

Financial Report as of end of March 2003 and Outlook

In the aftermath of The Great Bubble, prices have steeply corrected. Most major markets have now declined on average by 50% or more over the last 3 years.

Index	2000	2001	2002	2003 Year-to-date
Dow Jones	- 6.2	- 7.1	- 16.8	- 1.3
S&P 500	- 10.1	- 13.0	- 23.4	- 1.1
Nasdaq	- 39.3	- 21.1	- 31.5	+ 3.9
Nikkei 225	- 27.2	- 23.5	- 18.6	- 2.5
FT 100	- 10.2	- 16.2	- 24.5	- 5.1
DAX	- 7.5	- 19.8	- 44.0	-10.7
SMI	+ 7.5	- 21.1	- 27.8	- 8.2
Hang Sang	- 11.0	- 24.5	- 18.2	- 4.8
Singapore	- 22.3	- 15.8	- 17.4	- 2.0
MSCI World	- 14.1	- 17.9	- 21.0	- 2.4

More and more misdeeds of respectable companies during the exuberant years are coming to light and are now the cause of heavy losses. Many acquisitions, heralded as strategic and highly synergistic, turned out to be poorly selected and researched. Often they are a heavy drag on their parent and have to be written down in value. Industrial corporations, banks and insurance companies had increasingly invested in the booming stock market, expecting with confidence steady profits above the returns of bonds. These investments have now turned sour and resulted in heavy losses, often causing a lowering of the rating of the parent and sometimes necessitating an increase in capital. Pension funds, which had hailed equity investments as superior to bonds, are showing huge amounts of unfunded pension obligations that have to be financed, whether they do agree or don't, by the employers. We now find out that profits are no longer profits. Many cost items had been declared "extraordinary" or "non-recurring" to present an artificially brightened earnings picture. All these institutions and individuals are hurt financially, are suffering under the bear market and just don't know any more whether stocks will ever stop going down. Since they can't bear this risk any longer, they are selling despite the very low prices. The more prices go down, the more investors have to sell. This downward spiral will only end once we have a sizable undervaluation (the opposite of the preceding overvaluation) and when every fool can see that stocks are more attractive than bonds. Nobody knows, when this will happen, but the irrational behavior of the markets suggests that this point could be not too far off.

The present mood and fears remind me of the situation in 1973/74 during and after the Jom Kippur war in the Middle East. The Arabs had used the oil weapon and the markets just kept falling. The outlook was very bleak. Such times are characterized by deep pessimism and desolation. But in 1975 the market suddenly turned and within a year went up by 41%. A ray of hope can turn the situation quickly, people realize that they have been too pessimistic and nobody wants to miss the upturn. Unfortunately, we may not have reached this point yet.

To cope with the present difficult situation it seems best to have equity investments and bonds, and for us, high yielding bonds. Let me quote our expert Warren Buffett, what he has to say on this theme in his latest Annual Report. He is still surprisingly cautious on equities:

"We continue to do little in equities. Charlie and I are increasingly comfortable with our holdings in Berkshire's major investees because most of them have increased their earnings while their valuations have decreased. But we are not inclined to add to them. Though these enterprises have good prospects, we don't yet believe their shares are undervalued.

In our view, the same conclusion fits stocks generally. Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us. This dismal fact is testimony to the insanity of valuations reached during The Great Bubble. Unfortunately, the hangover may prove to be proportional to the binge.

The aversion of equities that Charlie and I exhibit today is far from congenial. We love owning common stocks – if they can be purchased at attractive prices. In my 61 years of investing, 50 or so years have offered that kind of opportunity. There will be years like that again. Unless, however, we see a very high probability of at least 10% pre-tax returns (which translate to 6.5 – 7% after corporate tax), we will sit on the sidelines. With short term money returning less than 1% after-tax, sitting it out is no fun. But occasionally successful investing requires inactivity.

Last year we were, however, able to make sensible investments in a few “junk” bonds and loans. Overall, our commitments in this sector sextupled, reaching \$8.3 billion by yearend.

Investing in junk bonds and investing in stocks are alike in certain ways: Both activities require us to make a price-value calculation and also to scan hundreds of securities to find the very few those have attractive reward/risk ratios. But there are important differences between the two disciplines as well. In stocks, we expect every commitment to work out well because we concentrate on conservatively financed businesses with strong competitive strengths, run by able and honest people. If we buy into these companies at sensible prices, losses should be rare. Indeed, during the 38 years we have run the company’s affairs, gains from the equities we manage at Berkshire (that is, excluding those managed at General Re and Geico) have exceeded losses by a ratio of about 100 to one.

Purchasing junk bonds, we are dealing with enterprises that are far more marginal. These businesses are usually overloaded with debt and often operate in industries characterized by low returns on capital. Additionally, the quality of management is sometimes questionable. Management may even have interests that are directly counter to those of debt-holders. Therefore, we expect that we will have occasional large losses in junk issues. So far, however, we have done reasonably well in this field.” (Berkshire Annual Report 2002)

The prudent or even negative attitude towards equities strikes the reader. After all, equity prices have fallen a lot over the last three years. What must have changed is his economic outlook. Growth has slowed down to a halt; there is some danger of stagnation. Taxes, which have been lowered in the past, may have to be raised to finance growing deficits. Market capitalism and globalization no longer enjoy the worldwide respect and support. All these developments could have a negative influence on corporate profitability. The market has turned from highly optimistic to deeply depressed, full of fear and expecting the worst. No wonder then that he thinks the hangover may still last for a while.

What does this mean for us? As we know the lean years are still on and will not disappear fast. Equities are in many cases very cheap and very attractive (despite the words of Buffett), but a hostile surrounding may delay their return to favor. There could be made a case that European equities are quite a bit cheaper than US equities, but their outlook too is clouded. Under these circumstances, like in 1973/74, it may be a good idea to invest first in attractively priced equities and second in what one calls high yielding debentures, fallen angels or junk bonds. Their high, steady cash flow makes them very attractive in the present environment. The Neue Zürcher Zeitung, just rated to be the 3rd best newspaper after the New York Times and the International Herald Tribune, writes in a essay on 17 March on emerging market bonds:

Despite the crises in Asia, Mexico, Russia and Brazil, emerging market bonds have performed better than any other asset class in the past 10 years.

By following the footsteps of a brilliant investor like Buffett we should do reasonably well even in adverse times.

Roland Schwab