INVESTMENT-COMMENTARY NO. 176

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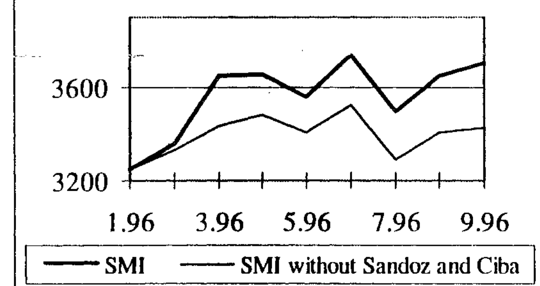
Times of Selectivity

1. When Appearances Deceive

Upon close inspection, 1996 has actually not been a very good year for the stock markets. This claim may be surprising given the generally upward trend of various stock indexes. Since the beginning of the year, has not the Dow Jones index climbed 14%, is not the German DAX up 17%, and the Swiss market index, the SMI, up 12%? Can this kind of upward trend be "bad"?

No -- and yes. Any investor who invested precisely in an index has experienced these levels of return. But what investor actually tailors his investments so precisely to an index? The following discussion details the performance consequences of various deviations from a strict index investment strategy. This is not just a numbers game, or statistical wizardry. There are very real economic causes that dictate these unique constellations on the financial markets. As will be shown, investment activities must be geared toward these unique constellations.

If we exclude the performance of the Sandoz and Ciba (that is, Novartis) registered shares from the SMI, then the index has experienced an increase of just 5%. Sandoz's stock price has climbed 41% since the beginning of the year, while Ciba's stock has risen 56%. These large jumps in value are a result of the March 7 announced merger of the two companies. The announcement was registered as a one-time jump of 22% for Sandoz and 29% for Ciba. At the beginning of the year, the weight of these two corporations in the index was 11.43% and 9.07% respectively; in other words a combined 20.5%. Any stock portfolio that did not contain at least one fifth stocks from these two chemical companies could not touch the index's 12% gain.



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other titles, then the result is even more striking. Without an investment in Nestlé's registered stock (up 8% this year) and other similarly strong performers, an investor even might have lost money.

It is not altogether unlikely that a Swiss stock portfolio would contain 15% Nestlé. 15% is the weight of Nestlé stock in the SMI. However, it is much less likely that at the beginning of 1996 a normal portfolio would have included 20% Ciba and Sandoz. Instead, most portfolios probably included a substantial percentage of last year's top gainer, Hoffman La Roche. Roche's certificates have just managed to maintain their value in 1996.

Now it might be argued that this kind of one-sidedness is attributable to the narrowness of the Swiss stock market. But a

look at the DAX or the Dow Jones confirms instead that for the most part individual branches, individual titles and special topics -- rather than the wider market as a whole -- are propelling the indexes upward. Without the German chemical industry (BASF, Bayer, Hoechst), the stock market of our northern neighbor would have been more than disappointing. On Wall Street, meanwhile, the investment topics continuously vary. For a few months technology stocks are what propel the market, and everyone has to have them. Then suddenly in the next phase those same technology stocks are what no one should have and the new hot titles are in the capital goods industry or with non-cyclical consumer goods (like Cola, Pfizer, or Gillette).

We cannot afford to underestimate the problem we face under these circumstances. Our examples make clear that staying away from certain titles or sectors can be devastating. That is to say, having the wrong proportions of stocks in a portfolio will lead to below average returns. It will, for instance, be particularly interesting to observe how investment funds have handled this problem this year. Did Fonsa, Swissac, Valsuisse, and the rest, have enough invested in Ciba and Sandoz in January to share in the "Novartis-Bang"?

When a market is being determined by individual titles or topics, the first piece of advice that comes to mind is: *"be selective"*. But can there be a more trivial piece of advice than "be in the right place at the right time"? If only it were so easy to know where the next Big Bang will occur.

2. *For Whom the Bell Tolls*

What we observe on the stock markets is, of course, simply a reflection of the structural transformation taking place in the economy. A structural transformation by no means necessarily includes the entire scope of the economy at once. In contrast to general economic trends, transformative processes typically occur at the level of the individual enterprise; transformation involves grueling work and unpleasant employment decisions.

Of course, whole economic sectors are more or less significantly impacted by transformative pressures. An entire sector may show weak productivity and have insufficient earnings. In the case of Switzerland's big banks, the fact that they are all making noise about needing to further reduce their workforces is attributable to a sector-wide weakness. However, while all the banks are under pressure to respond, exactly when and how each bank does so will depend on a multitude of factors, including management philosophy.

It is apparent that different companies in different branches have a different need for restructuring. But there is also a big difference between a company's need to restructure and its capacity to do so. This gap can be decisive in determining whether an enterprise remains solid or perishes. Thus, we should think in terms of the categories, *'need for transformation'* and *'capacity for transformation'*. In principal, this is a rewarding basis for financial analysis -- the structural transformation finally provides an opportunity for the utilization of specialized knowledge. Any analysis that accurately determines for whom the bell will toll and how loud that toll will be would certainly find takers.

Among the general public, structural transformation is typically perceived as a danger. Understandably, people question how all that has come before can suddenly be wrong. But when the environment changes so quickly and dramatically, even the most tried and tested structures can become obsolete. German and Swiss export industries have for some time been having this painful experience. Very high wages (in part a function of currency rates) are now an issue because in other places around the world people with much lower pay are capable of producing comparable quality. Outsourcing expensive production processes to countries with lower production costs is the typical immediate response. Who can blame people for seeing the layoffs associated with this outsourcing as a threat? But that is just one side of the story.

The other side is that numerous new opportunities are arising. Outsourcing can also be done domestically, which means the

creation of new jobs. Companies with antiquated structures and overly generous pay scales from a past era can use outsourcing to overcome these problems. So there is no reason that the second phase of a transformation cannot include a return to upward economic progress for countries like Switzerland. Lower wage demands, more individual risk, more profit with success -- these will be the hallmarks of a structurally transformed economy.

A dynamic and permeable social order -- along the road to that place some will come along for the ride and others will be left behind. Those who speak of "selectivity" during a process like the one we are currently experiencing are attempting to pinpoint not only exactly which firms will succeed but also when their success will begin. Is this possible? A look at the environment in which the structural transformation will take place is necessary.

3. *Who Will Survive This?*

We all are still too much locked into the old cyclical ups and downs and the traditional -- as a whole, static -- economic mechanisms to make another discussion of the hallmarks of structural transformation unnecessary. The firms that we are seeking to "select" out are, after all, a part of the transformation process -- they either flourish within its dynamics, sputter along, or go under.

Hallmark number one of the structural transformation is *the reduced importance of the state.* Throughout the Western world, state fiscal expansion continued for decades, seemingly unstoppable and regardless of the political parties in power. But today the government burocracies are in retreat, or under substantial pressure. In previous commentaries we have discussed the reasons for this reduction in the state's significance. The most immediate cause is the loss of the political threat from the East. As a result, many state institutions and social arrangements have either directly or indirectly lost their justification. Today state deficit economics, the cancer of the seventies and eighties, is "suddenly" no longer a necessary feature of modern state. In addition and simultaneously, state-of-the-art communication technologies are challenging the relevance of political borders. It appears as though the idea of political territorial subdivision could become a thing of the past. Nations are only territorial subdivisions.

The state's reduced significance has very practical consequences for the process of economic development. Those who until now sought nourishment from the fiscal milk cow will have to look elsewhere. The public construction sector, agriculture, the defense industry, the healthcare sector, subsidized culture: All of them are coming under pressure. New Public Management is called for. In practice, this means, first, budget restrictions. The tendency to reduce the amount of money in the public trough will continue. In Europe, at least, the consequences of these pressures have by no means been fully felt -- the worst is yet to come.

The decline in *real estate prices* -- hallmark number two -- is linked to the reduced importance of political territorial subdivisions. The loss of the bipolar threat means that many places on earth have become safer. Modern communications no longer know any borders. And states are becoming more and more questionable as guarantors of private property. Under these conditions, there are fewer reasons to own property in a specific place. Alternatives have emerged. The depreciation of over-inflated real estate prices is a phenomenon that travelled, like some kind of hazardous waste transport, from America, through Japan and arrived in Europe, where it continues to wreak havoc. By now the total value of real estate in Switzerland has fallen to two trillion Swiss Francs. This "value" stands in contrast to a cumulative market capitalization of Swiss enterprises of 500 billion Francs. Does this not suggest that there continues to be an imbalance?

A traditional recovery in the real estate market is very unlikely. Focus on assets will be replaced with a singular focus on cash flow. A piece of real estate is only worth the amount of future income it will bring in. This is linked to the future economic strength of renters and homeowners -- real estate prices become a projection of the

economy's future performance. This ought to make many real-estate-laden retirement funds stop and think.

Hallmark number three, related to the real estate crisis, is the *problem in the banking sector.* American banks were in crisis in the early 1990s, Japanese banks were hit around 1992, and now we in Switzerland are having to face the fact that our big banks, long viewed as pillars in the storm, are in need of drastic structural changes. An important piece of the Swiss Bank Corporations' recently announced reform package is aimed specifically at changing the valuation process for real estate. It is evident that other banks will (have to) follow suit. Experience in the United States in the early '90s taught us that as banks work to rectify their balance sheet their lending activities slow. Thus, a low lending rate is one of the glaring features of the current monetary situation in both Germany and Switzerland. The banking system profits from the steep interest rate curve: the "short" (passive side) is turned into the "long" (the active side). In a sense, monetary policy reforms the banking system through this process -- something which is not altogether a bad idea. This is how it happened in the U.S. and then in Japan. Now it is Europe's turn.

Insufficient credit availability, downward pressure on real estate prices, excess labor supply worldwide, *there is hardly any reason for inflation.* This is the fourth important hallmark of the structural transformation. A generous money supply does not automatically create the risk of inflation the way it does in a cyclical phase. The reasons for this are, for one, the already mentioned money absorption by the banking system. For two, any money that is available is used for investment purposes. These investments lead to increased productivity and, as a result, to expanded capacity. The structural transformation we are currently experiencing worldwide is comparable to the shock-like shift to industrialization in the last century. Thus money supply worries are unnecessary. (Which, of course, does not mean that such worries do not periodically reach the market and make participants nervous.)

In this environment, wage rates suffer -- especially those that are not justified by the value they add. When institutions that were justified during an era of worldwide threat (and which at that time may have even added a certain amount of value) become obsolete, the wage structure comes under pressure. Once again, we will use the *Schweizerische Käseunion*, "Swiss Cheese Cooperation", as the example. The *Käseunion* was created as part of an extremely complex and non-transparent system developed during WWII to preserve a kind of autarky for our country. Today, under the guise of marketing traditional Swiss cheeses, this institution has become a corrupt and infected sore that damages (i.e. reduces the value of) the market. In Switzerland and throughout Europe there are many institutions akin to the *Käseunion.* Not that by any means all of them have become corrupt, but most of them are obsolete. *Focusing on value creation* is the fifth hallmark of the structural transformation. Wage structures that are not justified by value creation will continue to disappear. Competition has come to the labor market.

We have now laid out the conditions under which enterprises are going about trying to secure their survival. It is a relatively nasty, highly competitive landscape. So truth be told, who among our economic leaders do we believe will succeed? And more importantly: Which politicians do we trust to navigate the choppy waters? Clearly, "selectivity" has its darwinistic implications!

4. Trust, Consider Who

If we are honest, we have to admit that it is anything but easy in this turbulent time to figure out which investment objects could ultimately come out on top. We suspect that for Switzerland it will be the industries that are active internationally, since these have already spent some time facing the headwinds of the global economy. We *suspect* that the big banks, long the beneficiaries of special circumstances, are just at the beginning of their struggles. Furthermore, we *suspect* that the tough times are just beginning for insurance companies, which are still relying on special circumstances. In addition, *we assume* that smaller domestic enterprises will fight heroically, but that there are also hopeless fights. Specifically,

we *suspect* it may be a hopeless fight in the building and consumer goods sector.

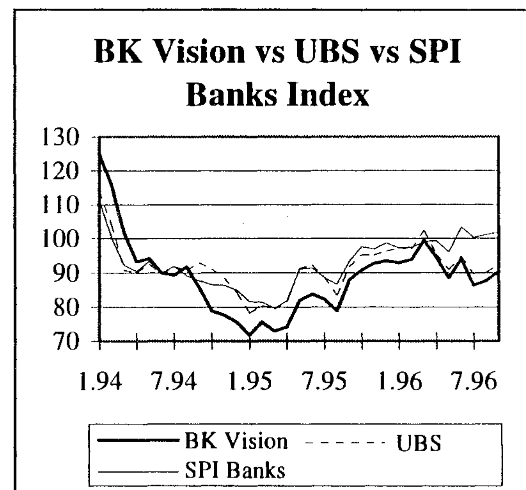
After all, is it not the task of an investment management bank to provide the customer and the reader with definitive answers; there is no market for ramblings about uncertainties. Well, let us consider several offerings on the market that would appear to have a monopoly on success, at least if one believes their advertising. Just how successful are these most aggressively marketed funds, visions, and investment companies when it comes to being "selective" in this difficult, structurally transforming environment? We will start with a few figures from Switzerland's more important investment funds. Taking the Swiss stock index, SPI, as the standard, the following picture emerges:

Total return (%)	94	95
BSS Swissfund/Banque Scand.	-15,7	19,4
FAR Act. Romandes/KB VD	**-2,1**	6,6
FL Trust/Switzerl./F.Lullin	-13,8	16,5
Fonsa/SBG	-10,8	20,8
Gesti CH/Gottardo	**- 4,9**	12,1
LO Swiss Opport./L. Odier	- 8,3	19,3
Multihelvetia/BSI	-11,0	18,4
Parsuisse/Paribas	-14,0	20,2
Pictet Valsuisse/Pictet	-10,1	22,2
Sara Swiss/Sarasin	-10,8	19,0
SBC 100 Index-F./SBV	- 8,6	22,0
Schweizeraktien/Credis	-11,9	22,7
Swiss Equity/Rothschild	- 9,1	12,5
Swiss Stock/Bär	-11,0	19,5
Swissac/Credis	-8,7	22,7
Swissbar/Bär	-9,7	**25,8**
Swissca Switzerl./Swissca	-8,8	20,8
Swiss Valor/SBV	- 8,0	**23,5**
UBZ Swiss Eq./UeberseeBank	-10,3	20,9
Vontobel Swiss Eq./Vontobel	-9,0	**35,0**
SPI Total (r)/(Index)	**-7,6**	***23,1***

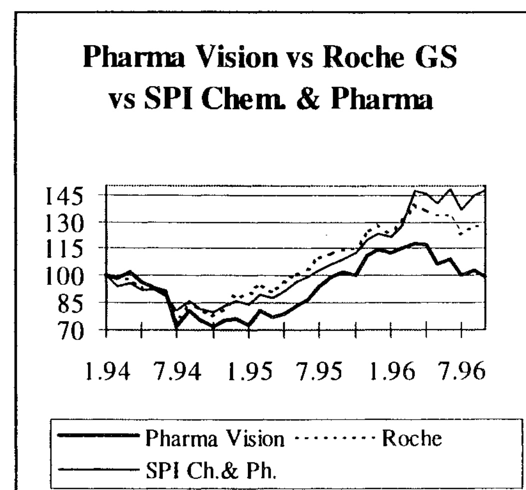
Source: NZZ

The selections made by the pros in investment fund management do not seem all that impressive after all. In both years, a bad market year 1994 and a good year 1995, only a few of the funds were able to perform up to the index. It is also interesting that the two best funds in 1994 were the worst in 1995, supporting the empirically observed claim that a fund's managers will only be able to achieve above average performance in a particular economic constellation. We point this out not for the purposes of taking pleasure in another's failings but rather in order to show that above average performance can only be achieved by disproportionately relying on selected titles. If the selections are poor ones then underperformance is the result.

And how are "Visions" and "BB-Investment Companies" doing? Are the champions of shareholder value and the promoters of efficient structures better at knowing where next the bell will toll? We looked at BK Vision, Pharma Vision, and BB Industries for the same period that we analysed investment funds. We compared their performance to a direct investment and an index as a benchmark.



Source: Bloomberg



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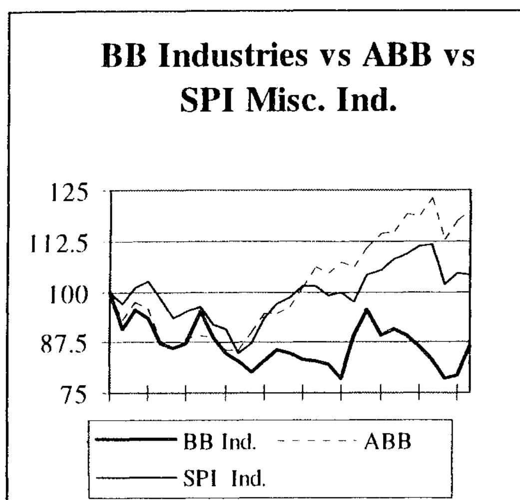

Source: Bloomberg

Here too the result is sobering. Again, please understand that it is in no way our objective to criticise anyone. We know full well how difficult selectivity is in practice. At most there could be a soft criticism of the marketing practices of some players. Modesty obviously cannot be a virtue if one is planning to offer the public an underperforming investment vehicle....

Watson Wyatt SA recently released a study of investment foundations, i.e. the fund-based investment vehicles for retirement funds (*Finanz und Wirtschaft* No. 75/96). They came to a conclusion very similar to ours. Among the study's findings that cause one to wonder, they found that much greater risk was taken for relatively meagre returns than would have been involved in an investment tied closely to an index. More risk for less earnings -- won't the pension fund clients be happy!

5. *Complex Answers in Complex Situations*

No matter how you spin it, selectivity just is not an easy endeavour. As we said in our last commentary (No. 175, September 2, 1996), because of low nominal interest rates the investor can hardly escape assuming some risk on the stock market. The low nominal interest rates should be seen in conjunction with the ongoing structural transformation as well. Ultimately, corporations are about turning investor's proprietary capital (i.e. shareholder equity) into profit. Clearly, outside capital will have relatively less appeal as the returns on equity increase.

We view the trend away from outside (i.e. borrowed) capital as the most important economic development of the decade. It changes the real economy, but it also changes the composition of portfolios. In a few years, the proportion of people's personal assets invested in stock will increase significantly. But equity is always risk capital. That is why we titled our last commentary "To (Have To) Live With Risk." Now, however, there is the additional problem that even if one is prepared to assume the risks of stocks, the structural transformation seems almost to jump from business to business. As a result, the chances increase that we will select poorly more often than we would like.

We advise our customers to pursue a mixed strategy, even though in all likelihood the strategy will bypass the "lucky punch." Using the *"focused buck-shot"* as our metaphor, we first advise an investment strategy that stays close to an index. Every index is a compilation of numerous stocks and is thus consistent with our buck-shot approach. Both positive and negative surprises are kept at bay by the mix. Because for Switzerland we take the SMI as our benchmark, our focus is turned to the essential "Blue Chip" companies.

In this area, we are inclined to directly hold several "core holdings." Blue Chips like Nestlé, Novartis, Roche, ABB etc. will survive the structural transformation. Anyone who buys Swiss multinationals is not buying Swiss risk but rather part of the global economy. Global competitive experience is the most important characteristic that recommends a stock investment. Possible gains from a weakening Swiss Franc are an additional argument.

If one is not prepared to carry the entire risk of an investment tied to an index then it is advisable to go with a structured product that includes safety features. An asymmetric risk pattern insures that market downturns --which are always a possibility -- are only partially passed on to the investor. But this kind of "insurance" has a premium attached that can erode returns significantly if

the market is on a moderate course. That is why these kinds of insured instruments are only worthwhile when relatively extreme market trends are expected.

We insure real selectivity with structured products that perform anti-cyclically. This way, phases of uncertainty or relatively stagnant market development do not go unutilized. Market declines allow the increase of stock holdings at low initial cost. If the market moves horizontally, the investor enjoys a return that is substantially higher than from bonds. In the case of exorbitant market development, these structured products limit risk little by little.

"Times of Selectivity:" These times present every investor and every investment manager with a major challenge. In the end, the best recipe for each potential stock purchase is to focus less on the stock's market value and more on who it is one is entrusting with one's money. After all, share capital is equity and equity is something one only gives to people one can trust. In times of structural transformation, we have to seek out the sharpest minds, the most superior strategists, and the most trustworthy personalities.

KH, 11.10.96