

Our Point of View, December 31st 2005

- | | |
|---|---|
| 1 The plain facts | 2005 – The statistics |
| 4 The good times are over | Bond yields are turning up |
| 5 Belated comeback | Japan finally puts deflation behind it |
| 6 The grass always seems greener on the other side | Swiss bourse comes out on top |
| 8 The temptation | Gold looks appealing, and not just for ladies |
| 9 It's that time of year again ... | Year after year, exchange rates are the most important factor influencing performance |
| 13 Things are better close to home | Not always: China, India and Brazil are booming |
| 15 Summa summarum | Where do we go from here? |

Burgauer Huser Aman & Partner
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.ch
www.bhapartners.ch

The plain facts

2005 – the statistics

As regular readers will know, we always include a table in our report showing an overview of the main stock market indices. Some of our clients have rightly pointed out that these summaries of developments on the financial markets have thus far had a bias towards the equity markets. In future, the table in question will therefore also feature some of the key bond indices, given that their balanced risk structure means that the bulk of our mandates are invested half in bonds with an equal weighting being afforded to equities. It is therefore appropriate that we should devote the same attention to the development of the bond indices as their stock market counterparts.

To give our readers an overview of how stocks and bonds have fared on average on the financial markets, we have also included an index that reflects the policy of the majority of our mandates and gives equal weightings to the Morgan Stanley World Indices for equities and bonds respectively. This will be featured as 'Index for balanced mandates', and we are sure you will find this a useful statistic.

In this context, we would like to reiterate that we do not find it particularly pertinent to simply compare our own performance unconditionally against that of certain indices and then give a verdict as to whether the investments made were good or bad. This would be akin to a relative performance comparison, i.e. if you beat the index, you've done well, if you lag behind the benchmark, it's a tragedy and you fire the asset manager. This approach may seem plausible in boom periods. Who doesn't want to outperform the stock market indices? The catch is that this mindset doesn't hold up when things take a turn for the worse. When the stock markets are in decline,

nobody wants to be on a par with the index, and the less said about relative performance the better.

As you know, we are of the opinion (and have been for some time) that it is only absolute performance that counts for private investors, as it is of no consolation to them in a poor year – for example 2002 – to have lost a “mere thirty percent” while the global index fared even worse. Our absolute return policy may mean that we underperform the global index slightly during the good years, but we hardly ever suffer massive slumps in the lean years. The period from 2000 to 2002 is a clear example of this in practice.

Statistics of leading stock markets

A) Year to date

		in US dollar	in local terms
Switzerland	SMI	+ 15.37 %	+ 32.79 %
Germany	DAX Xetra	+ 12.21 %	+ 28.24 %
France	CAC 40	+ 9.15 %	+ 24.29 %
U.K.	FT-SE 100	+ 5.05 %	+ 16.66 %
Sweden	OMX	+ 8.82 %	+ 29.18 %
Europe	STOXX 50	+ 7.10 %	+ 22.08 %
USA	S&P 500	+ 3.69 %	+ 3.69 %
	Nasdaq	+ 2.39 %	+ 2.39 %
Japan	Nikkei	+ 26.29 %	+ 42.29 %
	Bloomberg Effas US\$ Bond Index (5-7 years maturity)	+ 2.05 %	+ 2.05 %
	Balanced Mandate Index *	+ 4.94 %	+ 4.94 %

B) Over five years

		in US dollar	in local terms
Switzerland	SMI	+ 14.98 %	- 7.08 %
Germany	DAX Xetra	+ 7.48 %	- 15.33 %
France	CAC 40	+ 1.89 %	- 19.73 %
U.K.	FT-SE 100	+ 4.42 %	- 9.64 %
Sweden	OMX	+ 8.74 %	- 8.99 %
Europe	STOXX 50	- 4.11 %	- 24.46 %
USA	S&P 500	- 4.70 %	- 4.70 %
	Nasdaq	- 9.78 %	- 9.78 %
Japan	Nikkei	+ 14.35 %	+ 17.47 %
	Bloomberg- Effas US\$ Bond Index (5-7 years maturity)	+ 31.16 %	+ 31.16 %
	Balanced Mandate Index *	+ 17.43 %	+ 17.43 %

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

The good times are over

Bond yields are turning up

In our opinion, we fared well with regard to our investments in medium to long term bonds. Essentially we exited this segment somewhat too soon, but it is simply not possible to wait until the turnaround is apparent before acting. Like today, for example. When there is a shift in sentiment, bond prices can fall by much more than the annual coupon within the space of days. In Switzerland – a country characterized by low interest rates – bond prices have in fact fallen by a multiple of the annual coupon in the recent past, and those who reduced the average maturity of their bond portfolios at an early stage were fortunate to have done so.

Bonds are generally unattractive at present. This does not mean that we no longer hold any bonds in our portfolios, but we are restricting ourselves to investments in very short-term maturities, where the price risk is minimal and the investment is more like money market paper in nature. One exception in this regard is perhaps the GBP sector, where the interest-rate cycle is at a more advanced stage than in Europe and the USA.

Bond yields remained inexplicably low for some time in 2005, and in the USA around ten interest-rate hikes by the Fed were essentially ignored. However, this changed in the last quarter and we expect that the European Central Bank and the Swiss National Bank will be actively seeking to steepen the yield curve. This seems extraordinary given the rather sluggish economic performance in Europe and Switzerland. That said, inflation has reared its head again and if the central banks are serious with regard to stability, they must act now. Calls can be heard from politicians for a move in the other direction, but we hope that

noises from this profession go unheeded. This strikes us as generally being an advantageous approach.

In short: hands off medium to long-term bonds. The risk factor at present is high. If you see that we are, for example, holding seemingly rather unattractive short-term Swiss Franc time deposits, this does not mean that we are simply leaving your assets lying forlornly in the portfolios. On the contrary, these assets are merely parked for the time being and were until just recently invested in bonds that were “*pièces de résistance*”.

There is a great temptation not to invest the proceeds from sold bonds in such seemingly unattractive short-term investments and instead to switch into the stock market. However, this would be tantamount to casting aside the long-term investment guidelines and the risk matrix would gradually cease to tally with your risk profile. We have to avoid this, and it is therefore essential in our opinion that only the term to maturity of the fixed-income investments is changed – i.e. bonds are switched into short-term time deposits – rather than the risk profile of the clients. Discipline is therefore the order of the day.

Belated comeback

Japan finally puts deflation behind it

"Better late than never", as the saying goes. But back in 2004 our bullish assessment of the prospects for investing in Japan came if anything too soon. We predicted that Tokyo would be the top-performing market of the year, but as it turned out the market turnaround took a little longer than expected to materialize. Now that the fundamentals have taken a clear turn for the better, it seems safe to assume that the long-drawn-out era of deflation can finally be consigned to history and that Japan's housewives (who take the

decisions on whether to spend or save) will finally start shopping again on a sustained basis.

The banks, which took quite a hammering and had to be propped up by the government, are now leaner and fitter and back in good shape to face the future. After crumbling for over 15 years, real estate prices are rising again, enabling us to make quite a few successful stock market investments. While the turnaround has so far been restricted to the institutional market, it should not be long before the housing market follows suit. The days of ultra-cheap borrowing are at an end and the Bank of Japan never misses an opportunity to indicate that interest rates are set to rise. This amounts to a crude signal to the country's citizens that everything will soon (finally) start getting more expensive so they should please start consuming again.

We are generally overweight in Japan and expect the investment outlook there to remain positive in the new year. Unfortunately, the strength of the dollar has cast a shadow over the yen causing it to weaken markedly. We do not expect this situation to persist for long and do not consider it necessary to hedge the exchange rate risk. The yen should soon shake off the weak trend seen in 2005.

The grass always seems greener on the other side

Swiss bourse comes out on top

We have in the past often been wont to present a critical view of Switzerland. Not with regard to the Swiss standard of living, or the abilities of our young national football team – but instead with regard to the economic outlooks, protectionism, the reform logjam and the like. It's also not the case that things have suddenly improved dramatically

in this regard – slowly but surely is the Swiss maxim – and growth here is still limping along. However, the Swiss stock market was able to shrug off all these factors and posted a massive gain in the past year. Actually there was no need for asset managers here in 2005. Simply investing all your assets in line with the SMI Index would have been the most simple and most successful approach, the cheapest and surprisingly easy solution. We therefore apologise for our unpatriotic words in the past, for less scepticism on the domestic front would have saved us a great deal of effort in analysing foreign markets and would have brought easily generated returns for our CHF-based clients. However, it would have been a quite different story for our clients based in USD, as the marked appreciation of the greenback would have eroded the bulk of the book gains made in Swiss Francs. An asset manager's lot is not an easy one: what is a gain on the one hand all too often turns out to be a loss on the other. We will be coming back to the topic of exchange rates later in the report.

Over the short-term perspective, the basic fundamental data are often not the best means of gauging a given year. The Swiss stock market indexes were bolstered by the ebullient performance of the 5 Swiss heavyweights: Roche (+50.27%), Novartis (+19.37%), UBS (+31.73%), CS (+40.59 %), Nestlé (+30.92%). Incidentally, did you know that these five companies account for 73% of the SMI stock market index? This is truly excellent news for fund managers. Stick faithfully to these selected stocks in a Swiss equity fund, and you'll never go wrong as you are essentially replicating the SMI. This is not meant maliciously, simply a statement of fact – and it has the added advantage (for fund managers) of dispensing with the need to do your homework on the analysis.

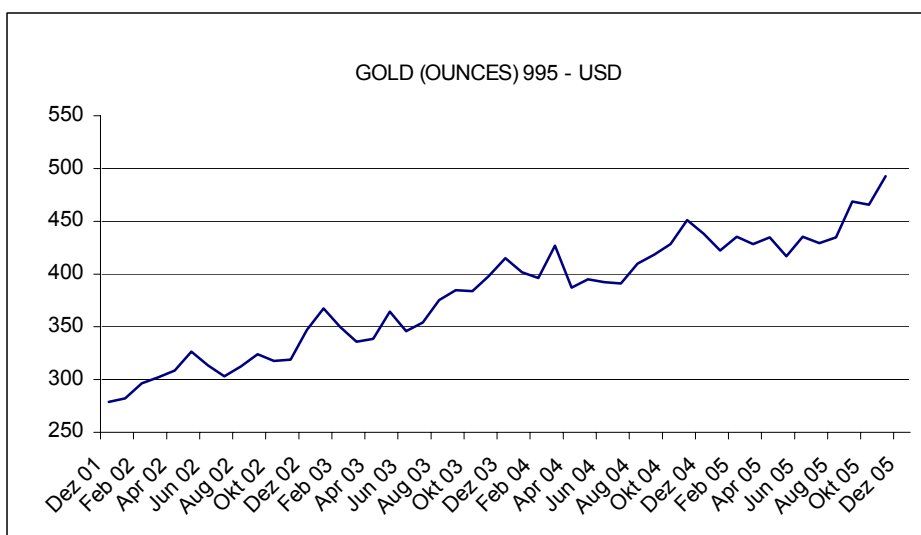
To cut a long story short: many of our CHF-based portfolios were underinvested in Switzerland in the past year. In the investment world too, the grass always seems greener on the other side of the fence.

Fortunately, we got some things right – for example, being invested in Japan.

The temptation

Gold looks appealing, and not just for ladies.

Gold is currently an entirely conceivable alternative to short-term time deposits – which are (still) offering virtually no returns for CHF-based investors. One factor supporting this is the unequivocal rise in inflation. From the technical perspective as well, gold has reached an interesting level:



The gold market is relatively tight, i.e. relatively insignificant amounts can have a massive influence on the gold price. If hedge fund managers were to switch from other commodities into gold, this could send the price soaring in a short space of time. We have seen how volatile the price of oil has been. This was not solely attributable to the Chinese (as with many other problems).

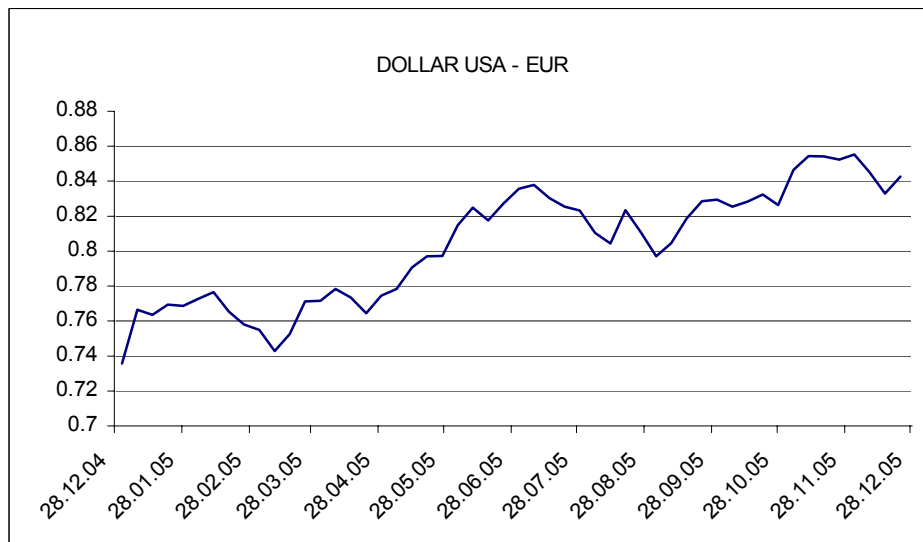
Central banks have been selling off 'unrequired' gold. In Switzerland, for example, the proceeds have largely gone to the cantons, and from there channelled into traffic roundabouts, cycle paths and other destroyers of public assets. However, these sales are now also nearing an end. The central banks have succeeded in selling off the 'unnecessary' gold reserves of the people at virtually the lowest point of the price cycle. Here in Switzerland, it was a shining example of the worst possible timing imaginable. Not that the Swiss National Bank could be blamed for this. It was the covetousness of the politicians and local authorities who lustfully eyed up the central bank's surplus and have in the meantime received their rewards in the form of a few billions. It is seldom that we give any guarantees, but in this case we will make an exception – people will soon notice that we have sold off the family silver. Or in this case, gold. And this for the benefit of the politicians and to the detriment of our children. Once again we find ourselves heaping criticism on Switzerland, which as we confessed earlier can prove to be inappropriate. Nevertheless, gold may at present be considered as an alternative to cash. Unfortunately, the USD exchange rate plays a crucial role in this regard for investors based in EUR or CHF. In other words, at least part of any potential gains could be eaten up by currency losses. Let us now then turn briefly to the outlooks for the USD...

It's that time of year again...

Year after year, exchange rates are the most important factor influencing performance

You may remember that one year ago, we said there was a strong probability that the dollar would stage a turnaround in 2005, this at a

time when virtually no banks had a good word to say about the greenback. Our forecast was close to the mark:



One year ago, every bank advisor, every analyst, even the woman at the kiosk who delivers our Financial Times, knew that the dollar was in dire straits and all of them talked about the same issues, parrot-fashion: the twin deficits (current account and balance of trade) in the USA were out of control and foreigners would soon no longer be willing to plug the gaping hole in the country seeking to be a force for good in the world. The consensus opinion was almost overwhelmingly negative with regard to the outlooks for the US Dollar. However, currency forecasts are always tricky, and often you find that you got your prediction right, but the timing completely wrong – which doesn't help much. Alan Greenspan, who actually should be best placed to predict the trend of the dollar, openly admitted a few months ago that you'd be as well tossing a coin with regard to currency forecasts and seeking expert opinion was superfluous. The facts presented below with regard to the forecasts made by the gurus of this world are unequivocal.

Be that as it may (we will refrain from commenting given our experiences with currency analysts), the sentiment with regard to the US Dollar was so negative one year ago that a turnaround was nigh on INEVITABLE. If everyone is bearish, they have logically all sold up and hedged their positions. We therefore based our prediction with regard to the US currency's trend one year ago largely on the prevailing and overwhelmingly negative consensus on the greenback. Actually, this was a rather easy call. However, we cannot resist pointing out to you now the predictions of the great experts at the beginning of 2005 (specifically the Financial Times issue of 8 January) with regard to the outlook for the Greenback:

Name of expert	Prediction as of end-2005	Actual exchange rate as of end 05	Deviation
Sean Collow, strategist, Idea Global	USD/EUR 1.40 USD/JPY 96 (!)	1.1915 117.15	- 14.90 % - 18.00 %
Bilal Hafeez, Global Head Foreign Exch. Deutsche Bank	USD/EUR 1.43 USD/JPY 93 (!!) and even USD/EUR 1.50 USD/JPY 87	1.1915 117.15 per 31.12.2006 per Ende 2006	- 16.70 % - 20.60 %
Michael Woolfolk, Senior Currency Strategist Bank of New York	USD/EUR 1.45 USD/JPY 90 (!!) USD/GBP 2.05 (!!)	1.1915 117.15 1.7380	- 17.80 % - 23.20 % - 15.20 %
Laurie Cameron, Head Forex Department JP Morgan	USD/EUR 1.40-45 USD/GBP 2.00 plus	1.1915 1.7380	- 14.90 /- 17.80 % - 13.10 %

Just look at these predictions! And we are really supposed to consult the world's head currency traders for their opinion? People who showed the same level of analytical prowess as the lady at our

newspaper kiosk? We prefer to trust our own common sense and will above all keep a close eye on the prevailing consensus.

The state of play today is slightly more complex than 12 months ago, but the US Dollar is once again likely to play a pivotal role with regard to performance in the New Year. No matter which way you look at it, there's no getting round the importance of the dollar and a global diversified portfolio will always have a significant exposure to the dollar zone. This once again poses the thorny question as to whether we should hedge the US Dollar for our Swiss Franc and Euro-based clients, or whether the greenback still has upside potential from its current level. If the latter is the case, we must on the other hand act on behalf of our USD clients and hedge the Euro and the Swiss franc respectively.

And the Yen? - Ah, the dear old yen. From the fundamental perspective, the Japanese currency never acts in the way that logic dictates it should, but instead as the Bank of Japan sees fit. We therefore mostly don't even try to predict the intentions of the central bankers. Most professionals who attempt to predict the trend of the Japanese Yen end up with their nails bitten to the quick.

The constellation with regard to the US Dollar is different than it was one year ago. The twin deficits are still very evident – but no one is talking about them any longer. This is actually quite strange. The Repatriation Act, which gave a significant tax incentive to US multinationals to transfer earnings held abroad back to the USA resulted in considerable if temporary demand for the US Dollar last year. The foreign central banks also continued to conscientiously send massive amounts of dollars to the USA and helped to plug the current account gap. Admittedly, in the wake of globalization the money flows where the best growth prospects are, and the USA has the better of Europe in this regard. That said, we are currently more cautious on the

dollar than we were this time last year, and are tending to hedge the USD in some cases, at least where the opportunity arises. However, given that the outlooks for the greenback are ambivalent, we are also considering to implement hedging tactics by way of an options strategy. Bolder readers with a speculative approach may wish to buy the Yen forward against the Dollar. At current levels, the Japanese currency seems cheap.

We are convinced that currency management will again play a pivotal role in the New Year and we will be doing our utmost to act pragmatically. Perhaps we would be well advised once again to ignore the opinions of the strategists. Last year they were almost all wrong. Perhaps this year we'll ask the lady at the newspaper kiosk once again.

Things are better close to home

Not always: China, India and Brazil are booming

Let us turn now to the emerging markets. Our position in Eastern Europe has performed nicely. The valuations are now no longer as favourable as they were a year ago, but the globalization of Europe will also bring harmonization to the new EU states and for Russia. Even the poorer countries of the old continent – Romania, Bulgaria – and the Balkan states that have taken a hammering of late are promising to become interesting investment countries. The outlook for the banks in particular are excellent. The interest-rate margins in the mortgage business are the stuff of dreams, and we can bank on the real estate markets in these countries being growth areas for some time to come. It is therefore little wonder that European banks are tussling over the takeover of many local financial institutions. We see no reason to sell up our investments in Eastern Europe and take profits. Although certain

markets (Czech Republic, Poland) are overvalued at present, new opportunities are also arising in the Ukraine, Serbia and Turkey.

In mid-2005, our comments on the short-term outlooks for China were somewhat more cautious. The stock market has indeed stagnated to a degree, although neither valuations nor returns are offering cause for concern. That said, it is still to be feared that profit margins will shrink in the New Year and it appears that this is being priced in on the stock market at present. We are sticking to our investments, but have trimmed back our exposure a touch in certain instances.

In the near term, India offers rather better outlooks than China. Free enterprise is significantly better established in India than in neighbouring China. The innovative power of the country is particularly impressive, and the will to work, immense productivity and not least the level of education of the young generation augur well for a rosy future. Did you know that genetic research has proven that Indians are clearly superior to other peoples in terms of mathematical skills? We have added India as a niche in our portfolio, and this position will more than likely be expanded. However, anyone investing in India must be able to live with volatility. A look back at the short-term performance data for the Mumbai stock exchange is sufficient to get the adrenalin pumping, and it is best to be prepared for significant price swings from the outset.

South America has thus far been an orphan child for many asset managers. The political turbulence has been too much for many investors to swallow, and this has also been the case for us to date. However, such assessments are often all too subjective and we are currently looking into a range of possibilities, which could result in investments for our globally active clients. Our global spread of investments has widened extensively. This makes our job interesting, but also means that our potential investment universe has become

immense. It is therefore entirely possible that we may overlook a nearby gem (Swiss stock market in 2005) in the search for new horizons.

Summa summarum

Where do we go from here?

We hope we haven't bored you yet and that you carry on reading. Sometimes we feel sorry for bank clients when we see the material they are forced to read, most of which culminates in an intellectual masterstroke saying that 'we are cautiously optimistic over the long term'. Such publications would indeed put you to sleep, and it is little wonder that they soon end in the shredder. The author of this report remembers distinctly the wisdom passed on by his boss at his first bank who said that one would do well to never give a clear forecast. Because this would mean you could never be wrong. We now do our utmost to do the exact opposite of this executive doctrine, and clearly speak our minds at all times. Like now.

The financial markets are still being dominated by a glut of liquidity worldwide, fuelled by the hyper-generous monetary policies in the industrialized nations. We are talking here about Japan and above all the developments in the USA in recent years. We said some time ago that Mr Greenspan would have been well advised to step down while at the peak of his career. We do not believe that the economic history books will be as full of praise for the departing Chairman of the US Federal Reserve as the editorials are at present. Greenspan made the mistake of devoting his efforts to the financial markets rather than monetary stability, which is without doubt the reason for the current surplus of liquidity. This is pleasing many, but we should not lose sight of the dangers this could pose going forward. Taking on debt has

become endemic. No wonder, when loans are being offered at virtually zero percent interest and house purchases are being entirely financed by the banks (2004: 70% of new acquisitions in California). Bankers never seem to learn. The US Federal Reserve got cold feet to a certain extent last year with regard to cheap money and has in the meantime raised its key rates twelve times to the current level of 4¼ %. The Bank of Japan has also made it clear that the period of zero-interest credit is at an end. Mr Trichet, President of the European Central Bank, is also seeking to communicate that stability must be protected by way of higher interest rates. However, this is prompting disquiet in several EU countries. 'Do as I say, not as I do', appears to be the maxim. So much for unity. Finally, the Swiss National Bank unequivocally prepared the market for interest rate hike(s) and the first such move has in fact taken place. In conclusion, the good times of excessively cheap money will soon be at an end. In defiance of all logic, the US bond market held up exceptionally well, but this phenomenon should not be regarded as sustainable. Otherwise the yield curve will become inverted (see our 2005 interim report), which would offer little to rejoice about. We are in any case particularly cautious on bonds (see 'The good times are over' above) and advise against longer maturities. Generally speaking, rising interest rates are a dangerous omen for stocks. So is it time to run for cover here as well? Good question. The answer will hinge on the steepness of the interest rate increases. From the historical perspective, interest rates will remain relatively low in the New Year and it is highly probable that there will be a further improvement in corporate earnings. It therefore seems premature to be overly pessimistic, but it goes without saying that we will be keeping very close tabs on the development of interest rates. We are not making any significant changes (yet) in our equity allocation. The key change came in the bond segment, where we have brought the average term to maturity back sharply and time deposits are more prominent than before. Gold has been included in certain instances as a replacement for liquidity. In the case of Swiss Franc based accounts, it is

unavoidable that the current account balance of smaller portfolios will on occasion remain uninvested, as there are minimum investment amounts for short-term time deposits and these cause almost as much in expenses on a net basis as they bring in income.

In Europe, we are sticking with various investments in niche companies. We admittedly missed out on some share price gains by European blue chips last year, but over the medium term we prefer to be invested in special situations.

Japan remains strongly represented, the exposure being complemented by South-East Asian funds (position being built up) and the investments in China and India mentioned earlier. Shifting to and fro eats up the assets. In the latter markets we will not be seeking to optimize the market timing or to avoid short-term setbacks by way of sales. We plan to be invested here for the longer term.

And so finally we come to the US stock market, which did not offer much to write home about last year. Wall Street adopted a classic stance, as the continual interest-rate hikes curbed enthusiasm and the broader market was boring. It will quickly become apparent in the New Year that a period of calm is about to set in with regard to interest rate increases, and we could imagine that the USA could be in somewhat better form in 2006, especially given that rather positive corporate earnings are again on the cards.

Generally speaking, we have to resist the temptation to reinvest the proceeds of bond sales excessively in equities. We also have to keep a close eye on the inflation figures, something which is no easy task. The official inflation figures have been totally manipulated across the board and in no way reflect the actual developments. If independent bodies were allowed to measure inflation, our hair would stand on end at the scale on which many factors influencing inflation have been

surreptitiously removed. Politicians are keen to ensure that the figures are 'right' and continually endeavour to tip truly significant factors out of the basket of goods.

Hence in the New Year we will once again be sticking to the tried-and-tested method of good commonsense and will be defending ourselves resolutely from the triumvirate of

- 1) the prevailing consensus
- 2) chief analysts (see 'It's that time of year again...') and
- 3) the promises and predictions of politicians.

If we follow this advice consistently, we will already be half way to successfully mastering the challenges that await us in 2006.

MAB