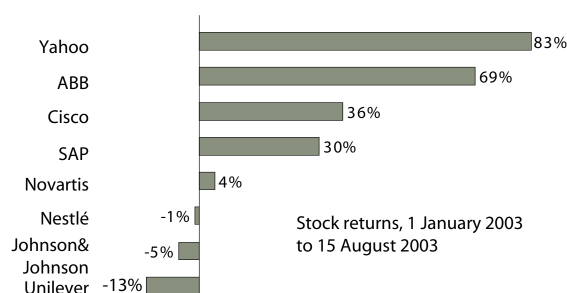
If only it were that simple!

1. Angels that rise again

The harder something is to explain, the greater the use of metaphor. Intellectual flights of fancy reach far into the sphere of metaphysics, and particularly attractive examples of this are the so-called “fallen angels”. These are, in financial jargon, the shares of companies that were formerly regarded as “high flyers” (itself a wonderful metaphor, that attributes the power of independent flight to the shares), only to subsequently to experience a disastrous crash-landing. The last three years have provided us with plenty of examples of such angelic kamikazes. A stock price of just a minute percentage of the all-time-high provides a very shaky basis for the survival, rather than the definitive end of such companies.

Turbocharged fallen angels



Source: analysis

And now we find that these fallen angels, or at least some of them, are able to rise again from the depths far faster than would have seemed possible. For, as we recall, over the past few years, the financial markets have taught all players that only sound balance sheets, only sound revenue streams, only a sound and positive assessment of future development – in short, quality, and quality alone – must be the criteria for any selection of stock market investments. And so we dutifully kept nice, reliable stocks like Nestlé, Novartis and Royal Dutch in our portfolios, only to find out that you can now actually lose money with such stocks, whereas Cisco, ABB, Credit Suisse and similarly adventurous fallen angels turn out to be very nice little investments. Nor has experience to date been much better with the so-called “dividend plays” whose prices stagnate, or even drop back, while the shares of companies for whom “cash” is still an unknown quantity literally take off.

There is no difficulty in finding explanations for this phenomenon. There is the fairly mechanistic argument that the harder they fall, the higher they’ll bounce back, rather like a ball pressed down below the water and then let loose – provided, of course, that it has not lost any air in the meantime. Or the more psychological approach, that both cases are a matter of irrational exaggeration, first upwards and then downwards, to be followed by some sort of normalization of the situation. Economists ponder over the loss of risk premiums and new return expectations, and are thus able to halfway justify the rise in stock prices. But they are surely not entirely comfortable with the fact that various technology stocks are already again achieving P/E ratios of 80 and more. It is hard to imagine what future profit expectations such rates are based on.

Back to the past?

	Current P/E ratio	P/E ratio at end 2000
Ebay	83	140
Yahoo	103	64
Comcast	421	141
Kudelski	169	135

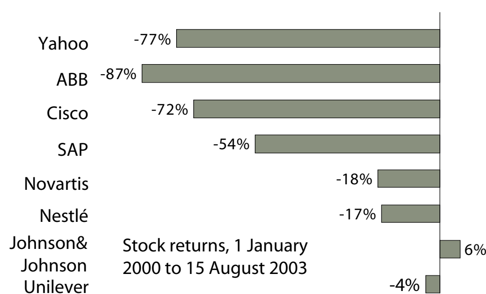
Source: Bloomberg

Have we perhaps already slipped into the next phase of exaggeration on the stock markets; have players again already succumbed to greed, and have they really learnt nothing at all from the past? After all that has happened, are people again buying up shares, left, right and centre, in companies whose revenue situations are highly questionable, and whose future prospects are worse than shaky? Have people already forgotten about quality?

Short-term perspectives, such as, for example, the stock performance since the lowest point, on 12 March this year, are, of course, not particularly meaningful. Looked at over the only slightly longer period of three years, the apparently

stronger performance of the fallen angels is seriously relativized, and it becomes increasingly apparent that such heavenly (or hellish) beings are only likely to make sense in the context of a balanced diversification strategy. And this brings us closer to a sound, economically justifiable perspective.

The angels are still flying low



Source: analysis

Nevertheless, and regardless of short-term considerations, we may conclude from the significantly higher valuation of technology stocks in particular that there are enough investors across the global financial markets who regard the current situation far more positively than they did three or four months ago, and that there are too few who hold a diametrically opposed position, and are therefore ready to speculate against the rise in technology stocks. This phenomenon is reason enough to devote this investment commentary to a consideration of the challenges of the likely economic situation, and their significance for the financial markets.

2. An unparalleled slump

Rising share prices during a recession are nothing exceptional. The pattern is very familiar from the 1970s and early 1980s: first, inflation, coupled with hyperactive economic activity and a, for the time being, still intact stock market, then an emergency stop by the central bank, in the form of higher interest rates, accompanied (or even preceded) by a crash on the bond market triggered by higher interest rates at the long end of the interest rate curve, and linked with this, a collapse in the price of financial sector stocks, followed by a general bear market. And then, once the central bank's policy has borne fruit, the supply of money and goods slowly normalizes, inventory reductions, or insolvencies, come to an end, and supply capacity begins to correspond to demand, but no-one yet really believes in the recovery – then comes the upturn on the stock market. Unexpected, stealthy, but increasingly strong and widespread. This is followed by economic recovery, which provides a justification for the expectations expressed in higher share prices, in the form of higher company earnings.

This is known as cyclicality. And it is so beautifully simple and preprogrammed. If we understand things correctly, then one of the notions currently observable among both companies and investors is that we may expect an economic upturn in the near future. This cyclical approach also finds particular favour among politicians. Governments in Europe in particular, now on the defensive, miss no opportunity to forecast – and talk up – economic recovery one or two quarters from now. The problem is simply that "now", and thus the next one or two quarters, is continually shifting. The latest figures for Germany indicate negative economic development for the second quarter of 2003, which is tough for the politicians, who badly need the additional tax revenue generated by an economic upturn to continue their previous redistributionary activities …

In our view, this cyclical approach is too simplistic – put more forcefully, it simply does not apply. In past commentaries we have pointed on several occasions to the very different starting point we now have: "normal" recessions begin with high inflation and an overactive economy, with corresponding crash stops by the central banks. High short-term interest rates and an inverse interest rate curve are the unavoidable concomitants of such a monetary policy. But: inflation has been less and less of a problem since the mid-1990s, there can be no question of economic hyperactivity, even at the height of the technology boom – au contraire, for a long while now there has been more and more evidence of overcapacity, resulting in real, painful cutbacks. Interest rates have been falling worldwide since the beginning of the 1990s, and there has been no evidence of any emergency braking manoeuvres by the central banks since autumn 2000 at the latest. Liquidity has been available in excess since the start of the crisis on the financial markets – the low money-market interest rates are the result of this excessively accommodating monetary policy.

The causes of the recession at the beginning of this century – a brief one in the USA, but a lengthy and tenacious one in Europe – are precisely not to be found in the relatively simple circumstances of cyclical "stop-and-go", but rather in an extraordinary investment phase with an unlimited appetite for capital, and in the clear-out of unnecessary or senseless investments ("overinvestments") in the aftermath of this boom. The main causes of what now appears as

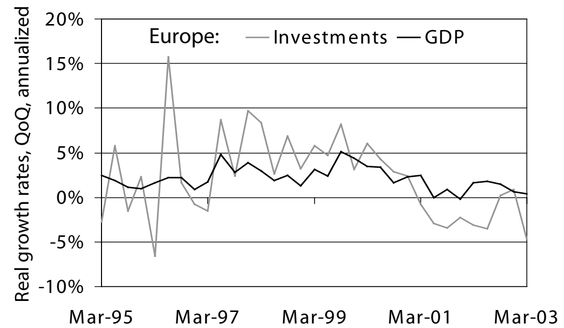
excessive investment are to be found on the technological, material side, and not in monetary or fiscal manoeuvres. We are well advised to recall what happened in the 1990s:

- To begin with, the political upheavals, with the end of the bi-polar conflict. The result: more land, more work, more markets.
- Rapid developments in the creation of new knowledge, particularly in biogenetics. The result: entirely new areas of economic activity, the possibility for obsolete methods and products to die out.
- A drastic reduction in information and transaction costs through the new possibilities of information and communication technology. The result: higher and faster flows of capital and goods on a global scale (globalization), the disruption of previous distribution structures.

The immediate result of these developments was a kind of state of emergency characterized by a sudden and rapid increase in uncertainty with regard to future developments. All sorts of things that ten years earlier would have been dismissed as mere fantasy suddenly became conceivable. The global response to this explosion of real options was the investment boom observable at the end of the 1990s. Unlike most other analysts, we still maintain today that that this sort of reaction was in no way irrational, but is explicable in terms of the relatively simple game theory approach of "prisoner's dilemma": given the unknown result of the investments of all the other players, not to invest would be the surest way to lose in any event. Being part of the investment hype, by contrast, at least offered a probability greater than zero of being one of the winners. Years ago, we compared the situation with what can be seen in nature when various creatures take possession of an empty biotope. Precisely the same "overproduction" of everyone against one another can be observed; precisely the same process of dying out occurs in several phases, and ultimately there is some sort of balance between the survivors, whose real options can then actually be exercised.

That of all the millions of new real options only relatively few would actually be exercised was clear to sober observers from the start – and equally so, that the dying out process would not occur without upheaval. The only real unpleasant surprise was the scale of the accompanying financial crisis, and the way the cutbacks spread to embrace more or less all economic and social sectors. Over the last three years, this cutback process has seen a drastic reduction in expectations practically across the board – one's own salary, returns from stocks and bonds, the security of pensions, the effectiveness of state institutions, and so on and so forth.

This is not what a cyclical crisis looks like!



Source: Bloomberg, own presentation

And this is how the economic recession and the condition of society manifest themselves: in the painful consciousness of boundaries that have suddenly become more narrowly set, in both private and public matters. There are only two possible reactions here, for private individuals and companies (and actually also for the public sector…): either to tighten one's belt (economize!), or to try, by means of more or better work in the broadest sense, to generate additional income.

In contrast to a cyclical crisis, which can be dealt with relatively simply in economic and social terms, not much can be forecast concerning the present recession. How, or indeed why, can we get back to a more or less attractive level of investment activity? For if everyone holds back on investments, why should anyone invest at all? Company A saves on deliveries from Company B, which itself does without the services of companies C, D, and E, and ultimately the managers of companies X, Y and Z get no more bonuses, don't build themselves new houses, and no longer buy themselves new Porsches. This is not a matter of celebrating the ghost of deflation. However, there is unfortunately no generally valid statement about how the mechanism for getting out of an investment crisis works. Is it sufficient to pin one's hopes on substitute investments? It is perfectly possible to conceive of scenarios featuring a lengthy period of anaemic economic activity, with progress being made at snail's pace. It is equally possible, however, that a favourable conjunction of several factors may accelerate things faster than appears probable from today's perspective.

3. No more shots in the monetary and fiscal locker?

The latest statements by the American Fed in connection with the decision not to raise interest rates, but also not to lower them any further – not that there is much room for manoeuvre here at the level of 1 percent – indicate an endeavour to give business, or perhaps rather Wall Street, exactly what it wants. An excessively negative picture – i.e. the full rhetoric of deflation – accompanied by a further drop in interest rates might have done significant damage to the rising hopes, and thus to the improved situation on the stock markets. But no-one would have understood a rise, because of the economic indicators: the GDP growth rate of 2.3 percent p.a. remains at the bottom of the acceptable range, and the unemployment rate of 6.2 percent remains at the upper limit of acceptability. Basically speaking, those in charge at the Fed have little room for manoeuvre: it does not seem possible to achieve anything positive, so they limit themselves to not doing any damage. So long as there is no danger of inflation for any reason, this policy of avoiding harm can be followed.

The European Central Bank's (ECB) room for manoeuvre in terms of monetary impulses would be significantly greater by comparison, were it not for the need to manage this tremendously divergent currency region. We referred last month to the very high current real interest rates in Germany. The need to take account of the comparatively overheated economic situation in the regions at the margins of Europe prevents the ECB from being able to exploit its room for manoeuvre downwards. Although it is undoubtedly the case that low interest rates alone are not sufficient for an upturn in Germany (this would also require very different measures – see below), there is also no doubt that lower real interest rates would indeed be needed.

And what of currency policy? As Jörg Baumberger, an economist from the university of St Gall, rightly remarks in a recent article (Schweizer Monatshefte No. 6/7, July 2003, pp. 11ff.), all the relevant currency areas, including in particular Japan, are confronted by the need to devalue vis-à-vis some other currency area. But, of course, "it is impossible for all currencies to devalue against all other currencies". In other words, the game of competitive devaluation, which the Americans may have played for a while, is not sustainable – no currency area can indulge in a serious devaluation. This does not mean that the possibility of attempts at making currency policy in the near future can be dismissed. The results of such attempts would be an unattractive to dangerous rise in the volatility of exchange rates.

On the fiscal side we can observe some interesting circumstances and developments. In Europe, governments, and particularly those of the core countries, Germany, France and Benelux, groan under the burden of their state spending and the lack of tax revenue. And there is no latitude to increase this revenue. Quite the reverse: even the Socialists, or at least the more responsible ones, have understood that additional taxation would mean a further economic downturn. There is also effectively no latitude for higher deficits, in view of the high level of accumulated debt, even if the Maastricht criteria are applied increasingly loosely. But even if all these genuine objections did not apply and, in disregard of all financial policy warnings, funds could be made available for the significant positive influencing of economic activity through state projects, the question remains of whether, in the current state of the European economy, fiscal activism could achieve any positive results whatsoever. For any fiscal activity must be financed – if not immediately, then at a later date. Given all Europe's experience with national budgets and the large number of probably at least partially empty promises (pension problems!), it would be naïve to believe that the additional future burden would not be immediately discounted. Negative feedback would result in an immediately effective crowding-out effect, which could manifest itself in a new wave of capital flight, for instance. In the longer term then, on balance there would remain less than if such fiscal activity had never been undertaken.

The room for action, and the activity, of the US fiscal authorities require more differentiated assessment. First the budgetary condition of the federal government and the states is overall far better than that of Europe, particularly when the level of tax burden is taken into account. Compared to European countries, there is still much upwards latitude, and it would probably be relatively easy to eliminate the current debt and deficit. The USA thus still has a good deal more fiscal shots in its locker than Europe. Secondly, and this is more interesting, the Bush administration is indeed pursuing an active fiscal policy. The Iraq war and its precursor in Afghanistan can also be regarded as economic phenomena. The Bush administration's security policy will generate additional expenditure of some 75 billion dollars in 2003, and expenditure last year was some 25 percent higher than originally envisaged. The Harvard economist Robert Barro

has calculated that some 75 percent of the additional expenditure on security will go to GDP, which represents just on 60 billion for 2003, or 0.6 percent of additional economic activity.

On condition that the security policy does not incur any loss of domestic production, and above all that the loss of lives remains relatively moderate, and indeed that the global security situation may actually be improved, the overall effect of such fiscal activity will be positive. It may sound cynical to our sensitive ears, but it cannot be dismissed: so far, the US security policy has been going in exactly this direction. A Washington Times columnist recently put it in a nutshell, with the sober observation that in the US capital alone, more people die every day as victims of violent crime than in the Iraq conflict, which allegedly involved such heavy losses. There is obviously no place for any feelings of euphoria, for victims remain victims, and it is still far from clear whether the USA will be able to translate their overwhelming military success into lasting strategic advantage. However, the economic benefits of the fighting and the increased defence expenditure cannot, as mentioned, be argued away. And just by the way, the investment crisis of the 1930s also ended with a war. This is merely an observation and in no way a recommendation. And one other remark: it is possible to fight wars well or badly. The Russians in Chechenia are probably now showing us how things really cannot be done any longer today. Unless we are completely mistaken, this military campaign will not improve the overall security situation, nor is it certain that it will not endanger Russian productivity. The loss of lives is extremely high. Interestingly though, hardly anyone seems to pay any attention to this conflict, never mind protesting about it …

4. The polishers and the polished

If central banks and governments cannot bring an end to the investment crisis, or can only do so by resorting to unconventional means such as war; if, then, there is only very limited monetary and fiscal ammunition left, then it will be up to the private sector to put things right. It needs to get back to more confidence and trust, we hear. The right people in the right positions – and then things must get better, must they not? The replacement of all the rip-off artists by morally impeccable personalities; more honesty and less greed – and the world would be put to rights again, surely?

Perhaps. And then again, perhaps not. In the second section of this investment commentary we attempted to explain how the world came to find itself in a phase of very high – with the benefit of hindsight, too high – investment. Rip-off artists, conmen and incompetent strategists do not feature in this analysis. In our view they were at most the fairly unavoidable and unattractive concomitants of a process that had quite different causes. And they had the misfortune that their machinations were brought to light by the dramatic events on the financial markets. No more and no less. They were in no way the cause of the crisis. But if this is so, then it cannot be the case that other, i.e. better, nicer, kinder, managers can be the cause of an upturn.

In practice, it is necessary to distinguish between two sorts of “better” managers. One sort provides that which the financial community has always valued above all else: impeccable numbers. These are the “polishers”. The others are servants of the new ethics; they are the new Mr Cleans, the peerless knights, who never act in their own interest, nor indeed primarily in the interest of the shareholders, but rather, with a corporate policy that wholly subscribes to a comprehensive perspective, is entirely dedicated to the interests of the poor stakeholders. These are the new, highly polished, golden boys.

The “polishers” certainly have successes to offer. Let us take as an example Credit Suisse’s recent, universally highly praised, star result. After heavy losses in 2002, this financial services group achieved a net profit of 652 million in the first quarter of 2003, and more than twice as much in the second quarter, namely CHF 1.346 billion. Closer inspection reveals that this good result is largely due to the private banking sector. Already in 2002, commission and service revenue fell disproportionally little, compared to the client money base, which was reduced by stock market losses. This business policy has been continued in 2003. With a gross margin of 1.2 percent on assets placed with Credit Suisse, we may have some suspicion of who is paying the bill. When we consider that these assets include those of institutional investors, well known for their extremely narrow margins, and funds belonging to advisory clients with a fairly low transaction quota, and also that retrocessions must be paid on some of the income to external asset managers, and when we set the size of the gross margin in relation to the returns currently achievable on the money and capital markets, then suspicion turns to certainty that there is a disproportionate disadvantage for the long-standing loyal clientele. For some time now, Credit Suisse has been very energetically mar-

keting alternative investments (i.e. so-called hedge funds and funds of funds), which bring the bank considerably more commission income than conventional investments. Such a business policy can certainly be justified, provided these sorts of investments do actually generate added value for clients, as compared to conventional investments. But it may well also be the case that there is no bottom-line benefit, other than higher fees for the bank. This would then confirm that today too, much as at the time of the biggest stock-market boom, the emphasis is on immediate, short-term results, at the expense of future potential. The cost savings concerning personnel and their training tend in the same direction. Of course existing overcapacity should be reduced. But when massive job reductions occur simultaneously with an overall positive flow of new funds in private banking, then this comes down to extracting more profit from client relationships, and the consequence of this may well be erosion of future potential.

We are obviously all happy and thankful that our second Swiss universal bank is clearly doing better. It is also not difficult to understand that the new management is making every effort, with very positive results, to convince the outside world of the correctness of its strategy. It is, however, impossible to avoid the impression of "polishing". Massive staff reductions (2003: some 6,000 people), the sale of valuable assets (Churchill in the UK and Winterthur Italy represent the loss of two choice chunks of the insurance portfolio), exploitation of the client base through high commissions for allegedly superior investment products, the spreading of management option schemes over several years, the reduction of write-downs and credit provisions when there is an overall high level of credit commitment: this may be appropriate as a recovery policy, but a strategy for long-term success would need to be less drastic.

The crux of the current economic situation is that on the one hand, "polishing" may indeed be necessary, because there is no use in possessing long-term potential if one is likely to perish in the short term. But investors are well advised not to overlook the "on the other hand". Drawing bills on the future may here and there occur to an extent that sooner or later may well be price-relevant.

5. Ethics at any cost?

The trade-off between short-term benefit and long term is anyway *the* key problem for management. Indeed, even more generally, weighing up short-term and long-term benefits is one of the toughest of all the challenges of the "condition humaine". The extra slice of cake allowed themselves by the corpulent, although they know of the long-term damage it can do, the extra glass of wine for those fond of a drop, although they are entirely aware of the serious consequences of driving under the influence – individuals are not always able to make the right decision even for themselves. The problem is that much more difficult when it involves a large number of people – in a business, for example.

A priori, it is not necessarily that clear which perspective – the long-term or the short-term one – is actually relevant. If one regards a business (from the shareholders' perspective) as the sum of the future cash flows, then the term used for the calculation will depend very much on the financing costs, that is, on the applicable interest rates. A cash flow in the distant future is worth more, the lower the discount interest rate – on simple mathematical grounds. From a shareholder perspective, with the current interest rates the calculation must be as long-term as possible. But if one regards the business rather as a social network of interest groups (the famous "stakeholders"), the result is generally a long-term calculation for the continuance of the structures and a very much shorter-term calculation for the immediately effective benefits, such as salaries, fringe benefits, and so on. Those in the business who have to determine the course of events, the management, are exposed to a great temptation to focus on their own short-term interests, at the expense of the long-term perspective.

The problem is familiar enough. But it is particularly acute in the current economic phase of inadequate investment – and thus inadequate confidence in the future. There is an obvious danger that, due to the lack of confidence in the future, the short-term perspective will gain further predominance, because the short-term bird in the hand looks a good deal more attractive than the long-term two birds in the bush, which may not exist anyway.

This is basically the point at which we hear the call for ethically impeccable management, and for "corporate governance". It is argued that, in view of the difficulty of choosing between one bird now and two birds later, it must at least not be possible for managers to devour the one bird right away and then manage to avoid any long-term responsibility for the two birds. There can be no objection to such an approach to business ethics. Au contraire: it is ultimately congruent

with the interests of the shareholders, and probably with those of most other interest groups.

The hard question concerns the choice of means. We have already expressed our opinion concerning the new genus of ethically polished Mr Cleans, who continually chant the mantra of corporate governance. There is a serious danger that significant areas of business will in future be managed by decent, respectable, but otherwise incompetent people. Ethics alone are not enough, and particularly not when they have just been compulsorily acquired, because of the requirement to attend such lectures at business college. Entrepreneurial success has also always been a matter of cunning, craftiness, pragmatism, the striving for power, and similar qualifications. Company management is, regrettable as it may seem, not a Sunday-school picnic, and there is accordingly no reason to suppose that ethics will provide the solution to all the problems of our time. Admittedly, the spirit of the age, and particularly our moralist media, takes a different view.

The next illusions are pre-programmed, and herein lies the other side of the argument. Those of us who, as realists, regard the true nature of the human character with even just a degree of skepticism will not find it difficult to predict that the problem of improper management will simply shift from the realm of rip-offs and fraud to that of the harder to measure “soft factors”. They have always existed, these remarkably energetic excursions by management into non-operationally necessary areas. The incompetent but “decent” are particularly at risk here, for they can in this way simulate activity that has little relevance for the company.

Lastly, a word on enforced ethics (if such a concept is conceivable). This is much indulged in at the moment, with all the numerous attempts to embed corporate governance in regulatory frameworks. Great scepticism is in order, not with regard to the idea of corporate governance as such, and particularly not concerning the desire for greater transparency, but with regard to the verbose regulatory frameworks. There is a great danger that company managements will simply observe the letter of the law, or have their real activities concealed by Corporate Governance Officers. Annual reports are nowadays real treasure troves for such efforts. It is obviously impossible to buck this trend, and in the meantime consulting firms have discovered a new and lucrative area of activity.

6. More realistisic expectations!

We earlier interpreted the current recession as an expression of fairly universally reduced expectations, and consequently pleaded for a greater sense of realism with regard to expectations. We have largely excluded the possibility that significant additional stimulus could come from the monetary or fiscal side, with the exception of American security policy, which may well make a certain amount of economic sense. On the contrary, in Europe only a drastic reduction of fiscal activity could have any stimulating effect. In line with the call for more realistic expectations, however, this possibility must be dismissed.

We have also warned of the danger of having unrealistic expectations of the new generation of managers. In the matter of getting back to reasonably acceptable company results, today’s managers will have to make use of much the same bag of tricks as their predecessors during the boom. Jettisoning future potential in favour of a short-term improvement of the revenue situation is one such approach. The acceptance of risks that only become apparent and effective in the future will soon be another. As we know from the notorious LTCM case, such engagements, converted to instant premiums, can indeed enhance the short-term revenue situation. Realistically, we shall have to continue to keep an appropriately sharp eye on the managerial caste. Serious financial analysis, beholden to no-one, can make a contribution here.

The hope of moral and ethical rearmament on the part of company managers is highly attractive for symposia and publications, but it is essentially misleading. Decency and honesty should normally be expected, but are in no way sufficient to manage a company successfully. Reliance on a new generation of ethically impeccable Mr Cleans may soon stand revealed as one of the great illusions of our time, as may the belief that an ever denser regulatory framework will result in improved conditions.

More realistically, we must assume that economically functional beings, that is, people oriented to their own benefit will continue to be active in all areas of business, the economy, and politics. We will have to include this ubiquitous optimization of personal advantage explicitly in our calculations. Salvation will not be found in following corporate governance regulations to the letter, but in the mechanisms provided by the capitalist system to punish violations of the rules –such as taking over a majority of the capital, so as to be able to sack the management. Or, if this proves impossible, getting rid of the stock.

In the current, tough and persistent recession, there are no easy answers. No help from the central banks, no stimulus from government funds, little prospect that a newly oriented management could provide significant impulses – what are we left with, then? The confidence that, realistically, there are enough people around in this wide and unbelievably complex world with an urgent desire to improve their standard of living (because they are also economically functional beings). The weak demand for investment goods may last for a tiresomely long time, and may also give rise to further disappointments on the stock exchange. Ultimately and realistically, though, it will come to an end, and then we may again confidently expect from stocks what they should provide: about seven percent per annum – over a very long-term average, nota bene. Will they be “fallen angels”, “dividend plays”, polished-up dinosaurs, “value stocks” or genuine growth stocks? If it were that easy we would know in advance.

KH, 18.8.2003