

Our Point of View, December 31st 2003

1	Revenge of the Fallen Angels	The victims of the bear market enjoyed a rebound. For others, 2003 was a year of repositioning
4	A little bit of history	The horror of negative compounding
7	Running faster than anybody else	The awakening of China
10	A fallacy?	The Euro is not a strong currency
13	Not like it used to be	Blue chips did not shine in 2003. We think they will do better this year

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2003 Statistics of leading stock markets

(January 1st – December 29th 2003, in local terms)

Switzerland	SMI	+ 15.45 %
Germany	DAX Xetra	+ 39.18 %
France	CAC 40	+ 16.90 %
U.K.	FT-SE 100	+ 13.07 %
Sweden	OMX	+ 29.18 %
Europe	STOXX 50	+ 16.03 %
USA	S&P 500	+ 24.32 %
	Nasdaq	+ 46.19 %
Japan	Nikkei	+ 23.52 %

Revenge of the Fallen Angels

The victims of the bear market enjoyed a rebound.
For others, 2003 was a year of repositioning

That does not look too bad, really. Double-digit index rises throughout. And if one were to base one's standard of information on what journalists report, the gains would even be higher. Brokers and journalists have a tendency to exaggerate (and invent), and thus stock price performance for the year 2003 is generally calculated by this league from the "low" of March 31st – effectively the trough of the long and gruelling bear market. Let us not forget that the first quarter of 2003 was pretty horrid. Here are a few examples of how major blue chips tumbled during the initial three months of the past year: Swiss Life down 53.6 %, Bayer lost 37.1 %, mighty Allianz gave up 48.8 %, Swiss Re declined a further 26.9 %, Münchner Rück down by 53.3 % and so on.

It is a fair question to ask whether the year 2003 should have been an above average year for investors in light of the solid index rise. It is interesting (and sometimes a bit frustrating for investment managers) that investors readily compare their performance with the world's stock indices when prices are up. When the going is tough though (2001 and 2002 are good examples) this attitude is swiftly given up in favour of a capital preservation approach. – Whatever. Before this question is answered, we should establish as to what the preconditions really were for a good 2003 performance. The answer is easily found. All the investors who fully participated in the previous years' awful rout were obviously participating in the past year's rally from day one. Fortunately, we were not part of that lot. The truth simply is that only one in a thousand investors (if that) was cleverly invested in cash and bonds during 2001, 2002 and the first quarter of 2003 (S&P 500 down 3.6 %, Euro Stoxx 50 down 14.6 %), in order to then go full blast for equities to celebrate the oncoming war in Iraq. We compare notes with a lot of people in our business, but we have not come across a single investment manager who managed to achieve this sort of timing. Either one lost an awful lot during the bear market (ending March 31st 2003) and went into the rebound quite fully invested or (what we did) one protected clients' capital to a very reasonable extent during the downturn, with the logical consequence that the initial and quite steep market rebound following the outbreak of hostilities in Iraq contributed to performance in a limited manner.

We have to emphasise that it is unrealistic to expect a 2003 performance that matches world stock market indices, unless one was one of the unlucky investors who gave up 50 % of capital value during 2001 and 2002. Those investors who managed to more or less protect their capital during the rout (this applies to our firm), were busy rebuilding their equity portfolio during the past year and therefore missed out on some of the fun. But then, let us not forget

that the average reader of our report is never ever fully engaged in equities anyway. We are not particularly concerned that we did not fully participate in the markets' rebound since March 31st 2003. A review of a single twelve-month period is hardly telling the whole story. An astute client assesses an investment result over a three-year – or even better – a five-year period. When doing just that you will inevitably come to the conclusion that a) one either lost an awful lot of money during the years 2001/2002 and then enjoyed a bit of a rebound last year or b) your manager protected your capital during the monster bear market and subsequently participated only in a limited way in the equity renaissance of 2003.

To illustrate that having missed out on some opportunities in 2003 is not the end of the world, we feel that you should now take a look at what actually happened over the last three, or even better, five years. You will quickly note that an investor who had an index-matching 2003 performance (but played stocks during the previous two years as well) could not come close to repairing the bear market damage. On the other hand, a cautious chap turns in a comfortable performance indeed over the combined period:

		in local terms		in US Dollar	
		since 31.12. 2000	since 31.12. 1998	since 31.12. 2000	since 31.12. 1998
Switzerland	SMI	- 31.75 %	- 23.96 %	- 13.29 %	- 17.76 %
Germany	DAX Xetra	- 37.54 %	- 20.18 %	- 18.30 %	- 16.36 %
France	CAC 40	- 39.89 %	- 9.08 %	- 21.00 %	- 3.71 %
U.K.	FT-SE 100	- 26.90 %	- 24.03 %	- 15.10 %	- 21.09 %
Sweden	OMX	- 39.53 %	- 9.48 %	- 21.52 %	+ 0.41 %
Europe	STOXX 50	- 41.88 %	- 16.88 %	- 23.53 %	- 13.20 %
USA	S&P 500	- 15.97 %	- 10.66 %	- 15.97 %	- 10.66 %
	Nasdaq	- 18.78 %	- 8.03 %	- 18.78 %	- 8.03 %
Japan	Nikkei	- 24.63 %	- 23.90 %	- 18.61 %	- 18.50 %

A little bit of history

The horror of negative compounding

Long-term readers of our report know that we do not usually bother to comment at length on what happened in the past. That is neither terribly interesting, nor in fact very useful to you. Page filling exercises of this sort rather remind us of the weather forecast of Swiss Television: they fill the greatest part of their time window with elaboration on the *past* day's weather, rather than dare to make a prediction on tomorrow's outlook.

This year, we need to make an exception though to our general approach, inasmuch as the past year's market constellation was unusual to such an extent that we feel compelled to comment in detail on what actually happened in the market place: Little is it realised that during the summer months of the past year, bond markets were subjected to their worst downturn since forty years. Strangely, equities **and** bonds celebrated the outbreak of the Iraq war in tandem, which was not only strange, but also outright illogical.

The war-induced equity euphoria either had to come to an end or bond values had to fall. For a bit too long, we thought the former had to occur, but it was clear in any case that one of the two asset classes had to reverse its trend. Both classes simply could not rise simultaneously for an extended period of time. It was less clear though which asset class was going up for the wrong reason. Either equities or bonds had to cave in. Some people thought President Bush's new war was the solution to all problems – and bought shares, while more cautious investors continued to bank on bonds and cash.

Finally, during the third week in June, the puzzle was solved and a winner emerged: Equities. The bond bubble burst with a vengeance and an avalanche of bond sales brought bond values down in a dramatic way within the shortest of time. Ten year U.S. government bond yields rose from 3.1 % to 4.3 % in a Blitz action and if anybody thought that the Bond debacle of 1994 could not repeat itself, he or she was taught for the better.

The consequences were clear: all those investors who sailed rather calmly through the rough years 2000, 2001 and 2002 by being mostly invested in bonds and cash, were now confronted with a considerable write-down on bond values, which was obviously a performance constricting factor in 2003. Therefore, investors who followed a hyper cautious policy during the rout years could not match or exceed average market returns, whereas the losers of 2001 and 2002, who then easily lost 50 %, were able to clock up a nice double digit return during the course of the past year.

At this time it is probably quite useful to recall the dire consequences of "negative compounding" which has recently hit all those investors who adhered to an approach of relative, rather than absolute performance. A fifteen percent performance in 2003 is not much of a consolation for an investor who lost half the capital during the course of the previous three bear market years. An investor of this kind (and there are quite a few around who did lose that much) has to double his or her capital just to revert to the original value. Not an easy exercise. A performance of + 15 % in 2003 may look attractive, but if this follows the destruction of half the capital, it brings Mr. Relative Performance only back to 57.5 cents for every Dollar originally invested.

Let us illustrate the horror of “negative compounding” by means of the following table:

Year	"Negative Compounder"		Pragmatic Investor	
	Performance	absolute value	Performance	absolute value
1998		100		100
1999	+ 24 %	124	+ 20 %	120
2000	- 14 %	107	+ 2 %	122
2001	- 18 %	88	- 3 %	118
2002	- 21 %	70	- 2%	116
2003	+ 15 %	81	+ 10 %	127
		- 19 %		+ 27 %

The above table makes it obvious that it is not terribly useful to assess one’s investment result over a one-year period. A five-year review however, gives a fair picture of your true success (or failure). Doing just that we find ourselves faced with the following scenario: 1999 was a good year. 2000 was the first year of the bear market period. 2001 and 2002 were catastrophic years and the final year of this five year period – 2003 – was a reasonably good year as far as stock market indices are concerned (not for bonds though).

Fact is, however (please fasten your seat belt), that the World Stock Market Index in Dollar terms (as established by Morgan Stanley and not by us) lost some 11 % over the past five years. Few investors realise this. Therefore, if you tend to compare your investment result with indices (which is not what we advocate) and if your investment capital happens to match or even exceed the total as per December 31st 1998, you should be reasonably happy. As a matter of fact, you have then beaten all major stock indices by a huge margin. We cannot overemphasise the importance of this truth inspiring approach. It is ridiculous to assess a corporation’s merits on the back of one quarterly

earnings report and it is equally misleading to draw conclusions on the back of one calendar year's result.

Now, that is enough of preaching. Let us now zero in on one of the world's most promising stories:

Running faster than anybody else

The awakening of China

Some four years ago we wrote in our mid-year report 1999 that investors could not afford to ignore the tremendous changes taking place in the world of high technology. Today, it is our contention that it would be equally negligent to exclude China from the universe of investment spheres. A new aera has emerged and whereas China disappointed investors over the past couple of decades, the middle Kingdom could from now on offer unequalled investment opportunities. China has swiftly turned into a political and economic superpower and the United States had better refrain from treating this country in a high-handed manner as evidenced in the recent past. Kicking giants can turn out to be detrimental to one's health. America's hysteric behaviour to the extent that China is apparently stealing millions of American jobs is not just absurd, it is outright wrong. If Levi Strauss is closing down its last U.S. manufacturing site in order to take advantage of China's low wages, if Nike pays four dollars for a pair of sport shoes "made in China" (and sells them for \$ 120 back home), if 70 % of super chains Wal-Mart's products nowadays originate from China, it is cynical and outright untrue to tell the world that China is destroying American employment. The truth is that Nike & Co. are exporting U.S. jobs to boost their own profitability. It is factually a lie to say that China dumps cheap products on to the United States and thus endangers millions of that

country's jobs. But that is exactly what this Administration claims. The electorate is impressed – it seems. How easy it is to manipulate public opinion! China is under imperative pressure to revalue its currency as if this could stop the flood of exports. Fact is that Chinese factory workers earn on average \$ 1'182 per year against \$ 29'000 in America. A ten or twenty percent revaluation does not change arithmetics in the slightest way nor does it have an effect on China's competitive edge. A revaluation of the Chinese Renmimbi has zero impact. Obviously, the U.S. finance minister knows this just as well as we do, but public opinion needs to be manipulated one year ahead of presidential elections. China is a vicious dumper of cheap goods. Period. Nike keeps quiet.

We have previously commented that the Western world cannot merely enjoy the benefits of globalisation. It has to accept the drawbacks as well and that means accepting the fact that the emerging world produces thousands of goods cheaper than the old world. Imports may be cheap, but there is an indirect price to pay. That of own job losses. To blame China for the elimination of domestic employment is cynical, unjust and factually wrong. Globalisation has a price and politicians know that only too well.

China's faith is by no means utterly dependent on its exports. It is a fallacy to believe Japan's well-being is and was dependent on the pace of exports only and the very same is true for China. For sure, China's current boom is founded to a good part on its competitiveness, through which it currently amasses a huge trade surplus. A major part of this is, incidentally, flowing into U.S. treasury debt and America had better be aware of this. Kicking your financier is neither nice nor smart.

China's exports are meaningful, but that is not the whole story. The country's domestic economy has come to life. And how. It is correct

that 80 % of the country's population is rural and that farmers are not turning into pizza munching crowds overnight. Hundreds of millions of Chinese are, however, eagerly turning into consumers and you do not need to be Einstein to realise that demand for basic consumer goods is bound to explode. The average Chinese household has yet to own an electric stove, a refrigerator, a motorbike or the ultimate dream – an automobile. We are talking about a staggering domestic demand for consumer products.

The whole story would almost be too good to be true, were China not confronted with a few problems as well. The country still has some 160'000 state owned enterprises with some 50 million state employees. About 8'000 of these organisations have gone bust over the last few years and thousands fight for survival in today's competitive environment. Things have changed. Enterprises that go on producing red figures are to close down. And that means people on the dole. Unemployment is a real problem in China. Furthermore, the country's banking system is very fragile. Banks have been forced for years to finance unprofitable state enterprises and the closing-down of such organisations has recently aggravated the banks' problems. 40 - 50 % of outstanding loans are deemed to be non-recoverable. In order to bring this quota down to 15 % (the Central Bank's goal), the system would have to absorb writeoffs to the tune of approximately \$ 500 billion. Japan revisited?

China has to cope with huge reforms. The country's free enterprise economy is booming, but it is vital that the centralised and communist way of running the country is maintained for the time being and liberalised slowly. Many aspects have indeed been liberalised, such as electricity, water supply, medicine etc. Free housing can no longer be taken for granted and state pensions are gradually cut in a meaningful way. Citizens are expected to look after their own financial well-being. Major challenges are confronting

China – primarily concerning society and the country's financial system. We cannot expect that all these gigantic tasks will disappear overnight. We think that the government is well advised to maintain its stringent leadership, as control over all these unsolved problems is better assured under the current political system than under a selfish free enterprise system. But let us not forget that China's economy has been growing at 8 % p.a. These are reassuring preconditions to solve outstanding problems and we would think that China has an excellent chance of ridding itself of its domestic challenges by means of growth. Western countries are busy pointing their fingers at China's unresolved banking problems while nations such as Germany are borrowing to the hilt in order to "achieve" zero growth. The future belongs to China and we had better discard prejudiced views surrounding the Middle Kingdom. Old world beware! Whatever. According to our view, it is imperative to now include China in an investor's asset allocation. It will not be a one-way street and we shall have to accept continuous volatility. It would be foolish though not to follow the signals of common sense.

A fallacy?

The Euro is not a strong currency

At present, most newspapers publish even more non-sensical reports than usual. "The Euro's astonishing run" and similar headlines catch readers' eyes and it would almost seem that Europe was the newly emerging growth machine.

Yes, we admit: we have been sceptical on the Euro's outlook for some time but the recent collapse of Europe's stability pact supports our thesis that national interests generally overrule the Union's interests.

We have, incidentally, also held a cautious view towards the U.S. Dollar for quite some time and we have argued repeatedly that America's twin deficit can no longer be financed without something giving in: either the external value of the Greenback – or interest rates. With elections looming, Mr. Greenspan is forbidden to raise interest rates (don't forget, the U.S. is a free country...) and thus the external value of the currency has to give way. It is thus a bit of a joke to claim that the Euro is going through the roof. European politicians utter of course many jokes (we mean lies) and therefore it is not surprising that the Dollar's weakness is swiftly made into Euro strength. It is ridiculous though to claim that Europe's currency is reaching "historical highs". It is the Dollar that has a cyclical problem. The Aussie Dollar, the Loonie (can\$), the Rand, Swiss Franc or Yen are sharing the same faith and it is much more objective (and a bit less politically biased) to accept that the U.S. currency has been under pressure.

Faithful readers of our report may recall that we have expected just this to happen for quite some time. We were just a touch early in our call. The current account is in trouble, the budget deficit growing (the Iraq war is an expensive mistake) and America's eager consumption is sucking in ever more products from abroad, boosting the trade deficit to whopping amounts. America relies on a daily inflow from abroad of roughly two billion Dollars. U.S. interest rates have no reason at all to remain at crisis levels of 1% as if the economy had permanently fallen out of bed. The U.S. economy has in true fact turned up to an unbelievable degree (compliments of President Bush's mammoth tax cuts) and with raw material prices rising strongly, the Federal Reserve Board should not sit on its hands. We said it before. Elections are looming and the economy must be strong at all cost during the course of 2004. The cost is – amongst other things – a weakish U.S. Dollar. We are not surprised about this course of events, but ask our readers whether America's economic and political future is weak in

comparison to Europe's. That of enlarged Europe, that is. The answer is no. America does have a temporary budget and current account problem, but the Iraq factor does not last forever and election criterias are soon out of the way. Then U.S. interest rates will rise and the U.S. Dollar will turn in due course.

The Euro is certainly not as strong as news reports make it to be. A "new high" against the Dollar means nothing. Especially when taking into account that Europe's Club is about to be enlarged by ten not exactly prosperous new countries and especially that the stability pact has been slaughtered by its very instigator: Germany. The new eastern entrants have followed this soap opera with great interest. They now know that fiscal discipline is a paper tiger.

We still have to be pragmatic though. The Euro *is* a world currency and cannot be ignored by the world's investors. One would also be well advised not to underestimate America's power and America's ability to influence the external value of its currency. The Euro, on the other hand, is subjected to umpteen national interests, clearly illustrated by the death of the stability pact. Europe's Central Bank is a toothless tiger, whereas America's Federal Reserve Board is usually (sorry, election times are an exception) a powerful institution, fully in control of the nation's monetary policy. Don't underestimate the Greenback. We think that U.S. interest rates will rise before long (as soon as George W. Bush is reasonably assured of his re-election), which will rebalance the demand and supply factor. At the same time the European Union will be enlarged and many empty hands will reach out towards Brussels. As usual, trends overshoot and the Dollar may still be weakish for some time. We think the end is nigh. The general consensus of being in a weak Dollar environment confirms our expectation that it will not be long before the trend turns around. Actually, we would not be surprised one bit, if the Dollar had reached its bottom when this report goes to press.

Not like it used to be

Blue Chips did not shine in 2003. We think they will do better this year

So many people dream about the good old times. It seems that progress, development of pristine land, longevity and whatever more are not as much appreciated as one would expect.

A lot has certainly changed as far as the investment world is concerned. And we are not just referring to chief executives' greed. We have for long held the view that a solid investment portfolio should concentrate on shares of sectorial leaders. Recently, however, - in 2003 to be exact - this longstanding recipee for success was temporarily out of touch. Top names with longstanding growth records, such as Nestlé, L'Oréal, Royal Dutch, Swiss Re, Johnson & Johnson and many other similar investments did not go anywhere or even fell in price whereas the most volatile of enterprises put on an enviable show. The year 2003 was the year of the opportunists, rather than the year of investors. We hope and expect that this will now change and that fundamentally solid companies will shine, rather than fallen angels. Principally, we shall not move away from our policy of investing in sectorial leaders, although we shall exceptionally engage in a purely pragmatic trading exercise.

One thing is for sure: The trough of the interest cycle is behind us. Bonds are now risky and will certainly not produce capital gains for the time being. Actually, bonds may nibble at the value of your capital. Time Deposits then, instead of bonds? In most currencies the returns on short time deposits are minimal and will not excite your appetite for a healthy return. Notwithstanding this aspect, we think that a very low yielding time deposit is a better proposition at this time than a ten-year bond investment. Very few of our clients have a

risk profile that allows a total switch of fixed interest investments into equities (which we would not recommend anyway). Thus, we all have to accept the fact that the non-equity portion of one's portfolio will return very little for the time being. It is foolhardy, however, to seek a high yield at all cost by investing in longer term bonds while interest rates are going up. And detrimental to performance.

The year 2003 was a year of change. A year when things did not fall into place as they used to do. Investors who sat on their investments through thick and thin (and who were subjected to bloodletting in 2001 and 2002) were able to make up some of their losses. Others (like ourselves) who spent the harsh years referred to above in hiding had to reorientate themselves and could logically only participate in the markets' recovery phase to a limited extent. In the meantime, our clients' equity exposure has been primarily reestablished in leading corporate names and in light of the fact that we were quite heavily underexposed to markets during the first few months of the initial recovery, we are reasonably happy with performance figures of the past year. We do admit that we were too defensive in our rebuilding exercise by banking more on high yielding blue chips, rather than fallen angels. But angels don't fly forever. And only an albatross can sleep in flight.

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