No end to lies and fraud?

Whoever appropriates a movable object belonging to another person in order to unlawfully enrich himself or others...
Whoever ... fraudulently misleads persons through the pretence or suppression of facts...
... shall be punished by imprisonment for up to five years.
(Swiss Criminal Code, Art. 138 resp. 146)

1. It's getting tough

Looking through the business sections of newspapers, or stock exchange magazines recently, it has been difficult to find a single page without reports of fraud, creative accounting, the firing of CFOs or controllers, special audits or massive corrections to earnings. Stock prices around the world are being dragged down by one scandal after another – and dragged down ever lower, to the consternation of investors – and it seems reasonable to ask the worrying question: Where will it all end? Is it true that the whole world of finance is just a mega-casino, steeped in corruption and fraud, which is more of a danger than a benefit to the real economy? After all these negative experiences, will a dense, and ultimately suffocating new regulatory network supplant the free allocation of capital? Are we entering a lengthy period of general lack of risk appetite, and thus of sustained lower valuations on the stock markets? Is the dream of average returns, that could reasonably be expected from investments in stocks, finally over? Must we now not merely review the allocation of our assets, but revise them radically, perhaps to the accompaniment of dirge-like music, for the cost price is far above the selling prices now attainable.

Question after question and, disagreeably enough, fairly existential questions if one has to make one's living in the "world of finance", whether as an investor, an investment adviser, or as the financial officer of a company or a pension fund. At the start of the third year of negative returns on stock investments, patience and reserves are both at an end. And so, the question of the correct strategy becomes ever more insistent. Can one, should one, take further falls in stock prices into account? Is one going to cap the next potential rise in price, perhaps at the worst possible moment? How much risk is one prepared to accept? These questions demand an answer, and it is predictable that a good many boards of directors, and foundation boards will be thinking hard about them in the coming weeks. For questions of strategy have suddenly become very real, and fraught with consequences.

This investment commentary attempts to shed some light on what currently seems such a confused and desolate situation. If, together with some additional consideration of economic and investment-specific issues, it can provide assistance in answering the unavoidable strategic questions, then its aim will have been largely achieved.

2. From scepticism to outright disbelief

News of the discovery of the fraudulent accounting of billions of dollars at Worldcom, the American telecommunications company, did not come as a complete surprise to sceptical observers. What was far more unexpected was that it came as an unpleasant surprise to the markets. For that the results of companies like Enron, Tyco, Worldcom, and others, so often glorified in the past, were no longer to be trusted should really have been general knowledge, and as such already discounted in their stock prices. Balance sheets and P&L statements do not add up, and we know that – having revealed themselves simply as part of a system designed to provide euphemistic interpretations of reality – those who describe themselves as independent financial analysts are no longer to be trusted. To quote the definition of fraud in the Swiss Criminal Code: "Whoever ... fraudulently misleads persons through the pretence or suppression of facts...". At the zenith of its stock market valuation, Worldcom had a market capitalization of some USD 160 billion; today it is just 2 billion. This enormous disparity undoubtedly includes the major swing in the markets since Spring 2000. But not only that; it must also include drastic mis-assessments, mis-booking, and misdirected payments, that were conscientiously and deliberately overlooked by a whole army of pseudo-accurate Chartered Financial Analysts. Why? Because they were (and, unless they have been fired, still are) part of a system that lives from the presentation of things as other, and above all better, than they in fact are.

The difference between things the way one would like them to be and things the way they actually are, is enormous. Given the lack of reliable third-party analysis, we may not shirk any effort to arrive at an independent, unbiased assessment of the intrinsic value of companies and their earnings power. The results are frequently terrifying. One example: Cisco, the American technology company, a thoroughly serious provider of thoroughly serious network technology, which among other things steers the avalanche of data in the house of
in the right directions, reported a net profit in 2001 of USD 3.09 billion, or 41 cents per share. This profit was described as "pro forma", which is another way of saying that it's not right. According to US GAAP accounting regulations, instead of a profit, it reported a loss of USD 1.014 billion, or –14 cents per share. The difference lies in the restructuring and acquisition costs, which are not taken into account in the pro forma figures, as if, in some way, they were not real costs. If one goes further, and includes the cost of management stock option plans, then Cisco's loss rises to over USD 2.5 billion, or –35 cents per share. Why on earth should personnel costs be excluded from a P&L statement just because they are paid out in the form of options, rather than cash?

A discrepancy of USD 5 billion in the figures of a prominent American company with total turnover of some USD 22 billion – no wonder this provokes some scepticism. And with the avalanche of fraud scandals, such as Enron, Worldcom, and so on, scepticism ("something must be wrong somewhere") has gradually given way to outright disbelief ("nothing is right anywhere").

3. Where is the next minefield?

The question arises as to whether with Worldcom, confidence has reached its lowest ebb, and whether, after the sharp falls in June 2002, the markets have now found a fair level of value. We suspect – unfortunately – that the current uncertainty will persist for some time to come. Can there indeed be a fair valuation of things that try so hard to evade rational analysis? There are four main areas that deserve our special attention in any attempt to ascertain the real facts:

a) *Acquisition costs, or the way acquired "goodwill" is handled; that is, the difference between the asset value for accounting purposes and the price actually paid for companies taken over. Both the requirement for linear depreciation according to IAS standards and the possibility of a value impairment in line with US GAAP can be deceptive. In the one case, there is no explicit comment on substantial changes in the value of assets, and in the other, management has unacceptably wide room for manoeuvre. Accordingly, in all cases, the balance sheet and P&L statement of companies actively involved in takeovers require meticulous examination.*

b) *Restructuring costs. The restructuring of a company to adapt it to the prevailing market conditions is an ongoing task for management, and must therefore appear in the accounts under operating expenses. The exclusion of restructuring costs has at best academic value, enabling management, controlling and the army of management consultants to check what the figures would have looked like if they had not decided to restructure.*

c) *Option schemes. These are part of remuneration, and must therefore appear in the accounts under personnel costs. Otherwise, the combination of the concealed dilution effect of option schemes with the tax benefit on exercise unique to American tax law results in practice in a vicious circle. Both the operating results and the free cash flow per share then appear too high, which generally results in an unduly high share price. The repurchase of shares necessitated by the option scheme itself further increases certain key indicators beloved of analysts, such as earnings per share, thus making the option scheme even more attractive. In operating terms, however, the company has not earned a single extra cent.*

d) *Pension liabilities. The standard American practice of including pension funds in company accounting brings with it serious dangers for the future earnings situation of companies, if they have taken on high payment obligations ("defined benefits"). According to the Financial Times, General Motors, for example, uses an expected return of 10 percent for pension assets. Should the actual return be, for example, "only" 8 percent, this would take about USD 8 billion off*

GM's results. Always providing it was properly accounted for...

Mines may go off in all sorts of different places. Option schemes are generally (but by no means exclusively) the custom in young, high-growth companies. And there, they have indeed, until recently paid off. Pension liabilities with fixed guarantees, on the other hand, tend to haunt "older" companies. We suspect that this is the main reason for the reluctance to close down steelworks in the USA. Restructuring costs are particularly popular among financial service providers. For with each restructuring, the battle for an even more improved profit centre, and thus an even higher bonus, can begin anew. Financial service providers' organizational charts have long been based not on structural requirements, but only on who in what position can cream off the most. Goodwill write-offs will persist for some time to come. However, auditors are likely to become more cautious, and to focus on those companies that have recently grown through many, or large acquisitions. AOL-Time Warner first set a sign for the times with its USD 50 billion write-off, closely followed by Tyco, the conglomerate that had been so ingeniously cobbled together over recent years.

Whether the markets will continue to be surprised by exploding mines to the same extent as with Enron and Worldcom remains to be seen. However, it is the nature of minefields that taking a stroll through them remains fairly unattractive even when one knows that there are mines, and thinks one knows where they might lie. The broad investor community will only return after the minesweeping has been completed.

4. Can the problem be localized?

The next question arises immediately: is this a typically American phenomenon? Can the mines – indeed, the whole minefield – be localized in some way? Yes and no.

It is true that the USA was the scene of the action during the technology boom, the series of take-over waves, the numberless Initial Public Offerings (IPOs), and the Nasdaq bubble. The USA is also the world champion in the production of new regulatory apparatus to ensure legally and ethically correct behaviour. The unattractive custom of paying managers excessive salaries had its origins in New York. The USA has the most efficient capital market in the world; one that was in a position to provide both the largest and the smallest enterprise with the capital they required. Indeed, it was the ability to channel so much capital into investment spending that made the unprecedented technological advances of recent years possible. Today, we know that too much capital was channelled this way.

Only history will reveal whether this "too much" was a necessary precondition for the technology boom. An excessive supply of capital as the necessary precondition for an evolutionary discontinuity: readers of this commentary are already familiar with the theory, but it remains unproven.

The necessary and predictable crash-stop of this ever-accelerating merry-go-round has left behind it some extremely malodorous remains – corpses on Schumpeter's rubbish heap, so to speak. The Austrian economist Joseph Schumpeter (1883-1950) coined the expression "creative destruction" seventy years ago. The economy is not a continuum, but a process involving birth and death. And creative destruction, as we have been reminded by our experience since 2000, does not occur in small doses, or tiny steps, but in waves of world-shaking proportions. It leaves behind it debris, flotsam and jetsam and, indeed, corpses that are beginning to stink to high heaven.

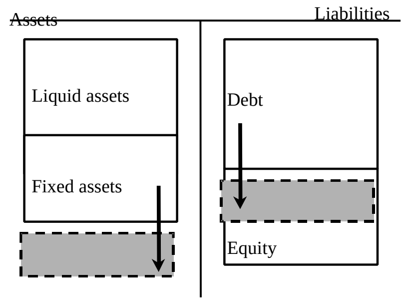
The American corpses are particularly malodorous because they are generally larger than those elsewhere in the world. Americans' great need to represent themselves as particularly well regulated model citizens, and to export their apparently high ethical standards as far as possible throughout the whole world, adds to the evil smell an additional aroma of double standards. But the Old World too, and even our little Switzerland, has its corpses, larger or smaller. And, likely enough, corpses to be. The German Neue Markt (Nemax) is in no way inferior to the American Nasdaq as to corpse production; on the contrary. And as for the corpses to be: given the high level of debt of European telecom companies, it is difficult to refrain from making forecasts...

5. Surplus capital – surplus investment opportunities

It is, in our opinion, well worth while analyzing the events on the financial markets over the last five years one more time. What did happen in the later 1990s, reaching a peak in 2000? We have stated that too much capital was made available: why "too much"? Because there were inflated expectations concerning productivity increases and returns on investment. In particular, people were greatly deceived as to the profits that would be generated through the application of new technologies. In reality, it was not company profits that benefited from the technology boom, but the consumer. Computers became cheaper, telephoning became cheaper, DVD films cost peanuts, and the Internet still costs nothing at all. Monopoly returns for innovators are simply not an issue; on the contrary, every successful invention has further depressed the price achievable in the market, and eroded profit margins.

During the boom, two things happened with regard to company balance sheets. Firstly, the assets side was inflated through acquisitions. The financial markets accepted this with no difficulty on account of the inflated expectations on returns. Indeed, the higher the stakes, the more funds they made available.

Phase I: Leveraging

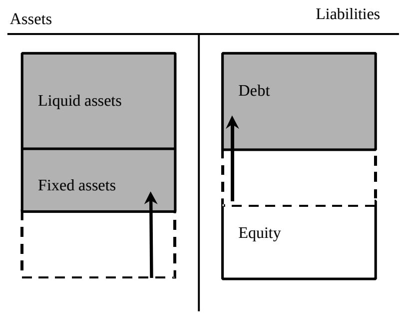


Source: Own presentation

With high expected returns, it pays to reduce expensive equity in favour of cheaper debt. That was the leveraging phase, which came to an end in Spring 2000. There were, of course, many ways of playing the game. Some companies, for example, developed supplementary, but ever more important financial assets, whose value increase acted as a turbocharger for the operational business. It was claimed that it was necessary to build up these assets as a balance against the risks of the core business. In fact, though, this raised the company's risk level. Another form of the game was to take on ever more contingent liabilities, which would have little effect on the equity in normal circumstances, but in exceptional (but from the perspective of the time improbable) circumstances would have serious impact. These are all the bits of companies taken over with repurchase agreements, which were often taken so little seriously that they were not even included in the accounts.

During the period of serious leveraging, capital was available in excess, and investment opportunities were sought more and more hectically, less and less critically, and ultimately entirely without proper consideration. Anyone who could present a business plan of a few pages was rewarded with 500 million for an IPO.

Phase II: De-leveraging



Source: Own presentation

The journey back is painful and laborious, and takes place amid exploding mines and scattered corpses. What has happened in the last two years? The flow of capital has dried up to almost nothing, the inflated asset sides of balance sheets require correction and the debt/equity ratio must be revised. This can either be done at the cost of the P&L statement – if possible – or via restructuring or insolvency. Schumpeter-style destruction, so to speak. Invariably and in all cases, it is the shareholders who suffer.

The period of de-leveraging, recapitalization and corporate savings is characterized by a lack of capital and an over-supply of investment opportunities. The flow of capital is sluggish, investors are sceptical and distrustful, react angrily to unpleasant surprises, and threaten from time to time to turn off the tap completely.

6. What the signs of the times signify

Profound mistrust, flows of capital that have run dry, an oversupply of investment opportunities: the "golden" 1990s are indeed over. The capital investment market has changed from a sellers' to a buyers' market. This is, in our view, the most important insight to be gained from our analysis, for its consequence is a dramatic paradigm shift for the entire financial industry. From the company seeking capital right down to the individual investor's portfolio, the structures were previously such that no-one really wanted to take a critical view in the interest of the investor. Everyone, including the investor's investment adviser, was locked into vertically integrated sales structures for investment products. As long as, due to the demand situation, the investments, so to speak, went ever upwards, these structures were not really a problem. Higher stock prices justified practically everything: high transaction costs, high margins on IPOs, high bonuses for investment bankers, and so on.

When there is an over-supply of investment opportunities, and when this state of affairs persists for some length of time, however, the situation changes. Investors seek independent, critical, unbiased advice. Funds will only flow if it can be demonstrated with sufficient certainty that value will actually be created, rather than bubbles inflated. It is obvious enough to us that under such conditions a large part of the gigantic marketing apparatus in investment banking becomes redundant. Buy-side analysis, on the other hand, will enjoy a revival, though it will be essential that it does not allow itself to be once again taken over by the sales department. Credibility and the straightforward pursuit of the interests of investors will, in our view, be increasingly in demand.

The target of capital allocation, the company, will also feel the effects of this paradigm shift. Crises of confidence, such as we have been experiencing for some while now, last a long time, and it takes an enormous amount of remedial measures for capital to begin to flow again. Words alone do not suffice. Crises of confidence have their impact not only on those whose actions initiate them and the obvious shysters, but also to some extent on the innocent, the respectable, those who have always been productive. Reputation management will thus become a core competence for all companies. In many cases, however, this alone will not be enough. The spotlight will undoubtedly be on those managers who have shown themselves to be incompetent and/or ill-behaved. It is clear that the current situation on the financial markets requires a change of generation in many top managements. The use of reserves accumulated over the years for allegedly more sensible purposes by, for example, the Swiss insurers Rentenanstalt, Winterthur and Zurich shows how the noose is tightening around the all too reckless vendors of the family silver. When these allegedly more sensible purposes turn out to be dramatically bad investments, the days of the managers (and the board?) responsible are rightly numbered. Putting profitability before security is a high-risk strategy for an insurance company.

Rethinking is also required here and there with regard to remuneration. A sense of proportion and a responsible approach to the remuneration of top management are part of reputation management. The table below shows the development of this paradigm shift by means of some examples (both negative and positive) from Germany.

Company	**Change in annual profit, 2000/2001 (in %)**	**Change in board remuneration, 2000/2001 (in %)**
Allianz	-62.8	+66.9
Commerzbank	-98.1	+27
Dt. Telekom	-140.0	+89.0
Hypo-Vereinsbk.	-16.4	+100.0
MAN	-68.1	+34.6
Bayer	-62.7	-21.6
Degussa	-21.7	-68.4
Deutsche Bank	-73.8	-10.9
EON	-40.0	-32.3
SAP	+5.5	-52.9

Source: Handelsblatt, company information

This development could be described as a "return to normality". With all the negative news from the stock markets, it is easy to overlook the positive signs. For example, the fact that the Swiss judicial authorities were ready, without turning a hair, to confiscate documents concerning the SAir Group from very high-ranking figures, is a significant – and hopeful – sign. Not that we would wish anyone a bad day in court. But the fact that applicable law – let us re-read the definition from the Swiss Criminal Code quoted at the beginning, and consider what aspects of Schumpeter's rubbish heap it might cover – is being enforced is noteworthy. Corporate governance rules may well be a good thing, but the thorough application of the existing rules of our society will be far more effective in recreating confidence. The drastic measures taken in America against Worldcom as a company and against the individuals responsible point in the same positive direction: the clean-up has begun.

7. How long will it last?

Balance sheet clean-ups, an increase in equity, rigorous cost-cutting programmes, the replacement of a generation of incompetent, ill-behaved or criminal managers, greater scepticism on the part of investors, a reduction or questioning of the justification for securities sale pipelines, greater importance for reputational issues, both for financial intermediaries and for companies seeking capital: the reform program for the financial markets is fairly clear, and its goal by no means unattractive – to inject a credible portion of ethics into the capitalist system. And also that ethically acceptable behaviour should pay off, for herein lies much of the frustration of recent years: all the rogues and bonus-hungry rip-off artists got away with it; indeed some of the robber barons of equity and reserves still remain in office.

The path to be travelled to overcome such deep-rooted distrust will be enormously long and laborious. It can only be travelled successfully if investors exercise the greatest sensitivity – that is to say, if even the smallest offence against the building of confidence is punished by drastic falls in the stock price. Our forecasts for the coming months, and probably years, tend in this direction: the stock market will be characterized by a series of further sanctions. Significantly more attention will therefore have to be given to the selection of investment opportunities. The tendency will be for transparent, prudent, appropriately capitalized, companies, that invest regularly and remunerate reasonably, to benefit. Greater importance will be attached to the payment of dividends, for a high pay-out ratio protects investors from a rapcious management, that allows the company's resources to disappear into thin air.

So there is hard work ahead for both investors and their advisers. The number of reasonable investment opportunities has fallen dramatically, and they have to be searched for. This selectivity, dictated by circumstance, necessitates a move away from indexes and benchmarks, and thus also carries with it its own risks. It will be a difficult task, in the immediate future, to find the right balance between sensible focusing (wherever one is certain as an investor that one will not be ripped off) and the (still necessary) degree of diversification.

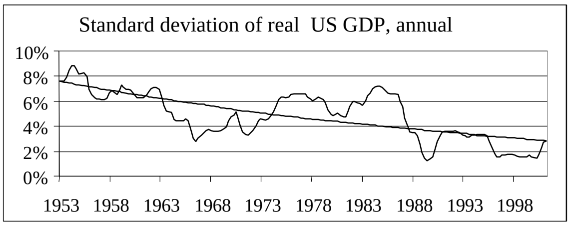
We regard it as fairly unlikely that the stock markets will rise generally and with significant sustained momentum in the near future. This, despite the fact that the macro-economic conditions are not at all bad. The American economic data in particular come as a surprise to even the greatest optimists. In the first quarter of this year, GDP rose by over 6 percent against the previous quarter. It is true that the last quarter of 2001 was seriously affected by the terror attacks in September. Nevertheless, even taking this into account, there still remains a growth level that is far removed from a recession-like tendency. With a pinch of salt, this can also be said of the European economy. Monetary conditions also appear attractive: steep interest curves for all the main currencies, so generous short-term money supply by the national banks, with long-term interest rates indicating reasonable growth rates.

In all previous recessions, under these conditions the stock market upturn had already taken place. Now, we are still waiting – or, more accurately, the incorrigible believers in cyclicity have been waiting long and in vain for the upturn. Their problem is that they have not recognized that the recession of 2001 was not a recession at all, or if it was, then one of a very special kind. For it affected neither consumers, nor house-builders, nor the production of major consumer goods to any significant extent, but was concentrated on one single area of the economy: investment spending. This has collapsed, in America and in Europe. And, because of the general distrust after all the bad investments of Spring 2000, it will stay that way, for exactly the same reasons as the stock markets.

8. Over-estimated economic risks, underestimated financial market risks

Interestingly, it is hardly appreciated that economic risks, shown on the diagram below in terms of the annual change in American GDP, have been falling continuously for a long while. There are a number of structural reasons why this must be so. The various economic sectors are far less closely interlinked than was previously the case. When, in 1930, the demand for cars collapsed, not only were 100,000 people fired in Detroit, but a corresponding number of steelworkers in Pennsylvania and railway workers also lost their jobs. In today's service-oriented economy, such correlated catastrophes are virtually inconceivable. The current lay-offs in the telecom sector have no impact on the demand among pensioners for cruise holidays. A second important reason is the significantly higher proportion of double-income households. If a software engineer in Silcon Valley loses his job, his household income is reduced but, when his wife's income as a university professor is taken into account, not to the extent that their entire consumer activity collapses.

Given this obvious and plausible reduction in economic risk, in our view far too much attention is paid to the changes in economic data, by so-called "policy-makers", economists and analysts. World economic summit meetings discuss the global economy as if there were such a thing and it could be directed, and both analysts and the markets get the jitters at the forthcoming publication of each new piece of economic data. In our view, their jitters are largely to no purpose.



Source: Bureau of Economic Analysis; own presentation

What, though, certainly should give them the jitters are the financial market risks, which have not fallen at all over the same period. When economic risks fall systematically, and financial market risks, measured, for example, by volatility, remain constant, the result is a relative rise in financial market risks. This also makes good sense for structural reasons. Why? Modern communication technology may well have raised the speed of information transmission for market players – globally – to something approaching the speed of light. However, the ability to interpret the information, and the speed of this process, have by no means increased. Game theory shows that it therefore makes sense for individual players to dispense with interpretation and simply follow the trend. Together with the possibilities for easier access to leverage offered by derivatives trading, this reinforces the trend, resulting in the ever stronger swings in the markets.

9. Get out?

Higher financial market risks, seriously damaged confidence in financial intermediaries and company managers: why on earth should anyone invest in stocks? We are now in the third year of negative returns on the stock markets, so it is not difficult to understand the question. Investors' patience has been tried, and the prospect of losing still more money by holding on to (or even increasing) the stock share of portfolios is not exactly inviting. For some investors, not only is their patience at an end, but their reserves are increasingly being depleted. Pension funds are getting close to deficient cover, the financial assets of industrial companies are threatening to be a further burden on the next set of annual figures, life insurers are faced with the problem of falling definitively short of their promised returns. If their equity has already been consumed by previous sins, their choice of investment strategy then becomes a life-or-death issue.

Our bank gave considerable thought to the question of risk communication at an early stage. It is, however, not easy to gain an understanding of the whole picture, and we discovered that for us too at what is most important is to be found in the small print. We use the diagram below to determine the appropriate asset allocation for our clients – naturally entirely in accordance with the principles of financial theory, and on the basis of impeccable statistical data – though whether it then really becomes clear what the "risks" might be is open to question. The horizontal axis (ellipse A), marked "Risk", shows the expected fluctuation in asset value per year for the given investment category. The left side shows the influence of the investment horizon on the achievement of a positive return. For example, with a high risk appetite, stock investments can be made with a very short investment horizon (ellipse B), and the additional time horizon adds little. But then comes the small print (ellipse C): this expectation only obtains for 80 percent of the cases! In 20 percent of the cases the expected return will be negative. Expressed in terms of time, it can happen that the investment target is not reached even with a long time horizon. The real risk – and one that is painful for the investor – is not the annual fluctuations, but the possibility of not reaching the strategic target even over a long period.

That is the snag. Too many investors, particularly institutional ones, rely on the occurrence of average returns, as if there were no contingency risk. And now, in the third year of negative returns, they are obliged to admit that their risk capacity has melted away, and that their risk appetite has also disappeared.

The bottom line, then: get out? Yes, if you have neither time, nor the capacity to live with the contingency risk. For a period of six months, the contingency risk for an average return on a stock investment is around 50 percent. This is something that CFOs and pension fund managers who are keen on at least neutral or slightly positive annual results must be aware of – as, too, must their directors. Get out? No, not if one has time, and is in no way dependent on the arrival of the expected annual return. Not being invested is ultimately always the greatest risk. For after this year of distrust, the general economic growth will generate new, healthy company figures, and stocks will profit disproportionately. When the markets realize this, and anticipate it, we do not know. Perhaps next year, perhaps the day after tomorrow. We do not know. Not knowing involves risk. It is precisely because of this risk that stocks systematically produce higher returns than other types of investment. Anyone who cannot, or will not accept this should not be holding stocks. That’s how difficult investing is.

KH, 1. 7. 2002