

## Comments 2009

### December 2009

Pride comes before the fall. A nice, pleasant recovery in debt and equity markets was interrupted by the liquidity problems of Dubai World, a huge government owned property developer in Dubai. A short time ago Dubai was the envy of the world, a financial and commercial hub with the finest and best facilities, growing at a breathtaking speed, full of ambitions, but also arrogance and hubris. Now, like a failed investor, it struggles to reschedule debt payments because of lack of funds. This new incident illustrates that the worst of the crisis may have passed, but its consequences will bother us for a long time to come, similar to the crisis in 1973/74. The recovery has been pleasant, but tough times are not yet over. On the other hand we believe this crisis also will pass. The Arab Emirates, in particular Abu Dhabi, have enormous wealth. They may not want to unconditionally finance all craziness of their partner, but in the end they will certainly support him in a way that he can resolve his problems, although bruised and humbled. The incident is a reminder how fragile well being and prosperity are and how fast they could escape.

### November 2009

Long term investors have been treated harshly by stock markets over the last 10 years. There was the crash in technology stocks in 2000 to 2002 and now the financial crash in 2008 and 2009. Over the last 10 years shareholders have earned no money. It was one of the worst decades for investors according to long term statistics. For some owners of stocks the pressure and fear exerted by stock market gyrations has been too great to bear, the outlook is too uncertain. They have left and opted for other forms of investment.

However, a look into long term records shows an encouraging picture. It is well known that the US have the best statistics. Since 1871 there have been 13 decades or 10-year periods with negative returns. The next 10 years gave investors real returns that averaged more than 10%, way above the average return of 6.6%. In addition, this return was twice the return provided by long term government bonds. 10-year periods with disappointing returns are most likely followed by decades with surprisingly high returns. A similar observation can be made by looking at the two halves of the last century. The beginning was very promising with peace, prosperity, growing world trade and fast technological progress. Two world wars, political upheaval and epidemics followed. The return on shares amounted to only 3.5%, still remarkable in view of what had happened. The second half started very subdued, with Europe in ashes, communism on the rise and a third world war looming. But events turned out much more positive than expected and annual returns of a world index reached 9%. This was certainly a much higher return than expected.

We have to draw the conclusion that high expectations most probably will be disappointed, but a gloomy and unpromising situation may very well surprise on the upside. What is required however are patience and perseverance, which could be beyond some people's willingness or capability.

### October 2009

After catastrophic winter and spring storms, investors enjoy now a mild, benevolent autumn in the markets. Time has come to ponder, why such extreme, violent and in the end unexpected movements have taken place in capital markets and the economy. Again a timely book by Yale

Economist Robert Shiller sheds some light on the reasons. Its title “ Animal Spirits: How Human Psychology Drives the Economy and Why it matters for Global Capitalism” addresses the principal causes. Humans behave irrationally and non-economically. We tend to be influenced more by lively and plausible stories than dry facts and numbers. Stories also stick better in our memories. Since the future is fundamentally uncertain, we tend to rely more on our intuitive side than on our quantitative side. This can lead to excesses which disrupt entire economies in the same way they disrupt financial markets. Investors tend to get overconfident, reinforced by prevalent moods and biased information. At the same time they exclude or choose to ignore other relevant facts. This often leads to overconfidence, which plays a big role in forming bubbles. Most recently stories of smart real estate speculators captured people’s attention and assured them, that real estate prices would keep going up, although this was demonstrably wrong. In addition, governments and regulators believed that the all-knowing markets would self correct before anything got out of hand, but this proved to be wrong. The lesson we should learn from this is that we rely less on stories and tales and more on numbers. If something is historically expensive, whatever the plausible and convincing reasons, be prudent and beware. If it is very inexpensive, but the outlook is pessimistic, it likely is attractive.

## September 2009

On March 6, 2009, the world seemed to be coming to an end. Now, 6 months later, we have experienced and enjoyed one of the biggest and fastest rebounds of the Dow in its 113 year history. While this is happy news for those who are invested, it must also be a reason to be cautious for the future. Undervaluations have been corrected and many markets are now reasonable priced.

It is generally assumed that economies will get out of recession by early next year. However, this recovery, as opposed to the stock market rally, could be slow and uneven; we should not forget that we have just gone through the worst financial crisis since the Great Depression. Probabilities are high that we will have a long, difficult period of recovery.

In March, investors feared getting destroyed by further, dramatic declines. Today, they are afraid of missing an extended rally. It is possible the market will go nowhere from here for quite a while, just up and down, up and down, similar to the performance after 1975. This is not necessarily bad, but it could be quite demanding and trying for many investors. Recently Jason Zweig quoted Benjamin Graham, the father of security analysis, in the Wall Street Journal: “The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances. To be an investor, you should try to exercise that kind of emotional control.” These wise words definitely make good reading, but to live by them daily is no easy task.

## August 2009

A swift and extended recovery has followed the apocalyptic mood prevalent early in the year. We think this is definitely not yet due to a sustained improvement of the world economy, which is not yet discernible, but is a result of big amounts of liquidity being in search of a return. Bank deposits and high grade bonds pay almost nothing. As panic and fear of an impending depression are retreating owners of funds are slightly less concerned about absolute safety and liquidity; they, at first reluctantly and then more adventurously, move into stocks and corporate bonds. However, their confidence is still fragile and should economic news turn bearish, which likely will happen

sometime in the future, they will retreat. Setbacks are inevitable. Despite this uncertain and volatile outlook, which is typical for the time after a big crash, we find investments in good stocks and bonds with an adequate yield will be rewarding for the next several years, much more so than liquidity and Government bonds.

## July 2009

The economic outlook seems to be slightly less grim, but still depressing. Orders are plunging, companies are cutting jobs and investments in plants and equipment. Nevertheless, the worst seems to be over. Investors also seem to be less pessimistic than they have been 4 months ago, but they know they have stiff headwinds ahead. The healing process has only started and will be long and difficult. Nevertheless, due to low prices, this is a time of ample opportunities for long term investors, be it in equities or bonds. Eventually, business activity will normalize and bring along higher valuations. We should not permit that a bleak market outlook and turmoil stampede us out of investments or worry us unduly. Within the next 5 years, chances are good that our patience and perseverance will be richly rewarded.

## June 2009

Sentiment and mood among investors has changed dramatically since early March of this year. This is in stark contrast to the real economy, where news continues to be bleak. A great number of firms reports dwindling orders and has to let go workers or even to close doors. There is no early turnaround in sight. Many investors therefore wonder: Is the new trend for real, do we have a global recovery or are we only enjoying a temporary bear market rally? In assessing the market we look at long term indices like the "Total return of US stocks" compiled by R. Shiller. The graph indicates a slight undervaluation for stocks. This is positive. The outlook for earnings and dividends, on the other hand, is quite poor. However, we should keep in mind that the value of a company or stock is based on the long term earnings power and the total sum of dividends paid out over many years. A few poor quarters or even years have less weight. Overall we are cautiously optimistic, in particular for the longer term, despite the fact that we think a correction is probable. We recommend taking advantage of any setbacks to increase investments. In particular we like drug and med. tech. companies, which are quite cheap. In addition, some financial and insurance values have still potential for recovery.

## May 2009

While economic news remains bleak and problems are mounting, stock prices have changed direction since mid March and continued to recover in April. Financial stocks snapped back after their dismal performance during the crash. Manufacturers of consumer goods have remained subdued. Their results probably will continue to deteriorate. Drug and medical implant producers also haven't yet participated in the upswing, presumably due to patent expirations and pricing pressures by the new Administration. We think these equities are trading at very attractive levels for the patient investor.

The big question on everybody's mind is whether this is a bear market rally, which will be ended by further declines to new lows, or whether have we seen the lows in March and have now a genuine turn around. The answer will be known only later on. What gives us confidence and makes us optimistic is the very low valuation afforded the market as a whole and some sectors in particular. This is the best basis for sustained profits in the future. In the short term, very tough

economic conditions with lower earnings could lead to new setbacks, but for the long term we are quite optimistic.

## April 2009

Warren Buffett said: "The future is never clear, and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values."

### Current Valuation of stocks:

The capitalization of the US stock market is approximately 60% of GDP at the moment (S&P 500). As a reference, in 2000 it reached an all time high of 180%, the long term average is 80-90%, and in 1983 it was approximately 40%. Many other indicators, such as the Shiller P/E ratio give similar results: stocks are cheap (Shiller P/E at 12, long term average is 16), below long term trend and below fair value. This gives confidence to long term bears like Jeremy Grantham (Chairman of GMO, a global investment management firm with over USD 85 billion in client assets, and a renowned value investor) to indicate expectations of 10% to 13% real returns (i.e. net of inflation, so nominal returns would be higher) for stocks for the next 7 years, this return would be well above the long term historical average. On the other hand, in the short run stock prices do not depend on fundamentals but on psychology and demand and supply: when there are only panicked sellers and no buyers, stocks can go lower and lower. In conclusion: we feel stocks are priced to deliver well above average real returns in the next few years, and in particular good blue chip solid companies, but we do not know what the next few months will bring, and indices could go lower if pessimism does not abate. While we have clearly been wrong in judging how bad the situation could get, we remain of the opinion that timing 1-2 year returns is extremely difficult, while it is highly probable that returns over the next few years will be very good. We therefore recommend gaining/maintaining exposure to the market as we know prices are attractive, without trying to pick a bottom, but possibly staggering a reinvestment/increasing positions in 2 or 3 moves as opposite to 1 single decision.

### Currencies:

For global multinational stocks currency exposure is not so relevant. The real exposure is not the denomination of the stock price but the underlying cash flows generated by the business, and these companies are in business everywhere. Nestlé and Coca-Cola both have exposure to a widely diversified basket of currencies, and hedging the portfolio would cost money and not bring benefits in the long run. It is possible, maybe even likely, that inflation will come back sometimes in the next few years, as all central banks are printing money. The FED is probably winning the printing race, hence that would suggest a USD weakness in the future, but it is not so clear, as the trade balance may improve quite quickly and also the EURO is not in the best shape either. In an inflationary environment, commodities would probably perform quite well, but they are extremely volatile and very difficult to analyze. Stocks of companies with pricing power and high returns on invested capital (characteristics of many strong blue chips with powerful competitive advantages) are also an excellent hedge against inflation over time, while the clear losers are cash and long term bonds (unless they provide already very high yields).

### Summary:

Jeremy Grantham summarizes the psychological difficulties for investors in the current

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environment, but also the importance of keeping in mind the attractiveness of current prices on a long term basis: If one invests too soon too much she or he will regret it, but also investing too little bears considerable risk as long term expected returns are very attractive and inflation will erode the purchasing power of cash. Not being able to forecast short term market movements (important but unknowable fact), we rely on what is important and knowable: stocks and in particular quality large caps are cheap and priced to deliver returns well in excess of inflation for the next few years. We therefore recommend that investors maintain exposure to the market or, if sitting on the sidelines, reflect on the fact that cash, while brilliant in the last two years, over time is a terrible asset in inflationary environments. While collective psychology currently emphasizes only downside risks and pessimism, periods like the present one have always been the basis for a much brighter future, and a comparison of prices and fundamentals gives strong signals that your patience will be rewarded.

## March 2009

Publication of Berkshire Hathaway's Annual Report is an important event in a time of disarray, fear and despair. Buffett points out, that 2008 has been the worst year for him and the S & P 500 index in the 44 years that he has been running Berkshire and that he never before has witnessed such a far reaching devastation of corporate and municipal bonds, stocks, real estate and commodities. Practically all investors have suffered huge losses and are confused and fearful of the future. In order to stop the vicious circle of fear, business contraction and mistrust, Governments and Central Banks had to intervene on a gigantic scale to avert a total collapse. In typical Buffett fashion, however, he reminds us, that the USA have faced far worse obstacles in the past. In the 20th Century it had to fight 2 World Wars, one of which it at first seemed to be losing; there have been about a dozen panics and recessions, an inflation out of control with a prime rate of 21.5% in 1980; and the Great Depression in the 1930s with unemployment between 15% and 25% for many years. Yet all these challenges have been mastered and at the same time the standard of living has improved nearly sevenfold during the 20th Century and the Dow Jones Industrials have risen from 66 to 11'497. During the 44 years of his guiding the company, the S & P 500 index has risen in 75% of the years. Buffett thinks over the next 44 years we will have approximately an equal percentage of positive years. He is happy that he was able to invest huge sums at very attractive conditions in the disarray, bringing him additional pretax revenues of \$1.5 billion yearly.

## February 2009

The year started on a sour note, with most indexes declining and closing the month in a loss. The mood is terrible, most investors seem to expect the stock market to fall much more, gold went up and cash lying in accounts is at historical high levels. In a continuation of the theme from last year, the USD significantly strengthened against most European currencies. Periods like the one we are living are testing the nerves of everybody, and many investors are approaching a state of resignation to a dark destiny. History, on the other hand, has taught us that wealth is built by keeping a cool head exactly in times like this. We are not able to tell you if last November's bottom (S&P 500 at 752) was the final one or not, nor will anybody else: listening constantly to CNBC news or staring at stock prices will not provide any guidance nor help to what is ultimately not knowable, it will only wear out your nerves further. The only help will come from staying focused on important and knowable key facts: a) the US and European stock markets are at the cheapest level of the last 20 years, and many high quality blue chips offer free cash flow yields triple the level of bond yields; b) most stock indexes have delivered negative real returns in the

past ten years, an unprecedented bad results that augurs very well for the next ten years (the ten year return from the crash of 1929 was a positive annual 2.5% real return, against a negative 2.4% since 1998). c) any investor that is going to be a net buyer of stocks in the next five years should welcome lower prices, as they are the base for higher long term returns; even investors that are left with low cash reserves will benefit as some of their investees take advantage of low prices to buy back their own stock or acquire competitors cheaply, as Pfizer just did with Wyeth) d) the only losers in this situation are sellers, as they will see a temporary decline in value turned into a real, permanent loss, and they will not find the courage to step into the market again for a long time. We are constantly monitoring the fundamentals of our investments as well as potential other opportunities, as volatility is a friend of the long term investor and may offer the chance to trade an average business for a great one at a similar level of undervaluation.

## January 2009

2008 will be remembered as the biggest stock market crash since the depression in the 1930s. A year ago we had still vaguely hoped stumbling blocks could be overcome and the year could end on a positive note, but this hope turned out to be wildly off the mark. The reasons for the dramatic deterioration of the economic situation worldwide and the outbreak of a banking crisis cannot simply be found in the bursting of the US real estate bubble. It was a prolonged period of prosperity since 1982 with sinking inflation, falling interest rates, remarkable increase in productivity and high rates of economic growth that led over many years to a huge build-up of the private sector debt. Economic growth was sustained by consumer demand from US households and rapid build-up of industrial production in emerging countries. Permanently low interest rates and easily available debt, facilitated by the development of credit derivatives, induced American households, banks and financial entities like Hedge Funds alike to steadily increase indebtedness. Through securitization, by packaging obligations into derivatives such as ABS (asset backed securities), CDO (collateralized debt obligations), SPV (special purpose vehicles), debt from many sources was pooled and distributed with high ratings to unsuspecting investors, providing a growing stream of available credit.

The ever growing debt burden of American households has worried us for a long time. Financial experts like Warren Buffett have also warned against the exponential growth of derivatives, calling them instruments of mass destruction, and worrying about the growing complexity of these vehicles and the irresponsible financial incentives accorded to investment bankers. We also knew of the bubble in US real estate. On the other hand, the world economy is highly complex, always beset by seemingly unsolvable problems, but somehow it keeps growing and developing to new highs. We were of the opinion that it would muddle through once more. Bernard Baruch, a veteran of the depression, said that bears don't own houses on Park Avenue. But in 2008 the meltdown in real estate, the bursting of asset-bubbles triggered a ferocious debt-liquidation cycle and a banking crisis not seen since the 1930s. The bankruptcy of Lehman Brothers shattered confidence completely and interbank lending came to a total halt. Writings since biblical, Greek and Roman times illustrate the fact that long periods of luck and prosperity render us human beings arrogant and overconfident. We underestimate dangers, commit mistakes and have to suffer to regain our balance. The famous economist Schumpeter calls this constructive destruction.

As we didn't foresee this massive break down of the markets, we have been hit badly by the crash. Being value investors and contrarians we have owned quite a few banks and financial stocks, which have been mauled in the financial panic. Some have participated in the game of amassing high debt and investing it in CDOs and SPVs, with disastrous results. Others have

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expanded greatly by tapping the interbank market for funding. When this source of credit was closed, they faced illiquidity and had to be saved by funding from Central Banks and Governments. Their business model is now in doubt and as a minimum they have to downsize considerably. In addition States are now important shareholders and will influence business decisions. We think that firms like AIG and Hypo Real Estate face huge obstacles to recuperate from this setback, whereas UBS, CS, Lloyds and Royal Bank of Scotland, while heavily diluted by urgent capital increases, have a fair chance to recover at least partially their earlier profitability and prominence. Insurance companies, with the exception of AIG, have fared somewhat better than banks and have been able to survive the crisis without government help. For us, very disappointing has been the fact that once again they have behaved not like investors but like traders and have sold almost all their equity investments at the trough of the market in October. The exceptions have been Berkshire Hathaway and Fairfax, which have continued to buy during the crash.

What fate awaits us in the coming months and years? The bursting of the bubbles in real estate and raw materials as well as the banking crisis has triggered a massive debt-liquidation cycle. US households have to reduce consumption and increase savings. Government regulators, banks, businesses, investors and markets will emphasize liquidity and sound balance sheets. This process could prove to be quite painful and drawn out, unlike past recessions. We also face the danger of a long lasting deflation. In a deflation everybody assumes that prices will fall; therefore people defer consumption and investment and hang on to cash. Economic activity contracts; unemployment rises. This is what happened during the depression in the 1930s. Governments and Central Banks are making an all-out effort to stabilize banks, reactivate interbank lending and to reestablish confidence. We are quite hopeful that they will succeed eventually, but it won't be a smooth process and there will be set-backs.

Stock markets have reacted violently to these dislocations and upheavals. We think they now more than reflect the tough times ahead of us. Most investors, fearing uncertainty and taking a pessimistic outlook, have preferred to get rid of their equities. Some plan to do so whenever there is a recovery after the heavy sell-off. After the crash and panic in September, October and November, many households, but also pension funds and corporate investors are still in a state of shock. After all, crashes with losses of 40 to 60% in such a short period of time happen only once in a lifetime; they test our patience, staying power and resolve. As we all know, the outlook is bleak and the risk of further set-backs or a prolonged deflation are real; however, at the same time stocks have fallen to their lowest valuation for the last 20 years and they are undervalued by about 30% by historical yardsticks. Any investor who aims to buy cheap and is patient shouldn't sell and rather add stocks. We are at a low point. History teaches us that there has always been a recovery sooner or later, which will lift the stock market eventually to new highs. Even a buyer at the peak in 1929, who then suffered a loss of 80%, has managed to regain his original value (adjusted for inflation) by 1936, however only if he didn't sell. We have to admit it was a mistake at the beginning of last year not to reduce equities. But it would probably also be a mistake to lighten up positions at the present levels. The potential for higher valuations is, despite the bleak outlook, much higher than the risk on the downside. We should not forget that US stocks over the last 130 years have grown 6.4% annually or in Switzerland approximately 6% over the last 80 years. Such rates are again probable in the future, despite our inclination to think that this time it will be different. Undervaluation by 30% and a historical growth rate of about 6% are powerful forces for future capital gains. It is no coincidence that the savviest investors like Buffett, Grantham and Watsa (from Fairfax) are now buying. But we should also keep in mind that they have two

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qualities which not everybody can muster: They are contrarians, and they think very long term and are extremely patient.

Often over the last few years, when interest rates have been low and liquidity high, we have noticed that we could find very few attractive high yielding bonds. This has changed abruptly this year, in particular in the fourth quarter. With the onset of the liquidity crisis any bond or obligation not enjoying a guarantee by a State or having unquestionably the highest safety ranking is now considered risky and therefore trading at a correspondingly higher yield. We now have the odd situation that a few very safe debtors are able to borrow at a yield close to zero, whereas the huge crowd of the remaining borrowers have to pay very high rates or are even unable to raise funds. We have taken advantage of this situation and bought debentures of banks and financial institutions at attractive yields. In addition we are purchasing some bonds of industrial leaders at double digit yields. Fear and uncertainty have pushed them to levels as if the companies had already fallen in bankruptcy. The field of high yielding bonds looks very promising to us, as opposed to public debt, whose yield is close to zero.

Those investors, who are traumatized by the huge losses of 2008 and are wavering about their commitment to equity investments, should keep in mind the superior results in the long run: Stocks have yielded 6.4% real return on average over the last 130 years in the US, despite bubbles and crashes, war and depression. This is about three times the return of bonds. Short term investments have had close to zero real, inflation adjusted return in the same period. In Switzerland, shares have yielded close to 6% over the last 80 years, again several times the return of bonds and short term placements. The Standard & Poor's 500 Index was created in 1957. In the 50 years from 1957 to 2007 it has grown by 10.8% yearly. An investment of \$10'000 has grown to \$1'600'000. For those who prefer a shorter period: The Dow Jones Industrial index has grown from 800 in the year 1982 to the present 8'500. Mr. Market may knock you down without pity, but in the long run the investor has been the winner.

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