

Our Point of View, June 30th 2006

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Statistics of leading stock markets

A) Year to date

		in US dolla	in local terms
Switzerland	SMI	+ 3.54 %	- 2.34 %
Germany	DAX Xetra	+ 7.79 %	+ 0.94 %
France	CAC 40	+ 8.06 %	+ 1.19 %
U.K.	FT-SE 100	+ 6.87 %	+ 0.60 %
Sweden	OMX Stockholm 30	+ 3.16 %	- 4.60 %
Europe	STOXX 50	+ 4.15 %	- 2.47 %
USA	S&P 500	- 0.73 %	- 0.73 %
	Nasdaq	- 4.76 %	- 4.76 %
Japan	Nikkei	- 4.33 %	- 5.83 %
	Bloomberg Effas US\$ Bond Index (5-7 years maturity)	- 1.38 %	- 1.38 %
	Balanced Mandate Index *	- 0.03 %	- 0.03 %

B) Over five years

		in US dollar	in local terms
Switzerland	SMI	+ 48.00 %	+ 2.30 %
Germany	DAX Xetra	+ 34.10%	- 9.89 %
France	CAC 40	+ 35.89 %	- 8.69 %
U.K.	FT-SE 100	+ 29.67 %	+ 0.17 %
Sweden	OMX Stockholm 30	+ 56.30 %	+ 5.60 %
Europe	STOXX 50	+ 19.79 %	- 19.50 %
USA	S&P 500	+ 1.23 %	+ 1.23 %
	Nasdaq	- 2.79 %	- 2.79 %
Japan	Nikkei	+ 25.63 %	+ 16.98 %
	Bloomberg- Effas US\$ Bond Index (5-7 years maturity)	+ 25.95 %	+ 25.95 %
	Balanced Mandate Index *	+ 21.71 %	+ 21.71 %

*50 % Morgan Stanley World Equity Index and
50 % Bloomberg Effas Bond Index (5-7- years maturity)

A correction is not a crash

General assessment of the recent sell-off in stocks

The author of these comments always takes great pains to provide the reader with a comprehensive picture of the current situation, to shed some light on some of the issues of the day and to formulate an outlook that moves away from the usual daily fare supplied by banks. While we cannot always be spot on target with our forecasts, it is our policy to formulate statements that are clearly defined and above all to dare to make predictions that are unambiguous. After all, having spent hours wading through some financial institution's glossy brochure, it is not a particularly edifying experience to be told at the end that one is "cautiously optimistic" and share X or Y appears to be "attractive in the long-term". As far back as John Maynard Keynes' time at least, we have known that by the time the long-term comes around we are long dead and buried and suppressing all talk of timing factors in favour of the long-term horizon is a rather ineffective approach when it comes to dispensing useful advice. How did one witty aphorist once put it? – "An expert is a completely normal person, who, when he is not sitting at home, spends his time giving everyone else advice". A rather apt remark!

It is our intention here and now to give you a report and our judgement on the major investment issues of the day as well.

However, we cannot help but assume that you are not really interested in discussions at the present time but have just one burning question on your mind: the question of whether the last few weeks have been the beginnings of a bear market, or whether the talk of a crash scenario should be firmly dismissed out of hand. Or to put it more succinctly: whether the fun in investing is finally over. We have all been experiencing a measure of disquiet of late – the recent volatility on the markets has been anything but pleasant. We therefore entirely

understand the fact that there is one question in particular that you need answering: should I sell the lot?

We are not going to answer that question with a 'yes' or a 'no', nor a 'yes and no', although the latter choice would be the safest bet as you invariably cannot go wrong. So let us get to the matter at hand. How serious is the situation at present?

Currently, there are a whole range of factors influencing the stock markets both negatively and positively. These are partly of a fundamental and technical nature respectively. That means that the situation is incredibly complex and very difficult to analyze.

Let us, however, make a start with the positive factors:

Most stock markets are not overpriced at least going by conventional valuation criteria. This is indeed reassuring although you cannot mistake the fact that shares of raw material producers are currently dear in the event that prices of base metals slide back to 2004 levels.

However, with regard to the future direction of commodity prices, opinions are divided.

While there is talk in one camp of a bubble, the other is predicting a commodities bull market lasting for many years, primarily induced by demand from China and India. So far as we are concerned, we are sitting on the fence. This is because, looking at it objectively, we know just as much as you and the overwhelming majority of investors do. Arguing whether one sector is overvalued and another is not is really a fruitless exercise. What counts is the market as a whole, the global trend – and this is not overwhelmingly dictated by the prices of base metals. The bottom line is, however, that based on price-earnings ratios, major stock markets are neither overvalued nor showing signs of a bubble:

Price/Earnings ratios of major stock markets

Switzerland	SMI	14.75
Germany	DAX	12.20
France	CAC 40	11.90
UK	FT-SE 100	11.90
Sweden	OMX	13.90
Europe	Stoxx 50	12.87
USA	S&P 500	14.53
	Nasdaq	26.30
Japan	Nikkei	18.53

The scapegoat

The stampede out of Emerging Markets

So far, so good.

Journalists tell you left, right and centre that investments in Emerging Markets are no longer attractive, that investors have reduced their exposure and that it is time to sell off these assets. It is essential here not to throw the baby out with the bathwater. The term “emerging markets” is really more of a blanket description, a misnomer in fact. Laos and Burma are lumped together under the same heading as Malaysia and Hong Kong. This is ridiculous. If a Martian were to peer down on the city of Zurich and then proceed to do the same with Hong Kong, his extraterrestrial intelligence would be sorely challenged in discerning which of the two cities was an emerging market. Such an observer would probably assume from Hong Kong’s appearance that it was at the cutting-edge of technological progress and would hardly rate an inclusion in the emerging market sub-category. Our view is that it would be foolhardy in the extreme to clump all the markets that are really growing at an above average rate – i.e. the “emerging markets” – in the same category, just because these are part of the Morgan Stanley Index.

Taiwan is a different creature to Laos and Kazakhstan is certainly not on a par with Slovenia as far as risk is concerned. Clearly, a distinction must be made.

It is obvious that certain “new” markets have gone rather off course. Hungary, for example, (non-existent budgetary discipline, delayed euro entry), or Turkey, where euphoria about the future has sucked in too much money in too short a space of time. Continuing volatility is waiting in the wings here and not just on the stock market, but also in terms of foreign exchange rates. We trust the inflation statistics these governments provide even less than those of other sovereign nations. However, despite this fact, it would be wrong to say that ‘emerging Europe’ should be completely extirpated from the portfolio. Absolutely not. Were you aware that Russia’s foreign debt now comprises only 7 % of its gross domestic product? We are not saying that you should immediately dive into the Russian market. We are only pointing out that much has changed compared to the way things used to be. Take the gas market, for example, where Russia’s Gazprom has become to Western Europe what Saudi Arabia is to the USA: a lifeblood.

By severing one’s ties with the emerging markets, an investor has to realize that he or she is cutting the ties from those countries that are undoubtedly exhibiting the highest rates of economic growth. And that is not only the case with respect to the past. Even if you were to halve China’s and India’s growth rates, they would still be at a level that Western European countries could only dream of. “But you cannot believe anything the Chinese say”, is the cry used in defence. Well, the author of these comments can all too well remember that exactly the same was being said about Japan three decades ago. And what happened? In the 1980s every professor of economics went on a pilgrimage to Tokyo to discover the secret holy grail of that country’s phenomenal success. Let us therefore guard against taking too short-term a view and most especially against harbouring prejudices.

Many of the so-called emerging markets are in actual fact either a) less risky than one gives them credit for, and b) not overvalued. India is an example of a “new” long-term jewel that often gets ahead of itself so to speak, gaining far too much ground within a short space of time, and reaching the point where it simply **must** correct. The major problem here for the investor is, however, in skilfully exploiting such moments of exuberance by selling and re-entering the market at the right time. The danger is high that an investor will take profits – which looks the sensible thing to do in the short-term – only to miss the boat when the market – mirroring economic growth – starts to move upwards again. This March we top sliced our Indian positions, believing the market was looking frothy. The market carried on rising, corrected in May/June by 20 % in a very short time, and fell to the level at which we had sold three months before. We had therefore sold before the correction but it had not been worth the effort. This is a lesson in how incredibly difficult it is to sell a promising long-term investment on the hunch that you will be able to buy it back at a cheaper price in the wake of a correction. This is a “shrewd” strategy of course, but selling promising investments exclusively on the grounds of short-term considerations is akin to walking a tightrope and is rarely successful.

Price/Earnings ratios of Emerging Markets

Brazil	Bovespa	8.01
Hongkong	HSI	15.53
India	SENSEX	18.10
Indonesia	JCI	11.83
Malaysia	Kuala Lumpur	14.09
Russia	RTS Index	11.97
Taiwan	Taiex Index	12.09
Thailand	SET	10.38
Czech Republic	Prag Stock Exchange	16.02
Turkey	ISE nat.	9.53
Hungary	Budapest Stock Exchange	11.10

More wheat than chaff

Asia offers investors a bounty

The question now arises as to how we put our investment philosophy into practice at this point in time. The solution lies in implementing a broad diversification in order to balance out accidents such as the Turkish market – to name an example of the recent past. We are definitely of the opinion that it is appropriate for investors to go on overweighting Asia and we advise to ignore quarterly performance of these markets. The largest growth of asset generation is taking place inside this region and this can spell nothing but good news for consumption – the single most important factor in economic growth. In China and India, for example, supermarkets are virtually non-existent and this means the sky is virtually the limit for service providers and suppliers of the supermarkets yet-to-be. We are not referring here to trifling sums but getting on for one

third of the world's population. With these kinds of trends, you do not invest for one quarter or two, but for a decade.

We have dedicated a lot of space to Emerging Markets on account of the fact that you currently read everywhere that the investment community is presently eager to reduce risk by selling their stakes in this very sector. When perusing some of these articles one might think that the recent market correction was limited to the "new" markets and that the bourses of the Old World were unscathed. That is not the case though. Since the year's "high" in early May, Germany's Dax fell 11.4 %, Switzerland's SMI dropped 9.2 %, while Taiwan or Singapore receded 12.7 % and 10.8 % respectively. No further comments here.

The interim conclusion of our report therefore is that based on fundamental analysis and valuation criteria, it is compelling to assume that the recent market fall was purely of technical nature.

Let us thus turn to some other issues to examine whether anything else is rotten in the state of Denmark.

There are indeed a number of aspects that augur negatively for world markets. Aspects, which have actually been around for quite some time.

Foremost, we are confronted with an environment of generally rising interest rates. In our year-end report 2005 we have already elaborated on this and we made clear that the outlook for bonds was in fact bad. Interest rates are rising everywhere and whether we like it or not, we have to accept that this is in principle negative for both equities and fixed interest investments. Not a bad time to hold cash. The only problem is that our poor clients who measure performance in Swiss Franc terms do not get much of a return on short-term deposits. After deduction of bank commissions and management fees the relevant yield is more or less nil. That makes it difficult to advocate a large cash position. For Dollar based

clients short term deposits are, however, a valid alternative to bonds and equities, following 16 subsequent interest rate hikes to the current level of 5 %. The U.S. and UK interest rate cycle is at a more advanced stage than is the case in Europe and Japan.

Inflation is back on the agenda and on the back of recently published data, we must realize that Europe's real interest rates (i.e. rates of short term deposits less ongoing inflation) are meagre at this stage. Europe's Central Bank is likely to hike interest rates further. That is not particularly good news for equity markets.

The spin doctors

The tricks journalists and bankers use

You do not see them very much at the moment: those dazzling charts that abound in the financial newspapers of the world, all demonstrating to the well-disposed reader how anyone who has not become rich over the past three years is dim-witted and has been poorly served. With what appears to be an almost pre-arranged regularity, these charts all have one thing in common: namely, they all take March 2003 as their starting point (the end of the 2000-2003 bear market) and without exception show an excellent one way performance until April of this year. Zürcher Kantonalbank, as an example, has proudly published an exponential graph of its "Vision" – the Fund, which it had to absorb from unlucky financier Martin Ebner. Innocent readers surely thought that Einstein's spirit was in charge of the "Vision". The only trouble was that this super graph started off from March 2003, disguising the less fortunate state of affairs prior to this date. It is futile to look at a short-term segment of a performance graph and the very same applies to world bourses. The truth is that world markets have not gone anywhere over the past six years. Nobody would have dreamed of publishing graphs of any

performance covering the years 2000 to 2003 (the bubble crash) and thus it is most inappropriate to boast with a result that covers only the rosy years of an overall period that has been a zero sum game. The past six years have been just that and one has no alternative but to acknowledge it.

Even though the tables presented at the beginning of the report illustrating the five-year performance of the world's major markets are a reflection of reality, they are an unsavoury fact that one would rather not digest. The Swiss stock market index has not risen by more than 2.30 % since June 2001, and the Euro Stoxx 50 actually fell by 19.5 % over the course of the past five years. – Looking on the bright side, however, we do have some good news: the particularly bleak bear market of 2000-2003 will soon no longer form part of the five-year performance figures and the picture will all appear rosy again. Rosy, yes, but it would be like looking at the world through rose-tinted spectacles. As has been mentioned, the truth is that the world's stock markets have on balance moved barely an inch for a long, long period of time – around six years to be more exact. This may sound like an excuse, but it really is not. – The GP of the author of this text said recently: “You’ve got the blood pressure of a teenager!” – Had I enlisted in my local military cadet school on the basis of this diagnosis, I would have been turning just as much a blind eye to reality as the smart PR person at Zürcher Kantonalbank who breezily glosses over the time factors of the Visionen Funds and can make two and two seem to add up to five with a slight of the hand.

We have already mentioned this before. From a purely fundamental perspective, the picture is not one of doom and gloom. – Yes, interest rates **do** rise and world liquidity **is** falling. Those are negative aspects for markets. We must also deal with the fact that the USA – the world's economic power engine – obviously has problems. Not that recent growth has been bad – completely the reverse. The sixteen hikes in interest rates are, however, having a dampening effect on the morale of

the residential construction sector and the buying euphoria has faded. There is actually now a glut of newly built US housing and prices are falling. No doubt this is eating into the confidence of American consumers and would mean one having to bolt the hatches down in anticipation of a slowdown in US economic growth. But we should not forget that US share indices have already factored in this pull back in the economy. In complete contrast to European and Asian markets, US share prices have long tended sideways and the price-earnings ratio of the US stock market has been continually falling. In other words, the forthcoming slowdown has already been reflected to a significant degree in today's valuations.

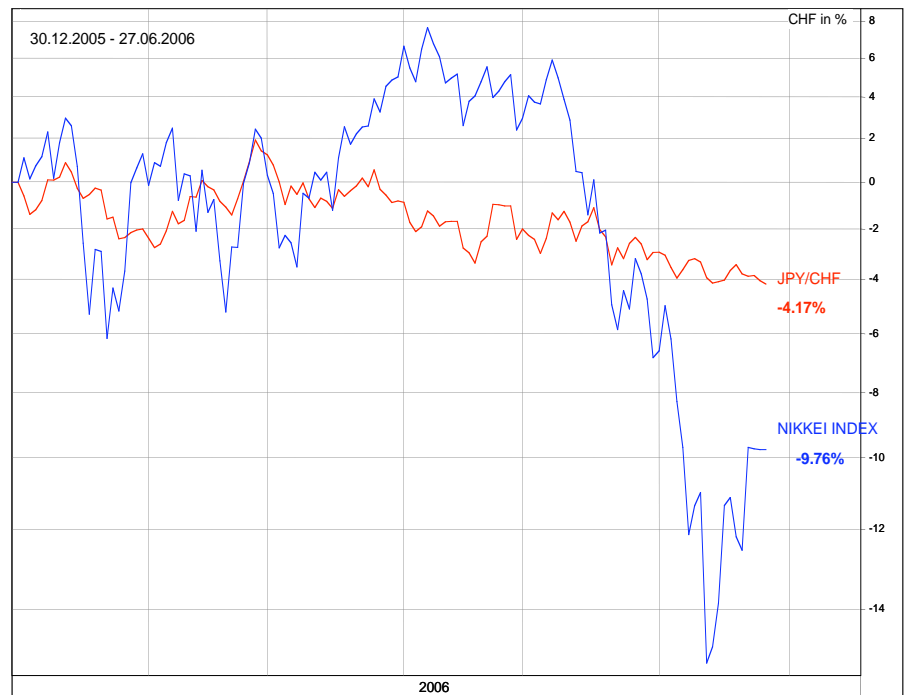
Disappointment

The stumbling Tokyo stock market

In hindsight, it almost had an air of inevitability about it. During November and December 2005, the buying frenzy reached a bursting point in Tokyo. Vast sums of money were pumped into Japanese shares from abroad, and many a hedge fund manager, whose knowledge of the intricacies of the Kabutocho (Japan's Wall Street) was rather shaky at best, rashly invested cheaply acquired credit. Tokyo emerged as the solitary favourite for 2006 in the traditional end of year analyst surveys, making what was set to happen virtually inevitable. Tokyo soon brought disappointment and the huge correction on all markets during the last couple of months hit Japanese stocks especially hard. Thousands of investors with insufficient knowledge of the macroeconomic situation in Japan (foreign investors mainly and hedge funds above all) got cold feet and liquidated the positions that they had only just been rushing to build up.

Now, as huge as the price correction in Tokyo may have been, we do not believe that it was justified. We are more of the opinion that this was

a purge of rather misguided speculators and that consequently the 20 % correction of the index was technical in nature. The fundamental macro data of the Japanese economy continues to give us grounds for optimism. The only drawback for European investors is the sad fact that the Yen has depreciated against continental currencies.



In terms of purchasing power parity, the yen is currently absurdly undervalued. The snag here, however, is that currencies often stay over- or undervalued for a considerable length of time before regaining their true market value.

The unwanted risk

The outlook for the US dollar

Our old friend - the dollar. Our expectation of a weakening dollar was confirmed. The dollar came under pressure and hedging the currency for franc and euro-based portfolios paid off.

The astonishing rise of the dollar in 2005 has now been neutralized. The primary reasons for the weakness of the US currency are currently as follows:

- the expiration of the American Patriot Act during which profits repatriated by US companies enjoyed tax breaks
- the imminent end to the cycle of US interest rate hikes (16 interest rate hikes since their low point)
- the rise in European interest rates and the resulting erosion of the interest rate advantage of the US dollar
- the diversification of currency reserves by countries with trade surpluses
- the continuation of the mammoth US balance of payments deficit

As surely as night follows day, excess liquidity will, in the long term, flow to where the best investment opportunities exist. This favours in principal America since it offers entrepreneurs and investors better long-term prospects than Europe. The trouble is, though, that other influencing factors may dominate in the short term and that seems in our view to be what is happening at the moment. Our positions in dollar-denominated investment instruments (such as the China Strategy Certificate, Arisaig Asia Fund, Amerequity, Elite Diversified, Concept Capital etc. etc.) coincidentally happen to be traded in US dollars and were bought in expectation of a rise in value of the underlying assets. For our European

clientele, we therefore currently continue to neutralize the currency effect arising from this situation by hedging the dollar. This strategy has so far proven to be appropriate. We will naturally monitor our assessment of this situation on an ongoing basis.

Swan song

We hold on to our investments

The first message that we are giving you today is to inform our readers that the sharp correction of the equity markets over the course of the previous two months is, in our view, a correction of excesses rather than a precursor to a world bear market. Our equity exposure today may be lower than at the end of 2005, but the sales of shares were not carried out during or as a consequence of the reversals just experienced but rather during the first quarter of 2006.

The air is certainly thinner than it was at the end of the major bear market three years ago. We believe that it was high time the markets meted out a lesson to the speculative element that influences them. Optimism had grown out of all proportions. We therefore caution you not to become beset by panic on account of the disconcerting experiences of May and June. After all, a company boss would never dream of closing down a branch just because it makes the occasional quarterly loss. So let us keep a stiff upper lip and hold that bottle of valium in reserve for more serious emergencies that may arise.

MAB