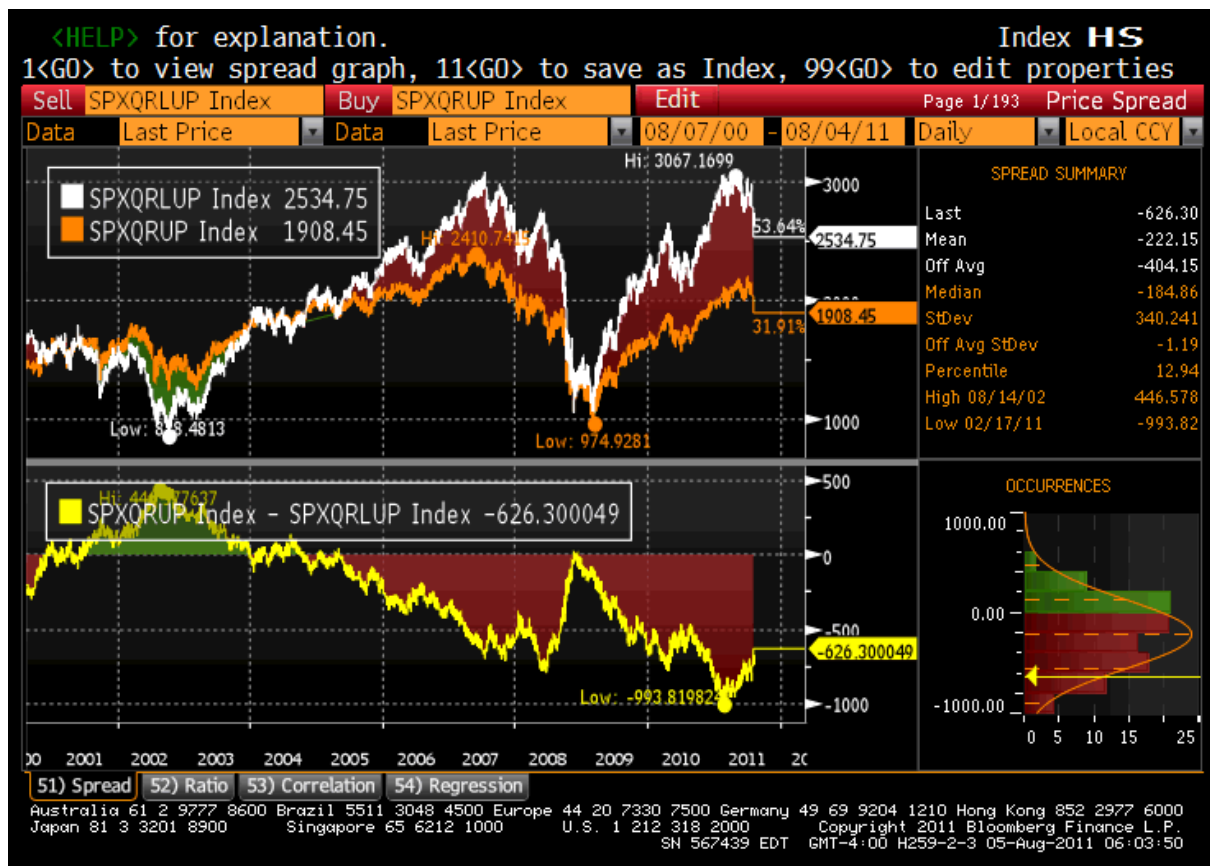


**“A great business at a fair price is superior to a fair business at a great price”
(Charlie Munger)**

Following the initiation by the US Federal Reserve of a second round of quantitative easing in August 2010, markets in the second half of 2010 and the beginning of 2011 have been characterized by a speculative burst heavily tilted toward cyclical companies, small-caps, commodities, shares characterized by low stability of earnings and high sensitivity to market risk. January 2011 confirmed and reinforced this trend of “risk on” mode. The run up of most of these stocks had not been justified by their fundamentals: and as we indicated in January 2011, many traded at full value on above average profit margin estimates, leaving scant room for error. Fundamental investors were absent and trading was largely originated by hedge funds, acting in herd, with a short time horizon, on the assumption that the FED had provided a "backstop" against losses. The peculiarity of this market had been, until few days ago, the extent to which high-quality blue-chips underperformed speculative sectors of the market, setting the basis for what might be a multi-year tailwind in favor of high quality. The S&P High Quality Index selects companies in the S&P 500 with a 10 year history of above average stability in profits and cash flows: since the bottom of the market in March 2009 it has massively underperformed the S&P Low Quality Index. The chart below shows how, in the last decade, a portfolio invested in high quality stocks and short low quality stocks would have done poorly, with two exceptions: the market crashes in 2002 and 2008.



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The high valuation of low quality companies was reached despite the fragility of the recovery and the many problems still unresolved, with riskier companies priced more optimistically than more stable ones. Recently, this discrepancy has started to be corrected: prices of small caps, cyclicals, commodities are now suffering heavily. While in market panic correlations go to 1 and everything goes down, stable, solid businesses with resilient profits, if cheap, will recover and do well in the future.

1) In the current market, many high quality companies are cheap or very cheap (see chart below: the green line shows that J&J is close to a 30 year low of its stock price relative to profits, the same is true for most pharma and medtech stocks and for some consumer companies such as P&G and Pepsi). We hold many of them in our portfolios, Medtronic, J&J, Zimmer, P&G, Pepsi, Nestle', Heineken, Berkshire Hathaway, etc. **These companies should do well in the next few years even in difficult environments** (despite currency volatility and governments with debt problems) because they are resilient, generate a lot of cash, sell products people want and need, are priced cheaply, are diversified geographically and currency wise, can increase prices if inflation increases and will gain market share from weaker competitors if economies suffer.



2) Many insurance stocks today are extraordinarily cheap (priced at book or below), despite having much stronger balance sheets and despite the insurance cycle starting to turn favorably.

After the crisis in 2008-2009, all insurance companies were forced to clean up their portfolios, and some took huge losses (e.g. AIG), while others did very well (e.g. Fairfax). Today, the memory of those losses is still fresh and painful, and most investment portfolios are very conservative, with few stocks, very few risky bonds. The only exposure is to European government bonds: many of our stocks have no European government bonds other than German ones (such as SwissRe or Fairfax), others such as MunichRe have more exposure, but we do not think it's realistic to envision large losses in Spanish or Italian Government bonds, as the damage would be too big for the whole European financial system and the EU will do everything to avoid this, including if necessary changing fiscal and monetary rules. Most of these companies indicated that insurance premia are increasing across the board, a very good sign that should increase the profitability in the future. This bodes very well also for one of our largest holding, Berkshire Hathaway, trading at an historically low level relative to book value, while generating more cash than ever before (1 bn USD per month!)

3) Banks: the situation is more mixed.

Some banks, such as UBS and most US banks, seem to be now solidly profitable, despite a more difficult regulatory environment. Many issues are still unclear and pending, but the assets, after three years of losses and clean up, should be generally in good shape. Here again, valuations are very cheap, as the memory of the disaster is still very fresh in our minds, but we think prudence is required in this area, as some institutions might still need additional capital. At this stage, we have very few investments in this area, and do not plan to increase exposure unless we see, in selected cases, more clarity on profitability and asset quality.

4) The CHF is possibly the most overvalued currency in the world.

Few days ago, the OECD defined the CHF the most overvalued currency in the world. The Swiss National Bank recently decided to lower interest rates and restart expansionary monetary policy, in an attempt to counter the relentless appreciation of the "massively overvalued" (in its words) CHF, that is starting to hurt the Swiss economy in a serious way. The chart below shows the value of the USD relative to the PPP (Purchasing Power Parity) exchange rate with the CHF. The PPP rate is an estimate of the equilibrium exchange rate that would render a diversified basket of tradable goods roughly equally expensive in both currencies (a Mercedes in Switzerland should cost roughly the same as an identical Mercedes in the US, adjusting for shipping costs). The chart shows that the USD is undervalued (and the CHF overvalued), according to this measure, by 60%!! Never this overvaluation of the CHF vs the USD has been reached in the past 20 years. Last time the CHF was overvalued by 40% (i.e. less than today), it was in 1993-94, during the savings and loans crisis in the US, and that set the stage for a 6 year long cycle of weakening versus the USD.



Some evidence supporting this view is provided by the long lines of Swiss queuing to go shopping in Germany or Italy, and the rapidly collapsing visits of foreigners to Switzerland. The last chart shows again the evolution over the last 20 years of the CHF/USD rate, this time not in percentage relative to PPP, but in absolute numbers. The PPP level has moved over time at a roughly stable 1.5-2% per annum (as inflation in Switzerland has been historically lower than in EUR and USD by this amount per year). A stable, gradual long term appreciation does not represent a problem, neither for the economy nor for investors. On the contrary, very extreme and sudden moves in the actual exchange rate far from this equilibrium level have always been, sooner or later, corrected, because they are unsustainable for the economy. We do not know when this will take place though, as the CHF is currently driven by panic, and we are not able to forecast when this will change (but we are confident it will). This is of particular importance to our Swiss clients, who have seen their recent performance wiped out by the currency effect: many stocks, in CHF, are cheaper today than at the lowest point in March 2009.

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We are optimistic and confident that our diversified portfolios of strong and cheap businesses are poised to do well in the future: especially in times of high uncertainty on the currency and monetary front, it is critically important to be invested, at least partially, in good businesses. This has been the only way historically to preserve capital through major crisis, such as in Germany in the 30's and during WWII and in Argentina after the default in 2000. Investors who kept their stocks through those volatile times preserved their wealth in real terms (i.e. taking into account inflation).

We would like to thank all of our clients for their loyalty and patience in these trying times

Kind regards

Kraemer, Schwab & Co. AG