FINANCIAL REVIEW 2002 AND OUTLOOK 2003

The financial markets faced the third year of a serious and stubborn retraction. We would have to go back a long way in history to find a comparable correction. The magnitude is by now more dramatic than in 1973-74, but by far less painful than the great crash of 1929-32!

The Performance figures (in %) of the most relevant stock-indices illustrate the bleak picture as seen below:

Index	**2000**	**2001**	**2002**
Dow Jones	- 6.2	- 7.1	- 16.8
S&P 500	- 10.1	- 13.0	- 23.4
Nasdaq	- 39.3	- 21.1	- 31.5
Nikkei 225	- 27.2	- 23.5	- 18.6
FT 100	- 10.2	- 16.2	- 24.5
DAX	- 7.5	- 19.8	- 44.0
SMI	+ 7.5	- 21.1	- 27.8
Hang Sang	- 11.0	- 24.5	- 18.2
Singapore	- 22.3	- 15.8	- 17.4
MSCI World	- 14.1	- 17.9	- 21.0

In 2002 we were able to keep portfolio losses within an acceptable range against a background of steeply declining equity markets. For some time we have drawn our investors' attention to the fact that the secular boom will not last forever. In 2000 and 2001 the tide of the market turned. 2002 was again an "annus horribilis" emotionally and financially, and for many investors one of the worst, as they continued to suffer heavy losses, as shown in the data table above. On the other hand, USD referenced accounts benefited from the strength of the currencies against the USD, particularly EURO and the Swiss Franc, which improved 19% resp. 17% during 2002.

Our equity portfolio weathered the storm better than the indices, but we too had some major losers. Our largest position, Berkshire Hathaway, managed to close with only a small loss. Well-known Blue Chips such as Coca-Cola and Gillette continued their slow retreat, showing once again only weak growth in earnings. Among insurance stocks, Aflac (and Berkshire Hathaway) performed above average and suffered only modest declines. It is worthwhile to mention the varied development in this industry. American companies with only limited equity holdings survived in much better shape than their European competitors who were heavily exposed to equities. Many had to raise new equity capital to remain solvent and to retain the ability to underwrite new business. They are now trying to replenish their depleted reserves - a difficult task when interest rates are at record lows. However, this clouded outlook is now reflected in very low prices. In addition, insurance premiums are increasing rapidly and competition is declining. We think that the patient, contrarian investor has here an opportunity to acquire strong companies like Swiss Re, Allianz, Munich Re and AIG at advantageous prices.

There were also remarkable differences among banks. While HSBC, Wells Fargo and UBS did relatively well, Credit Suisse and, to a minor extent, Citigroup were under heavy pressure due to overpaid acquisitions in the first case and to overly aggressive and even unethical behaviour in both cases. Some of the stocks in this sector are now quite cheap. Their business outlook is not without problems, but there are also some positive developments. Costs are being cut and unprofitable diversification being sold or liquidated. Furthermore, banks also profit from the very low interest rates they have to pay. Many of them have been able to more or less maintain their level of profitability. In spite of this, their market capitalisation was marked down considerably. This has rendered them attractive for the long-term value investor.

Our pharmaceutical companies also had a tough year. They were able to maintain their profitability, but there seem to be very few new blockbuster drugs in the pipeline. Research and development expenses are huge and still rising, but conditions for registration are getting tougher and more complicated. In addition, public health authorities are under intense pressure to lower drug costs. For these reasons, good drug companies are now available at P/E ratios of 16 to 20 times, which is relatively low and attractive.

Fortunately, high yielding bonds contributed positive returns. As their name indicates, they offer a higher yield at a higher risk of loss than investment grade securities. The negative exception was Argentina, where no improvement is yet in sight. Brazil at first frightened us with the election of socialist president Lula da Silva, but so far the new government promises to follow a responsible economic and financial policy. We hope they will follow up their words with deeds. In Turkey the people rejected the established parties and elected an Islamic government. There is hope in the market that the new government will free the economy from old corrupt practices and nationalistic constraints.

Most observers had expected that the burst of the New-Economy-Bubble would also cause a crash of the Emerging Market bonds. Fortunately this has not occurred. The International Monetary Fund and the World Bank were able to contain the crisis from spreading beyond Argentina. In Eastern Europe, most of the countries adhered to very strict financial and monetary rules. They have been rewarded with the planned admission to the European Union and have demonstrated to other developing nations that financial discipline and conservative spending is a precondition to future well being and creditworthiness. In addition to public debt we have also found an increasing number of private industrial debt with acceptable risk and attractive yields. In tough, recessionary times like these, many well-established credits are rated down out of fear and excessive pessimism. We take into consideration risk and return and often find that the market is overly pessimistic. Two good examples are Xerox, the Copier Company and Amazon, the Internet bookstore. They should be able to survive intact and are offering yields of over 10%. With high premiums on yields they more than compensate for their limited financial strength. High yielding government and private bonds will remain an attractive investment for long-term contrarian value investors.

Many disappointed investors don’t even want to know how markets will develop in the future, because they already know. After two shockingly bad years they are so frightened that they have reached the limits of their tolerance for risk and losses. The world economy seems to be moving towards stagnation or recession with unemployment rising. World politics are tense, with the bloody confrontation between Israelis and Palestinians polarising a large part of the world population. A war in Iraq seems an imminent threat. Politicians, entrepreneurs and the public are in low spirits.

However, as contrarian investors we shouldn’t succumb easily to pessimism and depression. The outlook may be clouded; we may be in the midst of the lean years with no end to the problems in sight. But after a bear market of more than two years, stock markets’ capitalisation reflect most of the problems with almost no turn for the better or a surprise on the upside. The dark clouds will one day lift and make way for better days. When that happens in the not too distant future, some of the present prices will look unbelievably low and attractive. Therefore, the long-term investor should buy even though the outlook is highly uncertain.

Today, stocks of many companies with stable earnings and an attractive economic outlook are changing hands at half the price! What has changed, are opinions and sentiments of the investors. Some time ago they had feared to miss the strong upswing and the profits that were being generated. Now, at much lower prices, they are preoccupied by the fear of further losses and don’t give much thought to the upside potential. We think that this pessimism is presently overdone. Those who wait for a better point of entry to the market may miss the best move. Thoughtful investors, who buy stocks and bonds at low bargain prices and wait patiently for their eventual reward, should live peacefully and sleep well.

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