

Our Point of View, June 30th 2008

2	Bank geniuses and other lunacies	The big banks' unbelievable conduct
5	History repeats itself – or does it?	The world's supposed dependence on the US giant
8	The arch enemy	Inflation is suddenly a problem again
10	Played well but still lost	Consequences of the rescue missions
12	Japan	Unloved, cheap stock market
13	A weak summer	Short-term prospects

Burgauer Huser Aman & Partner AG
Investment Managers and Consultants
Stockerstrasse 14
8002 Zürich

Mailing address:
P.O. Box, CH-8027 Zürich
Telephone +41(0)44 206 22 33
Telefax +41(0)44 206 22 44
info@bhapartners.com
www.bhapartners.com

Statistics of leading stock markets

A) Year to date		in US dollar	in local terms
Switzerland	SMI	- 9.69 %	- 18.09 %
Germany	DAX Xetra	- 13.76 %	- 19.93 %
France	CAC 40	- 15.09 %	- 21.16 %
U.K.	FT-SE 100	- 14.60 %	- 14.54 %
Sweden	OMX	- 11.35 %	- 18.00 %
Europe	STOXX 50	- 17.59 %	- 23.49 %
USA	S&P 500	- 12.61 %	- 12.61 %
	Nasdaq	- 12.48 %	- 12.48 %
Japan	Nikkei	- 5.56 %	- 9.39 %
Morgan Stanley World Equity Index		- 11.67 %	n.a.
Bloomberg Effas US\$ Bond Index (5-7 years maturity)		+ 2.54%	n.a.
Balanced Mandate Index *		- 4.57 %	n.a.

B) Over five years		in US dollar	in local terms
Switzerland	SMI	+ 90.45 %	+ 44.37 %
Germany	DAX Xetra	+175.06 %	+ 100.57 %
France	CAC 40	+ 96.81 %	+ 43.52 %
U.K.	FT-SE 100	+ 65.00 %	+ 36.88 %
Sweden	OMX	+122.30 %	+ 66.00 %
Europe	STOXX 50	+ 90.80 %	+ 39.13 %
USA	S&P 500	+ 31.67 %	+ 31.67 %
	Nasdaq	+ 43.05 %	+ 43.05 %
Japan	Nikkei	+ 70.48 %	+ 52.18 %
Morgan Stanley World Equity Index		+ 61.11 %	n.a.
Bloomberg- Effas US\$ Bond Index (5-7 years maturity)		+ 22.00 %	n.a.
Balanced Mandate Index *		+ 41.55 %	n.a.

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

Bank geniuses and other lunacies

The big banks' unbelievable conduct

The first quarter of 2008 was a disaster: a disaster for the financial markets and a disaster for the reputation of the major banks. It's just as well then that there are still financial institutions that act like private banks (we work mainly with such institutions) and – if we can blow our own trumpet for a moment – that there are certain independent financial advisors who put everything into protecting their clients when things are going wrong.

It would be true to say that we have often expressed our views here on the business practices of the world's big banks at length and sometimes in disparaging terms. However, we probably understated the situation, as the wreckage heaped up by those who are supposedly the brightest – and who pay themselves the most – among our financial services professionals is unimaginable. Unimaginable in terms of dimension and equally dramatic in its origin. In many previous reports we have commented in detail on the (cleverly exported) US mortgage catastrophe and do not wish to trouble you further with details already adequately reported in the press. The opinion we have expressed so far on this painful topic is that we are dealing not with a global, macroeconomic problem but with a quite specific, albeit gigantic, mess-up in the financial sector. In January, stock markets around the world acted as if a massive global recession was just around the corner. The financial markets anticipated that the US mortgage fiasco would wrench the entire world into a downward spiral, which we ruled out in our previous reports and still do. We have long argued that the emerging markets – chiefly Asia ex Japan – are now heavily driven by domestic demand and that the naive western view that Asia is totally reliant on exports is completely untenable. This opinion now appears to be taking hold. It is undoubtedly very

possible that growth in China, India or Brazil will drop a few percentage points. But even if it does, growth in these regions will remain three to four times stronger than in the west. More on this later.

But let us now return again to the origin of all the current woes – the antics of the big banks.

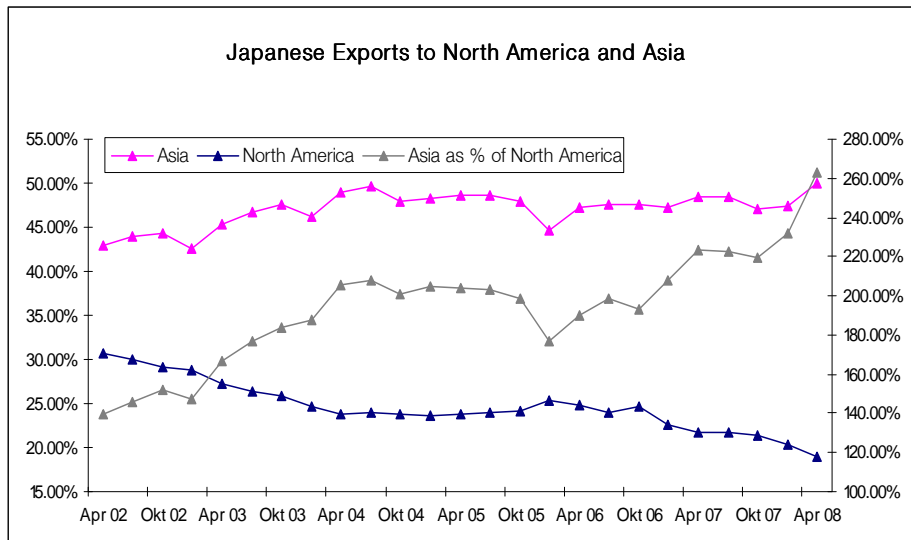
A few weeks back we were asked on occasions whether we hadn't missed out on the bargain of the century by not buying UBS shares at CHF 25 just before the previously proud bank's shares rebounded by 40%. But the gloss has since worn off UBS's shares again and the question is coming up less frequently. UBS – and its similar-sized rivals – is a Pandora's box of the first order. Their transparency is opaque, their reporting fragmented and their outlook weak. Their lack of integrity is even worse. Let's take Credit Suisse as an example. They boasted when their figures for the first quarter of 2008 were published about how they had exited subprime investments early on and losses were negligible. Great. They patted themselves on the back and paid out the customary, hideously inflated bonuses. Ten days later came the news that naughty traders had incorrectly reported some of their own positions and that billions would now have to be written off. Pity. The traders kept their inflated bonuses. Or let's look at the "sale" of subprime paper by UBS for USD 16 billion, announced a little over a month ago. The bank wanted to clear the decks and move forward, in its own words. However, the reality is that the clean-up sale was actually not a sale at all. The bulk of the purchase price was provided to the purchaser as a UBS loan. The buyer didn't shell out a penny for the deal. To sum up, if the US mortgage market recovers, the purchaser will benefit. But if it doesn't, UBS faces further problems because (unbelievable, isn't it?) the loan in question is secured on the rotten subprime paper the bank apparently sold. There's no such thing as a free lunch. For all the bragging about the brisk progress of the clearing-up operation, in reality this is just window-dressing. Mr Ospel, the cast-off CEO of UBS, expressed his shame at

“the small number of staff who exceeded their authority”. We, too, are ashamed – about the reputation of the banking profession, with which, please, we do not wish to be lumped together. The disastrous strategic decisions of recent years, the unethical practices towards those who provide their livelihoods (namely their shareholders) and their insatiable appetite for a killing are so far beyond the scope of comprehension that the world should be absolutely clear on one thing: when it comes to investing, shares in such institutions are like walking a tightrope. So how should one value the likes of UBS if one knows that such wonderful multi-billion profits, (half of which went to crafty management) are phantom figures? The quality of such profits is horrible, and valuations of the shares (i.e. P/E ratios) must accordingly be extremely low. Anyone who thinks that eight or nine or ten times earnings per share is “cheap” is quite simply naive, simple-minded or dim – or all three. So if to date we have not bought any UBS shares at apparent knock-down prices, then it’s precisely because we simply have no idea what kind of bad news is yet to emerge, never mind talking about profits. Certainly, UBS could be worth more if it was split up. But what is happening at the moment with goodwill, what is the situation surrounding the much-mentioned massive inflows of funds which are suddenly turning into an exodus and, last but not least, what about the imminent and dangerous litigation in the USA? We have no idea what UBS shares – and other similar stocks – may be worth today, so we are steering well clear of such bargains. We are investors. We call ourselves common-sense investors. Common sense tells us not to buy something when we don’t know what’s inside – except perhaps a Louis Vuitton bag. But at least in that case we know that our purchase is worthless straightaway.

History repeats itself – or does it?

The world's supposed dependence on the US giant

The prevailing opinion continues to be that, due to the collapse of the real estate market, the “world of credit” – i.e. the USA – is sliding unavoidably into recession and that this will almost inevitably pull the rest of the world down with it. Past US recessions have always had unpleasant consequences for Europe and above all for Asia, so experience from previous years gets extrapolated into the future. Analysts calculate right down to a tenth of a percent what a US recession will mean for the lightweights of this world. There are even tables from which you can read off what negative growth (a neat euphemism for recession) in the US economy will mean for countries such as Malaysia, Germany or Peru – to pick a few countries at random. It's that simple. Past = future = investment success. Now, from our cynical comment you'll guess where we're heading. BHA is going to lay into the big bankers' powers of judgement once again. But we are fair-minded observers and aren't going to do that. Rather, we would just like to say quite clearly that one thing has changed in our globalised world. Uncle Sam is no longer as influential as he used to be. The USA is in practice no longer the world's economic ruler and is heavily dependent on a drip-feed from countries running surpluses. They in turn are not at all happy about the loss of value of their huge central bank reserves and the continuing rate cuts on a sickly currency. The naive view that Asia's fortunes are entirely dependent on levels of exports to the USA is quite simply a foolish myth. So let's look at Japan's export figures, to take one example.



Just six years ago, a third of all Japanese exports still went to the USA. Now the figure is just 18%. More striking still is the respective significance of America and Asia.

Whereas in 2002 around 20% more Japanese goods went to Asia than to the USA, it's now 160% more. So, come on. You don't need to be a genius to work out that, firstly, Asian demand is growing much faster than US demand and, secondly, the more time that passes, the less Asia's fortunes are tied to the economic performance of the USA.

Asian domestic economies are contributing more and more to their countries' GDP. Hundreds of thousands of kilometres of motorways and railway lines, hundreds of new airports (yes, you read that correctly), hundreds of ports, container terminals, railway stations, nuclear power stations and dams are in the pipeline. The list of infrastructure projects is almost endless. At the same time, Asians' purchasing power is rising inexorably, and in our opinion consumer-dependent investments are most definitely sustainable. Our exposure to the Arisaig Asia Fund for instance,

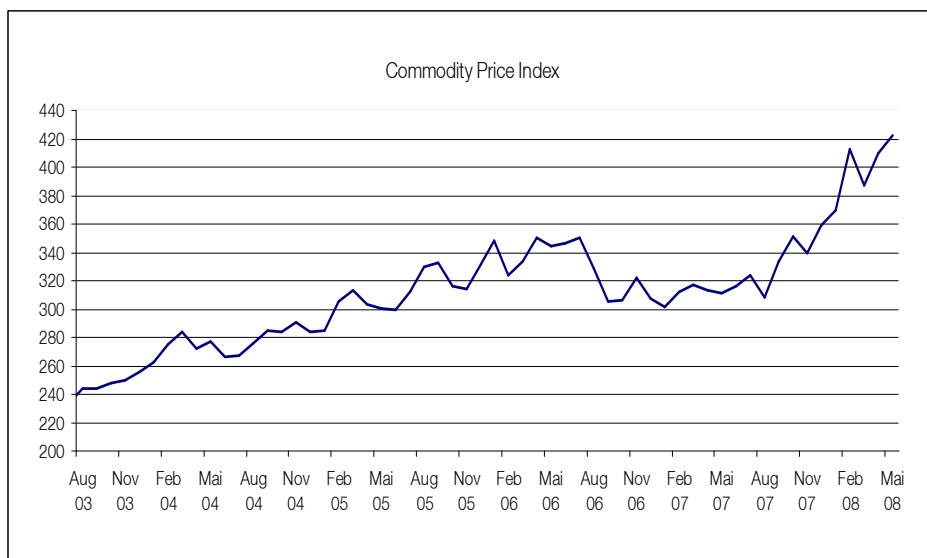
specifically targets this. Greengrocer Fong in Xian (a city of five million inhabitants) will hardly forego buying a new pair of shoes because of America's subprime crisis. In other words, we in the west are prone to massively overestimating our own importance. The world has long since stopped revolving around us. US economic growth is important for the world, but no longer so critical that Asia's megatrend could be brought to a standstill or even put into reverse. The equity markets are sometimes not a very good reflection of the facts. Why? Because they are still mainly dominated by western decision-makers. The Asian exchanges have stuttered so far this year – chiefly due to the nervousness of Americans and Europeans, who have an extremely large share of day-to-day business. However, the Asian markets are by no means overpriced and genuine investors are poised at the ready, as there's absolutely no reason to panic. Hundreds of Asian equities are sensibly valued and worth buying. Japanese small caps in particular are cheap and have long since ceased being spurned. We have just moved in here and added exposure via our "Choice of Japan" vehicle.

To sum up, our former expectation that the world would have to reckon with write-downs of around USD 350 billion on non-performing subprime loans was too conservative. The financial geniuses of this world have caused even greater losses, which still need to be digested. This is still hurting the system. None of the banks trust each other, and it's above all consumers in very specific areas of the USA who are at the limit of their resources. The central banks have poured vast amounts into the financial system to prevent a crisis of liquidity and confidence – only temporarily, of course. They say they want to get these hundreds of billions back again as soon as possible. Many people "want" to do something. Many people want to become rich, others to pay off debts and still others (the central banks) want to sterilise money that they frantically had to pour into the ailing banking system. Now, this does not look so simple without causing damage, so hardly anyone now is talking or writing about the huge

amounts of liquidity assistance the central bankers have tossed into the system. Which brings us onto the next topic.

The arch enemy

Inflation is suddenly a problem again



Today everybody's to blame for the rise in inflation: the Arabs with their expensive oil, the multinationals with their financial greed and the hedge funds, which are apparently greedily buying up all kinds of commodities with borrowed money. Everyone's to blame – except the central banks, which in the course of the last 6-8 months have pumped an estimated USD 540 billion in “temporary liquidity assistance” into our system. Now, unfortunately this is far from trivial, and it is absolutely astonishing how often opinion gets manipulated. The central banks have been flooding the financial system with quite unheard-of amounts. The almost inevitable

consequence is inflationary pressure, but, cheekily, everyone and everything else is to blame for the embarrassing course of events except for those who have brought the whole sorry affair about. Not that we think the liquidity injections were not necessary – they were. Otherwise we might have had a new form of grounding in Switzerland. Swissair certainly had more fans than many a bank that has run into difficulties, but it wouldn't have done anyone any good if one of the big banks had closed its doors. As good Swiss, we are neutral and are not naming any names.

Meting out blame as to who and what is supposed to be responsible for the renewed flare-up of inflation does not help much. What is clear is that inflation is an issue. It's also clear that it is much more serious than politicians' statistics would have us believe. Inflation is a fundamental enemy of our system, though – take note – deflation is even worse. However, if inflation gets combined with stagnation, as could currently happen in some western countries, then we really would have a problem on our hands.

But necessity is always the mother of invention. Rocketing oil prices have finally prompted the car industry to launch energy-saving models. It shouldn't be much longer before really worthwhile electric cars are on the market. But America's subsidising of biofuels is a flop and an absurdity, and partly responsible for the explosion in grain prices. From an ethical viewpoint, it cannot be acceptable that billions of people can no longer afford their basic foodstuffs merely in order for that portion of humanity that calls itself "developed" to fill up its over-sized gas guzzlers with biofuel and think it's doing humankind a favour in the process. That is totally absurd. Moreover, it has been shown that the production of biofuel is a nonsense that consumes more energy than is ultimately produced.

We don't know how serious the inflation problem actually is. But what is certain is that many companies cannot pass all the inflation in commodity prices onto their customers, so many profit margins are being squeezed.

Does this then mean there should be a flight to the safety of bonds? No. Current bond market yields are unattractive, which means that the defensive part of a portfolio should be invested on a short-term basis and that investments with maturities beyond two years should tend to be the exception. We must stay on our guard against inflation, as it is by no means certain that the guardians of stability (i.e. the central banks) are in a position to defy the wishes of politicians by raising interest rates in an economic slowdown. The central bankers are indeed independent, but unfortunately often only in theory. The Swiss National Bank may be a commendable exception. It has come out and said that Swiss inflation has now overshoot its acceptable range and that rates could therefore very well soon be raised in the Swiss franc area. Jean-Claude Trichet, the head of the European Central Bank, has for a long time bravely resisted opportunistic EU politicians by not lowering rates despite the subprime crisis. However, it appears highly doubtful whether the rate hikes now required given the rising inflation in Europe and the USA can be pushed through.

Played well but still lost

Consequences of the rescue missions

This spring, the Federal Reserve Board plainly showed that everything would be done to protect the financial system against collapse. We were effectively on the edge of the abyss. The failing investment bank Bear Stearns was merged with another bank overnight under the aegis of the US central bank, new safety nets were put in place and absolutely limitless liquidity was injected, which provided the financial system with emergency funding. A confidence crisis was about to occur. This is what happens if the real value of assets can no longer be discerned for psychological reasons. This is because the correct price (which is not an absolute) of a

stock, bond or piece of property is only what someone else is willing to pay for it. One can spend a long time complaining that a stock is historically dirt-cheap or that a house is unfairly valued. We are happy to accept exuberant prices in a bull market but plummeting prices during a crisis of confidence are hard to swallow. The Federal Reserve Board was afraid of the blaze getting out of control, and the liquidity provided knew no limits. Tactically, that was certainly correct, but after a successful rescue mission the clear-up ought to start. The banks should be prevented from using the liquidity overhang for another high-wire act and thinking that they could quietly enter into more crazy risks because, well, their central banks would always bale them out of trouble. Rapid action also ought to be taken to mop up the liquidity overhang. Interest rates and banks' minimum reserve requirements now need raising. But that's hardly what will happen. The well-fed politicians want to protect the poor mortgage borrowers, and Mr Bernanke should have a bit more of a social conscience, please. Nothing to do with the US elections later this year, we suppose?

The Fed therefore seems to have got on top of the confidence crisis. We would like to compare this course of action with series of cortisone injections. One such jab works wonders, if given strictly on a short-term basis. But in the long term they are fatal. Now, the US central bank would almost certainly have to pick up the long-term consequences of the treatment, i.e. the liquidity injections, ignore the thoughtful advice of politicians and forcefully reabsorb the huge overhang. This would of course mean that the present superficial recession would be followed by a two-year economic contraction. Everything in life has its price, including the prevention of a real crisis of confidence that we narrowly avoided a few months ago.

Unfortunately we don't think this Herculean feat will come about. Following the Greenspan mania (in which financial and economic problems were repeatedly resolved by cheap credit), we are now coming

down with the Bernanke virus, though we cannot ascribe any personal blame to the central bank boss. However, it would be naive to expect that one could pump hundreds upon hundreds of billions (USD 540 billion, to be precise) into our system in a short period of time without having to anticipate adverse consequences. Right now, we are not living in a land of milk and honey. In other words, the best we can face is higher inflation. The less attractive alternative is that the massive, new injection of liquidity culminates in a new bubble in the financial and commodities markets, which – we hardly dare utter this – could almost inevitably end in a nasty correction. This scenario would mean a rapid and substantial equity market recovery brought about by almost immeasurable floods of liquidity, like a pack of wild dogs that had run off into the distance before the gamekeeper (Mr Bernanke) realised that the door to the discipline enclosure had been left open a little too long.

Analysts often say they are cautiously optimistic. We tend to be cautiously realistic. The liquidity overhang is too large in our world today. In the short term it may turn out fine, but later on it could turn out to be a problem.

Japan

Unloved, cheap stock market

Many of our clients were not exactly overjoyed when we increased our exposure to the Tokyo stock market back in January of this year. Kabutocho investments were described as an “unending tale of woe” and so on. It is indeed true that the past few years have been unpleasant and that the yen has also weakened, exacerbating the situation.

However, many situations now genuinely can be identified in Japan that are attractive for investors. Half of listed shares are trading at below book

value. The average dividend yield is above yields on 10-year government bonds. Average debt is at its lowest for decades. Valuations were similar at previous historic lows (1985, 1998 and 2003), and it looks as though the recent lows have very probably heralded a trend reversal. Objectively there is a deep divide between prevailing market valuations and what investors deem to be reality idea of the real picture. Investors suppose that another ten-year period comparable to the 1990s has started and therefore fear Tokyo like the devil fears holy water. This could be a mistake. We are by no way over-invested in Japan, but we think that our current investments in Choice of Japan Inc. and also in some reverse convertible bonds (e.g. Canon and Komatsu) recently added to many portfolios should perform well going forward. If the view towards a particular investment area is as negative as it currently is towards Japan, one is not usually taking on major risk.

A weak summer

Short-term prospects

We do not expect the financial markets to deliver much excitement in the coming months. It will be a dull summer. The stock markets will swing to and fro and, like a dripping tap that soon gets on your nerves, the company newsflow pipeline will produce reports of more unpleasant losses in the subprime kitchen. However, the bad news will steadily improve, i.e. the newly disclosed write-downs will no longer be of the same magnitude as those of the past six months. The cleaning up of balance sheets will still continue, but market psychology will slowly grow more immune to bad news. Many bankers boldly asserted that the worst was behind us back at the end of the first quarter. After the subprime crisis one should perhaps not entirely trust the opinions of such

gentlemen, since well-founded doubts now exist as to their powers of judgement.

Unlike many other observers, we do not believe that the subprime disaster is likely to lead to a global recession. The latest US fundamental data are not in fact as bad as one would have generally expected. The financial markets and their publicists are all too concerned with the events and wrongs of their own sector and make too little allowance for the fact that not every US citizen is an impoverished mortgage borrower about to stop spending altogether. In addition, not every European or Asian company is reliant on exports to the USA, and hundreds of millions of new consumers in the emerging markets are most definitely not affected by the subprime catastrophe. So let's stay realistic and above all, let's not forget that we are not traders. We are investors striving for long-term success. We have not – for example – invested in Geberit because we wanted to earn a few francs per share, we haven't gone into Asia because it's fashionable and we haven't moved into Eastern Europe and Russia on the back of good prospects for a few months. No, we have invested for the long term. The subprime crisis and its manifold negative consequences have certainly set up an unpleasant obstacle to be negotiated. But this period will not last for ever, and so we ought not to be impatient. We shouldn't attempt, prematurely, to force performance as if brandishing a crowbar. We think that the fourth quarter of 2008 could turn out highly satisfactorily, with some undervaluations on the equity markets being corrected. The summer months will remain flat, however. Don't go rifling through the financial pages too often during the course of the lovely summer months. That may well cause unnecessary frustration.

And be on your guard against the advice of investment bankers. That may sound rather harsh, but we have never found a satisfactory explanation as to why good manners should prevent one from telling the truth.

MAB