

KRAEMER SCHWAB

INVESTMENT
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October 26th 2011: update of previous commentary (August/September)

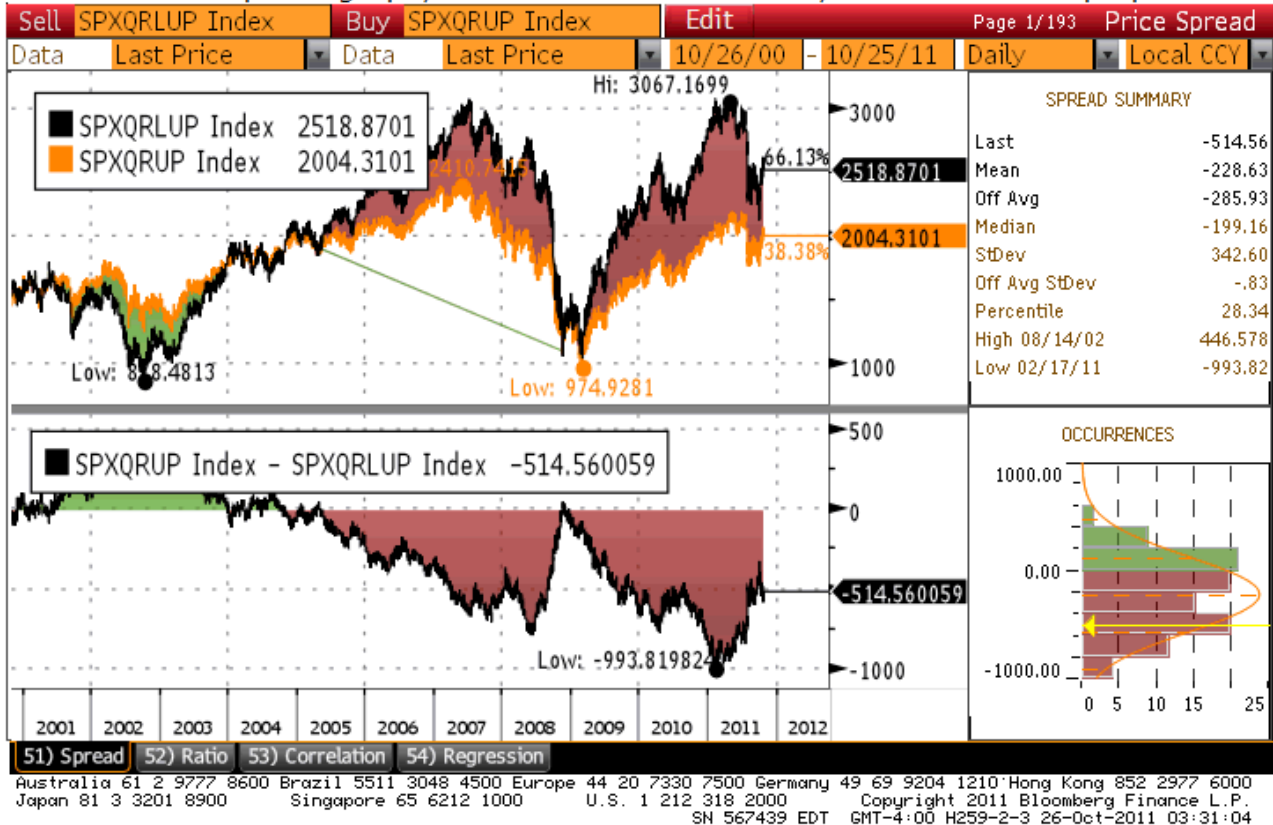
**“A great business at a fair price is superior to a fair business at a great price”
(Charlie Munger)**

Pushed by the second round of quantitative easing from the US Federal Reserve (August 2010), markets in the second half of 2010 and beginning of 2011 saw 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 these stocks had not been justified by their fundamentals: 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, 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 had been, until February 2011, the massive underperformance of high-quality blue-chips relative to speculative sectors of the market, setting the basis for possibly a multi-year tailwind for 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. 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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Index HS

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The chart above indicates that since February 2011 this long underperformance of high quality stocks has started to abate and revert to the mean, in fact in the last few months high quality has substantially outperformed the market. We think this process is far from being over, and count on many blue-chip, high quality companies to deliver satisfactory returns for many years to come. 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. While this discrepancy has started to be corrected and prices of small caps, cyclicals, commodities have suffered heavily, they have not reached very low valuations yet and the recent rally (October 2011) has nullified much of the previous correction.

- In the current market, many high quality companies are cheap or very cheap** (see chart below: the green line shows that Pepsi 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). 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.

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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.

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