

KRAEMER, SCHWAB & CO. AG

Investment Management

FINANCIAL REVIEW 2006 AND OUTLOOK 2007

2006 was a very rewarding year indeed, the fourth year of uninterrupted growth since 2003, a year marked by low inflation, low interest rates, a healthy economy and very high profitability of business enterprises. "As good as it gets" one is tempted to say. Investors with the US Dollar as base currency profited in addition from a weaker Dollar, unlike last year, when the Greenback was revalued. Higher market prices were driven mainly by higher earnings and not by applying higher multiples on earnings by the market. This is a positive point. Inflationary pressures due to increased raw material and energy prices and also due to wage demands are being checked by higher sourcing of production in lower cost countries and also by a freer flow of skilled workers worldwide. Shareholders, including owners of pension funds which invest in equities, are participating in the growing wealth brought about by globalization. In addition, emerging nations like China, India, Russia and Brazil have benefited the most and have been able to steadily advance their industrial and raw material production capacities. Their growing prosperity may be unevenly split, but it still enhances the situation of the lower classes. In the industrialized nations the opening of the markets to imports from lower cost countries has had and still has a huge impact on what can still be produced here and which new products and new markets have to be found to stay profitably in business. A large part of important production sectors have moved to the East in a relatively short period of time, resulting in the closing of sizable plants with thousands of workers. It is surprising and gratifying to know that this has not led to spectacular bankruptcies and mass unemployment. Enterprises have in general been able to adapt to new realities very quickly and the economies overall have benefited from higher growth and better profitability. While companies have done reasonably well, it has sometimes been the individual worker or employee, young and old, who has had difficulty to adapt. Losing a well paid position after years of employment comes as a shock, and successfully finding a new employment in a fast changing job market is sometimes beyond the capabilities of an individual. Fortunately we have programs to retrain and reeducate these people and giving them financial support during this time. Overall I think economies as well as all of us have profited from these changes and we should be very grateful for the prosperity we enjoy, which is much better than what our forefathers ever had.

The year 2006 has been a year for equities. Bonds yielded much more modest returns. It follows that the pressure to increase equity exposures is growing. However, logic tells us to become more cautious the higher the markets rise. After so many years of steady growth in value it is advisable to have a balanced portfolio with stocks and bonds, with defensive qualities and a margin of safety. Exuberant moods full of confidence can quickly and unexpectedly change. This is particularly important when almost all the experts like today are optimistic and when the question is not whether the indices will climb next year, but rather how much. At such times we try to be somewhat more cautious and to include the possibility of a setback into our thinking. We agree with most experts that many shares are not overvalued and offer decent returns, if the present prosperity continues.

In last year's report I mentioned insurance and reinsurance companies as inexpensive and neglected sectors. Up until the fall the interest was only muted. Investors were under the impression that storms and flooding would inevitably get worse from year to year and insurance companies would suffer more and more. Interest reappeared, when the hurricane season brought only little harm. The insurance sector was able to produce excellent profits and to bolster its equity. Opinions on the outlook diverge; some think that rates and profitability will

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- 2 -

decline, but we are less pessimistic and think that the sector is still quite attractive. One of the stars is Berkshire Hathaway. Warren Buffett announced that the Company's increase in intrinsic value would amount to approximately \$14 billion. In 1964 he had bought this company for only \$15 million; he has never used much debt and the number of shares has only increased by 50%. A share worth \$15 at the time is now \$110'000. And Mr. Buffett at 76 still enjoys day in, day out to create ever higher profits.

Another interesting group of stocks are some unpopular US and European blue chips like Home Depot, Citigroup, AIG, Wal-Mart Stores, General Electric, Pfizer, Medtronic, Merck, SLM and Johnson & Johnson in the US and Siemens, some big banks like Royal Bank of Scotland, HSBC, ABN Amro and Depfa in Europe. These companies have excellent financial standings, are very profitable and enjoy a strong competitive position. However, today's markets consider them unexciting and somewhat boring. We think the valuations are reasonable, dividend yields are relatively high and this should make them rewarding long term investments.

After a few good years with markets rising, there is a persuasive belief that good times will continue for ever or at least for the foreseeable future and any doubt is inappropriate. But great investors like Graham and Buffett have always stressed, that in their considerations risk avoidance is at least as important as recognizing the upside potential. Many large fortunes have been made and lost again. Recently I read an article by a certain William Pesek from Bloomberg on the curse of the highest buildings in the world. More or less every time a new record of height is achieved, a financial crisis ensues. The first one was the Tower of Babel, ending in total chaos. The Chrysler Building was finished in 1930, at the start of the Great Depression; the Sears Tower in Chicago was built in 1974, when the Oil embargo of the OPEC set in. In 1997 Malaysia built the Petronas Towers, just at the onset of the Asian crisis. The highest building today is in Taipei, where big neighbor China is closing in and the political outlook is getting more clouded. Dubai in the Arab Emirates is next to reach a record height with its tower. This country is thriving in a boom that could also end one day unexpectedly and abruptly. Skyscrapers tell you a lot about prosperity, technical capacity and ambition of the builders, but at the same time they are a sign of exuberance, vanity and hubris.

Although most indicators point to a continuation of favorable economic conditions, the investor has also to keep an eye on negative factors and problems. The cost of energy has shot up and remains high, with no easy solution apparent. The US Dollar has weakened, but it could come under additional pressure if the trading partners were to lose confidence in this world reserve currency. After the break of the building boom the US economy seems to hold up reasonably well and to avoid a recession, but the heavily indebted consumer has only limited spending power left. An improvement or a solution to this problem is not in sight. Another worry is the huge number of structured products and of hedge funds. Nobody can predict how we would survive a crisis or a crash in these sectors. The volumes are beyond comprehension, visibility and control extremely limited.

However, despite these clouds we are of the opinion, that the future will offer us decent chances to grow your wealth. But in view of the rosy outlook of the public we will also try to take into account the problems and dangers mentioned above and we will not abandon our cautious investment approach. The preservation of capital and wealth is very important to us.

Roland Schwab

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