

KRAEMER, SCHWAB & CO. AG

Investment Management

FINANCIAL REVIEW 2005 AND OUTLOOK 2006

In the past year, markets generally performed well, especially for European investors. However, despite good economic growth and the very attractive profitability of US companies, the returns for dollar investors were disappointing. The significant revaluation of the USD against its main competitors, i.e. EUR, GBP and YEN, was the principal reason, but it also appears that the appetite for risky investments such as stocks is running out of steam in the US. Risk free short-term interest rates of over 4% are becoming a viable alternative. European and Asian stock markets have boomed, but with the conversion into USD, a large chunk of the appreciation has disappeared.

It seems that the strength of the dollar was due to the strong economic performance of the US economy and the higher interest rates this currency offered. Current and Trade account deficits climbed to record heights, as did the national debt. Americans spend quite a bit more on favourable imports than they earn with their exports; in addition the Government finances a good part of its expenses with debt held by foreigners such as China, Middle Eastern oil exporters and Japanese pension funds. So far international investors are still willing to hold part of their investments in this currency and have faith in it. But the world's Superpower is relying increasingly on foreign borrowings and is therefore getting more and more vulnerable. One solution to correct this imbalance is through a weakening of the currency. It would improve the competitive edge of US producers and help to reduce the trade deficit. But such changes need time and don't happen overnight. The dire situation GM finds itself in for example is a reflection of the complex difficulties US manufacturers face. There are no fast and easy solutions.

US citizens are also getting more and more alienated by the disappointing turn of events in the fight against terrorism and the war in Iraq. It appears that the rhetoric and the propaganda of the US government were much more successful than the actual fight on the ground. Confidence is now evaporating, as the sobering reality finally begins to step in. The US government had hoped at the beginning of the war to gain decisive political influence over one of the main oil producers in the Middle East, which should have assured them low energy prices for the foreseeable future. The very opposite seems to have happened. Energy prices have doubled since 2003 and settled at high levels. The growth in demand by emerging countries such as China and India is soaking up additional supplies. Huge new discoveries are not in sight; it looks like we will have to live with permanently high prices. This, however, allows the production of high-priced sources such as tar sands, which will hopefully accelerate investments in the production of renewable energy. Barring energy prices, inflation has been tame so far. But with good economic growth, signs of scarcity could appear and spread also among metals and food, thus perhaps pushing up inflation. Everybody knows that higher inflation followed by higher interest rates would put pressure on equity prices.

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Over the years, one of the best methods to grow capital consistently and to preserve it has been to act as a contrarian investor. You ask yourself: What is cheap, unpopular and problematic, but has, beneath the actual troubles, economic attraction and value? Companies that come to mind are stock market dogs like Merck and Pfizer, many insurance companies like AIG, Swiss Re and Hannover Re, banks like Citicorp, J.P Morgan and Depfa. On the opposite side of the spectrum, you ask: What is hot and popular, has had a good performance, has the highest expectation for future growth and therefore the highest valuation? Here there is most likely some wishful thinking combined with an extended valuation, and therefore we should reduce these positions. Some European small and medium sized corporations, steel producers and companies in emerging countries (e.g. in Asia) could fit the profile.

The cautious outlook by many experts, the expectation that returns in the coming year will not be easy to get and will be rather average and not exceptional give us some confidence. We also observe that many blue chip companies like General Electric, Coca Cola, Disney, Citigroup, Estee Lauder, Home Depot, Univision and many others have over the last few years steadily increased their profits, but their prices have fallen. They are now even more attractive than they were in their heydays in the late nineties and in 2000, when they were accorded unrealistically high valuations. The outlook for their growth rate in earnings has come down but is now closer to reality. Most offer dividend yields of 2 to 3%. Add to this an expected growth of approximately 5-7% on average per annum and we should get a total return of about 8% including inflation. This could be a realistic long term expectation and would be in line with historic performance. High grade short term bond yields of about 4.5% are a risk free alternative. Most lower grade bonds are less attractive. Their premiums are insufficient to cover the additional risk.

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