Investment Commentary No. 213 of January 14, 2002

Investing the year thereafter

1. The blessings of sequencing

Few year ends have been awaited more anxiously than that of 2001. The editorials called it "Annus Horribilis", the year of horror. It was generally agreed that there could hardly be a worse year, which immediately prompted people to spread around a measure of optimism along with a little champagne as the year drew to a close. This, of course, is the purpose of editorials, and optimism, after all, is always a question of the point from which one gazes into the future.

Dividing the flow of time into years, days, hours, minutes and seconds is one of mankind's practical inventions and measures. It helps to put away past things and start new ones. Dividing time is some kind of bankruptcy law for the past, as it were. It would be difficult to imagine having to bear the burden of all past mistakes on a permanent basis. Indeed, the memory of past good fortune may not necessarily sweeten the future, because the past is unfortunately passé... Sequencing time makes it possible to keep track of things, define past matters, assign priorities and guide the capacity to remember. Soon enough, our thoughts will be impressed, completely selectively, only by what particularly pleases or bothers us. Depending on where we stand, the responsibility and the blame will be assigned to us or others.

This treatment of the past and the future has two consequences relevant to the investor. For one thing, there is an innate urge to take an (overly) positive view of things, which may be dangerous. Moreover, there is a tendency toward overestimating one's own judgment with regard to future developments. A review of market projections for 2001 by some major investment houses shows an astonishing convergence of optimism and a rather embarrassing degree of erroneous forecasts of almost 23%, on average(!). But this hardly prevents any of these firms from again being upbeat for 2002, albeit in a slightly more subdued manner. Nevertheless, in light of earlier wrong forecasts, nobody seems to be throwing in the towel. The blessing of loosing track applies to all of them and to some in particular.

Forecasting errors:

Investment firm	Forecast Dow Jones Index 2001	Forecasting error [1] 2001	Forecast Dow Jones Index 2002
JP Morgan	11'000	9.8%	8'500
Merrill Lynch	11'000	9.8%	10'000
Bank of America	11'500	14.8%	10'400
CSFB	12'650	26.2%	11'400
Goldman Sachs	13'000	29.7%	11'850
Lehman Brothers	13'000	29.7%	11'500
UBS Warburg	13'900	38.7%	N/A
Median forecast	***12'293***	***22.7%***	***10'608***

[1] Forecast less closing level as of the end of December

Source: Barrons

To be sure, we do not wish to make the same mistake by engaging in our own unwarranted optimism and overrating our own judgment. This would be extremely unwise in times of performance discussions with asset management clients. Instead, this Investment Commentary serves to examine the question whether thinking in terms of a fixed time period, for the most part a year, meets the requirements for strategic investing. It turns out that slicing up time periods into relatively short spans distorts the view of greater constellations and therefore is dangerous. On the other hand, as a result of this recognition, we will attempt to describe why such a relatively optimistic picture is justified for the longer term precisely when one does not simply throw the past into the garbage bin of history. Qualifying the problems of today and tomorrow through a sober comparison with earlier difficulties and mistakes is altogether promising.

2. The nineties have ended

Some of the readers of this Investment Commentary may recall the broad trends and development patterns we worked out for the nineties of the 20th century. Based on the epoch-making event following the Second World War, the fall of the Berlin Wall at the end of 1989 and the ensuing collapse of the Soviet empire, we pointed to the virtually shock-like ***increase in the availability*** of the production factors ***land and labor*** and predicted a protracted tendency toward negative inflation and monetary easing. The course of inflation and interest rates in the OECD countries supported this forecast during the nineties. This important development was overshadowed by the equally stupendous victory march of modern information and communication technology. It led to a marked ***decrease in information and transaction costs*** on a global scale and the demise of many supply-side cartel structures. The formerly quite unchallenged pricing power on the supply side deteriorated rapidly, with the anti-inflationary forces being strengthened further as a result. The significant increase in productivity between 1995 and 2000 had a similar effect. It occurred mainly in the United States and was primarily confined to the technology intensive sectors. A third broad trend emerged towards the end of the second millennium with the worldwide launching of the Internet technology. Since its introduction, ***knowledge*** is no longer a privilege of educated classes in the wealthy industrialized countries but is available ***in a highly democratized and socialized form*** more or less to the world at large and nearly all social groupings. The consequences of these broad trends are virtually just emerging.

The nineties of the past century were also the time of the self-liquidating government budget deficits in the industrial countries and the giant privatization moves in the former state monopoly sectors. Ironically, socialist and left-wing liberal regimes were mostly in power during that period. They included the Clinton government in the USA, Blair in the UK, Schröder in Germany and Jospin in France. It will be difficult to explain to posterity that all of the enormously positive developments of the nineties took place ***not because but despite of*** these political constellations. History has always tended to perceive in post-hoc fashion a direct causal link between two factors that have consecutive or overlapping characteristics. It is readily apparent, though, that, in view of the virtual absence of an external threat, defense expenditures could be reduced substantially. In addition, the economy's enhanced profitability, coupled with the proceeds from the sale of state enterprises, led to a massive expansion of government revenues. It is no great accomplishment to produce budget surpluses in such a situation. In point of fact, the remainder of the government projects was not reduced but enlarged further during the nineties. Be that as it may – if anyone should enter history as great pioneers of deregulation and privatization, it would not be Clinton and Blair but Reagan and Thatcher.

Therefore, we believe it is difficult to define a political mega-trend for the nineties. In absolute terms, the political sector was no less expansively inclined in this period than previously. Yet, relative to the dynamic nature of the economic growth and to the break-up of economic structures, it had less weight. Clearly, a decline in economic dynamics can cause a shift in this relative weighting. We will revert to this issue in the section dealing with re-regulation and fiscal policy.

Clearly, these ***mega-trends*** of the nineties more or less belong to the ***past.*** As to the possibility of freely using the production factors land and labor, this has already been questioned by the third-world crisis of 1998. The difficult to define the security situation after September 11, 2001, has led to a further discouragement of direct and portfolio investing outside of the OECD countries. There is also resistance on the other side, as the unions, the former guardians of the labor supply monopoly in the industrial countries, have been partially replaced by groupings that act under the label of "globalization opponents" to impede the free exchange of goods and services as much as possible. They are aided by the representatives of agriculture, which is highly subsidized in most OECD countries. The motley group also includes all those who mean well but notoriously have no inkling of economics. – Although China's WTO membership represents a further step in the direction of globalization, it should be noted that globalization's advance has been slowed somewhat and is unlikely to bolster the world economy in the near future.

The second mega-trend, the massive reduction of information and transaction costs through the use of modern information and communication technology, has also slowed down markedly. To be sure, e-mail and Internet platforms have fundamentally changed most operations, and among the participants, many processes have also been simplified, streamlined and freed of cartel structures. But the undeniable success in the business-to-business segment has not matched changes in the business to consumer segment. The traditional channels of distribution for the end user turn out to be surprisingly stable. Significant new impulses for the economy as a whole from this quarter are not in the offing.

The question arises, then, what else is part of the big picture? Are there any new lines of development that might provide a basis for forecasting the future?

3. Contradiction, redundancy and incoherence

Before searching for a new mega-trend, one should be cautious not to generalize too much. It is dangerous to regard the world as a coherent system functioning on the basis of specific or even known rules. It is dangerous because one is much too quickly inclined to derive causalities and formulate recipes. We recently reviewed a study examining the correlation between the economic development of different regions. The sobering result was that there is virtually no meaningful correlation between economic development in North America and Europe. The economies of Japan and the South East Asian "tiger" states also developed completely independently from the rest of the world. In fact, there is no significant dependence among them. The study also investigated various time related differences in the economic development of the two blocks, but there was no apparent interrelation either!

Intellectually, the result of the study is ***extremely alarming.*** Because if it is really correct, it makes little sense to talk about a world economy. This world economy, though, is a favorite of economic experts and analysts. If the study is applicable, it also makes no sense to talk about the United States as a "global economic locomotive." It seems that economic developments are rather attributable to accidents or changes in the internal or external country-specific framework. This is also alarming, because if it is true, reams of analytical material can be thrown away, because which study by the IMF, the OECD and the many other agencies that consider themselves as responsible for the economy do not talk about the locomotive function of the USA? Moreover, all those who seek a solution at the top and care little about improving the basic conditions are proved wrong.

Regional economies that are non-correlated and shaped by accidents or specific changes contrast sharply with the highly correlated financial markets. "When Wall Street coughs..." This is alarming, too. Because if it holds true, the developments on the financial markets have only little to do with specific economic conditions. Which market forecast, however, is not based on projections of economic growth?

Questions on questions in other areas, too. We have pointed out the irony of fate that, of all people, the converging socialist and left-wing liberal governments in Europe and the United States wiped out the budget deficits and became history's heroes of deregulation and privatization. The apparent contradiction is probably simply due to unrelatedness of events. This is difficult to absorb by our causality oriented thinking process.

Even more difficult to understand and accept is a case in which essentially different developments purely accidentally take place during a specific time in the same manner or very similarly. If the regional economies of this world indeed develop in largely independent fashion, a globally converging economic downturn, such as the current one, should not occur. Should it not? Take five dice and roll them until at least four of them show the same number. This happens about every fifty times, on average. If one seeks only a triple (accidental) convergence, the case even occurs every fifth time, i.e. relatively often. This is probably a reason why one likes to talk about a world economy.

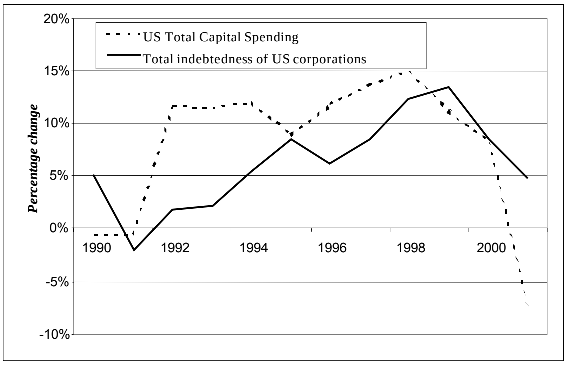
Superfluous mental acrobatics? By no means, because the ***supposed causalities*** ever so often not only prompt analysts and investors to arrive at wrong conclusions but also, even more critically, tempt participants to control the seemingly consistent system. The tendency to delegate assignments one does not want to complete to ever higher levels of authority until they reach the EU, the World Bank and the IMF, is closely linked with completely ***inappropriate conceptions of feasibility,*** from which the world's big agencies derive the justification for their existence and claim on power. We will show later in this report that this is the stuff international crises are made of, such as we have endured over the past ten years, as illustrated by the recent example of Argentina.

4. Searching for new mega-trends

The reservation is that the world economy and world politics either have no system in the narrower sense of manageability, or we do not know and understand it and certainly do not control it. Taking this proviso into account, we will nevertheless try to look for some fairly generally applicable developments that mold the present and will be of significance for the course of events.

First, there is a lot of cleaning up associated with the boom times of the nineties. The historically undoubtedly unique shock of new technologies drove the economy, notably the North American one, to a virtual frenzy of capital investment, which ended in the spring of 2000 and must now be digested. The chart below shows the enormous increase in capital expenditures in the USA and the concurrent corporate indebtedness. The latter is in contrast with the production capacity that current demand requires.

Leverage of the US economy



Source: Bloomberg; own presentation

The de-leveraging of the corporate sector is in progress. Expressed in economic terms, the (in today's view) excessive capital stock is reduced until renewed investing at an anticipated return on capital appears attractive again. This process has been painful and will continue for a while. In practice, de-leveraging for an individual company means writing down overvalued assets as a charge against earnings or equity capital. This would further raise the debt level. To avoid this, one must save. Savings can be achieved by dispensing with capital expenditures or by downsizing. If all of this is no longer possible because of insufficient revenue generation or not enough time to repay the debt, bankruptcy threatens. Put in another way, the process inflicts pain on four levels: (1) The shareholders' claim on the equity capital or the results is reduced; (2) The economy in general is affected because the pressure for savings precludes new capital investment; (3) Employees may be fired, and (4) Creditors may lose their money. Deleveraging is quite unrelated to the level of interest rates, so that the many interest rate reductions by the central bank will have little effect. The process is likely to be lengthy and harsh. For the investor, de-leveraging means the opposite of the wondrous creation of money through stepped up risk taking. A company with a solid equity capital base, a sound balance sheet and strong margins will fare better than some of those champions of creative accounting.

A second mega-trend we pointed out in our Investment Commentary after September 11, 2001, is an acceleration of the ***re-regulation process*** that already started before the terrorist attacks. The privatization wave of the nineties and, above all, the technology euphoria, have created substantial social costs, which the system does not simply absorb without consequences. Probably quite incorrectly but in political terms understandably, the salvation of so-called "market victims" and the like is being sought in the form of additional government controls. As a consequence of last year's terrorist attacks, notably in the United States, nobody dares point to the peril of the government failures, which have been proven and paid for a hundred times. At the present time, everything in the USA that is only slightly critical of government institutions is deemed as "un-American," unpatriotic and possibly treasonous. In Europe, which has a compelling need for sturdy harmonization, the urge to effectively persecute the terrorists came just at the right time to incorporate all sorts of fiscal needs in the realignment of government power. Thus, tax delinquents and cigarette smugglers will henceforth be persecuted with the same police facilities and authority as murderous terrorists. Among the losers is the principle of adequacy of government action.

Re-regulation and renewed focus on the interests of the fiscal authorities are closely related. Half-hearted or inefficient privatization in the energy sector or British railroads, the collapse of semi-government and highly regulated enterprises, such as Swissair and similar cases, leave the impression that the private sector has failed or is essentially incapable of implementing important public sector functions. Although an accurate and impartial analysis would probably produce different results, it should be noted that new privatization efforts in the near future are highly unlikely, and that the trend might actually reverse itself. Catastrophic events such as September 11 have led to drastic government intervention. In Switzerland, the Federal Government and the cantons, under the guise of safeguarding the national and regional interests, invest billions into aviation. The United States has plans for a fiscal stimulation program, the likes of which has been unheard of since the seventies. The relative weight of the government sector is shifting increasingly on the back of the private sector. This will result in new or higher government debt and/or higher taxes.

5. Strategic consequences

The two broad trends described above, de-leveraging in the corporate sector and re-regulation and realignment of fiscal activity, are in progress and shape economic developments to a considerable degree. Investors should have no illusions – such fundamental developments do not enhance prospects for returns. The weight of de-leveraging is born by corporate results or shareholders' equity, and if this does not suffice, the creditors will suffer. Re-regulation as such is a direct cost driver and certainly fills the pockets of lawyers and consulting firms. More detrimental are the indirect costs, which arise from the tendency toward renewed cartel formation and the maintenance of so-called "natural monopolies."

Expectations for the upcomming years

Asset class	3 years ago	Today
Money market CHF	3.0%	3.0%
Money market EUR	4.6%	3.4%
Money market USD	8.0%	5.0%
Bonds CH 3-5	4.6%	3.7%
Bonds EU 3-5	6.8%	5.0%
Bonds US 3-5	11.1%	6.6%
Bonds JP 3-5	6.1%	5.7%
Stocks CH	10.0%	6.1%
Stocks Europe	10.9%	6.8%
Stocks USA	14.2%	9.2%
Stocks UK	11.6%	6.7%
Stocks Japan	7.5%	5.5%

Source: Vescore/own presentation

Based on this new situation, our bank has fundamentally revised the strategic asset allocation. On the basis of a model based on modern financial theory, we have calculated implicit expectations of returns from prices that were generated in financial markets in recent months. They are markedly lower than the returns calculated in the same manner barely three years ago. In other words, the financial model furnishes results that are very similar to the macroeconomic considerations we have developed and presented above.

Changes in expectations of returns call for a rethinking of the portfolio structures. The optimal mix of fixed-income investments and equities is naturally determined by the difference between the anticipated returns and the differences in the risks of both investment categories. The investor will have to decide whether and to what extent he is prepared to bear the risk of equities if he is presumably no longer as handsomely rewarded as in the nineties. But since the expected returns in the fixed-income segment are also lower, and the risk of fixed-income investments in a period of de-leveraging is far from non-existent, the changes in the portfolio structures are likely to be less dramatic than one might have presumed based on the different return expectations three years earlier. After all, investing will remain a function of the opportunities available in the marketplace.

6. Silver linings

The assessment of the situation, then, does not inspire euphoria. Precisely for this reason, it is probably appropriate and important to focus on world reality. After all, in the golden nineties, it was the real changes in politics and technology that unleashed the earlier discussed mega-trends. What is in the offing, perhaps in a start-up mode – where are the silver linings on the horizon?

We essentially discern two phenomena that could change the world and the economic structures profoundly and more rapidly than is currently believed. One hope is called technology and the other one – and this may seem a bit surprising – is Russia.

Let's start with technology. Our analysis is as sober as most hopes between 1998 and 2000 were probably exaggerated. Surely, the objective usefulness of faster chips, enhanced software, greater storage capacity, better data priming and quicker memory access, etc., is hardly immaterial. Nor is it unimportant whether or not video conferences finally begin to function (particularly in a world political situation in which hectic travel activity is unadvisable). Should we not find it relevant that the electronic signature has finally attained practical significance, and that most companies are undergoing structural change by becoming much more flexible and pragmatic in their organizational setups due to the possibilities of e-mail and the Internet?

The implications in the field of biotechnology are receiving even less attention. The general thinking is still dominated by Dolly, the silly lamb which is suffering from arthritis. In the background, a development whose significance can not be overestimated is currently taking place. It involves the departure from inductive medical research toward a deductive approach and the replacement of "dumb" broad band pharmaceuticals by intelligent medications. Biotechnology finally permits the analytical understanding of diseases and the development of specific medicines. Conceivably, this will result in a dramatic reduction of health costs, one of the major problems plaguing industrialized countries.

In the wake of the euphoric nineties, the gold digger ambience and the ensuing katzenjammer, we are witnessing the beginning of a new phase of broad and consistent application of knowledge in all segments of society and business. Thus, just as the railroads did not simply vanish in the aftermath of the industrial revolution and the automobile developed into a recognized means of transportation after most coach builders had been eliminated from the market as car producers, there will be a renewed wave of technology, a second mega-trend. It will be more cautious, more respectable and also a bit more sedate than the first push. It will undoubtedly be profitable for the involved companies. Therefore, it would be a great mistake to shun technology stocks out of sheer spite.

The second silver lining is Russia. Current world economic focus, of course, is on the dramatic crisis unfolding on the other side of the globe, namely Argentina. An initially promising concept, pegging the Argentine currency to the dollar, has failed utterly. Why? Because the stabilization achieved at the beginning of the linkage was not used for structural reforms. Instead, the ample inflow of funds was channeled into the traditional pools of corruption, nepotism and crime. As a result of the peg, Argentina lost one of the more harmless means of getting around structural reform. To wit, it could not devalue its currency. With the aim of propping up the dollar peg, the World Bank extended substantial credit as late as last fall. Now, the bubble has burst, and the international agencies, such as the IMF and the World Bank, are largely responsible for the debacle. They are too strongly influenced by the Wall Street creditors, which seek to avert a default at any price.

Different and distinctly more positive signals are emanating from the country that precipitated a major crisis as recently as 1998. In the meantime, Russia has implemented a few rather remarkable reforms, and with a little luck from higher crude oil prices, the first two years of this reform policy have already been successful for the economy in general . Russia's economy grew by 8% in 2000 and 5% in 2001. The reforms to date have concentrated on income and company taxation. Russia is the only country worldwide that decided to introduce a flat tax. For private persons, the tax rate is 13% and for company profits it is 24%. Even a Swiss might consider moving to Moscow. In the area of social contributions, Russia has opted for a capital covered approach, which even gives the insured party a voice in selecting the type of investment. Additional reforms relate to contract and property laws. The objectives consistently point in the direction of market incentives, which will lead to an appreciable reduction in corruption.

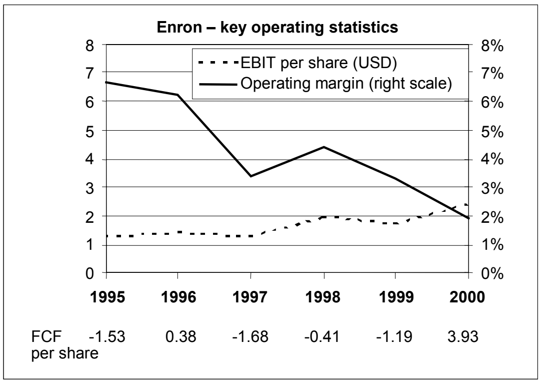
One remains skeptical, of course, because from a Western point of view, a rather autocratic regime with little democratic legitimacy is in power. However, we assume that along with the success of the Russian reform project, the matter of priority of democratic legitimacy for developing countries must be questioned. Too many reform projects in nominal democracies around the globe are mired in oligarchy, corruption and state tolerated and supported crime. And at all times, both Western politics and Western business are right inside the swamp. Perhaps Russia will become an example of how it should be done in other developing countries. The priority of the reforms clearly lies in the legal and structural framework for the private sector. Democracy can wait. The example of Chile has demonstrated, however, how unacceptable this road to greater prosperity is for Western thinking. Yet, we are confident that a come-back of the developing countries will constitute an important mega-trend.

7. Investing = avoiding mistakes

These four mega-trends of the first century of the third millennium are not suitable for handing the investor a simple recipe. De-leveraging and re-regulation are no environment for low-risk or blind investing. The second technology push will develop slowly and not necessarily bear fruit where it is anticipated. Perhaps the “dull” sectors will benefit the most, because they will enter the next phase with the least financial burden. A comeback of developing countries is always characterized by enormous political uncertainties. Euphoria in that direction would be completely out of place, although Moscow last year was one of the world’s most attractive bourses with a 60% advance.

Our recipe for the coming months, maybe years, consists of three guiding principles. First, we want to make as few mistakes in investing as possible. There were times when it was difficult to make serious mistakes, for when everything more or less moves up, selectivity is not that crucial. In the new environment, however, we consider a portfolio investment in shares of thinly financed and heavily indebted companies as a high risk. Companies with poor earnings are also dangerous, even if splendid opportunities are in prospect in the (mostly distant) future. They might fail. ***The search for quality***, therefore, is our foremost guiding principle. This search is by no means trivial. The players must do their homework and strictly ensure that they are not simply guided by somebody else’s findings. Enron, the bankrupt energy trading giant, until the fall of 2001 was highly recommended for investment by prominent securities houses. Credit Suisse First Boston, Goldman Sachs, Salomon Brothers and UBS Warburg downgraded the stock at the last moment, and Morgan Stanley and Lehman Brothers still listed Enron as a “strong buy” in the current year. At a couple of firms, the responsible analysts can no longer be reached. Could the Enron disaster have been foreseen earlier? We think so. It is true that the company over the past few years consistently reported moderately rising operating income (EBIT) per share, but the operating margin declined continually. Furthermore, Enron produced a cumulative negative free cash flow in the last five years, ruining its capital base. During the same period, shareholders’ equity shrank by more than 20% to less than 16% of total assets. It is quite inconceivable to us how one can issue a “strong buy” recommendation under such circumstances.

Enron facts that were kept secret



Source: Bloomberg; own presentation

The second motto is: do not pay too much, don’t shop too expensively! Transition phases create uncertainties on the financial markets. These offer a twofold benefit. First, stock purchases at the upper end of the valuation scale should be avoided. Second, one can profit from opportunities as they arise. Enron in 2000 traded at 55 times earnings. The average P/E ratio in the USA today approximates 25 times. On the other hand, if the shares of Swatch Group, with shareholders’ equity year after year equaling 70% of total assets and continuous earnings growth generating a return on equity (ROE) of 18%, are trading at 19 times earnings, the investor is at least aware that the stock is not too expensive. The key word, then, is ***value investing.***

Finally, though, we know from own experience that such calculations and efforts do not ensure the safety of an investment. There are no safe investments, because the equity markets ***promise*** returns but guarantee nothing whatsoever. The soundness of the analysis notwithstanding, there is no protection against a faulty presentation of balance sheets and income statements, particularly since there are some extremely creative accounting practices. Moreover, even a reliable looking company can make a mistake or may be adversely affected be external factors. Therefore, the investor is compelled not only to be selective in terms of investments but also to ***diversify*** adequately. We know that diversification looks like cowardice in the face of the enemy. It smacks of an attempt to avoid clear-cut investment decisions. Diversification also means that the investor is always prepared to earn less money on some holdings. Diversification is an admission of inherent ignorance. This is also why we find it so pleasant, because the self-assured know-it-alls with their claim on the absolute truth have always been suspect for more than just economic reasons.

KH, January 14, 2002