

## But You Just Have to Make Money!

### 1. Rotten Eggs?

While disrespectfully violating the principle of leaving earlier investment recommendations to the past, (it lies in the nature of the subject that the effective course of events must at some time or another compromise such forecasts made in uncertainty), the current Commentary bases its comments exclusively on the conclusions drawn in the previous issue No. 200 dealing with the theories of the relationship between the "New" and the "Old" Economy. Seldom has a Bulletin from St. Gall triggered such a great response of support as well as critique. In particular, many readers requested that they would appreciate further clarification of the arguments presented. This is certainly legitimate, because ultimately every client, every investment advisor, every market participant stands before an equally inevitable as well as unpleasant investment decision – one could be wrong.

In view of the virtually breathtaking speed in which the economy is inundated by new businesses in ever increasing varieties of newly developing technologies, we have used in our previous Commentary the rather provocative as well as obvious model of nature emphasizing essentially excessive sperm production to extrapolate the same Darwinian course for the economy: in the end only a few make it! On the basis of figures from American IPO-issues (Initial Public Offerings), we have shown that Darwinism in practice does have an impact. After only three years the chaff has been divided from the wheat. Only a very few companies have granted the investor a formidable return of 1000% or more. Two-thirds of the businesses were quoted under their issue price. Without the largest IPO top performers and the worst flops, an investment in this market would not have even reached a total return of 4%, and this within three years. Not only in the IPO sector of the very young businesses are these illusions constantly de-

stroyed – the newest correction of the technological indexes have shown that even relatively established companies like Microsoft or SAP move within a field of greatest uncertainty. The investors also suffer.

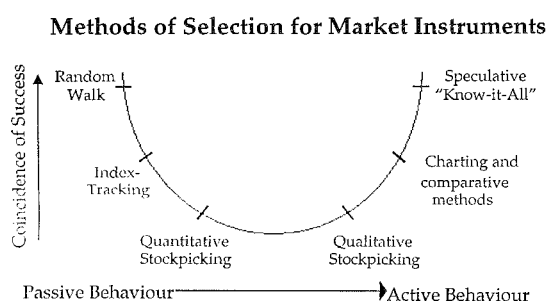
Therefore we have developed the sperm story a bit further; we suggest the theory that, instead of following a sperm strategy (exclusively and with much daring but without much hope for an actual success), the investor would rather be better off to embrace an "Egg Strategy." i.e. investment objects definitely exist in the real thriving, functioning, value-generating "traditional" economy, which objects fertilized by the new technology, have mutated to highly interesting new objects. The prospect for success of the Egg Strategy is among other things higher because the current generated cash flow provides sufficient food and therefore ensures an increased chance of survival. The largely dramatic Cash-Burn Ratios of the "New Economy" enterprises speak a clear language: liquidity bottlenecks are pre-programmed; whether investors will toss money in future to the new businesses to the same degree that they have during the last few months is justifiably doubtful. Boo.com, a sports and clothing dealer in the Internet has apparently blown 120 million Euros within a 6 month period. The recently exalted star is now broke. Is this the first of many to come?

The Egg Strategy, as an alternative to the high-risk investments in the pure "New Economy" sphere, is convincing due to its simplicity. In response, the objection can be raised that the practical application could nevertheless be difficult, because, in view of the speedy pace of things, who can say what is capable of survival and what is not. It is our desire in this Investment Commentary to show that doing basic economic homework can help.

### 2. Between the Magical Mystery Tour and Knowing It All

We are obviously aware that the catchword "selection" which, although is very stimulating, will hardly remain in the centre of a discussion about

the efficiency of the financial markets. Namely, if the efficiency theory had its unlimited accuracy, then it would not matter at all which financial instrument is chosen by an investor – the markets will see to it that the return/risk characteristic finds justice in the pricing of all its elements. The other way around, it certainly would not be worthwhile to make any effort to search for “intelligent” investments. The market will take care of that, too. The “Magical Mystery Tour” or the so-called “Random Walk” finds approval in theory. However, we must confess that we know of no single investor who uses this strategy in practice. It contradicts the human need to control one’s own affairs and actions. We dare to say that something redundant clings to it: markets are only efficient because the individual information accumulated by all of the market participants is recognised in the market price.



If all the market participants undertook a “Magical Mystery Tour,” then they would not have the slightest information position and subsequently the markets would not be efficient. As always: a “Random Walk” is incompatible with the search for non-rotten eggs.

In the above diagram, we try to organize the most common selection procedures for financial instruments in two dimensions. There exist more active and more passive procedures. And there is the success obtained by chance as well as that achieved through systematic work, which is more likely. And there is also the possibility of failure. Because we do not move in the realm of clarity, a high level of uncertainty and of risk prevails. Due to the positive risk-free return (money has its price over time), financial instruments, however, lie on average and over the long-term generally “in profit,” which is why none of the illustrated methods of selection are completely unsuccessful.

However, it proves also that no selection process is completely superior, because the continually (and from time to time, galloping) changing conditions see to it that even the most clever meth-

ods eventually walk on sand. So it was immensely reassuring to hear that even a dare-devil like Soros had experienced horrible losses (respectively, those who trusted him in the Quantum Funds with their money). But also the totally dull “Know-It-All” at the beer table will not only experience failure, as his neighbours would often like to wish. From time to time he will have some good luck, and then again bad luck (which he will carefully hide at his favourite haunt). On average, though, he will probably not nearly achieve the success that he would, should he play a game of darts with arrows. With a view to his intellectual performance, he is close to the “Random Walk,” but certainly is inferior insofar as he trades extensively pro-cyclically by his constant stare at the last few market minutes. On a “Random Walk” the danger of understanding past trends is gone.

### 3. Much Speaks for a System

The major part of investment activity is not involved with specifically high-risk-characterized instrument categories for the achievement of high returns. Rather the choice of an investment instrument must always keep the needs of the client foremost, and we believe that a very systematic appraisal brings with it essential advantages which other methods cannot offer. On the one hand, the knowledge of portfolio theory regarding the possibility of optimizing the obtainable yield at a given risk can only be used when the employed financial instrument is completely transparent. On the other hand, every method, which does not take into consideration the possibility of very dynamic changes in the business world and cannot deal with them, will fail in times of structural destruction. To invest and then go to sleep, as Kostolany recommended, cannot be a recipe to follow in the coming years when entire branches of industries will go under.

Or expressed differently: if a system exists in which a valid and relevant *constant* can be employed *across all dynamics*, then it has to be fundamentally successful. It is obvious to us which constant this must be. As trivial as it may be, so undisputed it is. Often, for example, we hear that the stock market has lost “all ties to reality,” the prevailing prices have nothing more to do with the real economy. In a weaker and a bit more cultivated form this reproach is called “Asset Inflation.” And when we do not understand anything at all any more, we say that it’s all “only psychology” anyway – whatever that means!

The trivial knowledge and with it, the constants on which our system is based, lie in the necessity of each maintainable economic value, which must support positive future cash flow. You just have to make money! Only then has one proved that "one" can – or at least is able to in the future.

We, of course, already hear the protest: "What about the Internet stocks, whose totally ridiculous prices cannot in any way be supported by anything in the direction of future cash flow?" There are two answers to this objection. Firstly, the Nasdaq has shown last week that steep declines can be tied to these high valuations. Too high expectations can be cooled down extremely quickly as well as brutally. The idea of a basic parallelism between maintenance of economic value and the market price of a financial instrument does not imply that a market participant cannot be occasionally fooled. Over time, however, trial and error even things out, which confirms the parallelism. Secondly, the economist Heinz Zimmermann of St. Gall, has commented recently in a noteworthy article, that with respect to these Internet shares, we are rather dealing with options which for the most part are far "out of the money," and whose underlying value as well as date of maturity additionally are relatively unknown. The high appraisal justifies itself nevertheless, should the present uncertainty reveal itself in one or the other case as the great success story of tomorrow.

#### The Discounted Cash Flow Model

$$\text{Share Price} = \frac{\text{Cashflow in Year 1}}{(1+r)} + \frac{\text{Cashflow in Year 2}}{(1+r)^2} + \dots + \frac{\text{Cashflow in Year n}}{(1+r)^n}$$

r: Discount Factor (Capital Cost Rate, resp. WACC)

However, the "Discounted Cash Flow Model", which refers to the trivial constants which are only of value should they bring future positive yields, acknowledges that the existing market share price reflects the expectations of the investor with reference to the discounted future profits (in economic jargon – the so-called free cash flow). Put another way: the market capitalization of a business represents the present value of the (expected) profits in Year 1, Year 2, Year 3 (and so forth), up to Year "n." Year "n" lies in the undefined future. However, due to the discounting procedure, one tends to neglect to say – more than 10 years into the future.

Therefore, as a result, the question arises as to how we should assess the probability of future

profits. Searching for non-rotten eggs, we can derive suitable forecasts for the future by way of various deductive methods based on that which we know (or least what we can deduce from the information available). It must always be kept in mind that the highest priority is the ability to obtain future profits.

#### 4. Whoever Creates Value Today Will Make a Profit

Suppose we are especially interested in those businesses which are the most attractive in the food sector. Would it be a Nestlé, a Unilever, could it be Coca Cola? Our first criterion would be to judge the ability of future profit attainment based on income potential to date. For all of the companies in this sector which are of interest (we will limit this due to practical reasons to the 40 or 50 largest world-wide), we calculate their increase in value by calculating the difference between their Return On Invested Capital (ROIC) and the Weighted Average Costs of Capital (WACC). The result is called the "Value Spread." And we will assume in the following that an ability so proved will not collapse so quickly in the future. Of course, we place more weight on recently occurring events than those of the distant past, because we believe that they are more relevant to the future.

After we have carried out all of the calculations, we are then able to construct a ranking order, which is independent of all absolute figures and of all currencies or country-related particularities. In the Table below, we have presented the ranking order for the food sector.

We have highlighted No. 5 on this list, Philip Morris. In the subsequent Tables which are ranked by other criteria, but always organized with an eye to future profit potential, we will continue to follow Philip Morris. To begin with let us examine a few details of this company.

| Title                       | Value Spread | Title                     | Value Spread |
|-----------------------------|--------------|---------------------------|--------------|
| 1 UNILEVER (UK)             | 17%          | 23 HEINZ HJ               | 5%           |
| 2 WRIGLEY WILLIAM           | 17%          | 24 BRIT. AMERICAN TOBACCO | 4%           |
| 3 GENERAL MILLS             | 16%          | 25 LINDT & SPRUNGLI R     | 4%           |
| 4 QUAKER OATS               | 16%          | 26 ALTADIS                | 4%           |
| 5 PHILIP MORRIS             | 16%          | 27 SARA LEE CORP.         | 3%           |
| 6 NUMICO (KON.)             | 14%          | 28 RICHEMONT B 'A'        | 2%           |
| 7 COCA COLA                 | 14%          | 29 DIAGEO                 | 2%           |
| 8 RALSTON PURINA RAL-PUR GP | 13%          | 30 CONAGRA                | 1%           |
| 9 UNILEVER CERTS. (NA)      | 13%          | 31 TATE & LYLE            | 1%           |
| 10 CAMPBELL SOUP            | 12%          | 32 PERNOD-RICARD          | 0%           |
| 11 BESTFOODS                | 12%          | 33 JAPAN TOBACCO          | 0%           |
| 12 CADBURY SCHWEPPES        | 10%          | 34 ORKLA                  | -1%          |
| 13 ANHEUSER-BUSCH           | 8%           | 35 ALLIED DOMECQ          | -2%          |
| 14 PEPSICO                  | 8%           | 36 KIRIN BREWERY          | -2%          |
| 15 KELLOGG                  | 8%           | 37 DANONE                 | -2%          |
| 16 NESTLE R                 | 8%           | 38 COCA COLA ENTS.        | -3%          |
| 17 SYSCO                    | 7%           | 39 ARCHER-DANIELS-MIDLAND | -3%          |
| 18 HEINEKEN                 | 6%           | 40 TAKARA SHUZO           | -3%          |
| 19 SOUTH AFRICAN BREWS.     | 6%           | 41 ASAHI BREWERIES        | -3%          |
| 20 HERO B'                  | 6%           | 42 SEAGRAM                | -4%          |
| 21 ITO EN                   | 5%           | 43 AJINOMOTO              | -4%          |
| 22 FOSTERS BREWING GP.      | 5%           |                           |              |

Whoever believes that Philip Morris is only in the tobacco business is mistaken. Today the company realizes about 60% of its sales volume from tobacco and the rest is divided into actual food (Kraft, Jacobs) and beer (Miller). Indeed the tobacco business still proves to be the most profitable; almost 70% of profits stem from this division. For strategic reasons, Philip Morris began to diversify to non-tobacco sectors years ago. As is well known, the entire US tobacco branch feels intimidated by the problems involving threatening court cases by the "victims" of the smoking habit, in whose favour judgments are being handed down in sums amounting to billions of Dollars. Although Philip Morris reached a so-called "Master Settlement Agreement" in 1998, this deal burdened the profit and loss statement with over 3 billion Dollars. Nevertheless, this Achilles' heel remains in an otherwise "fit as a fiddle" corporation, as we will see. Since the stock market is aware of this sore point, the shares are priced notoriously low, so to speak. It is exactly this that makes Philip Morris attractive for the following rationalization.

#### 5. Whoever is Already Profitable Today Will Make a Profit

We have explained in epic length in some of our earlier Investment Commentaries why the maximization of the profitability measured by the so-called "Return On Equity" (ROE), is so problematic. Firstly, this factor is very susceptible to short-term balance sheet cosmetics. When equity is paid back and third-party debt is increased, then the ROE reacts positively (Leverage Effect). In this case the short-term maximization of "returns" (reported corporate profits) is also dangerous, because it could lead to the neglect of long-term investments. We have, therefore, already repeatedly expressed strong criticism of corporate-internal incentive programs which are tied to ROE. In fact we view such bonus systems with disdain.

| Title                  | Δ ROE | Title                           | Δ ROE |
|------------------------|-------|---------------------------------|-------|
| 1 GENERAL MILLS        | 123%  | 23 JAPAN TOBACCO                | 0%    |
| 2 QUAKER OATS          | 123%  | 24 CADBURY SCHWEPES             | 0%    |
| 3 CAMPBELL SOUP        | 45%   | 25 TAKARA SHUZO                 | 0%    |
| 4 SARA LEE CORP.       | 34%   | 26 FERNOD-RICARD                | -1%   |
| 5 BESTFOODS            | 23%   | 27 WRIGLEY WILLIAM              | -1%   |
| 6 UNILEVER (UK)        | 5%    | 28 TATE & LYLE                  | -1%   |
| 7 PHILIP MORRIS        | 4%    | 29 ASAHI BREWERIES              | -1%   |
| 8 HERO B'              | 4%    | 30 ARCHER-DANIELS-MIDLAND       | -1%   |
| 9 ITO EN               | 3%    | 31 ORKLA                        | -3%   |
| 10 ANHEUSER-BUSCH      | 3%    | 32 SOUTH AFRICAN BREWS.         | -3%   |
| 11 SYSCO               | 3%    | 33 COCA COLA ENTS.              | -3%   |
| 12 PEPSICO             | 2%    | 34 KELLOGG                      | -3%   |
| 13 HEINEKEN            | 2%    | 35 UNILEVER CERTS. (NA)         | -4%   |
| 14 ALTADIS             | 2%    | 36 ALLIED DOMECQ                | -4%   |
| 15 LINDT&SPRUNGLI R    | 2%    | 37 RICHEMONT B'A'               | -4%   |
| 16 FOSTERS BREWING GP. | 1%    | 38 DIAGEO                       | -8%   |
| 17 DANONE              | 1%    | 39 CONAGRA                      | -8%   |
| 18 NESTLE R            | 1%    | 40 COCA COLA                    | -14%  |
| 19 KIRIN BREWERY       | 1%    | 41 RALSTON PURINA RAL-PUR GP15% | -18%  |
| 20 SEAGRAM             | 0%    | 42 NUMICO (KON.)                | -18%  |
| 21 HEINZ HJ            | 0%    | 43 BRIT.AMERICAN TOBACCO        | -513% |
| 22 AJINOMOTO           | 0%    |                                 |       |

So it may be all the more astonishing that we include the ROE as a factor in our profitability ranking system. There are two main reasons and one important exoneration. The first main reason for including the ROE lies in the availability of the data. It's not so easy to find a measurement of profitability which is valid and compatible across all national or continental bookkeeping systems. It doesn't help us either when perhaps more sophisticated factors arrive so late that they no longer hold any market significance. The second reason is that the ROE allows for relevant comparisons within a specific sector. To our "exoneration" we hold that we, of course, do not rely only on the ROE of a single year, but rather always use a weighted average of the changing rates over several years. It is probable that cosmetic manipulations of balance sheets will even themselves out over the time period under examination. Completely apart from that the ROE is not a factor which stands alone; our first factor – the Value Spread – takes into consideration the total capital costs (third-party debt and equity capital).

In order to be able to make comparisons within a sector, and yet be able to arrive at the "correct" or "adequate" ROE which is relevant across national and continental-specific applications, we do not utilize the factor but rather the respective rate of change from year to year.

Now what profitability does Philip Morris show and how does its position compare with the competition? The Table amazingly shows us great differences in the changes in profitabilities within the whole sector. There are a few leaders and a few underdogs whose numbers are subject to special influences. Philip Morris occupies a rather prominent position with a growth in profitability of 4%, despite the "Master Settlement!"

#### 6. Whoever Can Sell Profitably Today Will Make a Profit

A further approach towards the probability of future profits takes place by the assessment of the margin-relationships of the interested businesses within a sector. Undisputedly, there exist margin-richer and margin-poorer types of businesses. Luxury watches and fashion accessories can bring in far more than 100% of their production costs when sold. The proportions are basically different when it comes to bags of cement, corn flakes and orange juice. Nevertheless, "almost-commodities" too must have their margin differences monitored.

| Title                        | CF/<br>Sales | Title                     | CF/<br>Sales |
|------------------------------|--------------|---------------------------|--------------|
| 1 NUMICO (KON.)              | 28%          | 23 LINDT&SPRUNGLI R       | 10%          |
| 2 PEPSICO                    | 20%          | 24 UNILEVER CERTS. (NA)   | 9%           |
| 3 COCA COLA                  | 19%          | 25 UNILEVER (UK)          | 9%           |
| 4 ANHEUSER-BUSCH             | 18%          | 26 COCA COLA ENTS.        | 9%           |
| 5 CAMPBELL SOUP              | 17%          | 27 SARA LEE CORP.         | 9%           |
| 6 RICHEMONT B 'A'            | 17%          | 28 HERO 'B'               | 8%           |
| 7 WRIGLEY WILLIAM            | 17%          | 29 ALLIED DOMECQ          | 8%           |
| 8 PHILIP MORRIS              | 16%          | 30 ARCHER-DANIELS-MIDLAND | 7%           |
| 9 SOUTH AFRICAN BREWS.       | 16%          | 31 ASAHI BREWERIES        | 7%           |
| 10 HEINEKEN                  | 15%          | 32 PERNOD-RICARD          | 7%           |
| 11 RALSTON PURINA RAL-PUR GP | 15%          | 33 TATE & LYLE            | 7%           |
| 12 BRIT.AMERICAN TOBACCO     | 13%          | 34 TAKARA SHUZO           | 6%           |
| 13 CADBURY SCHWEPES          | 13%          | 35 ORKLA                  | 6%           |
| 14 FOSTERS BREWING GP.       | 12%          | 36 JAPAN TOBACCO          | 5%           |
| 15 QUAKER OATS               | 12%          | 37 KIRIN BREWERY          | 5%           |
| 16 GENERAL MILLS             | 12%          | 38 SEAGRAM                | 4%           |
| 17 BESTFOODS                 | 12%          | 39 CONAGRA                | 4%           |
| 18 KELLOGG                   | 11%          | 40 AJINOMOTO              | 4%           |
| 19 DIAGEO                    | 11%          | 41 ITO EN                 | 4%           |
| 20 HEINZ HJ                  | 10%          | 42 SYSCO                  | 3%           |
| 21 NESTLE R                  | 10%          | 43 ALTADIS                | 3%           |
| 22 DANONE                    | 10%          |                           |              |

Firstly it lies within the competence of the supplier to create a brand name, and whether an essentially analogous product can be sold at higher prices. In this case, margins are not easily pushed through. It is the sales representatives who always tend to ask management for lower margins, because they are then more able to generate high sales volumes, above all, in a more pleasant way. The leadership qualities of management stand therefore with respect to the building up of brand names as well as with respect to the "stick-to-itiveness" of the margin policy in a direct correlation with the question of how much margin can be charged.

Our factor "Cash Flow Margin" is derived from the profits attained before depreciation over a number of years, divided by the corresponding sales volume. The higher the volume and the lower the profit, the even lower the sales margin. In the Table it is striking to observe that several of the "almost-commodity" suppliers such as Coca Cola, Anheuser-Busch or Heineken occupy prominent positions, while typical food-stuff producers such as Nestlé, Danone and Unilever show rather disappointing rankings. That the luxury goods specialist Richemont is placed high margin-wise, is less surprising. Philip Morris landed in 8<sup>th</sup> place.

### 7. Whoever is Productive Today Will Make a Profit

| Title                     | Asset<br>Turn-<br>over | Title                        | Asset<br>Turn-<br>over |
|---------------------------|------------------------|------------------------------|------------------------|
| 1 SYSCO                   | 434%                   | 23 LINDT&SPRUNGLI R          | 106%                   |
| 2 ALTADIS                 | 274%                   | 24 COCA COLA                 | 102%                   |
| 3 CONAGRA                 | 207%                   | 25 PEPSICO                   | 102%                   |
| 4 ITO EN                  | 189%                   | 26 SOUTH AFRICAN BREWS.      | 102%                   |
| 5 QUAKER OATS             | 182%                   | 27 PHILIP MORRIS             | 101%                   |
| 6 SARA LEE CORP.          | 174%                   | 28 AJINOMOTO                 | 100%                   |
| 7 GENERAL MILLS           | 156%                   | 29 ASAHI BREWERIES           | 97%                    |
| 8 JAPAN TOBACCO           | 147%                   | 30 KIRIN BREWERY             | 95%                    |
| 9 UNILEVER CERTS. (NA)    | 141%                   | 31 ANHEUSER-BUSCH            | 94%                    |
| 10 KELLOGG                | 139%                   | 32 RALSTON PURINA RAL-PUR GP | 90%                    |
| 11 WRIGLEY WILLIAM        | 139%                   | 33 CADBURY SCHWEPES          | 88%                    |
| 12 UNILEVER (UK)          | 139%                   | 34 DANONE                    | 88%                    |
| 13 BESTFOODS              | 134%                   | 35 BRIT.AMERICAN TOBACCO     | 83%                    |
| 14 NUMICO (KON.)          | 133%                   | 36 PERNOD-RICARD             | 83%                    |
| 15 TATE & LYLE            | 132%                   | 37 ORKLA                     | 82%                    |
| 16 NESTLE R               | 132%                   | 38 COCA COLA ENTS.           | 69%                    |
| 17 TAKARA SHUZO           | 124%                   | 39 RICHEMONT B 'A'           | 63%                    |
| 18 HERO 'B'               | 118%                   | 40 FOSTERS BREWING GP.       | 61%                    |
| 19 HEINZ HJ               | 115%                   | 41 DIAGEO                    | 59%                    |
| 20 CAMPBELL SOUP          | 112%                   | 42 SEAGRAM                   | 44%                    |
| 21 ARCHER-DANIELS-MIDLAND | 111%                   | 43 ALLIED DOMECQ             | 42%                    |
| 22 HEINEKEN               | 107%                   |                              |                        |

Productivity is generally defined as added value per time unit. For our purpose of comparing different businesses within the same sector, we take as a quotient the annual turnover and the assets in the balance sheet. The higher the turnover and the lower the balance sheet total, the higher the factor. Again we do not rely on the results of only one year, because temporary boom phases would otherwise influence the result too strongly. However, the most current outcome is weighted most strongly in order to take corporate dynamics sufficiently into account.

From the Table we can see that there are quite large differences within the sector. The investment-intensive breweries do not belong to the most productive foodstuff producers. Philip Morris occupies a spot in the middle.

### 8. Whoever is Growing Today Will Make a Profit

Analysts generally tend to attach too little weight to dynamics. Balance sheets and annual accounts are fixed-term related highlights of things which change every day. Of the four factors described up to now, we have found a remedy in that we operate with changing rates or at least with a dynamic weighting drawn over several years. The fifth variable is completely dedicated to dynamics as such. We will attempt to filter out the companies which exhibit the greatest growth dynamics within a sector.

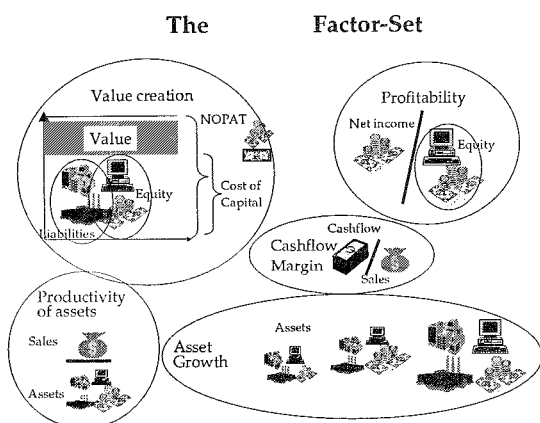
| Title                        | Asset<br>Growth | Title                   | Asset<br>Growth |
|------------------------------|-----------------|-------------------------|-----------------|
| 1 NUMICO (KON.)              | 169%            | 23 CONAGRA              | 3%              |
| 2 ALTADIS                    | 136%            | 24 TAKARA SHUZO         | 3%              |
| 3 BRIT.AMERICAN TOBACCO      | 66%             | 25 JAPAN TOBACCO        | 3%              |
| 4 SEAGRAM                    | 43%             | 26 AJINOMOTO            | 3%              |
| 5 COCA COLA ENTS.            | 20%             | 27 UNILEVER CERTS. (NA) | 0%              |
| 6 ORKLA                      | 12%             | 28 DANONE               | 0%              |
| 7 COCA COLA                  | 12%             | 29 ASAHI BREWERIES      | -1%             |
| 8 LINDT&SPRUNGLI R           | 10%             | 30 HEINZ HJ             | -1%             |
| 9 ITO EN                     | 9%              | 31 KELLOGG              | -2%             |
| 10 HEINEKEN                  | 9%              | 32 ALLIED DOMECQ        | -2%             |
| 11 PERNOD-RICARD             | 9%              | 33 RICHEMONT B 'A'      | -2%             |
| 12 SOUTH AFRICAN BREWS.      | 8%              | 34 BESTFOODS            | -2%             |
| 13 ARCHER-DANIELS-MIDLAND    | 8%              | 35 KIRIN BREWERY        | -3%             |
| 14 SYSCO                     | 8%              | 36 TATE & LYLE          | -3%             |
| 15 WRIGLEY WILLIAM           | 7%              | 37 CAMPBELL SOUP        | -5%             |
| 16 NESTLE R                  | 5%              | 38 UNILEVER (UK)        | -5%             |
| 17 ANHEUSER-BUSCH            | 5%              | 39 DIAGEO               | -6%             |
| 18 RALSTON PURINA RAL-PUR GP | 5%              | 40 SARA LEE CORP.       | -7%             |
| 19 GENERAL MILLS             | 4%              | 41 PEPSICO              | -9%             |
| 20 PHILIP MORRIS             | 4%              | 42 QUAKER OATS          | -11%            |
| 21 FOSTERS BREWING GP.       | 4%              | 43 HERO 'B'             | -12%            |
| 22 CADBURY SCHWEPES          | 4%              |                         |                 |

The annual change in assets averaged over several years serves us as the basis for the variable. With the comparison over several years we are able to catch such things as atypical depreciation, miscellaneous upward revaluations, spin-offs of corporate divisions which have a special influence on the assessment of growth dynamics.

With respect to growth, Philip Morris is in mid-field.

### 9. Future Profit – At Which Price?

Now we must consolidate the individual lists to an aggregate ranking. At we employ a weighting scheme co-ordinated with the specific characteristics of the individual sectors. The question of margin does not have the same relevance in every economic sector. Also asset growth must be weighted differently according to sector. In certain sectors certain variables play no role at all. So one can hardly begin something clever in the financial sector with turnover or with asset growth. In their stead indicators such as "Return On Assets" or the growth of assets hold more meaning. In the food sector, Philip Morris' overall ranking was fourth.



We are still searching for "the Egg," respectively for those businesses which, despite experiencing highly turbulent structural changes, still show a (continuing) high probability to make profits in the future. However, we do not want to acquire these future profits at just any price. We assume, therefore, that the relatively efficient financial markets themselves are not that efficient that one could not purchase "too expensive" or quite "cheap." In conclusion, whether we seek future growth in the upper or lower price ranges, we would like to introduce a last factor. At first glance it might be astounding that we fall back upon the price-earnings ratio which we have reviled many times previously. Our criticism of this factor resulted from the situation that namely "profit" is extremely manipulable. There hardly exists another useable factor should one wish to operate on a world-wide basis. We are forced to accept the "second-best" solution. By dividing the price-earnings ratio by the forecasted growth rate per share, we have defused the problem. The obtained quotient is called the PEG-Ratio (Price-Earnings Growth Ratio).

Earnings growth is an estimated figure. We count on the support of the consensus of the world-wide analyst community. This figure is certainly not correct, but it is seldom not far from the mark. Therefore again, a "second-best" solution. Anyway the result does not change very much on the basis of a somewhat higher or lower estimate, if one accepts the PEG-Ratio merely as an indicator for "expensive" or "cheap" and does consider the second position after the comma as very important.

| Company                         | Points<br>(% from Max.) | EST<br>PE | LT Growth<br>(%) | EST<br>PEG |
|---------------------------------|-------------------------|-----------|------------------|------------|
| 1 GENERAL MILLS INC             | 81                      | 19.62     | 9.89             | 1.98       |
| 2 WRIGLEY (WM.) JR CO           | 73                      | 24.96     | 10.97            | 2.28       |
| 3 KONINKLIJKE NUMICO NV         | 73                      | 23.38     | 10.00            | 2.34       |
| 4 PHILIP MORRIS COMPANIES INC   | 71                      | 7.49      | 11.78            | 0.64       |
| 5 QUAKER OATS CO                | 71                      | 21.70     | 10.35            | 2.10       |
| 6 HEINEKEN NV                   | 68                      | 33.35     | 10.00            | 3.34       |
| 7 ANHEUSER-BUSCH COS INC        | 67                      | 22.95     | 9.82             | 2.34       |
| 8 CAMPBELL SOUP CO              | 67                      | 16.41     | 9.57             | 1.72       |
| 9 BESTFOODS                     | 65                      | 23.05     | 10.59            | 2.18       |
| 10 COCA-COLA COMPANY            | 65                      | 33.70     | 13.27            | 2.54       |
| 11 UNILEVER PLC                 | 64                      | 16.12     | 9.00             | 1.79       |
| 12 ITO EN LIMITED               | 63                      | 60.74     | 11.00            | 5.52       |
| 13 SYSCO CORP                   | 63                      | 30.38     | 13.39            | 2.27       |
| 14 NESTLE SA-REGISTERED         | 62                      | 23.24     | 8.88             | 2.62       |
| 15 ALTADIS SA                   | 62                      | 11.84     | 17.96            | 0.66       |
| 16 PEPSCO INC                   | 59                      | 27.46     | 13.03            | 2.11       |
| 17 LINDT & SPRUENGLI AG-R       | 59                      | 23.49     | 11.77            | 2.00       |
| 18 SOUTH AFRICAN BREWERIES PLC  | 57                      | 12.18     | 8.00             | 1.52       |
| 19 SARA LEE CORP                | 54                      | 13.12     | 11.19            | 1.17       |
| 20 CADBURY SCHWEPES PLC         | 54                      | 18.81     | 9.00             | 2.09       |
| 21 UNILEVER NV-CVA              | 54                      | 18.72     | 8.38             | 2.24       |
| 22 KELLOGG CO                   | 52                      | 16.67     | 9.19             | 1.82       |
| 23 RALSTON-RALSTON PURINA GROUP | 51                      | 17.62     | 11.00            | 1.60       |
| 24 HEINZ (H.J.) CO              | 50                      | 14.82     | 9.62             | 1.54       |
| 25 FOSTER'S BREWING GROUP LTD   | 50                      | 17.72     | 18.04            | 0.98       |
| 26 BRITISH AMERICAN TOBACCO PLC | 48                      | 7.10      | 9.00             | 0.79       |
| 27 HERO AG-BEARER               | 48                      | 13.95     | 7.36             | 1.90       |
| 28 JAPAN TOBACCO INC            | 44                      | 35.82     | 14.55            | 2.46       |
| 29 ARCHER-DANIELS-MIDLAND CO    | 40                      | 18.39     | 10.67            | 1.72       |
| 30 CONAGRA INC                  | 40                      | 12.60     | 10.84            | 1.16       |
| 31 PERNOD-RICARD                | 39                      | 12.89     | 8.80             | 1.47       |
| 32 GROUPE DANONE                | 38                      | 24.17     | 10.47            | 2.31       |
| 33 COCA-COLA ENTERPRISES        | 37                      | 25.08     | 23.86            | 1.05       |
| 34 TAKARA SHUZO COMPANY LTD     | 37                      | n.a.      | n.a.             | n.a.       |
| 35 TATE & LYLE PLC              | 36                      | 7.44      | -5.54            | -1.34      |
| 36 ORKLA ASA                    | 36                      | 15.80     | 12.00            | 1.32       |
| 37 CIE FINANC RICHEMONT-UTS A   | 36                      | 19.72     | 13.61            | 1.45       |
| 38 SEAGRAM CO LTD               | 34                      | n.a.      | n.a.             | n.a.       |
| 39 KIRIN BREWERY CO LTD         | 29                      | 38.06     | 14.60            | 2.61       |
| 40 ASAHI BREWERIES LTD          | 28                      | 50.10     | 46.09            | 1.09       |
| 41 AJINOMOTO CO INC             | 28                      | 53.68     | 21.00            | 2.56       |
| 42 DIAGEO PLC                   | 25                      | 14.29     | 10.00            | 1.43       |

How does this factor function? Let us assume that a company such as Philip Morris has high earnings with a low share price. This would result in a low price-earnings ratio. If we divide this low number by a high denominator, i.e. by a high growth estimate, a low PEG-Ratio results. For high growth one pays a low price. The lower the PEG, the "cheaper" the share. This factor is quite acceptable from a financial theory standpoint, because according to the Discounted Cash Flow Model, future profits are also "hidden" in the share price.

From the Table it is apparent that Philip Morris with its PEG of barely 0.7 definitely stands out when compared to a company like Heineken, which, even though has an almost as formidable a ranking but which is clearly more "expensive." Our favourite Nestlé did quite well, but the

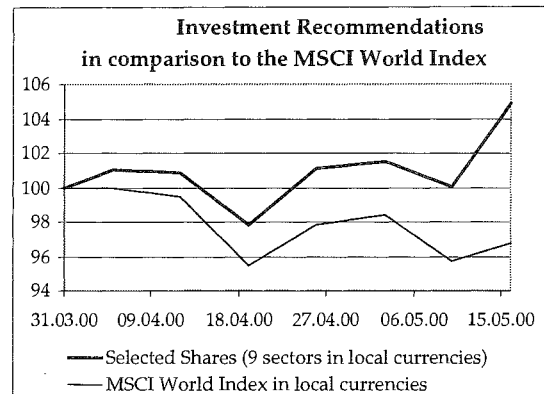
price-earnings ratio seems to be relatively high in comparison to earnings estimates. A high PEG results.

#### 10. What does this mean?

It would be highly improper to lead the reader through this difficult course of the world of figures and quotients, without showing that these efforts to learn the "basic economic homework" are worth it. What we have demonstrated in this Investment Commentary for one sector – the foodstuff sector – is carried out by our Bank on a continual basis for all nine sectors of the global economy. Approximately 400 companies are evaluated with regard to their earned results and their valuation on the stock market. One should be aware of the meaning of a list compiled in this way. It deals largely *not* with a selection of *subjective* feelings and suppositions, but rather subjects a part of the world economy to an *objective* test for future profit potential (admittedly, determined by our criteria). This is quantitative selection.

Of course, the existence of such a list does not exclude that a further, possibly completely different ("qualitative") selection from another point of view, whether analytical or intuitive, can take place. We have suggested, for example in the previous Investment Commentary No. 200, it is necessary that a business can in the future detach itself from vertical structures. This would be crucial for its further success, because this deals with such an additional criterion. And yet, with the pre-selection concerning the future earnings potential, we have a list of those companies which at least (probably!) will be able to financially survive such a structural change.

We have subjected our recommendations from the end of March 2000 to a benchmark comparison, the date we chose to apply our selections method. The results have yet to prove themselves. Up to mid-May our choice of shares, from which we have selected in each case the three fundamentally best companies (i.e. the "best" and at the same time "cheapest") out of the nine defined sectors, have performed clearly better than the world-wide index MSCI in their corresponding national currencies.



Admittedly the observation time span is short. But we also have analogous, positive back-testing material for many previous years. Needless to say we will continue to refine our ranking system and to adapt it constantly to structural change.

The food sector will keep changing if increased business-to-business technology is continually applied. Our factor-set should never be allowed to remain constant, but should constantly be adjusted to fit the changing situations. The same applies to the other sectors. The Pharma sector will restructure itself completely in the light of biotechnology. Vertical organizational forms will disappear in most of the sectors. Nevertheless because of this the investor must be involved as an *Investor in future earnings* ! By means of consistent economic logic we will try again and again to approach the future earnings potential.

KH, June 19, 2000