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YEAR-END REPORT 2000

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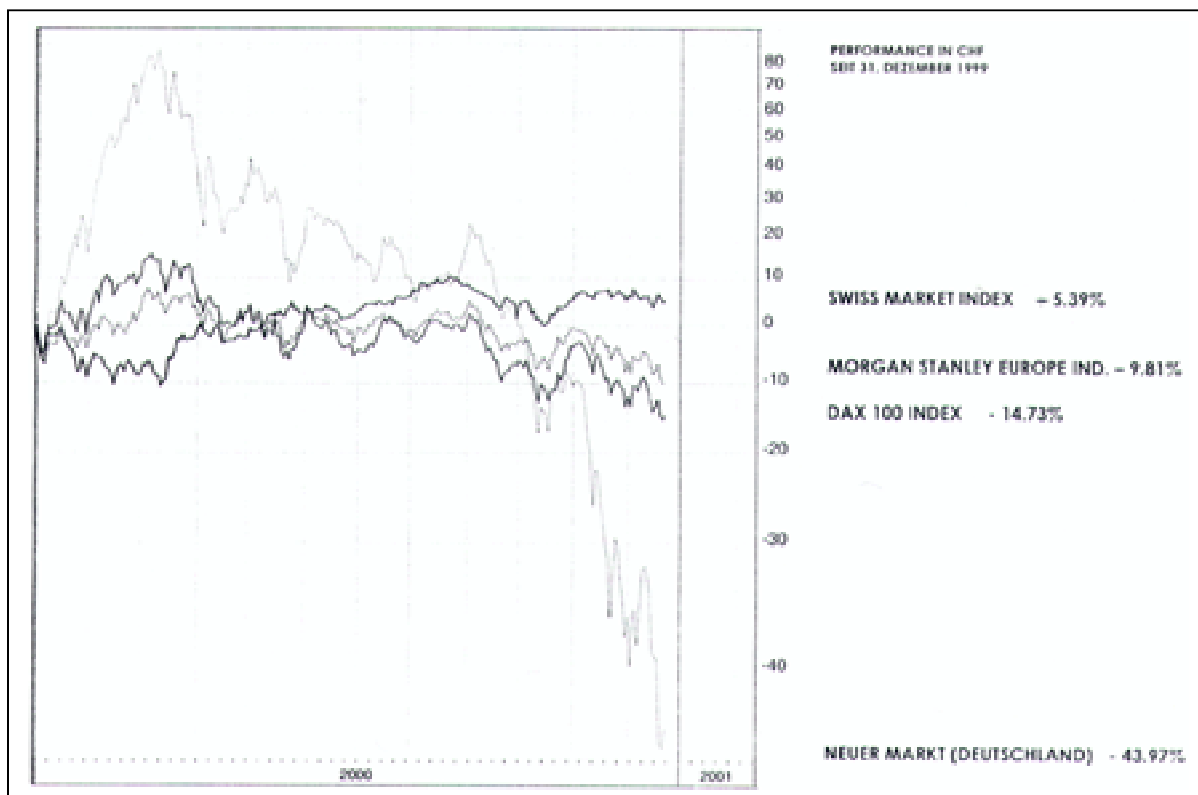
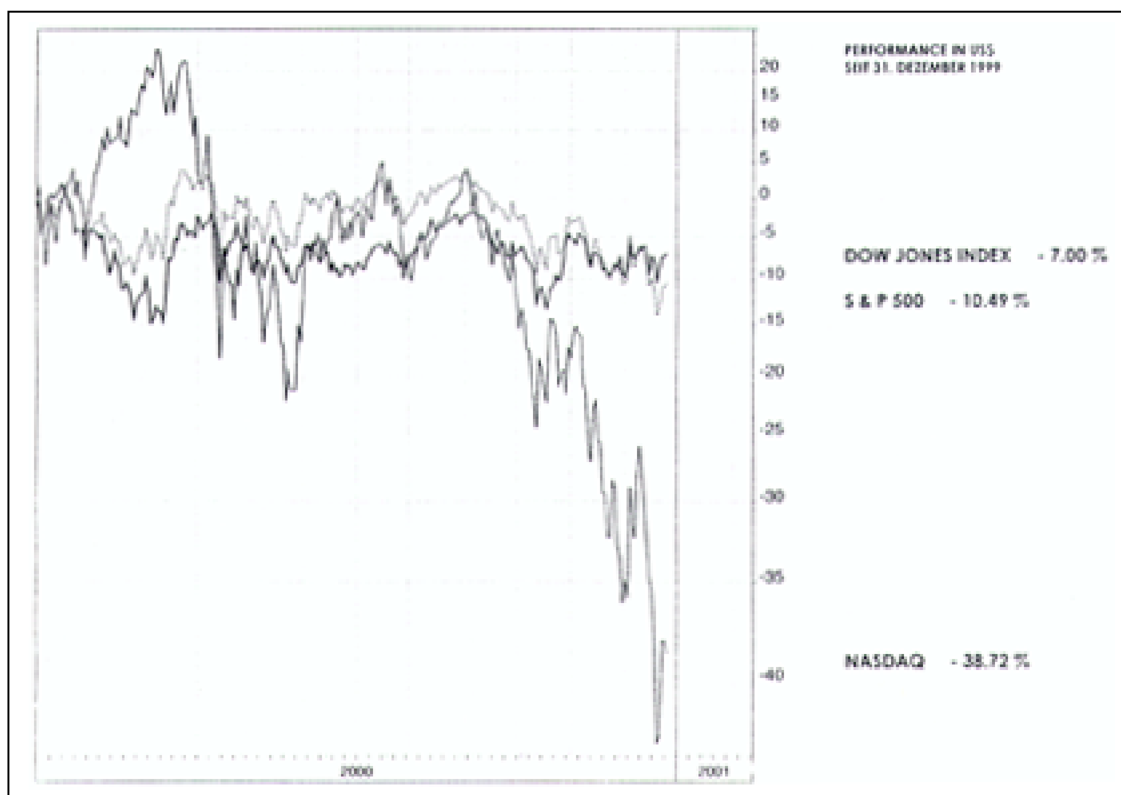
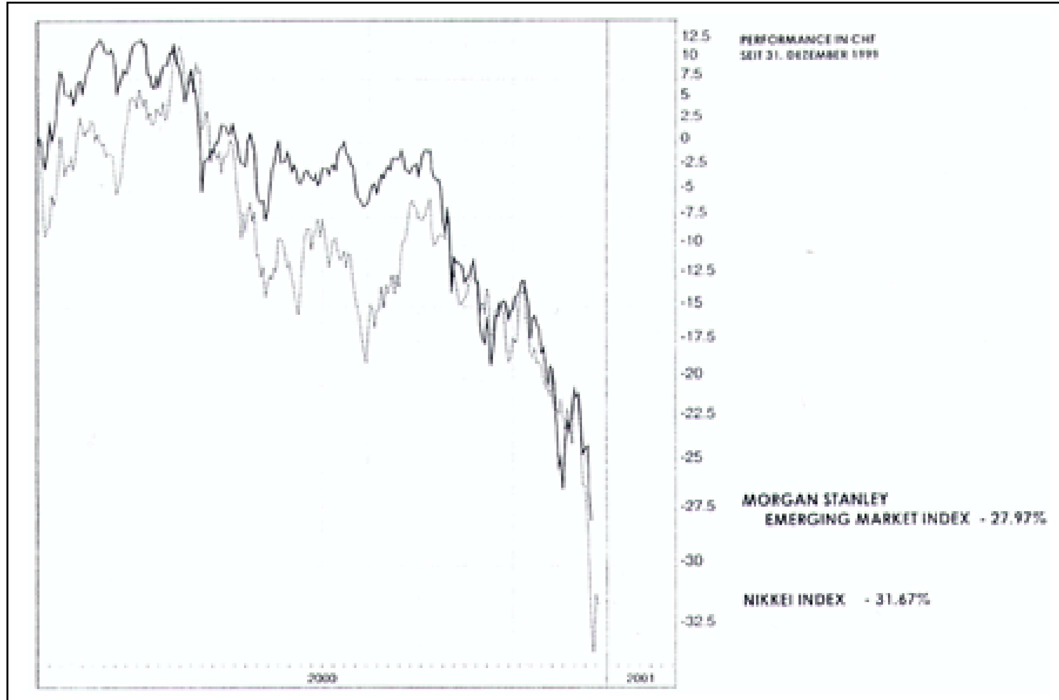
THE FORGOTTEN WORD

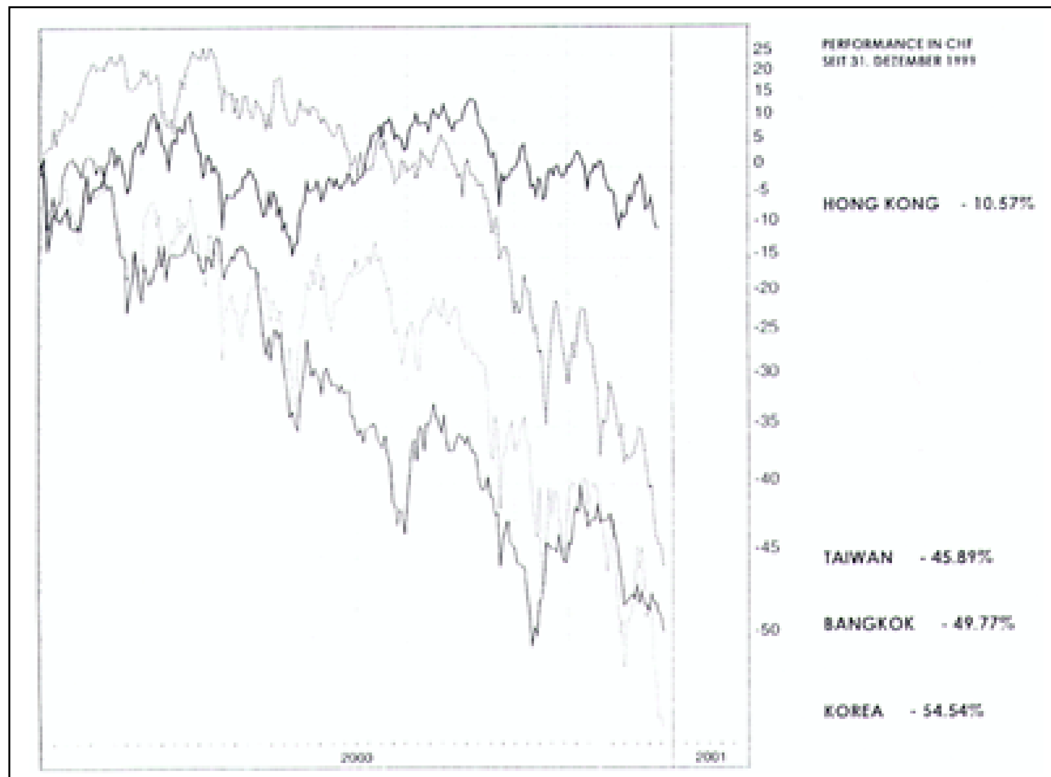
The past year was a year of noughts in the literal sense of the word. Unless one ran a fixed interest portfolio (and thus missing out on the fun of 1999) it was extremely difficult to stay even, leave alone make money. More than enough has been said and written about the collapse of the high-tech bubble. It was no surprise, it was overdue, it was appropriate. But then nobody speaks about a bear market. Strange. We have been in a bear phase for quite some time. Hasn't anybody noticed? Not the analysts, it seems, but then analysts are at times an unhelpful lot of people who are busy copying each other's outdated views. Joke apart. Imagine war broke out and nobody noticed. Absurd. But that is exactly the state of financial markets. Equity values fall (and how they fall!) and nobody appears to notice, nobody admits that we are simply in an old-fashioned bear market. The super bull phase of the Eighties and Nineties have struck this word off the Webster of modern language. Young bankers have been taught that every stock market set-back is a golden buying opportunity and ironically this seemingly absurd advice was the guideline to success for a long time. People in their thirties (some appear to be older too) don't appear to understand the logic of things anymore and demand the rewriting of recent textbooks. According to financial polls taken in the United States during the past few years, most people thought that a 15% recurring, annual return on stocks was normal and rather a minimum expectation. Less than that appeared to trigger some sort of constitutional right to either sue or fire one's investment manager – or both. Well, the world has been caught up by reality. The economy did not and will not produce annually recurring profit growth to the tune of 15% and performance expectations held over the last few years were simply absurd. Whatever. We have no choice but to accept the simple fact that the year 2000 was not a period during which it was reasonable to expect any sort of capital appreciation out of equity investments. During the past year we were meant to contain the damage. We had a bear market, whether we like it or not. It was of little help to own an oil share or food stock such as Nestlé. Most shares fell. And how. Let us briefly look at Europe's and America's stock indices to get the overall picture. Not a delight:


PERFORMANCE IN CHF
SEIT 31. DEZEMBER 1999
80
70
60
50
40
30
20
10
0
-10
-20
-30
-40
SWISS MARKET INDEX – 5.39%
MORGAN STANLEY EUROPE IND. – 9.81%
DAX 100 INDEX - 14.73%
NEUER MARKT (DEUTSCHLAND) - 43.97%
2000
2001


PERFORMANCE IN US$
SEIT 31. DEZEMBER 1999
20
15
10
5
0
-5
-10
-15
-20
-25
-30
-35
-40
DOW JONES INDEX - 7.00 %
S & P 500 - 10.49 %
NASDAQ - 38.72 %
2000
2001

And what about the Tiger countries? And Japan? And Emerging Markets? Here things looked even worse. The graphs of Southeast Asian markets appear to tell us that the Asian crisis of 1998 has started all over again:





As you can see, all markets dived and there was little remedy against the tide of the year 2000. Looking at the above charts, one does wonder why nobody appears to accept that market corrections can turn into such a thing as a bear market. These are our factual comments on the past year.

PLUS MINUS

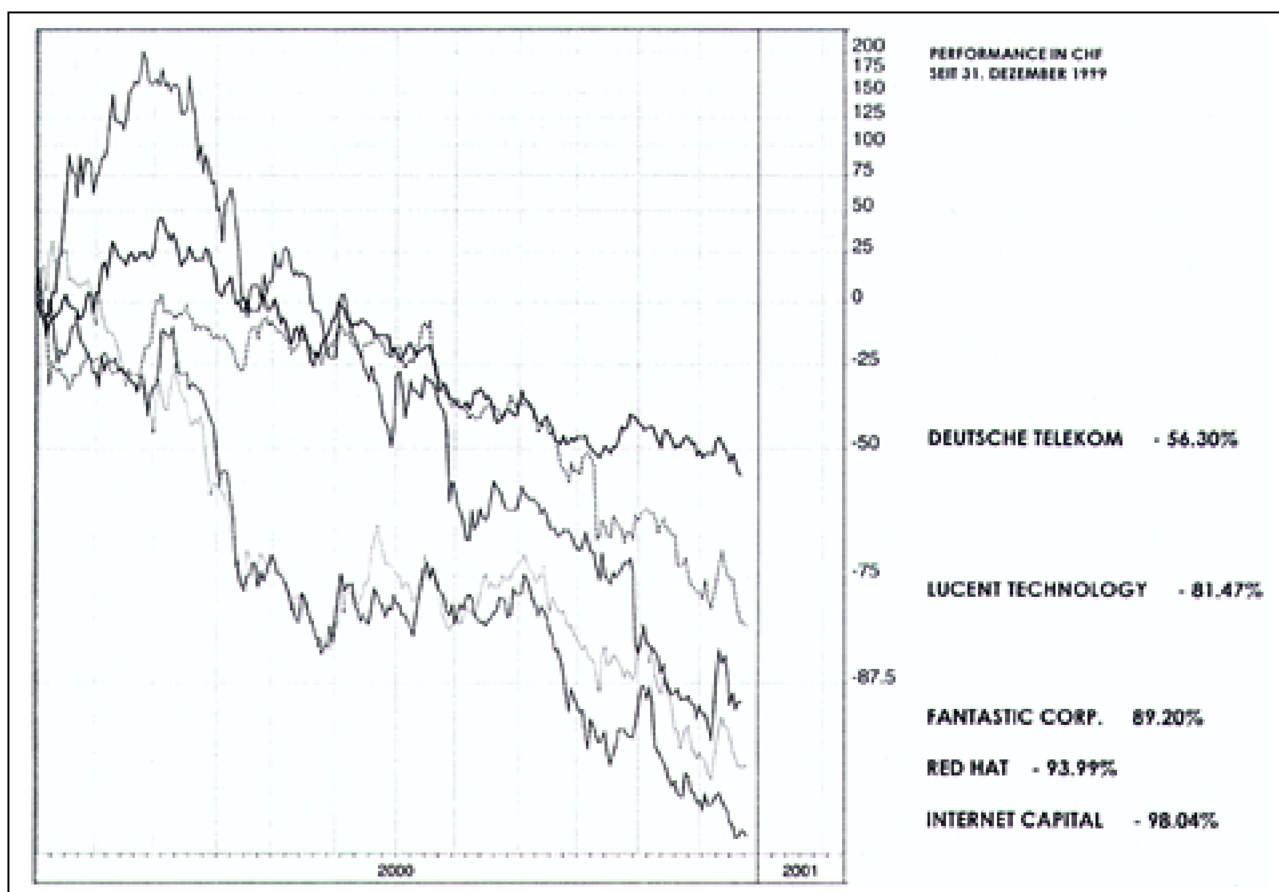
We now wish to zero in on our firm's recommendations, assessments and decisions made during the course of this difficult year with three zeroes. What was good as regards our timing and our views and what was bad.

Let us get started with the culprit of the action: high technology. Many of our clients have enjoyed very handsome gains in this sector during the course of 1999. A year ago we continued to be impressed with the phenomenal prospects of the communication revolution, but we did point out that the year 2000 would no longer offer similar opportunities. Actually, we recommended to realise a good part of the handsome gains and that one should refrain from ploughing internet profits back into the same sector. A year ago, we also said that profit warnings and earnings disappointments would be brutally punished and generally we were concerned about the high-tech euphoria. We closed by saying that it appeared to be timely to reallocate some of these gains into interest producing investments. The final phrase in our report said "The year 2000 will again not be an easy year for investors". As the year 2000 got started we were indeed surprised about the exponential rise of communication- and Internet related stocks. It seemed that the sky was the limit. It was proven once again that the very last phase of a bull phase produces by far the most important gains. We made use of this time period to go on liquidating Internet-related investments which had by now reached absurd valuations. With the benefit of hindsight we can be blamed for not selling the lot at once, being the very reason for the fact that our year 2000 performance was not only acceptable in relative terms, but in absolute terms as well.

At midyear we were quite concerned about the inverted yield curve, i.e. the fact that short term interest rates were higher than longer term bond yields in quite a few countries. Inverted yield curves usually foretell problems, but for whatever reason the market often takes little notice of this warning signal until it is too late. At that time we recommended to adhere to entrepreneurial core investments and to get rid of all opportunistic commitments. We closed in saying that one should not be ashamed of holding cash.

Overall, our expectations and recommendations for the year 2000 were reasonably accurate. The minus-score of the year was the fact that we did not carry out our convictions as vigorously as we should have done. With the benefit of hindsight this is easily said. The reasons for a slight hesitation here and there are not

fundamental, but rather psychological. For every investment manager in this world it is extremely difficult to change course 180 percent within the shortest period imaginable. The commitment process to high tech took some time. It did not take place overnight. And thus the disengagement, which was in fact carried out rather swiftly, also took some time to be realised. As a general yardstick we think that those investors who participated meaningfully in the run-up of high tech stocks during the course of 1999 were not badly treated in the year 2000 if they gave up some ten percent of a pretty unreal 1999 performance. Quite a few of the 99 darlings were actually badly gored in the recent past and we are reasonably pleased that we played these games only during happier times:



This is an arbitrary list, which could be extended to no end. The share of the world's biggest company by market capitalisation at year end 1999 – Microsoft - virtually collapsed and lost no less than 60 %.

REQUESTING PERMISSION TO LAND

Following an immensely long, an immensely successful period of non-stop growth, the American economy is about to land. Softly, the analysts say. What else? Economic landings are always supposed to be soft. In our last report we already voiced our surprise that economic forecasters invariably expect economic transition phases to be smooth – in spite of the fact that such scenarios rarely take place. Wishful thinking is simply projected into the future and what shall not be cannot be. Nonsense. There is reason to believe that the U.S. economic landing won't be soft and that a few tires could burst in the process. Our language is confusing. The tires are the banks… More about this aspect later.

What exactly are our concerns? Well, first of all it is high time for a cyclical slowdown. It is overdue. Mr. Greenspan has been busy stomping on the brakes and the European Central Bank has joined America in raising interest rates in various steps in order to bring about a cool down, although Europe's fiddling with interest rates had more to do with the problem of a weak Euro.

Then the price of energy. The oil price has tripled last year and although the quote has receded from the mid thirties worries prevail. Reserves in the western world are low by historic standards and are not geared to a cold winter, which could certainly still hit us. Just about all analysts predict an oil price of Dollar 25 or less by spring. Let us hope they are all right, but it is usually timely to reconsider things when everybody agrees. The fact of the matter is that an oil price of $ 35+ per barrel is a dark red signal. We witnessed a taste of what this means last autumn when the European transport industry took the problem into their own hands and blackmailed governments into price reductions. The French gave in quickly. More to follow next time? We certainly do not sell our oil shares.

We are concerned about the behaviour of Southeast Asian and emerging markets. Are stock markets totally off course or are they discounting problems in an invisible pipeline? Some of Asia's problems were dealt with half-heartedly and we think that the IMF has reverted to an accommodating stance much too early. It is certain though that a downswing in communication and high technology related investments augurs badly for export dependent Asia.

And now we come to the turbo of the American economic wonder: the U.S. consumer. In our last report we elaborated at length on the unbelievable consumption orgy to which the average American citizen has succumbed during the past many years. For some time now more money was spent than earned. Negative personal savings. The 'feel-rich factor' was so overwhelming that overspending became a matter of routine. 'No problem'. The stock market will even things out anyway. Maybe. But maybe no more. The collapse of the Nasdaq market will duly have its effect on consumer behaviour and on receipt of the year end

asset statement a few fridge orders might be cancelled and a down payment on a Florida flat recalled. Christmas sales are unlikely to be great. But then it had to happen some time. One cannot indefinitely spend more than one earns. It is as simple to understand as is the logic that an ever-recurring annual performance of 15% is an impossibility. Let us recall that some 60% of the national products are represented by consumption. When the consumer strikes (witness Japan) or when the consumer is forced by circumstances (American scenario) to cut down on spending, the overall economy is just about assured to stutter. We think that the time has now come for the American consumer to realise that it is no longer possible to live beyond one's means. PC sales are a good example. The Compaqs of the world are running into choppy waters and the next thing we see are rising inventories and hence reductions in manufacturing capacities. Semiconductor manufacturers give us presently a clear signal that end users are cutting down on purchases of electronic and electrical goods. If we are lucky this will just be a temporary, cyclical slow down. But has this cyclical slowdown, recession or whatever you want to call it, not actually set in a long time ago? If you carefully monitor the price development of true corporate America you will have noticed that the ongoing event of a cool-down has been anticipated by Wall Street over the past couple of years! The year 1999 produced many more stocks declining than rising and the very same is the case for the past year, simply to a more extreme degree. The world has simply taken no notice of this trend being totally mesmerised by the high technology mania. Investors were one track minded and ignored the fact that the Gillettes of this world tumbled badly. Maybe it *is* true that mobile phones cook one's brain…

Conclusion: Landing process ongoing. Not soft (as usual). Do not panic and rely on common sense.

TRANQUILLISERS AND GUTS

So here we are. In a downturn, induced by consumption cut backs and the high technology mania is a thing of the past. Its bubble has burst and most of the damage is now done. As expressed previously, the traditional segment of Wall Street has been in a correction phase for some time, although not officially recognised as a bear market. Most high tech shares fell just as quickly as they went up and it would be totally wrong to assume that the technology revolution is a thing of the past. This trend goes on and our task is now to distinguish long term winners from make believe companies (essentially most Dotcoms). Many shares are currently thrown out of portfolios just as impulsively as they were bought in panic a year ago. Lucent Technologies will not go bust (as the level of the share price might almost suggest), Intel will go on being the world's number one in semiconductors and Ericsson will go on being in the headlines as regards communication know-how. Most of the pure

Internet darlings of the past two years will disappear though. Even giants like Yahoo are marred with question marks.

Our job will now be to have the guts to ignore the negative sentiment of the current environment and to go out and buy the shares of those companies which are likely to be long term winners and which have been indiscriminately sold out by the investment community in tandem with the bubble stocks of this world. Remember that the best buys are never done when your neighbour agrees, but rather a time of despair. Motorola lost some 70% of its value within the shortest period of time. Who was the loser of the year? The chap who bought last spring at $ 61 or the apparent suicide manager who now looks at the share in the high teens? We shall not buy these fallen angels at the low of the cycle and keep our fingers crossed that we won't require a daily dose of tranquillisers to actually carry out such investments against the market's sentiment. What we have lived through is normal. Stocks fall ahead of economic slowdowns and bubbles are viciously punished. Bear markets always did take place. But young bankers don't know this sad truth. Pale and shocked they see this all as a new phenomena.

TALKING ABOUT BANKERS

In the United States a chap called 'Comptroller of the Currency' supervises the banks' credit risks. A similar job is done in the U.K. by the Bank of England. The biggest and most sophisticated of our banks claim that they are now well managed and that they understand risks better (they learned from the Long Term Credit debacle) and we all oblige and believe them. Well, Mr. David Gibbons, head of America's office of the comptroller of the currency isn't so sure about that and worryingly, the Bank of England holds a similar view. It seems that the big banks are messing up again. They do that quite regularly. Remember the Latin American crisis in the Eighties, America's horrid and costly savings and loan disaster, the near collapse of the Swedish banking system, the third world loan saga, Credit Lyonnais' annually recurring write-down of monster proportions, the Swiss Banks' real estate blood-letting, Japan's never ending bad debt episode. Well, that's enough. We don't want you to revise your esteem for the pinstriped profession. The truth is that the big banks have goofed again and again and most of the time they have been committing the same mistakes simultaneously. And now the latest act of wisdom: riskless lending to Dotcoms and Telecoms left right and centre.

Until very recently Barclays Bank had telecom exposure of around $ 20 billion, shared essentially by three companies only: British Telecom, Vodafone and Orange. It is little known that supervisory authorities have intervened so that these concentrated

risks are reduced. Whatever. The risk remains. The telecom monsters have raised some $ 300 billion to finance mobile licenses and their very costly infrastructure. The relevant cash flow is minute for the time being and thus the assistance of the friendly banker is not just welcome, it is essential. Meanwhile, telecom stocks have been dumped like hot potatoes, ratings have been cut and credit cost have markedly gone up. British Telecom or Vodafone are here to stay, of course, (we hope) – but what *is* the scenario if their gigantic mountain of debt cannot be brought down through cash flow, sale of minorities in mobile phone subsidiaries etc.? The 'Wap' mobile phone generation was an outright flop in Europe. Will the next generation, for which staggering amounts have been dished out for licenses and infrastructure, be more successful? The investment world is no longer so sure. Ron Summer's visions (Deutsche Telekom) are less convincing now than a short while back. His share has collapsed, but the company is stuck with a huge amount of debt. The Bank of England's very recent publication in which the institution is clearly worried about the concentration of bank debt in the telecom sector speaks a clear language. Are we about to witness another episode of misjudgement? Might well be the case. Some bank shares may be riskier than their name implies.

JOKER OF THE YEAR

Year after year it is the same story. If we get the currency assessment right, we have won half the game. The king pin is always the US currency inasmuch as Dollar-based investments invariably represent a very important segment of an investment portfolio. It is frustrating to get the purchase timing right on an American share, only to see the stock's appreciation being eaten away by an equivalent loss in the exchange rate. The year 2001 will be no exception in so far as a timely assessment of the Dollar's prospects will once again contribute meaningfully to the performance. As you may recall we indicated in our last report that the Euro may have seen the worst. At that time the Euro stood at around 0.93 to the Dollar. With the benefit of hindsight we were slightly early with our call as the Euro succumbed to further weakness and reached a low of 0.82 or thereabouts. This was the low point, we think. The Euro has recovered rapidly to the current level of 0.93. We expected the turnaround a bit too early, but basically our assessment was correct that the risk/reward ratio of holding cash in U.S. Dollars was no longer interesting for European investors.

Why do we believe that the Euro has turned around? Well, essentially it is the Dollar that is turning rather than the European currency. We believe that the Dollar's appreciating trend has run its course and is likely to lose value against all European currencies. There is a question mark as regards the Yen. As the British are British and not

considering themselves to be part of Europe, we hasten to add that the Dollar is likely to lose ground against Pound Sterling as well. During the course of the past boom years staggering flows of capital flows took place across the Atlantic. These institutional flows easily balanced out America's current account deficit. America went on living beyond its means. The deficit went on growing, the gap of the trade balance went to a record almost monthly and America's appetite for foreign goods was virtually insatiable. On top of all that came the tripling of the oil price. "No problem", most observers said. America's productivity gains and the economy's momentum are such that the country can cope with these problems. Effectively this assessment proved to be accurate for years, as the capital flows into America financed the gap. Now, however, the U.S. economy is weakening. Personal income has begun to decline. Europe's takeover frenzy is abating and suddenly it appears quite possible that the old continent's growth exceeds that of America and that therefore capital flows may reverse. Should all this prove to be the case – and there are a lot of indications that this is so – the Dollar could be in trouble. Investors can be a vicious lot. Suddenly they may zero in on the dark side of fundamental aspects and rediscover the gaping hole in the current account, be horrified about the record trade balance and the precarious situation of the American consumer who appeared to think for a long time that overconsumption could eternally be covered by rising stock prices.

A year ago the Euro stood more or less at parity to the Dollar. The U.S. economy boomed, while Europe jogged along at a reasonable, although lower pace. Hence the Euro dived as previously described, but now we think that the trend has turned. The Euro is likely to climb back to parity against the greenback, a level that is actually justified by economic fundamentals. But then trends always overshoot. Just as much as the recent exchange rate of 82 cents to the Euro was an excessive punishment, the reversal could blow out on the upside. In other words, we would not be surprised to see the Euro appreciate beyond 1.00. The Swiss Franc will follow more or less the same path and the recent 'high' of the Dollar at 1.83 should not be exceeded for some time. European investors enjoyed quite a bit of a windfall on the Yen exchange rate during the year 2000. This is likely to reverse now and exposure should be hedged.

Currency management will be important this year. We should not limit our homework to asset allocation, but be most conscious at this point in time that currency considerations will be of cardinal importance this year. If we get the Dollar right, we have opened the first door to a successful 2001. This may sound too simple. Well, the most obvious is often overlooked. Let us forget the year 2000. The year was essentially just taking care of gross excesses witnessed the year before. European investors should be happy that the Dollar's appreciation helped us to master a most difficult year half way successfully. But let us not expect a similarly favourable act of God during the course of this year. Back to the future. We shall now need to be clever stock pickers and – we cannot repeat it often enough – astute in our currency management. Sounds easy. Well, it isn't.

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