

# Our Point of View, June 30<sup>th</sup> 2010

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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

## Performance of the world's major stock markets

<b>A) Year to date</b>		in US dollar	in local terms
Switzerland	SMI	- 7.98 %	- 3.59 %
Germany	DAX Xetra	- 11.15 %	+ 3.35 %
France	CAC 40	- 21.89 %	- 9.14 %
United Kingdom	FTSE 100	- 12.32 %	- 6.30 %
Sweden	OMX Stockholm 30	- 0.36 %	+ 7.79 %
Europe	STOXX 50	- 22.65 %	- 10.03 %
USA	S&P 500	- 3.63 %	- 3.63 %
	Nasdaq	- 2.14 %	- 2.14 %
Japan	Nikkei	- 4.73 %	- 8.68 %
Morgan Stanley World Equity Index		- 7.35 %	- 7.35 %
Bloomberg-Effas US\$ Bond Index (5-7-years maturity)		+ 7.06 %	+ 7.06 %
Balanced mandate Index*		- 0.15 %	- 0.15 %

<b>B) Over five years</b>		in US dollar	in local terms
Switzerland	SMI	+ 19.37 %	+ 0.93 %
Germany	DAX Xetra	+ 36.78 %	+ 34.25 %
France	CAC 40	- 13.85 %	- 15.44 %
United Kingdom	FTSE 100	- 15.71 %	- 0.81 %
Sweden	OMX Stockholm 30	+ 26.09 %	+ 24.73 %
Europe	STOXX 50	- 13.82 %	- 16.12 %
USA	S&P 500	- 9.80 %	- 9.80 %
	Nasdaq	+ 7.96 %	+ 7.96 %
Japan	Nikkei	+ 3.91 %	+ 3.91 %
Morgan Stanley World Equity Index		- 5.76 %	- 5.76 %
Bloomberg-Effas US\$ Bond Index (5.7 years maturity)		+ 35.55 %	+ 35.55 %
Balanced Mandate Index *		+ 14.90 %	+ 14.90 %

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

*“Austerity” is a Greek word (austeros) and means “harsh”*

## Not Austerity, but Reality

The debt trap

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It is amazing at times how seemingly well-informed people can ignore a known problem and then, like a bolt from the blue, it's brown trousers time as the basically foreseeable crisis breaks out and hysteria ensues.

A case in point is the Greek debt crisis, which has brought Europe to the brink of monetary collapse even though Greece only accounts for roughly 3% of the EU's economic output. We say “roughly” because no one really knows whether the statistics produced in Athens are exaggerated, underestimated or simply made up. An observer of the Europe-wide vendetta against Greece might quite justifiably ask whether its admission of insolvency was not a storm in a teacup, given the country's relatively small contribution to Europe's economic output. The answer is “yes”, because a Europe on a sound financial footing would have been able to absorb Greece's effective bankruptcy without difficulty. The problem is, however, that the countries of the EU are in anything but good health, and its “garlic belt Med” states – as the Mediterranean countries are sometimes disparagingly referred to – are also mired in debt. We should remember that before the advent of the euro, Italy, Spain and Portugal – not to mention Greece – had interest rates of 10% or more. Suddenly, God created the single European currency and bestowed upon these nations lending costs at German levels, a fraction of their usual rates. We had arrived at the land of milk and honey, and people borrowed to the hilt. It became possible to buy a house, add a swimming pool or lease a Cayenne jeep by putting down scarcely any capital up front. And our smart old friends, the banks, embarked on a frenzy of lending. In Spain, hundreds of thousands of hideous condominiums were thrown up on an entirely speculative basis. As a Swiss person driving through Andalusia these last few years, one has

had the sensation of being the last person in the world not to have snapped up one of these gems with unparalleled motorway views. Greece's admission of insolvency merely opened the eyes of the financial world to the possibility that various EU countries could follow suit. That is not good news, given that a country like Spain is a heavyweight compared with Greece.

## Fighting fire with fire

Europe borrows to meet debts

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The implications of Greece's bankruptcy were quite simply too harsh for politicians to accept as reality. In a sensible world (unfortunately "sensible" is not a word we readily associate with politics), they would have simply let the Greek bankruptcy wash over them. The country would have left the eurozone, the drachma would have been reintroduced and creditors would have taken a hit, end of story. That would have been the right thing to do from an economic perspective, and we are likely to discover in 2012 that it was a huge mistake to send countless billions in aid to Athens when that money was much needed elsewhere in Europe. Greece was not admitted to EMU on the premise that it would be bailed out in the event of bankruptcy. In fact, Greece joined the single currency area by committing to criteria such as a 60% limit on the gross government debt to GDP ratio and a budget deficit of no greater than 3% of GDP. But in reality, Greece has never stuck to these limits and has blithely reported massaged figures to the central bank in Frankfurt that bore no resemblance to reality. We are all therefore quite justified in asking why exactly we should be bailing Greece out now.

Today, everyone is quite simply afraid of the garlic belt.

Economists at the Royal Bank of Scotland estimate that the public and private sectors in Greece, Spain and Portugal owe foreign creditors a total of around EUR 2,000 billion. We are quite accustomed to hearing billions bandied about these days, but EUR 2,000 billion is a shockingly high figure, and equivalent to about 22% of Europe's entire GDP. Of course, no one is talking about the whole of this vast sum being defaulted on, but even a fraction of that would be impossible to absorb. A few sums were therefore scratched on the back of envelopes and Athens was granted the assistance it needed, in a decision which we are sure will come back to haunt us.

Did you know that Greece was – believe it or not – either insolvent, bankrupt or in debt restructuring 52% of the time over the past 200 years? And France went bankrupt eight(!) times between the 16<sup>th</sup> and 19<sup>th</sup> centuries.

The Germans have fared rather better. In the last 100 years, our northern neighbours have undergone “only” two currency reforms, in which state debt was reduced to zero – not that great for someone who had been saving their entire life.

We can add plenty more names to the roll-call of shame. Spain, for example, lost its status as a global power some 300 years ago. It went bankrupt on 14 occasions, which forced the country's departure from the world stage. France's regime collapsed 220 years ago, when the country was spending some two-thirds of its government revenues on servicing its debts.

“This time it's different” are words that should set alarm bells ringing in anyone's mind. History may not repeat itself precisely, but the triggers of many an upheaval are often the same. Sooner or later, excessive debts always result in writedowns and trouble for creditors, and when politicians can pull it off (as they usually can), then this ends up hitting taxpayers' pockets. That was the case 200 years ago, and it remains the case today. This is in no way a subjective view, as we will go on to see.

# Time is money

## Banks rescued again

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The heads of Europe's central banks are naturally rather brainier than we are. These good people are well aware that plugging Greece's black hole in no way resolves the debt problem for good. Their hope (and one must always have hope and faith) is that the debt situation will somehow ease and/or that they will no longer be in office when Greece (or other European countries) are forced to restructure their borrowing. They have simply shut their eyes and handed over the cash. But who or what is really being helped? Greece? The unity of the EU? Or perhaps the stability of the financial system? Now we are getting closer to the truth. Greek bankruptcy would have been a disaster for many banks across Europe. German banks have countless billions of outstanding loans to Greek borrowers, and their French counterparts have been no less generous in their lending. The sounder countries of Europe have not only dug deep into their pockets to rescue the untrustworthy Greek state, but have also authorised their central bank in Frankfurt to buy up Greek government bonds at nominal value. Europe's fine banks can therefore offload their exposure to Greece at an unrealistically high price onto the European Central Bank, which will pay for it with newly created money. In other words, the citizens of the solvent countries of Europe will once again be taken to the cleaners, just like in past centuries when many European countries regularly became insolvent. Has anything changed today? No, not at all. And we would do well to bear that in mind, for example when formulating current investment policy, or in a couple of years when the truth comes to light and the bill must be paid for our system living beyond its means all these years.

To return to the present day, risk aversion among investors has increased steadily, and fear is upon us. What is deemed safe enough under these circumstances? Only the very best. Investors have therefore sought refuge in what are perceived as the very safest investments, namely sovereign

debt. Investors feel they absolutely must have the very best government issuers in their portfolio. Yields on safe haven paper have been falling consistently. Even UK gilts are now yielding just 1.23% (three-year maturity), while German government bonds, the best-rated in Europe, are offering a yield of only 0.69% (also three-year maturity). But are government bonds really the answer to investors' prayers? They would indeed be a good choice if we are to assume that everything has changed and that no modern state will now become bankrupt.

The problem is that we do not believe that the basics of financial logic have ceased to apply or that vastly over-indebted countries (or individuals) can perpetually live on tick, by continuously plugging the gaps with fresh borrowing. The game must be up at some point, but the question is, when? And the answer is when confidence in the borrower is lost. Greece had been walking a tightrope for a long while, but for years nothing happened and all those cunning bankers kept borrowing cheap money in order to invest it in Athens and exploit interest rate differentials. This worked well for a long time, but this spring confidence was suddenly shattered and Greece was teetering on the brink. We now know that the eurozone countries have prevented bankruptcy, rescuing Greece's creditors (our friends the banks once again) and once more plugged the debt hole with additional credit. In this light, the financial markets' recent hyping up of government bonds, seen as offering capital protection of the first order, was wholly mistaken. We are wary of investing the defensive portion of our portfolio in government bonds and have a clear preference for fixed-income paper from *industrial issuers*. We would not be at all surprised if today's government bond valuations go down in history as a severe bubble. And when America points an accusatory finger at Europe and proclaims that it is at the end of the road, we should take a moment to consider the state of US finances. People in glasshouses shouldn't throw stones. Why not break off from your reading for a moment, turn on your computer and go to the website [www.usdebtclock.org](http://www.usdebtclock.org)? Make sure you are sitting down first, because the incredible and inexorably rising US debt numbers it reveals could send you reeling. The debt mountain is rising by

USD 1 million every few seconds, and over a 24-hour period the increase is a mind-blowing USD 5 billion. That is not a typo. Take a moment to study this site, but be warned that your peace of mind may not last long! You will plainly see the rate at which US debt is ballooning, the pace at which the country's interest rate costs are rocketing, the speed at which credit card debt is soaring and the astronomical scale of unfunded liabilities. This last figure currently stands at around USD 110 trillion – a figure that calls to mind Zimbabwe and takes nearly an entire line to write out: USD 110,000,000,000,000. That makes the Medicare liabilities of USD 76,000,000,000,000 a little easier to digest – but only a very little. You may not want to believe that the world's leading superpower is running up such enormous liabilities, but that is the reality, as you can see for yourself from the usdebtclock website. Of course, there is a risk that these figures will be out of date by the time you read this, and that the reality will be even more austere. At the time of writing, US debt totalled roughly USD 55.7 trillion that comes at a time when GDP is estimated at around USD 14.2 trillion. Sleep well! We hope you won't need to hide your copy of our "Point of View" and resort to the whisky bottle to do so!

## The counter-argument

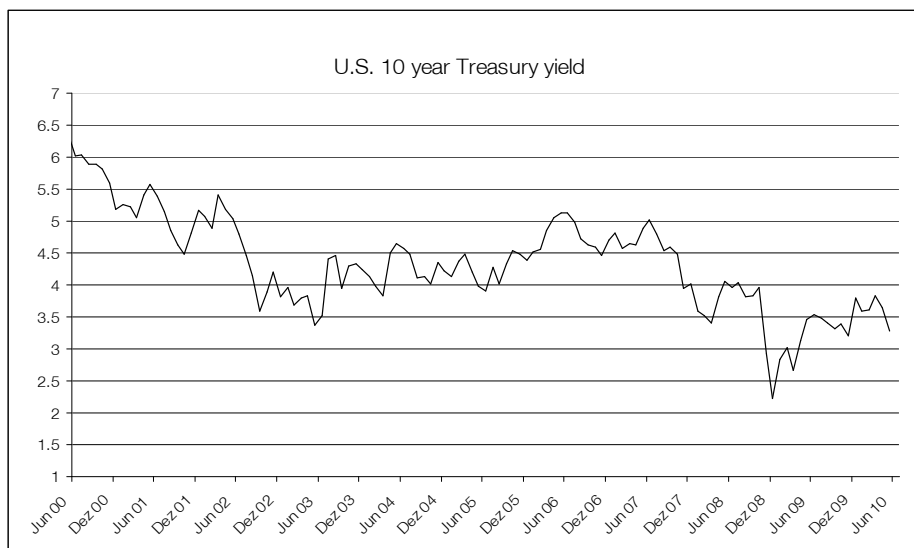
Why government bonds cannot be a safe haven

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There is likely to be some improvement before the debt mountain escalates. Today, we are hearing from all corners of the "end of the euro" (courtesy of Newsweek), while the G7 is holding emergency talks on multilateral intervention to support the euro, in a similar vein to the 1985 Plaza Accord, which had a very sizeable impact on the currency markets. Jim O'Neill, Head of Goldman Sachs' Global Economic Research Council, recently asked a 600-strong audience whether the euro would be significantly higher or lower against the dollar 12 months from now. Just two people anticipated euro appreciation, which is a strong signal that the

euro is unlikely to keep tumbling versus the dollar in the near term. That conclusion would also seem logical given what we have said above about US debt levels. Why should investors abandon the endangered eurozone only to turn to US dollar bonds as a safe haven? There is no sense in that. Europe's problems are quicker to come to light, because we have currency union without political union. The situation in the US is quite different; because both types of union exist, no one mentions the fact that 14 US states are bankrupt, California among them.

So let's forget about European and US government paper representing a safe haven. There are near-identical debt problems on both sides of the Atlantic. The spotlight has very much been on Europe and the euro because of the Greek crisis. However, there are very real doubts about the idea that any assets that one wants to invest and shield against erosion of value should be put into US government bonds.



Do you know when the last flight to government bonds took place? A time when people simply did not want to lose any money and chose what appeared to be the very safest of safe options? In 1929 and 1931. And that became the trigger for the worst destruction of capital in human

history. It was not the stock market slump that made the Great Depression so austere; it was the state bankruptcies that separated seemingly ultra-cautious investors from their capital. Many people lost everything they owned through government bonds, whereas shares in solid companies plunged temporarily, but eventually recovered. Is that really any different from how we are behaving today? Are today's central bank mechanisms really infallible saviours under all circumstances? Is it really possible this time around for states to print unlimited money (the much-vaunted policy of quantitative easing) without consequences and without diluting the value of money? For a while, perhaps. But not for any significant length of time, unless economic growth in the West reaches dizzying Chinese levels, and that is about as likely as the existence of the Easter bunny. We therefore believe that reality will sooner or later hit home and cause blood-letting on the markets.

So far, we have focused mainly on Europe. But what is the state of the *global* debt problem? We have already touched on the USA, but a few hundred million more has probably been added to the total you saw on the usdebtclock website a couple of pages back. Let us now look at a few worldwide facts and figures:

- Today, more than 40% of global gross national product comes from countries with fiscal deficits of 10% or more, and these are not exotic countries, but “established” states.
- If there is no change in spending habits, budget deficits will balloon, to at least 8-10% in Japan, Spain, the UK and the USA and something approaching 7% in Germany, the Netherlands, Belgium and Austria. We do not have the confidence to make any predictions about southern Europe, but Ireland and Greece will of course be in double-digit territory.
- Debt: without drastic savings measures (which would be sure to deliver deflation), debt ratios will in the coming decade top 300% in

Japan, 200% in the UK and 150% in many “old” EU states and the USA.

- If inflation rises to 5% (which is almost being wished for at present), government’s interest costs would probably treble.
- The official statistics on government debt are often effectively doctored. Let’s take the UK as an example. The figures that it publishes exclude the bank debts guaranteed by the government, which currently tally more than 300 billion Pounds. The politicians are simply assuming that everything will change for the better, the banks will be completely restored to health and these guarantees can be removed. But the liabilities fall due in 2012. It is totally unrealistic to expect the banks to be able to take on that amount of debt, and that will add around 20% to the country’s debt mountain.
- The USA is no better than the UK when it comes to such massaging. The government acts as guarantor for the debts of government-sponsored enterprises, such as the mortgage giants Fannie Mae and Freddie Mac, both of which went bankrupt last year and are still losing money every day. And we are not talking about a “mere” couple of hundred billion, but about USD 5 trillion (again, not a typo), or roughly 35% of US GNP, which does not appear at all in the debt statistics.

Enough is enough. Let’s spare your health and peace of mind and conclude the presentation of our evidence that the orgy of borrowing has reached staggering proportions. We should make it crystal clear that the Greek affair could go down in history as opening up the Pandora’s box of debt. The country’s debt collapse could mark just the start of an impending avalanche of restructuring. “Restructuring” may sound anodyne, but it requires victims. We do not want to make such sacrifices, and victimhood would be better avoided. The solution is caution. We must

be cautious about what appears to be the best quality; we must be cautious about AAA-rated government bonds.

## Beware of highest quality

Spheres of safe investments

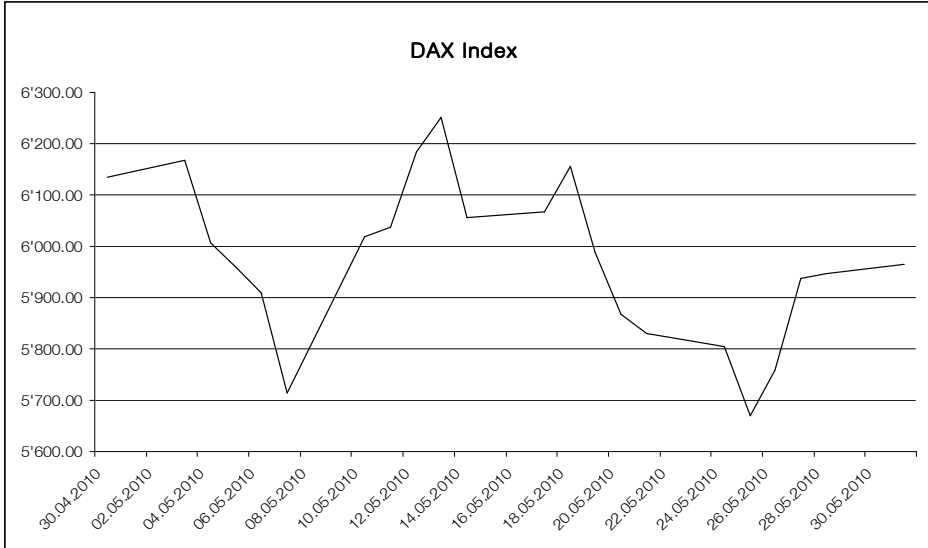
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The heading that we have chosen for this section may sound a trifle absurd. Either we have gone mad or succumbed wholly to cynicism (we will admit that these pages have featured a dash of cynicism from time to time) or the investment world has changed fundamentally. The latter is probably closest to the truth. We should start by asking why the stock markets have grown so volatile, up 4% today, down 5% tomorrow, euphoria again the next day followed rapidly by another slump. That is unprecedented. And people claim that the modern world is so well connected that almost everyone is equally well informed of facts and opinions. That makes no sense. In reality, the investment world is experiencing something that cannot be quantified. Something that has never happened before – at least not within the lifetime of most market participants. There is a tension on the markets, rather like the atmospheric pressure that builds before a storm. It is possible to sense that something is present, but there is an absence of any objectivity. Only those lacking conscious thought seek cover – animals, for example, that quietly withdraw before the lightning breaks. And why do they do that? Out of instinct, pure and simple.

The stock markets also have instincts. They are currently sensing that there is something in the air that they have not encountered before. Jitters are prevailing; otherwise the world's major indices would not be jumping around by several percentage points almost every day. We think that this turmoil is connected to global debt levels, which have reached unprecedented proportions.

Billions, trillions and quadrillions are being merrily bandied about. There are enormous liabilities within the system, and Mr and Ms Everyperson (to be PC about it) instinctively know that such giant sums can come nowhere close to being repaid. It is little help when crafty economists preach that the principal of such loans is not intended to be repaid. The game must be up at some point; even a billionaire has his limits.

As we have said, volatility on the world’s stock markets is extremely high. Let’s take a look at some of the lurches that German shares underwent in May alone:



Movements on this scale cease to have any fundamental connection to the real economy. What is right today is seen as a mistake tomorrow. When valuations of some of the world’s biggest firms are gaining or falling by five percentage points a day, we are bordering on neurotic behaviour. The intensity of this volatility is without precedent and is unsettling the world, politicians, all you investors and us as decision-makers. So what course can one take when borrowers can no longer be trusted, apocalyptic

trading turns into euphoria overnight and politicians are bumbling about with no idea of what to do?

## Unable to see the wood for the trees

Investors must nail their colours to the mast

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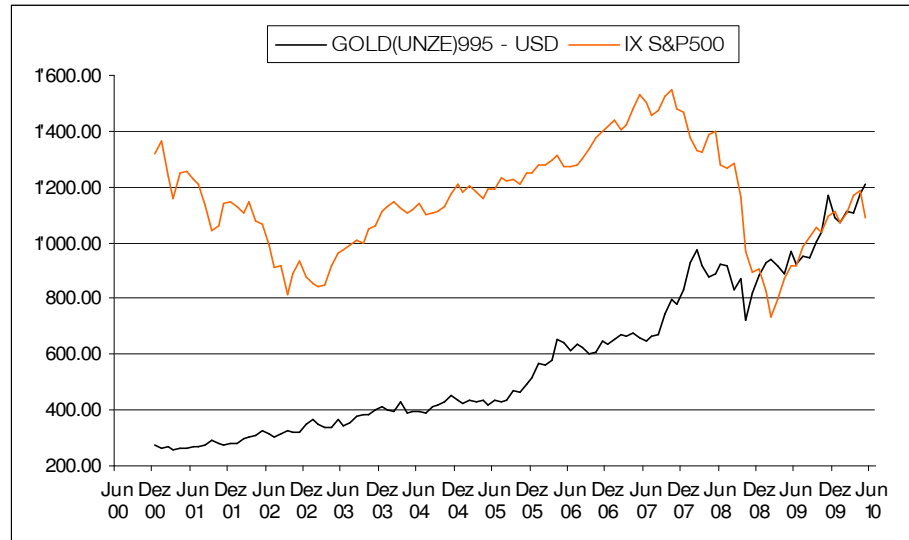
Let us now consider the prospects for the financial markets and a sensibly formulated investment policy.

Based on all that we have outlined above, we cannot be accused of lacking a strategy if we hoard plenty of cash for our clients on occasion. But doing “nothing” can at times be a deliberate choice. Cash is not simply left sitting haphazardly in clients’ current accounts; this is powder which must be kept dry. The same goes for short-dated bonds from top-rated corporate denominated in Swiss francs, which are yielding less than 1% and could be seen as little more than a joke investment. We are also shunning time deposits for the most part, as we take the view that our clients are better off doing without the largely symbolic interest income currently available, as the bank risk is out of proportion with the meagre return. We have therefore opted in favour of large cash holdings, which are in better hands with the highly regarded private banks with which we mainly work than in the euromarket – a wholly unregulated system. A euro-market time deposit cannot be compared to a domestic term deposit, which is subject to withholding tax and appears on the counterparty’s balance sheet.

Our doubts about the world’s current alarming debt levels mean that we regard term deposits as an unwanted and unwarranted risk. That is our first point.

We are ultra-cautious about the much-hyped fixed-income investments, for reasons we have gone into in detail above. Government issuers should be avoided where possible in favour of first-rate corporate. Unfortunately, we are not the only ones to plump for this route, and top-quality paper is in short supply and not yielding much. That begs the question whether it is really worth risking capital in order to earn another 1% in interest. The answer is “certainly not”, unless one is forced to work against a benchmark, which will naturally consist mainly of top-rated government bonds. The poor investor (i.e. us) must then invest against his convictions in things that are fair on the outside but foul on the inside. Point no. 2.

We have sought for some time to add a degree of protection against the unknown to your portfolio in the form of gold – physical gold that is sitting in bars in a vault. That may sound rather archaic, but we do not entirely trust banks and prefer to pay a couple of dollars more than it costs to buy a synthetic ounce of paper gold. The Americans still do not understand why there are investors who take a lump of metal, i.e. gold, seriously as an investment. In Europe, Asia and South America, however, there is a historical affinity with gold. People know that this yellow metal has rescued others from past economic and political upheaval and even saved lives. We do not hold physical gold because we have a particular price target in mind; in fact we have no idea whether USD 1,200/ounce is expensive or cheap. Nobody can say, although many “Gold letters” claim the opposite. Investing in gold should be seen as a form of insurance. If suddenly all is well once again, then gold will probably not go much higher and is likely to fall. No problem! In an environment like that, one would expect our equities to perform very strongly. Gold acts as reinsurance. One need not necessarily earn money from it; when taking out life insurance, we do not do so in the hope of dying right away so that a juicy sum is paid out immediately. The circumstances today make it advisable to insure one’s securities portfolios. That is point no. 3.



We turn now to the wildcard of every year: exchange rates. As we have often said, this factor accounts for a very sizeable proportion of performance year in and year out, and not always for the better. Our view has proven well-founded on various occasions. At times we have even held part of the cash allocation in a foreign currency in order to benefit from anticipated appreciation by the dollar, euro or yen. The situation today is quite different; we have (virtually) no idea whether, for example, the US dollar will end the year higher or lower against the Swiss franc. And what of the euro? In theory the euro ought to weaken further, but not everyone likes that. The Swiss National Bank has bought up billions upon billions of euros of late to support the currency. That may continue, or it may not. It is quite conceivable that the euro could slide further, as the currency cannot currently be described as cheap. We should bear in mind that the euro has previously changed hands for just 83 US cents – a very long way off today's levels.

So what about the dollar? It is claimed that the U.S. currency is strong at present, and the euro is falling steadily. It is true that the euro is losing value on the back of the Greek tragedy, but does that make the dollar a strong currency? No, not by any means. The greenback has its own

homemade problems and the good fortune to be a reserve currency. The country's financial backers – i.e. China – do not have any real interest in a falling dollar and so the fact that the greenback is not exactly the greatest asset on Earth remains obscured (for the moment). So which way should we go if neither the euro nor the dollar can be trusted? In our opinion, it is impossible to forecast where these two currencies will head, and we therefore take the view that foreign exchange risk should be neutralised. So what does this mean? This upshot is that currency risks should not be entered into casually. When Swiss investors buy shares in Siemens, they do so because of the potential for share price gains, not because they expect a higher euro. Likewise, when investors with the dollar as their reference currency buy into Nestlé, this is because they see good prospects for the company and not because they want to benefit from Swiss franc appreciation. The exchange rate risk associated with the underlying stock is the casual risk we speak of, which we generally want to eliminate. This does not mean that we never make exceptions. For instance, we have deliberately added US dollar exposure to our Swiss franc-based portfolios since January and capitalised on dollar appreciation. However, a return to hedging is under way or already implemented at this time. To sum up, exchange rates are almost impossible to call at present, and currency risks are therefore unwanted risks that should be widely hedged against. Point number four.

And so we come finally to the most “imaginative” part of the portfolio, namely equities.

You might think that if we are negative about even safe government bonds, then equities must be completely taboo. Far from it. We take the view that in the event of a sustained crisis in government debt, investors would be better protected with equities than with most other asset classes. If southern Europe is unable to avoid restructuring and holders of these government bonds have to take a hair cut, then that does not by any stretch mean that Nestlé or Roche will suffer. Quite the contrary: companies with good balance sheets and little or (preferably) no debt will be

able to emerge from the financial storm in top shape. Share prices may temporarily lose ground as a consequence of the uncertainty, but in the medium term investors will be better protected against capital losses than a seemingly defensive investor who parks all his money in gilt-edged government bonds and is then unexpectedly and capriciously fleeced, as so often before in financial history.

It is impossible for us right now to judge how sustainable the delicate global economic recovery truly is. Neither can we say when the policy of cheap money – one might almost say free money – will be brought to an end. That will hurt a lot of people. Given that hundreds of thousands of homeowners are already finding it hard to service their mortgage interest, alarm bells start ringing when we ponder what will happen when interest rates return to normal. It is all perfectly logical. Small debts mean small interest payments. Huge debts (like those presented above) mean big interest payments. Excessive debts mean “game over” as soon as interest rates reach historical norms.

Our fifth and final point is therefore that shares in solid companies with a long-term focus and healthy balance sheets are much less risky than one might think, and even for portfolios with an extremely conservative risk strategy, caution should not lead one into a narrow policy built solely around bonds. Let’s not forget that yields on some blue chip stocks are at present higher than on bonds. Nestlé is yielding 3%. Risk is relative, and today it is smarter to hold shares in a solid company than to lend money to ailing states.

Time will tell. Meanwhile let us not be fooled by governments.

MAB