

Investment Policy Report - 30th September 2008

Reorganisation of Financial Markets

Exceptional events require an exceptional report. Recent events lead us to depart from the familiar format of our Investment Policy Report. Our main focus will be on the events of the most recent weeks of the past quarter and on assessing the current situation.

The decision to prevent a “moral hazard”¹ by allowing the fourth largest, as well as one of the oldest investment banks, Lehman Brothers Holding Inc., to go under, has proved to be a serious mistake on the part of the American treasury. The decision poisoned the already shaken trust between the banks unnecessarily. Infected by this toxic situation, lending rates amongst banks exploded overnight. Globally, lending came to a standstill. Everyone was hoarding liquidity. This anomaly is likely to unwind in the medium-term. However, with the proviso that mutual trust and the provision of funding to each other is re-established. Which is precisely the issue Central Banks are currently working on intensively.

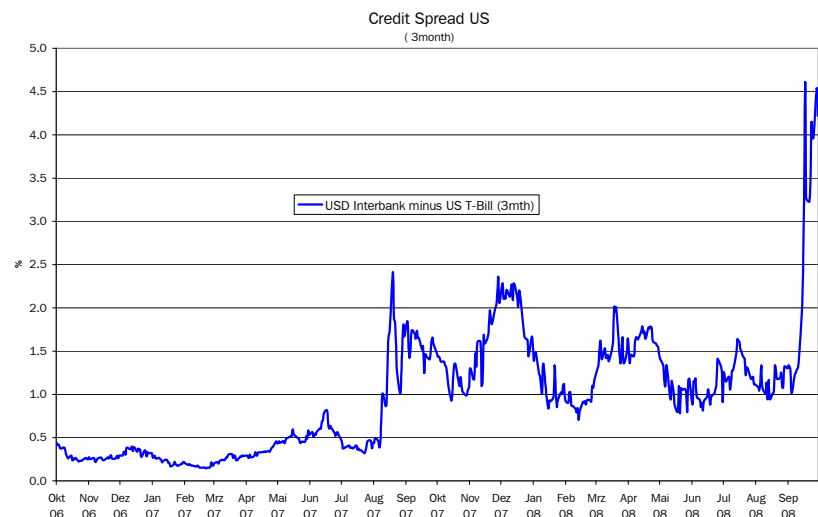
In the near to 25 years since the foundation of Salmann’s, this is the first time that the market situation has dictated that its Investment Committee sit three in the space of 10 days to assess the situation. During these past few weeks, the rules of the game have changed on a daily basis. In such volatile markets, pro-cyclical and short-term action mostly results in higher costs with only a limited chance of success. Only disciplined action will enable us to stay on course in such stormy seas and to achieve our clients’ objectives in the long-term. In doing so, it is important to us to build portfolio structures in the simplest and most transparent way possible. Once again, structured products have proven their capability of turning into boomerangs, delivering equity exposure at a time least wanted by the holders. Even more painful is the discovery that at times like these, upon enquiry to the product provider, the bid/offer spread has taken on the proportions of an eight-lane motorway. – Not something for our clients!

¹ www.wikipedia.com: **Moral Hazard** is the prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk.

In this report, we will go into our clients’ most pressing immediate questions:

- is the global financial system headed for a crash landing or
- will this crisis lead to a global depression?

From the outset, we can say no to both scenarios. Ben Bernanke², president of the US Fed, analysed the Great Depression³ in a book in great depths, concluding that during the late twenties, a massive reduction in monetary stock led to the Great Depression. He further concluded that those countries which abandoned the gold standard earlier, such as the U.K., experienced a faster recovery, whereas countries which adhered strictly to the gold standard, such as France, suffered the longest.



Hence, it can be assumed that the US, with Mr. Bernanke at the helm, will not make similar mistakes a second time round. At the time of writing this report, the Senate and the House of Representatives are attempting to counteract precisely this risk by passing a USD 700 billion rescue package.

² Former professor and head of the economics faculty at the University of Princeton

³ Essay on the Great Depression, March 2006

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Further, our report will shed some light on the most likely scenarios for the economy and financial markets.

Most likely scenario for

| | USA | Europe |
|------------------------------|-----|--------|
| issuance of government bonds | ↑ | ↑ |
| budget deficit | ↑ | ↑ |
| taxes short-term | ↗ | ↗ |
| taxes long-term | ↘ | → |
| interest rates short-term | ↓ | ↘ |
| interest rates long-term | ↑ | ↑ |
| corporate profits | ↓ | ↓ |
| economic growth potential | ↓ | ↘ |
| trade deficit | ↑ | ↑ |
| inflation | ↑ | ↗ |
| unemployment | ↑ | ↗ |
| consumption | ↓ | ↘ |
| currency | ↘ | ↗ |

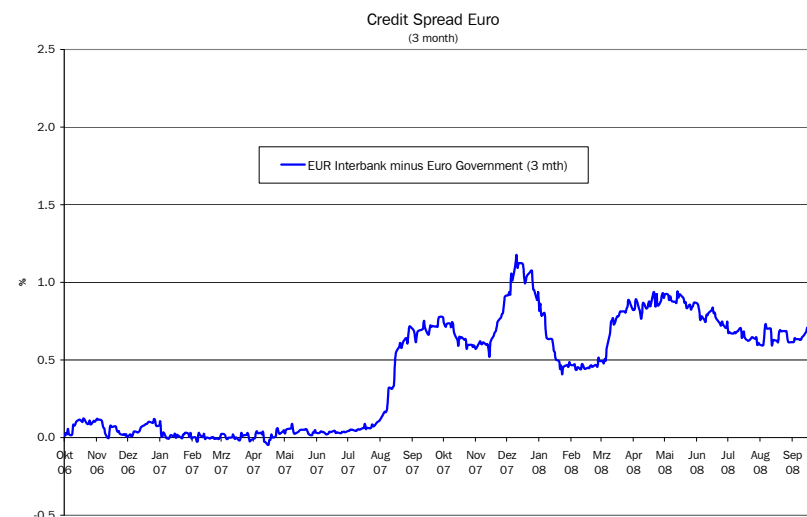
At a first glance, the consequences for the two largest economic blocks appear very similar. There are, however, fundamental differences:

In the US, a rescue package to the tune of USD 700 billion has just been passed. Europe, on the other hand, is unlikely to be able to agree on a comprehensive package within a useful time-frame, so individual national solutions are likely to prevail.

As the form of the bail out in the US is further developed, concentrated and transparent, the economic consequences are rather more apparent. Equally, it is quite obvious that on the far side of the Atlantic a rather larger number of finance companies are in trouble as is the case on this side. The FDIC⁴ estimates that far in excess of 100 financial institutions are close to insolvency in the USA, with the cost of rescue amounting to more than 1500 billion. In Europe, this number is likely to be significantly lower. Hence, the rescue package proposed by the French president Sarkozy only amounted to EURO 300 billion (USD 420 billion). We have our doubts as to Europe's ability to launch a rescue package similar that in the US. Because of the difference in magnitude, the total cost to the American economy will be much higher.

⁴ Federal Deposit Insurance Corporation

Good news on one side, bad news on the other! Certainly, the rescue package will help financial markets and as a result, a crash landing of the financial system will be avoided. The fact, however, that a USD 100 billion tax relief is tied to the package, shows the US's unwillingness to save. The consequence is a rising government deficit and higher inflation.



Already today, in excess of 50% of US American debt is held in non-American hands. In other words, foreign investors made low-cost finance available to Americans to buy housing and to finance the consumption of goods exported by us.

The essential question for the American treasury is how to keep creditors lending or rather to create additional incentives for them to increase their share in financing the government deficit, as no contribution can be expected from either the American consumers, who are in essence insolvent, or the American banks, which are in the midst of a retrenching process.

During the last recession, foreign investors left US government bonds to support their own economies. Should this happen this time round, it would be extremely unfortunate timing for America. Hence, the US economy has to be kept ticking over, not matter what the cost!

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All-in-all, it is not going to be an easy task for the American Fed or the “post-Bush-administration”.

Rescue packages in Europe will, sooner or later, equally be financed with increasing government debt, the total amount, however, is likely to be less of a drag on the economy and thus less of an inflationary nature.

Order of Magnitude

Measured on the GDP, global economic activity amounted to 54.62⁵ billion last year.

| | EU | USD 16.620 Bn | 30.4% | |
|-----------------|--------|---------------|--------------|--|
| 1. USA | 13.840 | 25.3% | 55.7% | |
| 2. Japan | 4.384 | 8.0% | 63.7% | |
| 3. Germany | 3.322 | 6.1% | | |
| 4. China | 3.251 | 6.0% | | |
| 5. UK | 2.773 | 5.1% | | |
| 6. France | 2.560 | 4.7% | | |
| 7. Italy | 2.105 | 3.9% | | |
| 8. Spain | 1.439 | 2.6% | | |
| 9. Canada | 1.432 | 2.6% | 66.3% | |
| 10. Brazil | 1.314 | 2.4% | | |
| 11. Russia | 1.286 | 2.4% | | |
| 12. India | 1.099 | 2.0% | | |
| 13. Switzerland | 0.424 | 0.8% | 67.1% | |

The above ranking may surprise some readers. The by far largest economic block is not the USA but Europe. No surprise, however, is the fact that about two thirds of economic activity continues to rest in the hands of the industrialised world. This is unlikely to change dramatically in favour of the BRIC countries in the near future (see emerging countries).

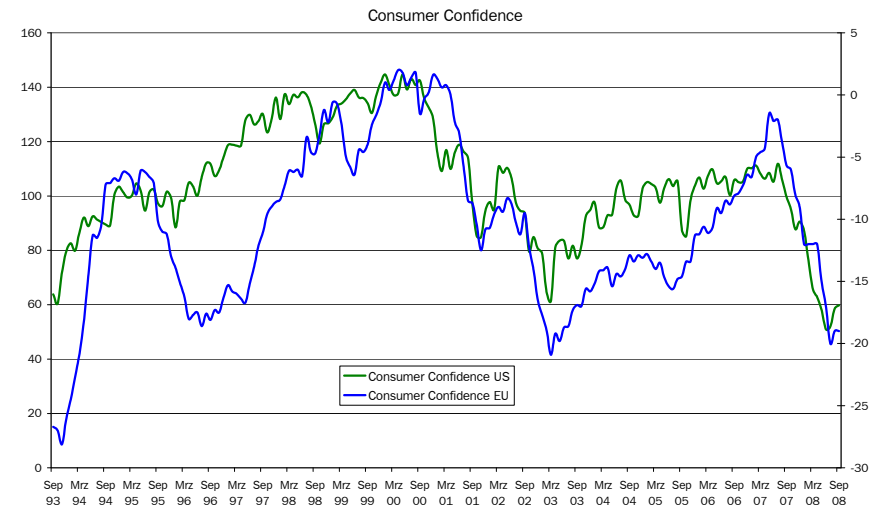
Assuming that about 60-70% of GDP is based on private consumption, the industrialised world's consumers account for about 43%⁶ of GDP, however it should be noted that 18% emanates from the US and 25% from Europe! Hence, it is rather important to know about the current frame of mind of consumers in these regions.

⁵ CIA Factbook 2007

⁶ $(25.3 + 2.6) * 0.7 + (30.4 + 8.0 + 0.8) * 0.6 = 43.05$

In short: **“It looks bad!”** All the leading indicators for the US as well as Europe point south. A recession appears unavoidable. Looking back, the European economy declined 0.2% during the second quarter of 2008. On the other hand, the US has managed to make some ground (+2.6%) due to tax gifts granted. However, a rise in the US unemployment rate to currently 6.1% points in a different direction, which is the reason why there is another tax gift of USD 100 billion on its way. As mentioned above, Americans prefer to spend rather than save. The proposed package may just help America to keep its head above water during the coming quarter.

Even though employment figures in Europe continue to be running at the highest levels, this is a so-called lagging indicator, which reacts to economic slowdowns with a significant delay. Consumer's sentiment is falling, not only in Europe, but throughout the industrialised world.



Seen from the current situation, should the American economy recover quicker than the European one despite all, this can only be at the expense of higher government borrowing. With that, the seed of the next crisis will be sown.

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Credit Markets

The American private sector's deleveraging process is advancing at great speed. In a first step, the liabilities are to be transferred to Uncle Sam. The associated cost will be nationalised, i.e. the taxpayer will have to bear the cost of borrowing. However, this does not necessarily mean that medium-term losses will arise from this transfer. Quite the contrary, if the treasury takes on the debt at reasonable prices, profits may be achieved over the long-term. The answer to the question as to why nationalise the debt in the first place is that, unlike banks, the government has the time banks lack.

In future, new regulations will ensure that lending by universal banks will be handled in a more restrictive manner. The cost of capital, namely interest rates, will rise and investments will decelerate. These higher costs will feed through to the consumer in the long-term, which will in turn increase inflationary pressures.

Implications for

a) small and medium-sized businesses

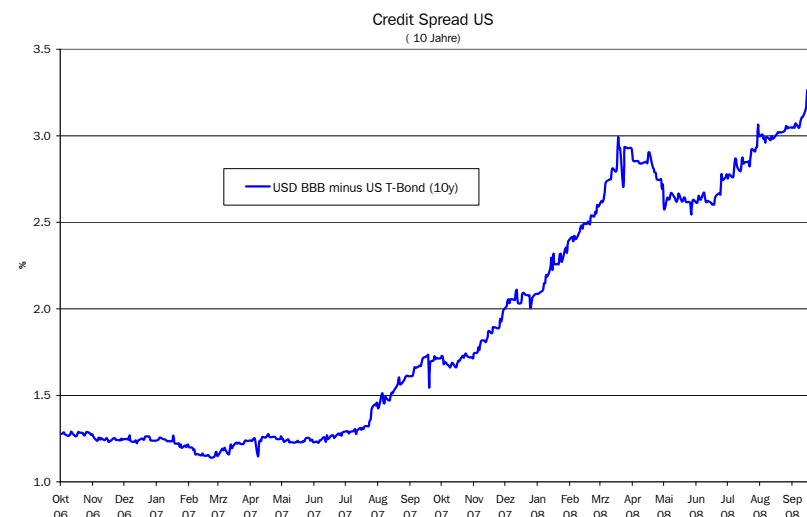
Bank lending to small and medium-sized companies will be restricted as banks will not be able to inflate their balance sheets and access capital markets as easily. Other market participants such as private equity funds, venture capital funds and hedge funds will have to fill this gap. This may also happen in ways we are currently unable to imagine. One example here is the English supermarket chain, Tesco, which is currently considering entering the savings and mortgage business due to increased demand.

Until new ways to access finance are found, the cost of finance to this sector of the market will increase.

b) Public companies

Banks will also be more restrictive on this market segment. I.e. public companies will increasingly be seen directly in capital markets with banks acting as advisors and/or placement agents. This will equally lead to an increase in the cost of finance.

With the above structural changes, the cost of finance will generally rise. The tendency will be for corporate profits to be impacted negatively but the volatility in earnings should decline.



Capital Markets Today

In spite of all central banks' activism, the current situation on the capital markets is tense. The mutual trust between banks must be restored urgently, in order for interest premiums on bonds of lower quality to fall. The premiums are currently trading at highs last seen in early 2003 – the near future will provide us with investment opportunities, particularly in the high-yield sector, which only occur once every five to ten years.

Currencies

Up until now, the US currency has been considered to be a safe haven. The current strength of the American currency is most likely to have its roots in the repatriation of funds, on hedge funds seeking liquidity, the 'most-liquid-market' premium (USD) and lower commodity prices. All these are rather volatile monetary flows. Hence the assumption is that once the financial market's volatility declines and in recognition of the fact that not all is triple A that is labelled AAA, the US Dollar will once again resume its decline towards a weaker currency.

The Euro was unable to take on the role of safe haven, as interest rates on the Old Continent were at a higher risk of falling than was the case in the US. This is one of

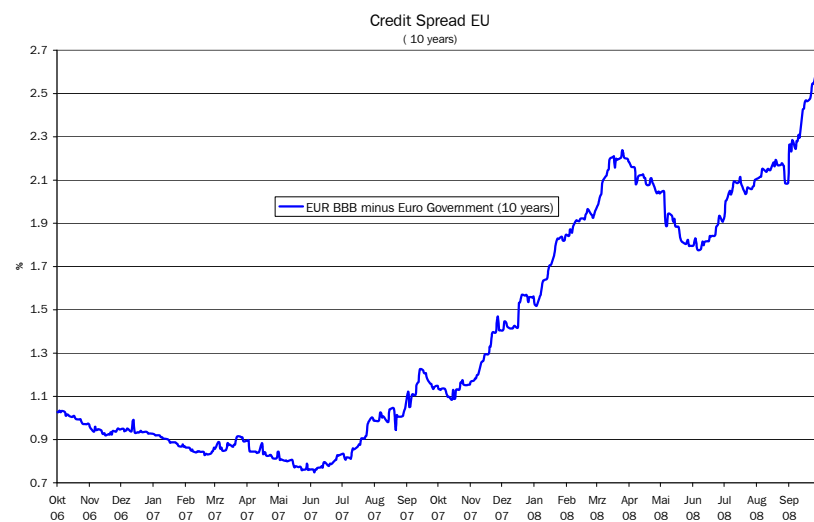
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the main reasons for the weakening Euro in these past weeks. Many hedge funds closed their EURO/YEN carry trades⁷.

Hedge Funds

On a relative basis, this asset class has done well this year. From an absolute point of view, many investors are disappointed. Within eight years, hedge funds has grown to an industry with in excess of USD 2 trillion under management. A separation of the wheat from the chaff is to be expected and many a shop will close its doors. This will increase the transparency demanded for some time.

At the present moment in time, it is difficult to say which of the funds will survive. Nevertheless, we believe in this asset class and think it is wise to spread our bets over a range of fund of funds. We expect the incorporation of this asset class in a balanced portfolio to continue to have a stabilising effect on volatility.



Emerging Countries

For some time now, we have maintained that because of globalisation a decoupling of emerging countries is difficult to imagine. The following table, giving the important

⁷ borrowing in low interest rate currencies such as Yen or Swiss Franc to invest in higher yielding currencies

trading partners of the respective emerging countries, supports this argument once more.

| | | | |
|--|--------------|---|-------|
| Brazil | USD 160.6 bn | USA | 14.2% |
| | | China | 9.2% |
| | | Argentina | 8.3% |
| | | Germany | 4.4% |
| | | Holland | 4.3% |
| Total of largest developed export countries | | | 22.9% |
| Total largest emerging country export partners | | | 17.5% |
| Russia | USD 365 bn | Germany | 9.5% |
| | | Holland | 7.5% |
| | | Turkey | 6% |
| | | Italy | 5.6% |
| | | Ukraine | 5% |
| | | China | 5% |
| | | USA | 4.8% |
| | | White Russia (Belarus) | 4.6% |
| | | Switzerland | 4% |
| | | Total of largest developed export countries | |
| Total largest emerging country export partners | | | 20.6% |
| India | USD 150.8 bn | USA | 15.1% |
| | | UAE | 8.8% |
| | | China | 8.4% |
| | | U.K. | 4.3% |
| | | Total of largest developed export countries | |
| Total largest emerging country export partners | | | 17.2% |
| China | USD 1'217 bn | USA | 19.4% |
| | | Hong Kong | 15.2% |
| | | Japan | 8.4% |
| | | South Korea | 4.6% |
| | | Germany | 4.1% |
| | | Total of largest developed export countries | |
| Total largest emerging country export partner | | | 19.8% |

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Brazil and Russia will suffer from declining prices and demand for commodities. India and China are closely linked to the industrialised world and will suffer from the reduced demand for goods and services. The decline in freight rates over the past few months of up to 70% speaks volumes.

It is simply an illusion to believe that China, with its consumption accounting for just 30% of GDP, will be able to save its bacon as industrialised nations' economies decline.

Outlook Equity Markets

So far the American rescue package continues to grab equity markets' attention. But focus will soon shift to the topic of corporate profits during the third quarter. The main focus, however, will be the equity market's fear of a recession. Some of this is likely to be discounted in current prices.

The move in short-term USD T-Bill yields indicates that a huge amount of liquidity has been parked there in recent weeks at negative real interest rates. How long is it going to remain parked there?

The risk of being underweight is rising dramatically. Relative to bonds as well as from an absolute point of view, equities are undervalued. European and Japanese equities are our favourites.

Conclusion

Financial Markets are extremely unsettled and again and again are overshadowed by panic attacks. Market sentiment is severely battered; Mr. Market is currently suffering from a deep depression to a degree last seen during the late twenties of the past century.

With 3 month US T-Bills yielding 0.07% at its lowest point of last week, there is a clear investment state of emergency. Markets are disoriented. – The Market is looking for reliable navigational aids; equity valuations, security and dividend yields will play a disproportional role in this. Largely capitalized, undervalued equities and other value oriented investments will return above average yields in the years to come!

Summary of our asset allocation:

Investment Category

| | |
|---------------------------|-----------------------------------|
| Money Market | overweight |
| Bonds | neutral weighted / short duration |
| Equities USA | underweight |
| Equities Europe | underweight |
| Equities Switzerland | underweight |
| Equities Japan | underweight |
| Equities Emerging Markets | overweight |
| Non-traditional Assets | neutral weighted |

Stefan Riesen, CFA
Chief Investment Officer

Vaduz/Zurich, 30 September 2008

| | Profit-/Earnings Ratio | | Change |
|-----------------------|--|----------------|--------------------------------------|
| | 30.9.2008 | 31.12.2007 | |
| MSCI World Index | 13.6 | 15.7 | -13.4% |
| DAX Index/DE | 11.4 | 13.6 | -16.2% |
| DJ STOXX 600 Index/EU | 10.9 | 12.4 | -12.1% |
| S & P 500 Index/USA | 21.7 | 18.3 | 18.6% |
| SPI Index/CH | 30.8 | 15.8 | 94.9% |
| TOPIX Index/JPN | 13.1 | 17.8 | -26.4% |
| | Equity Earnings- Yield ⁸ | Bond- Yield | Risk-Premium Premium ⁹ |
| Germany | 8.8% | 3.9% | 4.9% |
| Europe | 9.2% | 3.9% | 5.3% |
| USA | 4.6% | 3.7% | 0.9% |
| Switzerland | 3.5% | 2.6% | 0.9% |
| Japan | 7.6% | 1.5% | 6.1% |

⁸ Bloomberg per quarter end

⁹ Average risk premium for American equities lies near 1.5%