

**"The future is never clear, and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values."**

**(W. Buffett)**

## **Current Valuation of stocks:**

The capitalization of the US stock market is approximately 60% of GDP at the moment (S&P at 700). As a reference, in 2000 it reached an all time high of 180%, the long term average is 80-90%, and in 1983 it was approximately 40%. Many other indicators, such as the Shiller P/E ratio give similar results: stocks are cheap (Shiller P/E at 12, long term average is 16), below long term trend and below fair value. This gives confidence to long term bears like Jeremy Grantham (Chairman of GMO, a global investment management firm with over USD 85 billion in client assets, and a renowned value investor) to indicate expectations of 10% to 13% real returns (i.e. net of inflation, so nominal returns would be higher) for stocks for the next 7 years, this return would be well above the long term historical average. On the other hand, in the short run stock prices do not depend on fundamentals but on psychology and demand and supply: when there are only panicked sellers and no buyers, stocks can go lower and lower. **In conclusion: we feel stocks are priced to deliver well above average real returns in the next few years**, and in particular good blue chip solid companies, but we do not know what the next year will bring, and indexes could go lower if pessimism does not abate. While we have clearly been wrong in judging how bad the situation could get, we remain of the opinion that timing 1-2 year returns is extremely difficult, while it is highly probable that returns over the next few years will be very good. We therefore recommend gaining/maintaining exposure to the market as we know prices are attractive, without trying to pick a bottom, but possibly staggering a reinvestment/increasing positions in 2 or 3 moves as opposite to 1 single decision.

## **On currency:**

For global multinational stocks currency exposure is not so relevant. The real exposure is not the denomination of the stock price but the underlying cash flows generated by the business, and these companies are in business everywhere. Nestle' and Coca-cola both have exposure to a widely diversified basket of currencies, and hedging the portfolio would cost money and not bring benefits in the long run.

## **Inflation:**

It is possible, may be even likely, that inflation will come back sometimes in the next few years, as all central banks are printing money. The FED is probably winning the printing race, hence that would suggest a USD weakness in the future, but it is not so clear, as the trade balance may improve quite quickly and also the EURO is not in the best shape either. In an inflationary environment, commodities would probably perform quite well, but they are extremely volatile and very difficult to analyze. Stocks of companies with pricing power and high returns on invested capital (characteristics of many strong blue chips with powerful competitive advantages) are also an excellent hedge against inflation over time, while the clear losers are cash and long term bonds (unless they provide already very high yields).

-2-

## Specific stocks:

Our suggestions for the target portfolio are the following:

- Pharmaceuticals/Medical Devices: Johnson and Johnson, Pfizer, Roche, Merck, Glaxo, Novartis, Sanofi, Zimmer, Stryker, Medtronic
- Consumer goods: Nestle', Heineken, Procter & Gamble, Colgate, L'Oreal, Coca-cola, Unilever, Pepsi, Luxottica, Lindt & Sprungli, Swatch
- Conglomerates: Cheung Kong, Pargesa
- Financials: Berkshire Hathaway, Fairfax Financial, Markel, HSBC, Renaissance Re, Zurich, McGraw Hill, Legg Mason
- Industrials: Siemens, GE, ABB, 3M
- Other: Automatic Data Processing, Conoco

Jeremy Grantham summarizes the psychological difficulties for investors in the current environment, but also the importance of keeping in mind the attractiveness of current prices on a long term basis. If one invests too soon too much she or he will regret it, but also investing too little bears considerable risk as long term expected returns are very attractive and inflation will erode the purchasing power of cash.

Not being able to forecast short term market movements (important but unknowable fact), we rely on what is important and knowable: stocks and in particular quality large caps are cheap and priced to deliver returns well in excess of inflation for the next few years. We therefore recommend that investors maintain exposure to the market or, if sitting on the sidelines, reflect on the fact that cash, while brilliant in the last two years, over time is a terrible asset in inflationary environments.

While collective psychology currently emphasizes only downside risks and pessimism, periods like the present one have always been the basis for a much brighter future, and a comparison of prices and fundamentals gives strong signals that your patience will be rewarded

Thank you for your support in these trying times

Roland Schwab  
Paolo Tramontana

March 2009