Comments 2007

December 2007

The last few weeks wrecked havoc on financial stocks and finally also brought down the general market. Almost daily news of huge write downs of structured products by banks and other financial institutions upset the public and eroded confidence to a dangerous degree. Many stocks plunged precipitously day after day as if the system was about to collapse. It then was a great relief when Citigroup and Abu Dhabi announced a cash injection of $7.5 billion by the oil producer in the bank. While the stock of Citigroup didn’t become a top performer over night, it still showed that these companies at the present valuations are cheap and attractive and a knowledgeable investor is prepared to invest in a big way. In similar fashion Sony received funds from Dubai and Ping An, a big Chinese life insurance company acquired 4.2% of Fortis, a bank and insurance concern. These deals validate the belief of the value investor that assets at a sufficiently low price attract eventually buyers and prices will recover. The crisis may not yet have run its course, but at least we see some reason returning to the marketplace.

November 2007

The crisis in subprime mortgages and related CDOs has worsened and it has inflicted substantial losses on a prime Swiss company, UBS. Almost all big investment banks, to a higher or lesser degree, have to lick their wounds. How is this possible, given the fact that these institutions are run by very smart people with all information tools at their disposal? For some time discussions on the overheating US real estate market have gone on and nobody should have been surprised by its fall. We can only explain it by the “institutional imperative”, as Warren Buffett calls it. Charles Prince, CEO of giant Citibank, said: “We have to dance, as long as the music plays”. It is peer pressure, the fear to miss some profits, which competitors will collect, what forces these firms to put common sense aside and gamble until they sink in an abyss. Time and again they have done it and they never seem to learn. This is one reason why banks and financial institutions, often with good growth and high returns on equity, hardly ever command a high valuation. They usually fail with the herd when periodically speculations are spreading and ending in excesses. Monetary incentives promote a culture of short term success without regard for the long term wellbeing of the firm. We disapprove of this immature gambling mentality, but there is not much we can do. The crisis pressures these stocks to very low levels and we try to take advantage to increase positions, hoping that reason and common sense will last for a good while. We also see that insurance companies have been purified somewhat by their past tragic mistakes and have been more prudent so far. In addition we also look into building and real estate stocks for undervalued situations.

October 2007

Turmoil in global financial markets frightens investors, while they still hope for a soft landing. One of the biggest bubbles in the US real estate, much bigger than the preceding one in the late eighties, has burst and has and will hit likely and unlikely investors and financial institutions. We don’t think the crisis will soon be over – its size and dimension has been too extensive. Easy and cheap availability of financing, coupled with steadily rising prices, have led a majority of people to believe that prosperity will last! For such persons the last three months have come as a shock. Only a skillful economic policy should be able to avoid painful crashes and a bursting of the bubble.

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The danger of a recession has increased in the last few weeks. For a value investor, this is no reason to turn pessimistic. On the contrary, after rainy days the sun is bound to shine again and the economy resume its growth. In the meantime, our companies earn good returns and pay dividends. We are ready to invest more funds, should prices fall in the coming months. Sectors under pressure include financial institutions and insurance companies. Most of them have the financial stamina to weather the storm and are very attractive at low prices. Drug companies are also being avoided because they have disappointed in the recent past, but their profits are, if not exciting, at least solid and they will shine again sometime in the future.

September 2007

Investors are still worrying about problems in the US subprime mortgage markets. Consumer investor confidence has eroded considerably. Turmoil is biggest in collateralized debt obligations (CDOs), derivatives, hedge funds and venture capital firms. It will take time for the situation to normalize because the suffering has to last long enough and be felt by enough people to have a lasting impact. A quick return to business as usual would be counterproductive, because the same mistakes would soon be repeated. Economic activity will slow down and some investors even fear a recession. Nobody knows the outcome, we just see that some stocks of good companies are under pressure and have fallen in price. They trade now at attractive levels. Gradually we will increase our investments and add to existing positions. Uncertainty may be high at the moment, but it is the friend of the long term investor because risk is reduced as market prices are dropping. We try to profit from these situations.

August 2007

The problems at some hedge funds and private equity firms have deepened considerably in the last month. The malaise in the US sub-prime mortgage market is spreading worldwide. The Deutsche Industriebank IKB had to be rescued by its biggest shareholder, the KfW. Bernanke, head of the Fed, talks of $100 billion in potential losses, which is a substantial amount of money. It demonstrates once again that speculation, overconfidence and excesses normally end in a crash and losses. We have no idea whether the market weakness will spread or be contained. Our stocks, in particular banks and insurance companies, have suffered, but we think that their earnings power and dividend payment capacity are not impaired, they should grow over the coming years. HSBC, the big British bank, has shown in the last quarterly report its defensive qualities. Despite billions in additions to reserves for soured loans in the US, its earnings have grown thanks to strength in other parts of the world. In general, we will take advantage of weaker prices to add to positions.

July 2007

Markets face headwinds after four good years. Interest rates and inflation have risen. News of problems at two big hedge funds in New York has raised fear of a collapse in the market for CDOs (collateralized debt obligations). Underlying these funds are sub prime mortgage obligations, which are very hard to sell at a time, when many investors expect even lower prices. For the moment a collapse and fire sale have been avoided, but the problems have not been resolved. Investors wonder, whether they should sell and wait on the sidelines. We base our investment decisions less on market sentiment but on value. Many high quality blue chip companies have performed only moderately since the beginning of the Millennium. Earnings and dividends have increased, but the stocks have hardly moved. Others, like banks and insurance

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companies enjoy only low valuations, because investors have been burned in the past and mistrust them. Drug companies have recently been unable to replace their aging block busters and face increased competition. Wherever there is concern and mistrust, prices tend to be under pressure, and are therefore attractive. If we are convinced, that future profitability can be sustained, then we will buy the stocks and keep them for the next few years. Rising earnings and dividends will generate a satisfactory return.

June 2007

Stock markets continue to hold optimistic expectations. Economic news has been rather favourable, despite the high price of oil. On the other hand, political unrest in the Middle East has worsened. Greenspan has warned about the build-up of a speculative stock market bubble in China, which also the Government tries to defuse by increasing turnover taxes. The immediate impact is considerable, but after the first shock people continue to trade as usual. Mergers and acquisitions proceed at a hectic pace. We continue to seek value in what we consider underpriced stocks. These include banks and insurance companies, which investors rate lower than the average company because they fear volatile earnings. Drug and medical technology companies are also out of favour. Negative news pop up regularly, but this difficult period will pass and the medical needs of aging populations augur well for future prosperity.

May 2007

Finally, big blue chip companies are acting better in the stock market. After an underperformance since 2003 they seem to gain more attention. These large companies have often more international operations than smaller competitors, their finances are stronger and they should be better able to withstand economic weakness in their local market. In addition, US blue chips should profit from the weaker dollar, because their foreign earnings will be higher when transferred into dollars. Many earnings reports for the first quarter of 2007 have been surprisingly robust.

Speculation, mergers and acquisitions seem to be on the rise. The take over of ABN Amro would be the biggest since the acquisition of Time Warner by AOL in January 2000. It seems that then and now, too much money is chasing too few goods – not a good sign. We feel comfortable owning solid companies with growing profits and dividends, as long as they are available at reasonable prices.

April 2007

It seems that we are in a correction phase. In these times it is important to remember that we are value investors. We buy stocks for their present and future earnings and dividends and not for an expected rise of the price. Of course, if it happens, it is a nice occurrence.

Most people do not know that in the long run the most important factor for wealth creation has been the reinvestment of dividends and not price appreciation.

Knowing about the importance of increasing dividends and their reinvestment at favourable, meaning low prices for the long term success, it is evident, that the value investor doesn't view corrections and plunging prices as catastrophes and reasons to bail out as quickly as possible, but as chances to reinvest some of his liquid funds and revenues for good future returns. The only

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condition is that he concentrates on values, knows them well and avoids speculative temptations. He also has to stand firm against all the negative sentiment, criticism and fear, which will weaken his resolve and try to throw him out of the market during a decline or a crash.

March 2007

Finally on Feb. 27 we have been hit by a market correction, a killer wave, the worst since Sept. 11, 2001. Increased speculation, mentioned in the January commentary (the bursting of a speculative bubble in China, high volatility and expectations in small and medium sized companies, pervasive complacency) have preceded the correction. Earnings reports so far look very good: Swiss Re earned CHF 13.49 in 2006 and proposes a dividend of CHF 3.40. In addition, the Company will redeem half of the stocks issued to GE in remuneration of the purchase of GE's insurance interests. This purchase amounts to 4.7% of the outstanding shares. Munich Re also announced excellent results: Earnings per share of EURO 15, a dividend of EURO 4.50 and later in the year possibly a repurchase of shares for EURO 2 billion. These are strong figures, but the market doesnt believe in their sustainability. We think that the companies in this sector will remain attractive for a longer time than the market gives them credit.

February 2007

The year started again on a positive note for all the major stock indices. Merger & Acquisition activity continues at a fast pace, fueling bid speculations across several sectors. KKR recently launched a bid for Laureate Education at very steep valuation multiples that would value our holding (and competitor to Laureate) Apollo Group at twice the current share price. In an environment of abundant liquidity and historically low volatility, a few alarm bells have been ringing lately: money supply in Europe is growing at an accelerating double digit pace (normally a leading indicator of higher inflation), in the US several cyclical companies have lowered guidance for profit growth in 2007 (e.g. UPS, 3M) and Chinese officials warned of a speculative bubble in their stock market. These events remind us of the high level of complacency in todays markets. While not immune from possible downturns, we are invested in large companies with strong cash flows and reasonable valuations. These businesses would stand to benefit from a more difficult environment by gaining market share from weaker competitors: as Buffett said, its only when the tide goes down then you can see who has been swimming naked.

January 2007

2006 has again been a good year for investors, marked by low inflation, low interest rates, a healthy economy and high profitability of private enterprises. Investors are profiting from globalization, which opens markets and keeps inflation under control. Higher market prices have been driven by higher earnings and not an expansion of multiples, which is positive. Many stocks, in particular big blue chip companies, have lagged the market and are still reasonably priced. To mind come names like HSBC, Royal Bank of Scotland, Carrefour, Depfa and Swiss Re in Europe, Wal-Mart, Johnson & Johnson, Home Depot, Citigroup and AIG in the US.

While most experts have a rosy outlook, there are also some clouds on the horizon, like the risk of rising interest rates, weakness of the Dollar or a recession in the US. We will continue a cautious policy and will strive for further steady growth.

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