

**KRAEMER, SCHWAB & CO. AG**  
Investment Management

Dear Investor,

As you may remember we have been quite cautious on the outlook for the markets at the beginning of the year and still are not exuberant. Instead of stocks we have emphasised high yielding bonds in the accounts, so the present lack of positive momentum is not really a surprise. Nevertheless we do not try to time the market and have kept most of our equities. As participants have turned more bearish and as prices have declined, we have turned somewhat more positive.

When we buy equities we look for under priced situations. They are most of the time disliked, are not on the buying list of brokers and banks and possibly have a problem to solve before returning to favour. We are almost never able to buy them at their lowest price, but we usually buy them below their intrinsic value. If they go lower, we add to our positions. With this method we likely end up with good average costs. Market prices may move lower (as they presently do), but we are not worried, if we see earnings eventually moving higher and therefore the value of our investment will go up. In bear markets the undervaluation may last longer, but as long as the earning power is maintained we build value which eventually will show up in higher stock prices. As contrarians we often buy when the majority is selling.

After the highly successful 2003 it was probable that the year could be rather difficult. Economic parameters like interest rates, profitability and inflation (with low priced and abundant raw materials) have not much leeway to improve and will rather deteriorate. Political stability and terrorism have worsened. Beside these handicaps we were also hit by wholly unexpected events like the hurricanes in Florida and the Gulf of Mexico, the investigation by attorney general Elliot Spitzer in New York or the product withdrawal in the case of Merck. These misfortunes tend to push prices down at the moment but they also give an opportunity to add to positions at favourable prices. We see lots of problems at the moment but when all the bad news are out, companies will work their way back up eventually and we will participate.

Take as an example insurance and reinsurance stocks. They got hit very badly first by lax underwriting during the boom years, when they made a loss on insurance contracts but were able to profit from the strong stock market. When the market plunged they were left with the unprofitable insurance. The second hit was the immense losses from World Trade Center. After that they continued to suffer from bad investments during the bear market and the low yield on bonds. Fortunately insurance premiums shot up. However, this year the hurricanes hit them with damages of a magnitude which occur perhaps once every hundred years. Add to this the investigation by attorney general Spitzer of New York. Small wonder that nobody wants to own insurance stocks. They are very cheap; many trade at book value or only slightly above. Their expertise and know-how, market position and client relations are worth very little. Their service is very much needed and rates will fluctuate but should be attractive in a world flooded by disasters. The patient investor finds here well managed companies with good earnings power and growing dividends at low prices.

Another sector with low esteem is the consumer non-durable with manufacturers like Nestlé, Coca Cola, Unilever or L'Oréal. Many consumers seem to be very price conscious at the moment and are opting for lower priced private labels rather than higher quality brand names. This hinders big companies to pass on higher costs for advertising, transport and packaging and squeezes their margins. But again, we think these problems come and go, the stock prices are cheap, the dividends attractive and growing. It is a good time to buy them. The situation is similar among drug stocks. Several setbacks with well known products have tarnished their attractiveness and their outlook is thought to be very cloudy. Stock prices have suffered heavily. But they enjoy a high profitability and with a growing population of seniors demand for drugs should keep rising. We would add to positions.

We have never been able to time the market and to predict the next move; we are not market followers as that is just not our calling, but we have been able to buy good values against the market's fears. In the short term prices retreat more, but in the long run this is the best method to invest, to preserve and grow a fortune, even in difficult times. After the tide, the next flood should move us higher, if we add now to positions when the outlook is cloudy.

Roland Schwab

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