Investment Commentary No. 196

September 9th, 1999

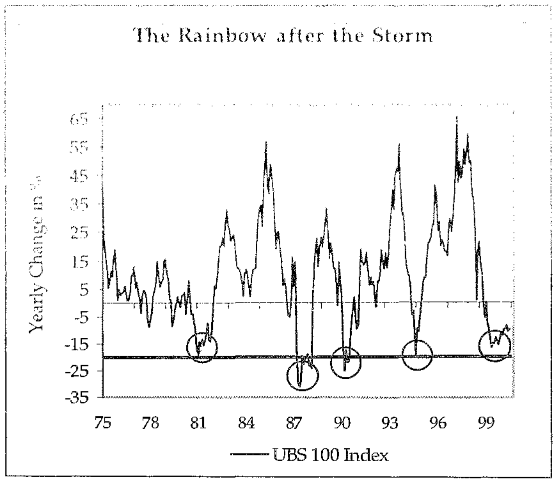
Shares for all Seasons

1. Recommendations at an Inopportune Moment?

The Swiss stock exchange has lost almost 20 percent within the past year, meaning the period between July 1998 and August 1999. Because the majority of analyses and performance reports refer to the end of the year as the key day, sobering developments are not so obvious when viewed in historical comparisons. Certain stocks would show an even poorer comparison; proud names such as Zürich, Novartis and UBS have become problematic cases in portfolios. Since the beginning of the year, this zero-sum game is being met and explained with shoulder shrugs. In case that this lateral movement continues or does even worsen by year-end, there will be many long faces.

Therefore it might seem a little daring to dedicate an entire Wegelin Commentary to equity holdings. There are, however, two reason which put all doubts in check. Firstly, one certainly knows that shares, in comparison to alternative investments, for example in fixed-interest instruments, achieve higher yields on average and longer-term; this being, of course at the price of higher risk. If this risk manifests itself from time to time, then it only confirms an intrinsic characteristic of investment instruments, and it therefore follows that one should not lose fundamental interest.

Secondly, there is an accepted statistical observation which at this point, as we are just now examining shares, and specifically *Swiss* shares, seems opportune to mention. Experience shows namely, that the Swiss stock exchange obtains, in beautiful regularity, clearly above-average yields following each year in which a 20 percent loss was incurred. This argument may sound a lot like chartism and possibly annoy the economically trained reader. Therefore to escape any reproach, we will try to prove that such a behavior pattern does not, at least, appear to be completely improbable by staying within economic terminology.



Source: Dr. G. Landert;

It is quite possible that the timing to address equity holdings is not bad at all, especially then when the general public shows definite signs of frustration. This is called anti-cyclical behavior.

2. Back to Normality

Careful analysis of financial market data of the last 18 months repudiates even more clearly our opinion that we were dealing with a crisis-like, singular event last Fall, from which the world economy and the financial markets are now moving back to normality. As is well-known, interest rates in all of the major currencies collapsed to absurd lows during the course of the crisis. This was because, on the one hand, investments which were liquidated with respectable discounts (one still remembers the Credit Suisse share price of Fr. 138.-- ...). On the other hand, the Central Banks created additional liquidity to protect the banking system.

Since increasing yields have been observed over the past few months in bond markets (and the safety-oriented bond investors had correspondingly suffered losses with their positions), then this must not be hastily interpreted as a sign of new fears of inflation, but rather a calm signal of the return of a period of economic growth and to an adequate supply/demand pricing situation for money. It is thus only a return to normality, nothing more or nothing less.

The same can be observed in currency relationships. The major currencies are once again moving in relatively narrow trading bands, and currency volatilities have diminished considerably. Only the price movements of the Japanese Yen which tend to strengthen when compared to the Dollar and the European currencies, do not exactly fit into this generally peaceful picture.

With respect to economic developments, the 1998 crisis leaves behind rather a dip than a change in trend. The return to clear-cut growth and with it to normality has occurred at an astonishing rate, for example in Asia. With the exception of Indonesia, where above all, political proceedings prevent serious investment activities, the majority of countries again show growth figures in excess of 4 percent p.a. The drop in European corporate export activities in the Far East appears to also have been weathered, and the numbers seem again to be normalizing. Correspondingly, the growth prognosis for Europe can be raised, if only with caution, to about ½% to 1%. However, the most astonishing phenomenon is that, even after the financial market crisis, the American economy is expanding unstoppably and practically inflation-free.

Now it would be completely wrong in view of this quite calming return to normality to underestimate the extent of the Fall crisis of 1998 and its effects on specific mechanisms of global economy and the financial markets. Appearances deceive. There are in fact many indicators and many rates (such as interest, currency ratios, and share prices), which more or less find themselves at the same levels they once held. Nevertheless, a general trend towards more caution and more selectivity is emerging which has never been observed before. These mood changes are abrupt and the consequences are often quite brutal.

3. Darwinian World

As everybody knows, our interpretation of the Fall crisis of 1998 maintained that the sudden collapse of the (to a great extent alleged) guarantee framework of the International Monetary Fund (IMF), placed the multitude of investments in high-risk countries and instruments in a completely new light, and thus led to rigorous and abrupt reassessments of such. This interpretation is shared by most analysts today. We predicted an increase in the separation of the wheat from the shaft at that time and meant by this above all direct investments in the listed countries and currencies.

Now it seems to appear that the distinctly elevated caution and skepticism not only affects emerging nations and related high-risk positions, but also that this mentality above all is spreading over to the stock markets. The valuation differences between individual stocks has become enormous; what one earlier encountered in isolated insignificant segments, is becoming a habit in the field of Blue Chip shares. It was possible to suffer losses this year between 16 percent and 18 percent on investments such as Novartis or Schweizer Rück. In the same period we experienced gains of 56 percent and 32 percent with ABB or Adecco respectively. It can be safely said that neither Novartis nor Schweizer Rück are lying in their death beds, nor that ABB and Adecco are completely without reproach. But the fly in the soup on the one hand and the convincing characteristics on the other take on much more importance than they did before last year's financial market crisis.

Selectivity in Switzerland ...

Winners	*in %*	*and Losers*	*in %*
ABB	+56	Novartis	-16
Swatch (Inh.)	+36	Swiss Life	-17
CS Group	+31	Swiss Re	-18

Source: Bloomberg

This return to more selectivity does not only apply to the Swiss market, but also to the markets of all of Europe and the US. Entire sectors are dissected under the magnifying glass and will experience extreme discounting. Thus, recently the rates for certain internet shares have been halved within less than a month's time. One could dismiss this due to an allusion of previous exaggeration and also due to the lack of experience in this completely new sector. However: the valuation differences are often not any less clear in the classic Blue Chip field.

... in Europe ...

Winners	*in %*	*and Losers*	*in %*
Elf Aquitaine	+74	Glaxo	-21
Philips	+64	Aegon	-21
Nokia	+51	Allianz	-18

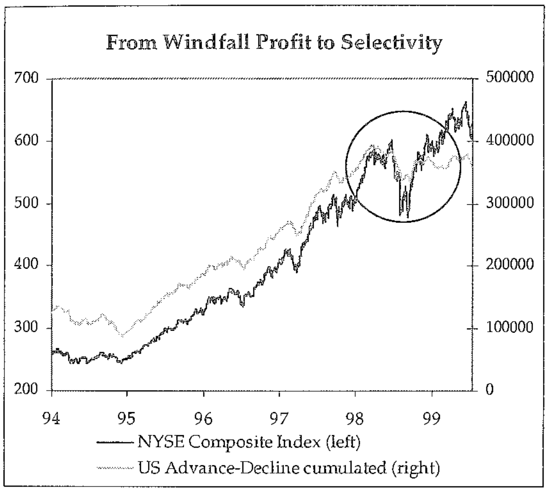
Source: Bloomberg;

... and also in America

Winners	*in %*	*and Losers*	*in %*
Alcoa	+74	Philip Morris	-31
Union Carbide	+51	Cola	-13
Hewlett-P.	+49	Merck	-11

Source: Bloomberg;

Increased sm, repeatedly taking a closer look, before taking an investment decision: this phenomenon is new and must be more closely examined. The following chart shows the development of the broad market indexes of the New York Stock Exchange (NYSE Composite Index) as well as the development of the number of advancing and declining stocks (the so-called Advance Decline Index, cumulated). During the entire market boom since 1992 and up until the financial market crisis of 1998, the movement of the advancing stocks more or less followed the Index. This means nothing more than that the market in its entity moved upwards. Singular movements of specific shares were relatively meaningless against the volume of this aggregated view. This has clearly changed since the Fall of 1998. Even though the Index has risen, the number of distinctly lower and distinctly higher valuations has increased.



Source: GL Research

This means nothing other than that in quick succession, capital is being newly allotted. Every hour, every minute, companies are attempting to be convincing through strategy, product lines, research and development, marketing, profit situation, balance sheet structure, etc., and are being rewarded or punished in their efforts with capital inflow or outflow. This is called market efficiency. What is so remarkable is that this efficiency is not only found in microeconomic textbooks, but actually exists.

4. The End of the No-Brains-Phase

Retrospectively we must honestly confess that one could do no wrong in the prevailing market up to the summer of 1998. One only had to diversify equity investments more or less, and after a while, one was richer. An essential reason for this relatively problem-free "accumulation of wealth" lays in the global interest rate decline and the vanishing inflation problems in the most important world economic countries. A so-called continual "windfall profit" made this exercise simple and pleasant (and has, in our opinion, invited some simple-minded souls to take part and has rewarded them for playing along).

Since the Fall of 1998, interest rates *are* low, inflation *is* at a very low level, and the assessments of companies *have* adjusted themselves to the macro-economic circumstances (this means that they have become generally higher). These developments will not happen a second time. What now counts are the profit and growth outlooks. And because behind every business stand people, more or less clever, who more or less act with foresight, and who exhibit better or poorer leadership qualities; whatever happens now is up to the grace of God in macro-economic heaven, and up to the shifts in capital which follow the micro-economic principle of supply and demand. As previously mentioned, the enormous efficiency which governs today's financial markets is continually being ignored or underestimated. "Efficiency" used to be a subject in micro-economic textbooks only. Today it is a reality.

In two respects, the No-Brains phase is history. On the one hand the *investor* does not get around the careful consideration of why and to whom he is giving his capital. One can no longer expect genuine windfall profits à la 90's by pure indexing or indiscriminate "random-walk investments". The intelligent investment, which is chosen as a result of clear and convincing criteria, holds a fundamentally higher importance in such surroundings.

It is not by accident that our Bank has invested considerable energy into a quantitatively-oriented, consistent investment system in the last 12 months, in order to be able to filter out of the immense universe of possible investments those who hold up to our criteria of enduring capacity for growth and prosperity. The results of this work will gradually be passed down to our clients and readers. Moreover, the "yellow pages" of our Investment Commentary will be re-designed. In a first phase we will invest our Equity Fund "W2" according to the list of stocks chosen in connection with this investment system.

No brain – no gain: This also applies to the opposing side, to *businesses*. Because when markets set so clear preferences, judge so brutally, send such clear signals as to capital in- and outflow, then corporate management as well remains exposed to the influence of this constant pressure. There is no issue which can be quoted unsatisfactorily over a longer time, without someone calling out that "something now has to happen". In Switzerland, the managers of Novartis, especially, Ciba, UBS and Zürich, are exposed to increasing pressure.

Obviously it is predictable that on the wave of restructuring in the nineties which in the first place was aimed at the adjustment of capital structure (utilization of hidden reserves, shifting of capital into more profitable assets, etc.), a second much more fundamental wave of restructuring will follow in which companies would (and must) seek their optimal form and size. Not the merger, the mega-merger, will become the subject of this new design, but rather portfolio optimization by spin-offs and acquisitions. The chain-saw will not be the tool of choice, rather the scalpel. More and more this new type of corporate financial business will come under the control of specialized companies rooted in financial sectors, which possibly at first glance might be condemned as raiding behavior, but consequently will assume the role of a natural necessity in a liquid corporate market.

Undoubtedly in this world of new restructuring necessities, accidents will happen, entire enterprises will fall to the wayside, social chasms will yawn. The possibility to lose money in grand style will be very real for the investor. Understandably reasoning that at least not everything will be wrong, opens new possibilities. The question is whether it is enough to recommend "shares for all seasons".

5. Equity – Is there any Alternative?

It is legitimate to argue that, with the end of the "windfall profit" situation, the end of the concept "equity savings" has also come. Such notions could only have been nourished by the (relatively) low-risk stock market booms of the nineties. In fact shares have been again proven to be dangerous instruments, which are hardly suitable to be placed in the framework of investment positions in which the primary goal is that of safety. Shares for all seasons – this could be a problematic prescription.

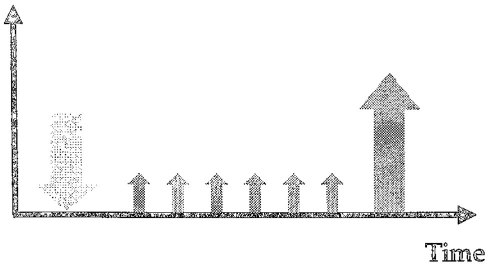
Indeed, we have had the feeling that for the past 10 years, things have gone much too well in financial markets for many participants and above all for their advisors and assistants. A comparison with the situation on the Swiss property market of the 70's and 80's cannot be denied: At that time one only had to purchase early on a few square meters of land, and was then practically assured of speculatory gain. Also at that time the property market drew diversity; even the most stupid real estate sharks were successful. Until in the 90's came the rude awakening, and the real estate business became most selective, and a situation arose which was characterized by a coexistence of the highestvalued and the most-worthless of properties right next to each other.

The problem with the argument against equity investments lies in a twofold economic condition. Since, firstly, exactly *because* equity holdings return are more venturesome, their return *is* also higher. A lengthy continuation of the "windfall profit" situation of the 90's would ultimately have had to bring an end to these excessive gains. Basically we must also be happy about the situation of selectivity which has arisen. Secondly: risk, in its negative form, is mostly of a short-term or specific nature. Said tongue in cheek: What does not kill me right away, will not hurt me in the long-term. The long stability and the prevention of extreme situations in which the investor depends only on a few positions (which in isolated cases could eventually become worthless), are the only situations in which equity holdings or also other risky investments are really justified. The only relevant question is whether one possesses the time and/or enough reserves (including nerves!), in order to be able to cope with setbacks. In other words, "stocks for all seasons" depends upon at which point in time one has the time and/or reserves at one's disposal, and is in itself a question of degree and time.

6. All depends upon the Architecture of the Payment Flow

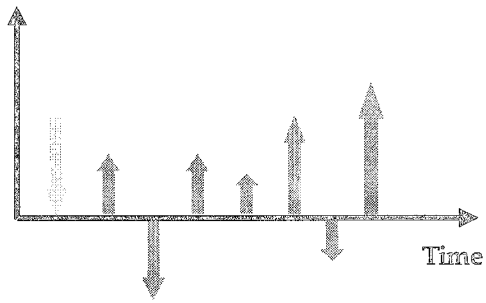
In principle there are two ways to be able to have the opportunity to enjoy payment flows at distant points in time. Either one protects himself for a specific period with an expected, constant flow of payments, or one allows himself the promise of cash flow, its amount and regularity relying on various probabilities. Should the first alternative be chosen, one is a bond investor or salaried, and subsequently must forego a high yield.

Payment Flows of a Bond



Constant payment flows are literally something very unnatural: in real life they practically do not exist. Everything flows and changes, runs dry and swells. One has to pay a high price for a constant flow from the reservoir. It is exactly the same in the economy. For the most simple, because they are nonrecurring and most probable, and because they mature in the near future, the flow of payments from money market instruments yield lower interest rates than for the already more complex bonds with their graded payment schedules and their longer- terms bristling with higher failure probabilities.

Payment Flows of a Share



Contrary to frequently expressed opinions, shareholding is also a vehicle for future payment flows. This encompasses the value which the enterprise is capable of creating. Since the generation of increased value merely is probable regarding its realization and amount, and since these probabilities vary over time, the price of shares fluctuate. And for the shareholder the flow of payments also fluctuates: At one point in time they are extremely high, but perhaps one year later they are negative, and soon thereafter they swing back to a reasonable growth level. Unlike bonds, the flow of payments are so-to-speak virtual, because with the exception of dividends, there is no actual money flowing back to the investor. The influential profits and losses which control the flow of payments are of a "non-realizable" nature. Whether "realized" or "non-realized": economically and in reality nothing has changed the flow or payments, since one *could* realize them at any time.

For this up and down and the constant insecurity as to which direction the next day will lead, the investor receives on average a higher compensation, and it is this high average which makes it more attractive. The table below, drawn from long-term observations, shows the achieved yield differences for money market investments, bonds, and shares in various currencies.

Long-term Yields

	Money Market	*Bonds*	*Stocks*
Switzer-land	3.4 %	4.7 %	10.5 %
USA	3.8 %	5.2 %	10.6 %

Source: Leu, Pictet, J.G. Siegel 1998

Of course the financial markets offer much more complex payment flow models than the "plain vanilla" bond and the ordinary, "run-of-the-mill" share. One can, for example, award bond-like characteristics to stock holdings with structured products; by means of bond with equity option, one does exactly the opposite. The principle, however, remains the same: The steadier and safer the payment flow, the lower the compensation.

Whether equity is suitable for all seasons is a question which only can be answered if all other flows of payment which are involved in life, are also taken into consideration. Typically the Spring of one's career is marked by fixed payment flows stemming from wages, and also for the first time some savings in small amounts can be put aside. Frequently between the ages of 35 and 45 the building up of a family and the purchase of a house adds increased burdens, followed by a second phase in flow of payments, supplemented by more and more share-like bonus payments. After completion of one's active career, wage and salary payments dry up, and now as a substitute, payment flows which stem from savings must come into play. It is obvious that a lifelong pension covering this need is now standing in the foreground. The crux of the matter is: a pension is from the same family as the bond, and accordingly there is a high foregoing of returns. At today's interest rate level this can really hurt.

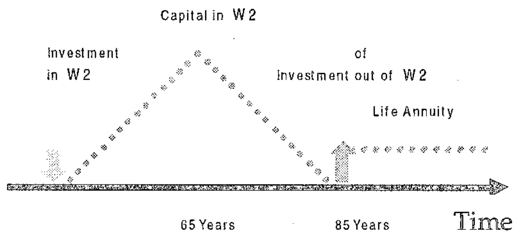
Therefore, and in view of the constantly-expanding life expectancies enjoyed in our part of the world (and which of course, appear to cut pensions due to their longer pay-out periods), we must ultimately ask the question as to what extent shares play a role in the Autumn season of life.

7. Life Cycle Cash Flow Planning: From Undefined to Formula

There exists rich literature covering the topic of how assets should be managed over a lifetime, respectively, what do individuals normally do with their money. We derive our pragmatic approach from the principle cited jokingly above: "What does not kill me right away, will not hurt me in the longer term." This means nothing other than only after the conscious securing of a satisfactory amount of continuous payment flows, that one can afford to extend investments into higher-return (and higher-risk, i.e., inconstant and uncertain) flows of payment.

As private bankers we are often confronted with literally the "last" question. Even in old age, the fact of the matter of passing away is still yet postponed to a distant unknown future. During the time "in between", there legitimately exist great fears and doubts of financial nature. Old age and nursing homes, high medical and hospital costs dim an already dismal horizon. We have experienced that only by really and sufficiently guaranteeing a continuing flow of payments, can we build the confidence that is necessary in view of this phase of life not to put too many reserves aside which are only low-yield.

The FIA-Model



Source: :

There is, in other words, a discrepancy between the subjectively very long and therefore presumable very expensive last phase of life, and the objectively limited, when also mostly more than sufficiently available financial resources to be bridged over. This kind of Life Cycle Cash Flow Planning has been built into the Allfinanz product "FIA – Liberty for Retirement", in which a life annuity after a certain age (for example after 80 or after 85 is set up). This will provide a continuous cash flow when life presumably becomes more expensive and one is not in the position to do something about it. The inclusion of these constant payment flows permits higher risks in earlier stages of life for the accumulated assets and, should it be necessary, recommends a savings plan.

„FIA – Liberty for Retirement" is an example which is an especially good illustration of how the incorporation of constant payment flows can influence investment behavior, respectively the liberty to be able to invest. The great similarity of the needs of the aging population made it possible for us to form a workable formula in product form. Due to demographic development, it will certainly have its marketing possibilities.

The incorporation of constant flows of payment is of course also possible for other phases in life and, also on a client-specific basis can be considered imperative. Economically-viewed, constant payment flows increase investment horizons, and a broad horizon is just what is needed when one would like to make use of inconsistent, uncertain, but high-yielding financial instruments such as shares for all seasons in one's life.

KH, September 9th, 1999