

KRAEMER, SCHWAB & CO. AG

Investment Management

FINANCIAL REVIEW 2003 AND OUTLOOK 2004

After 2 consecutive years of decline, and a very weak first quarter, stock markets as well as bonds have risen steadily until the end of the year. Another helpful factor has been the strength of the EUR, CHF and GBP against the USD. Against returns achieved on safe, short-term instruments of 2-3%, results must be viewed as extraordinary and of a one-time nature, and should not lead to unrealistic expectations.

There is no question that the economic outlook has improved since the beginning of the year. Widespread fear or even panic of an imminent crash (particularly among insurance companies and pension funds) has given way to more confidence and trust. Lower taxes in the US have lent support to consumers and businesses. Enterprises have restructured and lowered costs to be more competitive after the sobering-up of the bear market. Many companies have reduced debt and increased equity to be able to withstand tougher times. Despite all these positive developments we do not believe that all problems have been overcome and that we are now entering the golden age. Rather, we expect to see a rolling movement of ups and downs with favorable news followed by setbacks, and probably no clear trend being able to establish itself. Globalization is a powerful competitive factor: cheaper products from emerging countries, mostly from Asia are ousting products made in industrialized nations. Similar moves are now also taking place in sectors like software development, service areas or call-centers. This evolution is enhancing growth in emerging countries while at the same time limiting it in the developed world. As a result, the conclusion to invest more in these areas could be drawn. We do it already to quite an extent with our investments in bonds of emerging countries. To invest directly in companies, however, has its drawbacks: Accounting and reporting standards, accountability, honesty and respect for the rights of outside shareholders may not be perfect in Europe and the US, but they are much less developed, established and enforceable there. Therefore it may be more advantageous to invest in international companies that have their production partly or wholly in low cost countries.

There are indications that the economy and businesses face challenges and dislocations. The dramatic weakness of the dollar shows how unstable and unbalanced world trade is. Scandals, cheating and malfeasance as a legacy of the boom years are now coming to light. They demonstrate that honesty, truthfulness, moderation and respect of the law have often been pushed to the side by aggressiveness, greed and hubris. Not only small speculators and stock promoters have lost sight of reality and their limits, but also chief executives of global leaders have got carried away by the "Zeitgeist". Even Procter & Gamble, Coca Cola, Gillette and Lloyds TSB embraced the goal to grow profits by at least 15% yearly in order to belong to the exclusive club of the "growth stocks" and thus being attributed a much higher valuation. If ordinary operations didn't supply the desired results, all kind of expenses were declared "extraordinary", "non-recurring" or "for restructuring" and excluded from "ordinary" or "pro forma results". After a while the embellishment was over and much more modest results came to light. Xerox went even further and actively manipulated sales and profits. Almost all large insurance companies had over-invested in equities during the boom phase to chase capital gains. They sold these positions in the crash at huge losses. Estimates put their total losses at \$250 billion or 10 times their losses in the terrorist attack on the World Trade Center in New York. Mobil COM, a subsidiary of France Telecom, had a few years ago acquired a 3G license for Germany for EUR 8.4 billion. Recently the company gave back the license for free because the buildup of the net would not be profitable and the firm probably didn't have the money. Companies like Enron, Worldcom and Parmalat committed outright fraud in their dealings.

KRAEMER, SCHWAB & CO. AG

Investment Management

2

To correct and adjust these misallocated investments and excesses will take a while and is probably not over yet. The healing process is important in order to form a better foundation for a future upswing. The investor should always pay attention to problems, downfalls and crashes, because avoiding them is a prerequisite for long term success. By disregarding this rule many of the most astute speculators have in the end fallen down.

How should an investor proceed in the present circumstances? It appears that we are in a volatile period. Presently the markets are moving up, but we doubt whether it is sustainable. Under these conditions it is advisable and probably advantageous to act as a contrarian and not to follow the crowd. One should be cautious while the market moves up and valuations are generous. One should also keep in mind, that interest rates eventually will move up from their very low levels, which could hurt many careless investors. There are also economic problems that have to be addressed: Weakness and low confidence in the dollar, globalization, and slow structural adaptations to a changing environment. However, we are not completely bearish. When markets are weak and valuations become more attractive we will try to turn more positive and be on the lookout for bargains. The emotional handling of this contrast or this antithesis, together with the analytical capacity to evaluate the quality of businesses and economies, are the basic preconditions for success in the market.

Our two principal investment vehicles will remain high yielding bonds (as long as we can find them) and shares of excellent companies. Bond yields, even in our universe, have declined dramatically. Admittedly some countries and companies have improved their financial situation like Brazil, Turkey and the Eastern European nations newly admitted to the EU, or among the corporate debtors ABB, Amazon, Ascom and Xerox. We greatly benefited from their ascent but now scratch our heads to find replacements. In the face of a dearth of offerings one has to be all the more attentive and critical to avoid disasters like Parmalat and Argentina. Not an easy job!

The situation in the stock market is not much different. Most stocks have nicely recovered, as much or more so than the underlying economic fundamentals. The eventual rise of interest rates, when it comes later will be a negative factor. We will try hard to acquire companies with attractive long term economic features and profitability at reasonable prices. Presently pharmaceutical, food, as well as financial and insurance companies look attractive to us. Occasionally we buy discount certificates of companies we like. These securities are commitments against a fee to buy the stock at a lower price. In addition, cash is at the moment a good alternative when prices are at lofty levels.

Early 2003, in our general review letter to clients we we said that "in the not too distant future, some of the present prices will look unbelievably low and attractive." This year, the situation has changed. The bargain prices have gone and the upside potential is limited. However, investors can now afford to be content with a smaller yield. Markets will change and there will be new opportunities.

Kraemer, Schwab & Co AG
January 2004