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MID-YEAR REPORT 2001

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PERFORMANCE OF MAJOR STOCK MARKET INDICES SINCE JAN.1 - JUNE 28, 2001

(US Dollar Base)

Switzerland	SMI	- 21.06 %
Germany	DAX Xetra	- 16.74 %
France	CAC 40	- 21.62 %
U.K.	FT-SE 100	- 14.38 %
Sweden	Affärsvärldens AFGX	- 26.20 %
Europe	STOXX 50	- 20.64 %
USA	S & P 500	- 8.27 %
	Nasdaq	- 16.02 %
Japan	Nikkei	- 14.47 %

UNCHARTED TERRITORY

The first half of the year 2001 was not particularly kind to investors. As a matter of fact, the first quarter was outright awful and a great many people were mauled badly during the course of the first few months of the current year. At last, the leaders and blue chips of the high tech world were brought down to earth as well. And how! In any bear market, stocks of weakish companies tumble first and the best of the class come down last. The pattern was confirmed in the current cycle. The darlings of the high technology boom, such as Nortel, Cisco, Intel etc. finally tumbled. We have previously alluded to the unbelievably reckless financial behaviour of the leading telecom companies and there are serious doubts in our mind

whether stock prices of giants such as Deutsche Telekom, British Telecom, even Vodafone, will see the 'highs' of the year 2000 again before a very long time. Yet, the communication equipment *suppliers* (such as Cisco) should probably not be chased by investors either. This sector had monstrously expensive ratings back in summer last year and although stocks such as Cisco have come down some 80% from their highs, they hardly look cheap at this time. The truth may be disguised by the rally witnessed recently from very oversold levels. Intel may well be an exception. We like this stock at current levels. Being the world's premier semi-conductor company, there is no doubt that Intel's chips will again be in high demand before

long and the company will remain the leader of this industry.

We do not wish to engulf too much into stock picking comments, however. We rather wish to give some reasons as to why the massive market correction witnessed was not altogether surprising. Historically, the aggregate value of the U.S. stock market seldom exceeded 80% of GDP and on certain occasions fell below 50%. In the mid 90's, around the time Mr. Greenspan gave his famous 'irrational exuberance' speech, saying that the stock market had clearly reached overvalued levels, the stock market was around 100% of GDP – yet it went on rising from a Dow Jones level of 6500 at that time to over 11000 in the years that followed. By the end of the year 2000 the value of U.S. stocks exceeded 150% of GDP.

The real economy had gradually become dependent on the wealth effect triggered by financial markets and as we reported previously the national savings rate gradually declined to below zero. That could not last. Over the last 15 months we saw a world equity market decline of some \$ 10 trillion (= \$ 10'000 billion). Half of this was attributable to the U.S. We have been arguing that if the wealth effect was visible in the real economy on the way up, it is reasonable to assume that it should

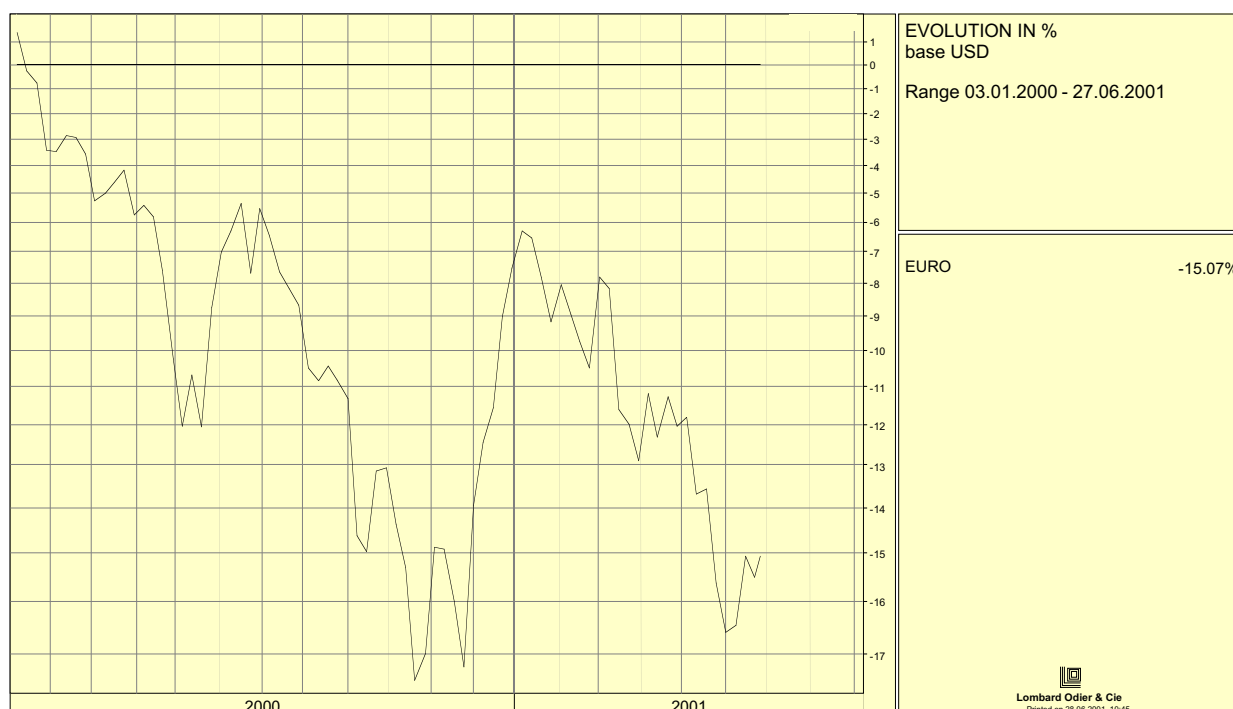
also be visible on the way down. Surprisingly, U.S. consumer sentiment has not appeared to cave in so far. All the same, we are confident that the time when financial markets have lead the real economy is over. Stocks no longer go up on account of phantom stories and hope (..remember third generation mobile licenses?..), but on the back of fundamental aspects – as it should be. The speculative bubble has clearly burst, but it is wrong to assume that following the crash of many leading stocks, the overall market is now fundamentally cheap. Historically, the market indices are actually rather dear and it may be very dangerous to assume that the crashed high tech darlings are now a 'steal' simply because they have come down a long way. The Ciscos of this world dropped from fairytale valuations – and on top of that their earnings vanished. And besides that remember that the favourite sector of a previous bull market is hardly ever the leader during a renewed up swing.

We are now clearly dealing in a market of stocks rather than in a stock market. That may sound weird. The message is that very careful stock picking has become the name of the game – and in case of doubt cash is a better alternative than chasing fallen angels.

THE AMAZING DOLLAR

As you may recall, we turned rather positive on the Euro late last year. Our timing initially appeared to be rather fortunate as the Dollar

succumbed to weakness during the course of December 2000. Hence, however, the Euro's rally petered out rather quickly early this year:



Against the odds the Dollar defied gravity and it is indeed difficult to justify the continued strength of the Greenback. One may argue, of course, that it isn't the Dollar's behaviour, which is hard to understand, but rather the problematic environment of Europe's new currency. Whatever, it appears that we under-

estimated the Euro's continued credibility problem and that we extended premature scepticism towards the U.S. currency. There is no doubt that the Dollar is overvalued on a trade-weighted basis. The current account deficit continues to loom as a real problem for America and the economy is stuttering. Yet,

the American consumer, whom we expected to take shelter on account of sudden job insecurity and dwindling savings following the Nasdaq's dive, kept up a rather active spending pattern. Surprisingly, the U.S. consumer confidence has so far not caved in. On the other side of the equation, Europe goes on being an unknown quantity. Germany and France continue to drift apart, policy rifts are clearly evident and Europe's Central Bank is in urgent need of a psychologist's tactical lesson. Mr. Duisenberg, the Central Bank's president is shoved around by politicians and cannot quite make up his mind whether a strong or a weak Euro is the best of all worlds. The undecided, feeble policy of Europe's Central Bank has contributed meaningfully to renewed and probably justified credibility problems surrounding the Euro.

Also, it should not be forgotten that staggering amounts of cash, have circulated in Europe beyond the taxman's reach. The underground 'cash economy' has thrived for decades in Southern and Eastern Europe, but for some time now the local plumber in Germany has learned a lot from his colleague in Milan and is rather more accommodating in settling a problem if no invoice is asked for and his work is settled for cash. The underground economy is a lot bigger than our

politicians admit. And then there is Turkey, Russia, and the whole former eastern bloc. Most things are for sale only if you have a ready wad of Deutsche Marks or Dollars available. - And suddenly a problem looms: Early next year all this European cash has to be exchanged for Euro bank notes. No problem technically, but these nasty bank tellers wish to take down details as to why the customer happens to sit on a hundred thousand Deutsche Marks in cash. Hard to explain and dangerous too if one wants to avoid mail from the taxman. The answer is to exchange this European cash for Dollars **now** and this is exactly what is going on. Huge amounts of underground cash are in circulation and the owners have to get rid of these ahead of the introduction of Euro bank notes. We are sure that this unquantifiable aspect has a lot to do with the recent strong demand for the U.S. currency. But of course, you read nothing about such matters as these billions of cash do not exist at all as every Sicilian will readily confirm.

During the first half of this year we held more Euros in our clients' accounts than we should have had, although we accepted the message of the currency's trend during the course of May. We were wrong to expect a lasting turn of the Dollar's strength - or we may have been early in our call, which is indeed a

distinct possibility. As long, however, as Europe's unity is anything but established and as long as Mr. Joschka Fischer keeps telling us that the European Union must expand eastward at express speed, the investment community is thinking twice about selling Dollars for Euro. We shall endeavour to be pragmatic from here on. The Dollar has its fair share of problems itself and it will be of cardinal importance to be alert and on the lookout as far as a change in sentiment is concerned. Meanwhile, Europe's underground economy is busy repositioning its 'cash savings'.

THE NONSENSE OF RELATIVE PERFORMANCE

The long-term readers of our comments know that we have been critical of comparing a private client's investment performance with a benchmark. Following Morgan Stanley's revision of its indices, we would like to take up the subject of 'benchmarking'. We are astounded by the fact that more and more private investors measure their investment success in relative terms by comparing their own performance with those of stock market indices such as Morgan Stanley's many individual market barometers or simply with their home country's stock

market index. To our mind this approach of measuring success or failure is a total nonsense for private investors. It may all be well to compare one's own money manager's performance with the development of the Morgan Stanley World Index at times of bull markets, although even then such an approach makes little sense. Are you really doing badly if you clock up a 15% gain when the world index is up 18%? Hardly. But then look at the inverse. Look at a bear market. Are you doing well, losing 15% when Morgan Stanley's World Index is down 20%? Many fund managers may well be cheerful and boast about such a miraculous out-performance of the benchmark comparison and rather expect the client to call him a genius. – It is obvious that there is nothing to celebrate under the circumstances. A loss is a loss! You do not pay your bills with negative performance whatever the benchmark chaps tell you. Thus, whereas it may be fun to compare your investment results to benchmarks during moneymaking periods, it is clear nonsense at times of choppy markets. Such as now. What good is it to you to have a portfolio full of technology stocks (which did more than well in 1999 and early 2000) during the last twelve months and have your investment manager tell you that the Nasdaq Index dropped rather more than your own

account? We cannot reiterate often enough that benchmark comparisons are utter nonsense for private investors. Why? Because the first priority for private investors is to avoid down-years. You do not ever want to run a negative year and if market circumstances are such that a positive year is close to impossible (such as 2001) you do not wish to be down anywhere nearly as much as the benchmark, which your friendly banker competed against during bull market times. Remember: Gladly accept a great performance at times of roaring stock markets, although you should not mind lagging these famous benchmarks at such times. Against this concession major damage must be avoided at all cost when markets are falling. It is here when you must stay on top of things. It is in bad times when your account should outperform these much talked about indices. Forget bull markets. You probably make decent money anyway. Buy your money manager flowers though when he avoids the chopper at times of horrid circumstances. At times when he defies gravity by not losing much or any of your money while the famous bankers' indices are dropping like a stone.

Morgan Stanley has recently revised most of its many indices by changing the weighting of many leading shares in order to give due con-

sideration to free float, i.e. shares held closely by founding families, banks etc. lost a major part of their weighting. This effectively meant that stocks such as L'Oréal, Munich Re, LVMH, Allianz Insurance and many other blue chips lost half their index weighting on account of this ruling. Result? Investors eagerly tracking the famous Morgan Stanley indices were virtually forced to sell a major part of their favourite core investments. Not on account of fundamental investment assessment, but purely on account of fear that their portfolio would otherwise divert to an undue degree from a benchmark. New stocks were added to the index, which may well be unfit for this manager's client, but having a major weighting in the index, the manager is compelled to add an investment which he may be unfamiliar with or which may simply be a dud. All on account of tracking a benchmark index.

We obviously do not think highly of this approach, which is becoming every day practice in the investment world. Remember: *absolute* performance is what you seek and whatever some egghead may tell you, a down-year is bad whatever the expert say. Don't mind lagging these famous indices somewhat in good years, but make sure your capital remains more or less in tact in bad years. If a professional tells you that a twenty percent loss is quite

good in relative terms, remind him that it is absolute performance that counts. A money manager who tracks an index for the sake of never looking bad in relative terms is useless to you.

VIAGRA AND DIOXITE

During a recent talk show, the newly elected Japanese prime minister, Mr. Koizumi, was asked what should rather be abolished: the environmentally hazardous Dioxite or the import ban on Viagra. – Mr. Koizumi said that Viagra made people happier than Dioxite. – Well, this statement was of course quite funny, but it was insofar important as it gave clear proof that Japan had entered a new aera and that the old dinosaurs who had run the country for some fifty years, were on the way out. Tokyo's stock market greeted the political breakthrough by rallying strongly from the recently depressed levels. Koizumi was considered to be the only LDP politician who would tackle the overdue problem of liberalisation, rationalisation and who would finally dare to tackle the country's banking problem. Banks have merged left right and centre, they have tried to hide bad credits, they have fiddled with accounts, they transferred bad debts to subsidiaries, they have pulled every trick, but the truth of the matter is that the

country's debt problem is staggering. Japan's banks are under a cloud of some six hundred billion Dollars of bad debt, which nobody quite knows how to deal with. Debt is not a nice thing to have at times of deflation and if one thing is sure it is the fact that the world's second

largest economy is indeed gripped by deflation. Interest rates are hovering around zero, but nobody wants to borrow. Borrow? No thank you. Prices will be lower tomorrow. We rather wait and buy later. That's how deflation works. Whereas inflation induced people to buy unnecessary items, simply for the fear that they may cost more tomorrow, deflation kills consumption. Banks are sitting on huge amounts of unwanted deposits and wonder how they can squeeze out a return. The first thing the writer of this report learned from Sir Siegmund Warburg during his trainee days in London was a conventional wisdom: "the easiest way for a bank to go bankrupt is to borrow short and lend long". – And what are the Japanese Banks doing these days? – Your guess is right. Not only have they awarded staggering amounts of credits to their friendly customers, which have turned their balance sheets into red monsters. No, they now use their customers' short-term

deposits (costing zero interest) to buy long-term government bonds in huge quantities. At the end of March the banks held in excess of 600 billion Dollars (reads as \$ 600'000'000'000) of Japanese government bonds; almost double the amount held 12 months earlier. An upswing of bond interest rates (10 year bonds now yield around 1%.) could have catastrophic consequences. If the government comes out with decisive measures to deal with bad loans – which everybody says are holding back the economy – then interest rates could well rise. It is understandable that the banks seek new sources of income, but we believe that it is reckless to lend long-term money to such a degree, financed by call deposits. The ABC of a banker's behaviour should forbid such an approach. But then bankers are only human beings. Don't we know.

Mr. Koizumi still has to prove that he is able to dominate the powerful Liberal Democratic Party. The Nikkei Index has fallen back again after the fireworks following his election and it is not clear at all as to how the debt problem can be solved without further damage to the economy. The Yen's exchange rate is at an illogically high level and whereas it is risky enough to invest in this market on fundamental merits, we are additionally dealing with a considerable

uncertainty as regards the Yen's external value. We are observing matters as they develop and continue to run a minimal exposure to the world's second largest economy. We realise that a breakthrough surrounding the debt problem could boost the Nikkei considerably, but we prefer to sit tight for the moment. We do not particularly like what we see and give the benefit of the doubt to caution.

WHERE DO WE GO FROM HERE?

In our opening comments we have held the view that most markets are not particularly cheap despite the routing witnessed since summer 2000. The Nasdaq appears to be valued somewhere in the mid-fifties as far as the price/earnings ratio is concerned, but if we deduct current corporate losses from the total of generated profits, the average P/E is probably way above 100. Beware thus of thinking that Nasdaq stocks are a steal. No doubt, many well-founded stocks have dropped along with duds, but it is dangerous to generalise and to assume that high technology shares will soon be back on a star-tracking trend. We have been in the business for some time and somehow appear to remember that the Nasdaq has usually not bottomed before the majority of its

shares traded below \$ 10. Now, this is too simple a pattern to take seriously, but then it is the truth...

And what about the rest of the world? We have already touched upon Japan. Considerable uncertainty there. Actually an outright speculation that the new prime minister will perform wonders in terms of deregulation and debt management. Fundamentally, we have difficulties spotting undervalued shares although we admit that price/earnings ratios do need to be a lot higher here than elsewhere on account of interest rates being close to zero in Japan. All the same, the environment is murky, earnings visibility bad and the outlook for the financial system anything but assuring. The second largest economy of this world is not exactly a screaming buy on fundamental as well as common sense grounds.

Europe's economy is basically slowing down and inflation rising from a low level. A recession is not in sight, but the leaders (Germany, France) feel the pinch. The capital investment craze in telecom and media, which boosted Europe's economy meaningfully during the course of 1999 and 2000 has gone dull and along with it, the investment stars of the last two years have gone from love status to total neglect. What is true in America is true in

Europe. Beware of getting excited about seemingly cheap European high tech stars. The valuations of spring 2000 were absurd and the world has meanwhile discovered that companies such as Deutsche Telekom have thrown billions of Dollars out of the window on grand business plans, which are yet to generate a single penny. We are not reinvesting into this sector at this time, but prefer previously neglected sectors (such as Pharmaceuticals). It is currently unbelievably difficult to establish a halfway sensible picture on macroeconomics. The political rift between Mr. Bush's America and the rest of the world as well as the clear disagreements within Europe prevent unified action on the political as well as on the economic front. We feel that it is futile at this time to formulate a world economic scenario on the back of which we can establish our clients' asset allocation. We currently have to resort to a 'bottom-up' investment approach, meaning that we endeavour to single out individual companies whose prospects are bright whatever the economic scenario may turn out to be. Thus, whereas we have often taken a clearly sectorial approach, our clients' investment portfolio may presently comprise stocks in a great variety of fields. Financials, Pharmaceuticals, Outsourcing, Upmarket consumer non-durables, Energy are some of the sectors in which we are

invested. Quite a contrast to 1999 when a very meaningful part of our share commitments were exposed to media and communication!

We do not expect the remainder of the current year to turn into a bull market. We are still in the midst of re-establishing proper valuation levels and the communication bubble is still in the process of deflating itself. As an example: half a year ago we have voiced some fear as regards the banks' happy lending spree to Telecom companies. So far, no credit losses were officially reported,

but headaches may soon turn into a migraine. If all goes well, the year 2002 may turn out to be a reasonably good year for us investors, but meanwhile we must be patient and accept the fact that bargains are hard to find despite having gone through an apparent market crash. In light of the prevailing uncertainty, we hold quite substantial cash reserves and equity commitments are centered on a wide variety of sectorial leaders. This is no time to play hero. Capital preservation continues to be our top priority. Remember: heroes die young.

MAB