

KRAEMER, SCHWAB & CO. AG

Investment Management

RESULTS OF OUR VALUE INVESTING APPROACH AND SOME INVESTMENT THOUGHTS

2006 was the fourth year in a row with good, even very good growth worldwide. Stock prices surged, but more important, earnings also surged and underpinned higher valuations. Again investors in stocks vastly over performed those that held bonds and fixed income securities. The favorable performance was broadly based geographically and among business sectors. US Dollar investors profited in addition by the strength of currencies like Euro, Pound Sterling and Swiss Franc.

Our largest holding, Berkshire Hathaway, had a banner year with profits totaling USD16.8 billion. Buffett thinks this is the biggest retained growth in wealth among all US companies (other big companies spend huge amounts on dividends and share repurchases, Berkshire reinvests all this money). In 1964 this stock was about USD15 and the whole Company had a value of USD18 million. Today the profits alone amount to 16.8 billion, the Company's worth is approximately USD170 billion, has 75 subsidiaries and over 200'000 employees, with a world head office of 19 employees. Buffett's comment: "There is much to be said for just putting one foot in front of the other every day".

Insurance and reinsurance companies worldwide benefited from benign weather and very few land-falls of hurricanes. Premiums on the other hand have been at record levels in view of the huge damages suffered in the preceding years. General perception counts on ever increasing levels of intensity of damages and destruction due to global warming. There is definitely an element of exaggerated expectations spreading, up to an extreme scenario of pervasive doom. Nobody knows the magnitude of future damages for sure and this uncertainty weighs on the valuation of insurance companies. We think these are good conditions to keep the business profitable and attractive for longer than is generally assumed. Valuations are low and skepticism reigns; dividends are growing and companies repurchase sizable numbers of shares. Risk is limited, because most companies trade between 1 and 1.5 times book value. A Berkshire Hathaway at 1.5 times book value is attractive, despite its run up in price.

In similar fashion, first class banks trade at 10 to 12 times earnings and pay dividends yielding 2 to 5%. It is possible that earnings could languish for the next few years, even retreat somewhat, but they shouldn't fall off a cliff either. A low price and a high dividend with a stable outlook look like an attractive combination to us. We will reduce more volatile positions like Credit Suisse, which has performed outstandingly in the last year, and increase more stable banks like UBS and HSBC.

Pharmaceutical and medical technology companies are under a cloud of legal problems like product liabilities (Merck, Pfizer) and the coming presidential elections. Democrats are in the upwind and they are in favor of state involvements and interventions to lower the cost of drugs and medical treatments. Hillary Clinton in particular has already in 1994 tried to lower drug prices unilaterally, but she hasn't succeeded. Widespread use of generic substitutes of patented drugs could reduce sales and profits of producers of the latter. In addition, product liability trials have been on the rise, in particular due to the Vioxx case, and there have been problems with stents and defibrillators. These issues and concerns are political topics and will remain so for a while. They will continue to weigh for a while on the sector and pressure prices downward. We on the other hand will try to take advantage of the weakness and add to existing positions. Medical technology is a business with a small number of strong competitors and high margins. The barrier of entry for a new competitor is high, the moat is large. Long term the demand for these products and services will certainly grow as people live longer and therefore will be exposed to a higher number of diseases than our ancestors with a much shorter life expectancy.

We also like consumer product companies, e.g. Coca Cola, Home Depot, Nestle and Numico. They are growing steadily and are also increasing dividends. Performance is not fancy, but growth is steady and reliable.

Interest rates are slowly moving higher worldwide. Inflation is not a problem at the moment, although it can't be dismissed either. Beneficial effects of globalization are helping to dampen inflationary wage demands by unions and employees. Qualified personnel migrate to places of higher demand. Production can often be moved to lower cost sites and countries, so there is competition for the plant and this tends to lower costs. Thanks to globalization, investors presently enjoy record high profits as a percentage of Gross National Product. Dividend payments and repurchases of stocks are on the rise. These factors have supported higher stock prices.

The geopolitical situation is becoming more volatile and worrisome. The USA is no longer the supreme, widely respected super power. They have increasingly problems to control the situations in Iraq, Iran, Palestine and Afghanistan and they are widely disliked for their support of Israel. Economically they are still the leading nation, but their influence is slowly declining, while China, India and other nations are rising. A sign of change is the fact that the biggest holders of financial reserves, e.g. China, Japan, Korea and some Middle Eastern nations, are diversifying them and no longer hold US dollars exclusively. Nevertheless, the US remains the biggest investment market with by far the widest selection of first class companies incorporating reliable and honest accounting. However, volatility and insecurity will probably increase in the future.

Since some Eastern nations are growing faster than Europe and the US, an observer could conclude that it must be much more rewarding to concentrate his investments there and not in the developed world. There is some logic to this idea, but it is a peculiarity of investment markets that it leads one to miss the mark. Simply put, if the crowds turn their attention and focus on these markets, they invariably overrate and overvalue the positive factors and under appreciate the risks and dangers inherent, and they overpay, sometimes wildly. However, overpaying is the biggest danger, the biggest sin of an investor. Buffett says: "A fool and his money are always welcome". We prefer today the blue chips mentioned above, first class companies with first class finances, which are being overlooked and neglected. They should move ahead steadily even in a crisis, and the risk of a decline is smaller and limited by their earnings and dividends.

Personally I consider bonds not very attractive. The yield curve is very flat, short term placements yield almost the same rate as bonds. There is a latent risk of higher inflation. Second quality bonds compensate only partially for the higher risk and could fall in a crisis. High quality stocks at reasonable prices look more rewarding.

It seems that we are in a correction phase. In these times it is important to remember that we are value investors. We buy stocks for their present and future earnings and dividends and not for an expected rise of the price. Of course, if it happens, it is a nice occurrence.

People tend to forget, that in the long run the most important factor for wealth creation is the reinvestment of dividends and not price appreciation. Jeremy Siegel describes these facts in his book "The Future for Investors".

Knowing about the importance of increasing dividends and their reinvestment at favourable, meaning low prices for the long term success, it is evident that the value investor doesn't view corrections and plunging prices like the present ones as catastrophes and reasons to bail out as quickly as possible, but as chances to reinvest some of his liquid funds and revenues for good future returns. The only condition is that he concentrates on values, knows them well and avoids speculative temptations. He also has to stand firm against all the negative sentiment, criticism and fear, which will weaken his resolve and try to throw him out of the market during a decline or a crash.

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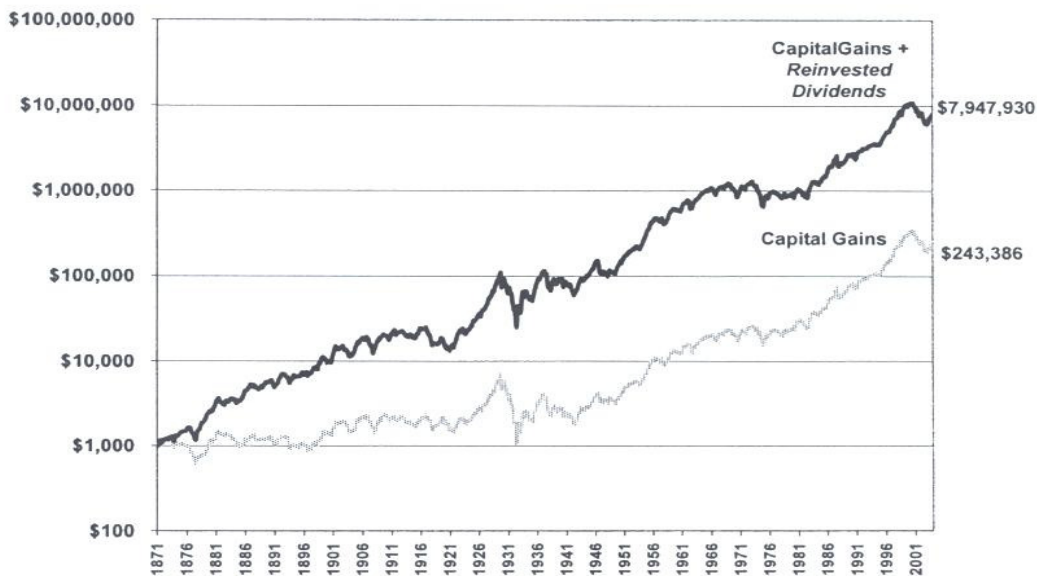
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Annex:

From 1871 through 2003, 97% of the total after-inflation accumulation from stocks comes from reinvesting dividends. Only 3% comes from capital gains.

Take a look at this figure, which appears in Chapter 9 of *The Future for Investors*. \$1,000 invested in stocks 1871 would have accumulated to almost \$8 million after inflation by the end of 2003.¹ Without reinvesting dividends, the accumulation would be less than \$250,000.

Figure 9-1: The Powerful Impact of Dividend Reinvestment



During these 122 years investors did collect about \$90,000 in dividends. If these dividends are simply added to the price appreciation, the total would be about one third of a million dollars. But this total is still tiny compared to the wealth accumulated when dividends are reinvested. In terms of annual returns, the numbers are equally striking. Without reinvesting dividends the average annual after-inflation return on stocks falls from 7% to 4.5%, a drop of over one-third.

The importance of dividends for providing wealth to investors is self-evident. Dividends not only dwarf inflation, growth, and changing valuation levels individually, but they also dwarf the combined importance of inflation, growth, and changing valuation levels.

Robert Arnott, "Dividends and the Three Dwarfs," 2003

¹ The 1871-2003 period is analyzed because this is when data on dividends, available from the Cowles Foundation studies, becomes very reliable. See Siegel (2002) for more details.