# Our Point of View, December 31st 2013




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## Performance of the world's major stock markets

| A) January 1, 2013 – December 27, 2013 | | in US dollar | in local terms |
|---|---|---|---|
| Switzerland | SMI | + 23.77 % | + 20.51 % |
| Germany | DAX Xetra | + 31.17 % | + 25.97 % |
| France | CAC 40 | + 22.57 % | + 17.48 % |
| United Kingdom | FT-SE 100 | + 16.20 % | + 14.46 % |
| Sweden | OMX Stockholm 30 | + 20.82 % | + 20.79 % |
| Europe | STOXX 50 | + 23.14 % | + 18.04 % |
| USA | S&P 500 | + 29.11 % | + 29.11 % |
| | Nasdaq | + 37.66 % | + 37.66 % |
| Japan | Nikkei | + 27.51 % | + 55.64 % |
| India | Sensex | - 3.57 % | + 9.10 % |
| China | Enterprise Index | - 5.34 % | - 5.30 % |
| Morgan Stanley World Equity Index | | + 23.58 % | n.a. |
| Bloomberg Effas US$ Bond Index (5-7 years maturity) | | - 3.42 % | n.a. |
| Balanced mandate Index* | | + 10.08 % | n.a. |

| B) Over five years | | in US dollar | in local terms |
|---|---|---|---|
| Switzerland | SMI | + 76.56 % | + 48.56 % |
| Germany | DAX Xetra | + 94.47 % | + 99.36 % |
| France | CAC 40 | + 31.17 % | + 32.93 % |
| U.K. | FT-SE 100 | + 72.23 % | + 52.25 % |
| Sweden | OMX Stockholm 30 | + 140.54 % | +101.47 % |
| Europe | STOXX 50 | + 25.43 % | + 27.12 % |
| USA | S&P 500 | + 103.86 % | +103.86 % |
| | Nasdaq | + 163.57 % | +163.57 % |
| Japan | Nikkei | + 57.00 % | + 82.62 % |
| India | Sensex | + 72.51 % | +119.68 % |
| China | Enterprise Index | + 37.15 % | + 37.23 % |
| Morgan Stanley World Equity Index | | + 79.76 % | n.a. |
| Bloomberg- Effas US$ Bond Index (5-7 years maturity) | | + 15.82 % | n.a. |
| Balanced Mandate Index * | | + 47.79 % | n.a. |

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

# AMERICA! AMERICA!

The US is still working miracles

Say what you like, but what has happened in the US since the global banking system came within a hair's breadth of collapsing in autumn 2007 is unparalleled. Time and again, America is able to extricate itself from extremely precarious economic situations. This is in stark contrast to Europe, where the national interests of the individual member states constantly preclude a united approach to problems. Greece sends its regards, by the way.
A great deal has been written and said about the biggest financial experiment the world has ever seen. I am talking, of course, about quantitative easing, the colossal flooding of the system with freshly printed money. We are among the sceptical commentators – and there are many, including within the US itself – who have followed the hitherto purely theoretical experiment of a country's central bank buying up almost unlimited quantities of sovereign and mortgage debt with a mixture of fear and trepidation. Remember, the government gets into debt, its own central bank then buys this debt up, and the banking system is inundated with new money. This new in vitro monetary policy experiment, never previously tested at any point throughout economic history, so far appears to be working. 'Twas ever thus. The US has proved yet again that its free market economy functions significantly better than those in other parts of the world. America is happy. However, investor attention is no longer focused primarily on fundamental economic performance but almost exclusively on the crucial question of whether the central bank will continue pumping money into the system. This inevitably raises the question of whether it is actually humanly possible for the Federal Reserve Board to keep inflating its balance sheet ad infinitum without weakening the external value of the dollar or triggering massive inflation, as has already been observed under similar circumstances on several occasions throughout economic history. One also has every right to question whether the moderate recovery is really down to the creation of untold billions in new money. There is no consensus whatsoever about this among theoretical economists, and one is entitled to ask whether the flood of money

only benefits the financial industry and the affluent section of society, while having a solely negative impact on the man in the street. The truth, in fact, is that savers are having their wealth quietly expropriated by the zero interest rate policy that is currently being touted as the answer to all our prayers. Mr and Mrs Average Citizen no longer receive any income from their savings, while the guardian of their money – the banking system – merrily speculates away with the zero interest funds entrusted to it. And of course, this pays off handsomely for our chums. It's worth noting that UBS, for example, the flagship of Swiss banking and of course *"too big to fail"*, as the politicians say with a shrug, has a meagre leverage ratio of 2.9%. This means that for every million on its balance sheet, the bank has just 29,000 francs of equity. Admittedly, though, UBS is not right at the bottom of the creditworthiness league. Bringing up the rear is the biggest bank in proud Germany, namely Deutsche Bank, with an alarming leverage ratio of just 1.9%. Nothing for widows and orphans here.

# NO LESSONS LEARNED

The big banks are carrying on just as they always have

It was not all that long ago that your correspondent, having seemingly mellowed with age, viewed the international banking world in a somewhat softer light. This shift was sparked by UBS's announcement that it was to restructure its investment banking operations, which we took as an indication that the global banks would learn lessons from the fiasco of 2007.
Unfortunately, however, it soon became clear that it is still business as usual in big bank world. These men have learned nothing – absolutely nothing. They care not a jot that they have survived only thanks to the dear taxpayers, who have patiently allowed themselves to be milked dry. New charges are emerging on an ongoing basis. Hot on the heels of the securitisation of junk debt in the form of fantastical and misleading "subprime" products came the discovery of the scandalous manipulation of Libor rates. Countless millions of

homeowners paid too much mortgage interest because the banks conspired – for their own benefit, of course – to falsely report interest rates. The fines imposed on the banks are enormous. And now there are also well founded suspicions that these guilds have for years been manipulating exchange rates in favour of themselves. The dock is a veritable who's who of the banking world. Let's wait and see how big the fines will be this time around. There is no doubt that draconian penalties will be imposed. We are entitled to ask ourselves whether any global banking services at all are honestly provided.

Unfortunately the world seems inured to the unfair and immoral behaviour of the big banks. The public appears to shrug off fines of 13 billion dollars (!) per misdemeanour, as J.P. Morgan is threatened with, like a parking ticket after a visit to the cinema. And no-one seems to be seriously asking themselves whether there will ever be an end to these ceaseless shenanigans. Banks pay out tens of billions for an infraction without batting an eyelid, but always in conjunction with a statement that they do not admit any guilt. The state coffers jingle happily and everyone moves on to the next unfair practice. Misbehaving banks are good business for the state.

What is particularly astonishing, however, is that the banking sector is not shunned by investors. Quite the reverse, in fact: it is a "cyclically promising industry," we are told. All the negatives are behind us. Really? Until tomorrow morning, maybe…

Our clients lost out slightly in terms of performance last year due to our firm's reservations regarding bank stocks. The European bank index rose by around 25% in 2013, while its US counterpart grew by a full 35%. A spectacular showing. And since this sector represents around one-third of the leading share indices, the run on bank stocks has had a very positive influence on the latter.

There is a danger that our negative attitude towards the banking sector, which is based on the fundamentals, could be labelled stubborn. And perhaps that is fair comment. A cobbler should stick to his last, however, and that's exactly what we're doing. We will only consider investments in sustainably functioning business models. And certainly not in companies whose earnings fluctuate by hundreds of percent from one quarter to the next and whose revenues are repeatedly generated through unfair practices. Even

today, after all the hardship they have spread around the world, the banks are still looking after number one.
The mellowness of age can also be coupled with obstinacy. That's what's supposed to happen. But until someone reveals to us the hidden secret that the big banks are actually on the road to sustainability, we will stick with our assessment, very well founded based on the fundamentals, that playing with bank stocks is a dangerous game. With a casino, at least you know that everything is rigged in the house's favour. With banks it's even worse. You think you own a blue chip, but in reality your money is being pumped into a company that resembles a ghost train. There isn't any light there either, just a never-ending succession of scares.

# IT WAS NOT QUITE THAT SIMPLE

2013 wasn't completely rosy

The emerging markets have been delighting us for many years with very positive performance. The past 18 months, however, have brought little in the way of cheer; more gloom, in fact. Now, 12 months is no reflection of long-term performance, and one cannot begin to question exposure to these emerging and volatile markets as a result of temporary malaise. Nevertheless, it has to be said that investments in this area fell sharply last year compared to those in the US and Europe. Hardship seldom comes unaccompanied. Civil unrest in Brazil and Turkey caused their currencies and stock markets to collapse, India's backlog of reforms triggered the collapse of its national currency, and the prospect of higher interest rates in the US also sent the Indonesian rupiah reeling. As a result, investments in emerging market stocks provided little in the way of cheer overall.
In view of the long-term performance, our exposure to this market segment still looks healthy. Take the Arisaig Consumer Fund, for example, which is prominently represented in our client portfolios. Last year, however, the developing world proved a real obstacle to performance, with indices in this investment segment stagnating at

best and recording losses overall when adjusted for currency effects. We believe we are well positioned in the emerging markets segment. Our exposure to the segment is primarily concentrated in the consumer goods sector – we avoid quasi-governmental organisations, banks, infrastructure-related industries and, perhaps surprisingly, technology. Quite simply, we are convinced that long-term investments in the consumer sector are almost guaranteed growth drivers. Bearing in mind that consumption accounts for almost 70% of economic output in the US and Europe, while the corresponding share in the emerging markets is perhaps half that, it is very easy to see that consumer-based investments in emerging markets are extremely promising from a medium to long-term perspective. To date, the performance of our preferred investment vehicles in this segment (the consumer funds of the Arisaig Group) has clearly confirmed this view. Comparatively, Africa offers the best prospects, but the continent is not suitable for all investors due to the higher levels of volatility. We are still able to invest in these funds thanks to our longstanding relationship with Arisaig, but they are currently "closed" and no longer available to individual and third-party investors.

The past 12 months were not a good year for globally diversified portfolios. Swiss investors will be wondering why one needs to diversify at all when there's as much ripe fruit in one's own garden as was the case in 2013. This is a justified question in retrospect, but is nevertheless only based on a monetary snapshot. Investors with a long-term focus are certainly right to diversify their risks. We of course hope that our domestic market will continue to perform as well as it did last year, but judging from the way the political wind is blowing in the land of William Tell, one unfortunately has to conclude that efforts to redistribute wealth are being stepped up, due not least to the rampant greed of certain top executives over the course of the last decade. The results of the top-quality Carmignac Patrimoine Fund, for example, which up to the end of November had achieved a performance of 4.74% for the Swiss franc asset class, clearly demonstrate that 2013 was certainly no walk in the park. The trees unfortunately didn't soar skywards for globally diversified investors last year, and as we will explain in more detail below, for once the hedging instrument that is gold also threw a spanner in the works.

# GAME-CHANGING

Exchange rates

A year ago we anticipated a general strengthening of the dollar based on our expectation that the era of unbridled quantitative easing was coming to an end. During the first half of the year our assessment proved to be correct. The picture then changed, however. Mr Bernanke's capitulation in the face of the powerful financial market lobby and the prospect of a continuing zero interest rate policy were not good news for the dollar's external value. The much-maligned euro soared in value as a result, punishing all the poor wretches who at the start of the year had expected nothing but disappointment from the European single currency. Unfortunately we were among those caught out by the US monetary authorities' capitulation. We had not hedged the greenback for our European clientele, and this proved to be an unwelcome performance handicap.

Our gold positions, which for many years had been making a major contribution to our annual result, also mutated into a quite substantial burden in 2013. Around the middle of the year, US hedge funds and ETF providers in particular sold off enormous gold holdings almost overnight. The price per ounce of the yellow metal collapsed by almost 400 dollars within a very short time. It was practically impossible to act once this wave of disposals had begun. In June, for example, the price per ounce fell by 200 dollars within two days.

We must freely admit that our foreign exchange and gold management last year led to unfavourable consequences and had a not insignificant impact on performance.

As far as exchange rates are concerned, from a fundamental perspective the outlook for 2014 is exactly the same as it was a year ago. In other words, a tapering of US stimulus measures should result in rising interest rates and therefore a stronger dollar as well. When one considers just how much lobbying power Wall Street has, however, and also listens to the initial statements from the new chair of the US Federal Reserve, the inevitable conclusion reached is that the US authorities might just fly in the face of common sense and persist with their mania for printing money. Since the politicians can ill afford for the financial markets to collapse, they prefer to risk the uncertain and a jump in inflation, at least in theory.

# HELLO GHOST TRAIN

Never-ending money creation

While having the utmost respect for the US's performance and the way it has picked itself up out of the ruins of 2007-08, one always has to bring common sense (admittedly a relative term) into play and seriously question whether this wondrous quantitative easing can really continue indefinitely. The problem with addictive substances is not that they have unpleasant effects, but that the level of dependency increases the longer they are used. An individual with a serious heroin addiction barely survives going cold turkey, and a similar situation could arise with our financial system as soon as the US ceases its limitless flood of liquidity. Six months ago, don't forget, your correspondent predicted that May 2013 would probably prove to be the moment that signalled the beginning of the end of the mania for printing money. At the time, the powerful chief of the US Federal Reserve Board effectively warned everyone who would listen that this was the Fed's intention. Stock exchanges worldwide reacted with such outrage to the monetary watchdog's progressive words, however, that Mr Bernanke felt compelled to tell the world that he had been completely misunderstood. A reduction in quantitative easing had merely been considered, and nothing of the sort would actually take place until further notice. The pouting markets smiled and corrected the price falls that had occurred. Anyone can fluff their lines, of course. After all, to err is human, and misunderstandings are part and parcel of day-to-day political life.
We still think that quantitative easing (aka the zero interest rate policy) is at best an exercise in pepping up a financial industry that has gone off the rails, but realistically is quite simply an experiment. The truth is that the vast majority of the money that the central

banks are pumping into the system does not actually make it into the economy at all, and the original purpose of banking – collecting savings deposits and granting loans to the market economy – no longer exists. Most of the stimulus cash lands in the financial system itself and is – let's not mince words – the heroin of the stock markets. We can all work extremely hard to analyse the macroeconomic data for these markets day in, day out and only select stocks from companies whose business models demonstrate sustainability. The reality is, though, that clouds will start to gather across the financial markets as soon as the central banks' stimulus well begins to run dry. The air on the stock exchanges will then start to get rarefied. It is debatable whether that can ever happen without provoking a new systemic crisis, however. The world may now be too dependent on the drug of constant new money creation for the drip to be removed from our arm.

# BUT WHERE'S THE GHOST?

No sign of inflationary tendencies

One would assume that the unbridled creation of new money throughout the world would inevitably have triggered massive inflation some time ago. In fact we have seen nothing of the kind. Authorities everywhere are fervently hoping for an inflation level of at least 2%. That means stability, we are told. How do our leaders actually know this? It is a mystery to us, too – but people the length and breadth of the country are nevertheless praying to be spared from the plague of deflation. Japan has shown us that this means a consumer strike, an eternal wait for even more attractive prices with the result that consumers remain in a state of constant dormancy. If one looks around a little, though, there is no escaping the fact that on the whole prices are falling rather than rising. Mummy Merkel and her fellow leaders don't like this at all, and one therefore has to agree with the central banks that tightening the interest rate screw is completely out of the question. Mr Draghi has just cut the key euro interest rate again and is even talking about the possibility of negative rates to force the banks to reduce their gigantic asset levels and stimulate lending. Nothing like this has ever been seen before – like so much that the central banks have prescribed for us in recent years. The current chiefs will probably no longer be at the helm when the moment of truth arrives, for if something makes no sense then that's almost always because – as we have said before – it is indeed nonsense. For the time being, however, the financial world is ruled by one thing and one thing only: a megalomaniacal orgy for printing money with the aim of keeping interest rates at zero. To the joy of the financial industry and the woe of savers and pension funds.

It would appear that our authorities will continue to act in the same way. The heroin will still not be rationed, which is good news for the markets and abhorrent for all those who try to put a small amount aside each month for a rainy day, because their income (interest) is zero and their wealth is slowly and insidiously being expropriated.

Talking of expropriation, the International Monetary Fund has proposed that a special 10% tax – just as a one-off, of course – could perhaps be imposed on the savings of all EU citizens in order to – and here's the good news – reduce Europe's sovereign debt to zero (almost) at a stroke. Please don't laugh. Over the course of the last few centuries, many things have been proposed that seemed incredible and yet nevertheless became a reality! Like the SPD's recent suggestion that it could cooperate with Germany's left in four years' time, even though this had up to now always been categorically dismissed as being "never a possibility". Time will tell whether this will end in success or disaster.

# THE CRYSTAL BALL

What next?

At present, an investor examining a globally diversified portfolio that not only spreads risks geographically but also invests widely in all available asset classes cannot fail to notice that the long-running investment crisis has got even worse. Bonds are yielding scarcely more than the bank and management fees they incur, and the last year has clearly shown that attempts to optimise returns can go seriously awry as soon as one starts investing in tertiary currencies such as the Australian dollar, the Brazilian real, the Turkish lira, the Indian rupee, the Indonesian rupiah and even the Norwegian krone, which for many years was considered a safe haven. The higher returns promised by these securities were more than erased by currency losses. Time deposits have brought nothing but expenses for some time – we have Mr Bernanke to thank for that.

Precious metals, which have long been a lucrative addition to one's portfolio, took a huge battering in a very short time last year. One is now perfectly entitled to ask whether there is actually any motive for including inflation protection in our calculations. OK, so the guardians of our currencies (!?) are almost praying for inflation, but one might quite rightly ask exactly what it will take given that even untold billions of newly created money have scarcely triggered even the merest whiff of inflation. As a result, all that is now left for gold – the backup plan – is to provide protection against a short circuit in the system, a bank collapse or a crisis of confidence – all possibilities that are by no means purely theoretical in nature. Put simply, this means that one now holds gold in one's portfolio not with the intention of achieving value growth within the next 12 months but as insurance against events on the financial markets. It's a bit like a life insurance policy, which of course one also doesn't actually conclude with the aim of cashing it in as soon as possible.

As before, then, the sole segment left is equities, which from a realistic and practical perspective offer the only prospects of performance. It is nevertheless a positive sign that here and there people are talking about bubbles. In the past, stock market experts have never recognised imminent dangers at an early stage. In our opinion, disasters are more likely to be triggered by aspects that have no causal link with economic performance. What could these be? Well, perhaps those around us will suddenly realise one day, completely out of the blue, that it simply cannot be right for all the world's key central banks to merrily continue buying up government bonds and other debt instruments for all eternity. Trust is a delicate beast that has a life of its own and can suddenly – no-one knows why – be turned on its head. The banking system too has certainly not become risk-free, even if the politicians are constantly trying to

convince us otherwise. It is no accident that there have long been calls for the balance sheets of the world's big banks to be backed with much more equity capital. There is still a great deal to do in this regard, but one has to have serious doubts about whether the politicians will triumph over the banking lobby. Midway through 2013 we were convinced that interest rates would start to move. Bond yields did in fact rise sharply over the past 12 months, resulting in correspondingly large losses for bondholders, but key interest rates (in other words short-term rates) remained extremely low or fell back even further due to the vast stimulus measures.
Most of our favourite equity stocks are now not overvalued from a fundamental perspective, particularly given the prevailing zero interest rate environment, as some blue chips are yielding many times more than government bonds. The repression fuelled by the central banks' quantitative easing strategy is currently forcing us to hold a relatively overweight equities position, especially as the politicians have in fact stolen the alternatives away from us. With this in mind, we urgently advise all readers to carry out an in-depth assessment of their personal financial situation to ensure they do not lose sight of the realities in the fog of the prevailing zero interest rate policy. The time has come for every investor to give an exact account of their own risk acceptance. Can you handle a setback on the financial markets without any problems, not just financially but also mentally? This is a question that only you yourself can answer, but just as people repeatedly put off making a will, there is a danger that you would prefer to leave it until tomorrow rather than tackling it today. Our final piece of advice is that you should carry out this assessment as soon as possible so that you can then inform us of your current preferences. *"Circumspection countervails deceit,"* as Goethe said. We have to be in complete agreement on this. The multiplication of the loaves in the Bible was wondrous enough, but the frenzy of quantitative easing that the central banks have brought upon the world is much more than even that. It is a questionable gift in the shape of a gigantic Pandora's Box that – God forbid – must if possible never ever be opened.

Marcel A. Burgauer

"Anyone who lives within their means suffers from a lack of imagination"

Oscar Wilde