the U.S.



Source: Institute of Int'l Education; Data from the National Center for Education Statistics