INVESTMENT REVIEW 2001

The years 2000 and 2001 were not easy years for investors in general. After a long run of economic growth, the tide took a downturn. We had been drawing our investors' attention for quite some time now to the fact that the secular boom would not last forever, since markets were overheated. The events of September 11 only accelerated the whole process. In fact, 2001 was an "annus horribilis" emotionally and financially, and for many investors one of the worst. The Standard & Poors 500 Industrials Index declined by 13%, the Swiss Performance Index by 21% and the MSCI by 18%. For our standard, balanced portfolios, the performance averaged between -5% and +2%, depending on the composition as well as the time span of the portfolio. Relative to the market performances, we believe we have been able to contain the losses.

Our equity portfolio has weathered the storm better than the indices, but we too have had some major losers. Our largest position, Berkshire Hathaway, managed to close with a small gain. However, well-known Blue Chips such as Coca-Cola and Gillette retreated, because they could not deliver the growth they had promised. A weak market punishes poor results mercilessly. Investors may also exaggerate on the downside as they had exaggerated on the upside before. La baisse amène la baisse.

The high yielding bonds contributed a positive return. The exception was Argentina, which unfortunately defaulted late in the year. Other Emerging Country debtors like Brazil and Turkey, with help from the IMF, have shown healthier prospects. The worldwide recession poses a problem for all of them. They should be manageable, because most of these countries have made progress in implementing a more market-oriented economy. One gets the impression that the IMF and the USA use Argentina's dire state as a strong warning signal to other countries not to relent on their financial discipline, as otherwise they will suffer the same fate.

The question now is what should we expect in the future? Many observers believe that the tragic events of September 11 have changed the world completely. We don't think so. "Whatever you thought about the stock market before the attack on the World Trade Centre is what you should be thinking today. I don't have any feeling that this will cause the market to behave much differently from how it would have behaved without the disaster. It's a market that has been through a bubble" (Buffett). The world was heading for a recession before September. The excesses in investments in boom sectors like technology and telecommunication have to be corrected and written down. This will take time and will be painful. Terrorist attacks and the war in Afghanistan have accelerated this process and added somewhat to a pessimistic feeling, but they are not the cause of the downturn.

After a long period of peace and prosperity, terrorist attacks like those of September frighten and shock us deeply, giving us the impression that nothing similar has ever happened. World history, however, shows that there have always been peaceful, prosperous periods as well as periods of war and destruction. This is bound to be the case in the future too. There are the fat years followed by the lean years. Terrorists' threats and war will exert a negative influence on the economy and stock prices, but their influence on the economy should not be overrated.

In the long run, two fundamental economic variables influence stock prices the most: Interest rates and corporate profits. They decide in the end over success or failure of our investments. Every change in rates changes the value of every financial asset. You see it easily in fluctuating bond prices. But the rule applies as well to land and equities. The value of these financial assets is high, if interest rates are low. If interest rates move up, these values will move down. At present, interest rates are at historically low levels. The second fundamental variable, i.e. corporate profitability, has steadily moved up in the last 17 years, from a low of about 3% of GNP to almost 6%. Recently it started to decline and is presently at about 5% of GNP. It appears that these two factors have both climbed to their zenith, causing a secular bull market that is now running out of steam.

Most experts contend that the present slump will end in the second half of 2002 and that thereafter the "normal" growth will resume. We consider this method, where your outlook is based on the rear-view mirror and where you expect the recent past to happen again in the future, as understandable but nevertheless a mistake that investors often make. It is much more likely, that basic conditions will be rather difficult over the next few years. Investors need not despair, but they better temper their expectations to realistic levels, more appropriate to lean years. We think that a return on stocks of 7% could be close to the mark. This is less than in the past, but it is still a lot more than the present yield of high grade bonds.

Emerging Country bonds remain very attractive, because the yield premium over high grade bonds has widened. The danger of default is real and may cause losses, as the default of Argentina highlights. The premium in yield however is high and should compensate for any losses. We also think that the plight of Argentina disciplines other countries not to make the same mistakes.

Roland Schwab — January 2002