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## Investment Policy Report - 31<sup>st</sup> December 2008

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### Overview

A bubble in US T-Bonds? A negative real yield certainly indicates to one. To lend money to the US government and to be charged for the privilege of doing so is not rational economic behaviour. If investors place their bets on the government as the better investment manager, it is a clear vote of no confidence in private industry.

Concerns about safety and the lemming effect drove yields down to three-year US T-Bonds yielding only about 0.9%, against a current inflation rate of 1.1%.

This plays into the hands of the US government, which has an interest in keeping interest rates artificially low, in order to prop up the housing market with low mortgage costs.

A burst of this bubble would have unpleasant consequences:

- The US would have great difficulty in funding its enormous capital requirements. It is already estimated that under the new administration the government deficit will be USD 1.2 billion, excluding economic stimulus packages. This represents, after all, about 8% of GDP.
- A decline in credit quality of the United States
- Higher inflation and with it, rising interest rates
- A weakening US currency

The Americans are thus well advised not to upset their foreign creditors and keep them happy. Hence, the US government's interest has to focus clearly on lower inflation, as they are dependent on international investors such as China and Japan. These two countries alone own in excess of USD 1,200 billion US government debt, amounting to about 40% of the total held by foreigners.

These low interest bearing monies will sooner or later move on into other asset classes. This is only likely to happen once volatilities have calmed down. In a first step, the second ranking asset class in terms of safety, i.e. corporate debt of good quality, is likely to benefit from this. But equities as well as corporate bonds of lower quality (high-yield bonds) should not be disregarded. It is quite possible that the latter two asset classes, together with corporate bonds, will experience large capital inflows.

A brief word on the economic environment: Historically, recessions normally last a year, more or less. Officially, the USA has been in recession since December 2007. Assuming that this time around the recession is more severe and will last twice as long, a recovery should become visible towards the end of 2009. Light at the end of the tunnel! Particularly so, if you bear in mind that financial markets lead the real economy by about 6 to 9 months.

Further, we view positively, the current high levels of corporate and institutional investors' liquidity on the one hand and the strongly pessimistic expectations of private as well as institutional investors, on the other.

### Review

#### Equities

2008 was one of the worst years for equities: The Icelandic index was nearly wiped out (-97%), Russia corrected by -71% and Dutch equities lost -52%, to name but a few of the victims.

One of the reasons for the extreme degree of the distortions lies in financial mathematics and its assumption that financial markets act efficiently and rationally in nearly 100% of all instances. The hedge fund industry develops and works on such assumptions in its models. However, we have witnessed what such models are worth during phases of stress such as those seen in the past 18 months. Forced sales by hedge funds were the order of the day during the past quarter. The commodity bubble burst last summer and as a result, many hedge funds came under pressure. In trade lingo, a de-leveraging took place, i.e. stock bought with borrowed money had to be sold, which in turn accelerated the correction in equity markets. Instead of adding efficiency, hedge funds contributed for a large part to the exaggeration on the downside and in doing so, added to the inefficiency of the markets. Fund redemptions increased the selling pressure further. Collateralised loans had to be repaid because of insufficient cover. There was no escaping the vicious circle.

Correspondingly, hedge funds have been unable to avoid the weakness in financial markets entirely, however, they have performed better from a relative point of view than traditional asset classes, with the exception of government bonds:

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	USD <sup>1</sup>	EUR	CHF
<u>Thalmann &amp; Verling</u> Fund of HF Global	<b>-27.7%</b>	<b>-25.8%</b>	<b>-26.4%</b>
<u>Bank Reichmuth &amp; Co.</u> Matterhorn Fund	<b>-18.7%</b>	<b>-19.0%</b>	<b>-20.4%</b>
Matterhorn Certificate (DB)		<b>-19.4%</b>	
Matterhorn Certificate (H&A)		<b>-23.1%</b>	

As can be seen in the table below, equity markets have suffered even greater punishment from the financial crisis:

	Dec 2008	Dec 2007	Change <sup>2</sup>
Asia ex Japan DJ Pacific Index	264.8	555.5	<b>-52.3%</b>
Germany DAX	4'810.2	8'067.3	<b>-40.4%</b>
Europe DJ STOXX 600	198.4	364.6	<b>-45.6%</b>
Japan TOPIX	859.2	1'475.7	<b>-41.8%</b>
Switzerland SPI	4'567.6	6'925.4	<b>-34.0%</b>
USA S & P 500	903.3	1'468.4	<b>-38.5%</b>

The products employed by us compare to this as follows<sup>3</sup>:

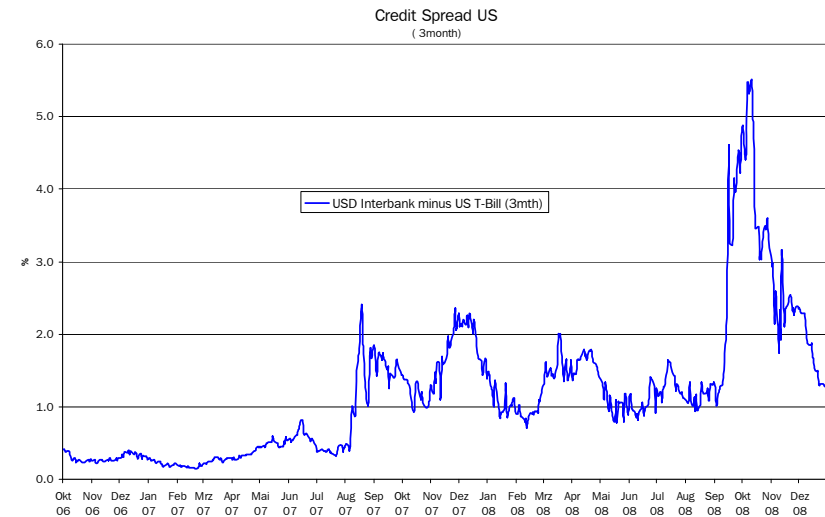
Neuberger Berman US Equity Value (USD)	<b>-50.2%</b>
Performa Fund - Asian Equities (USD)	<b>-55.3%</b>
Performa Fund - European Equities (EUR)	<b>-38.9%</b>
Performa Fund - US Equities (USD)	<b>-48.5%</b>
SIM European Stock Portfolio (EUR)	<b>-45.2%</b>

Viewed from the perspective of the whole year, growth stocks have suffered less than value-oriented investments.

### Bonds and Interest Rates

Banks' distrust and refusal to supply credit to each other led to a virtual collapse of the financial system and made refinancing difficult. Looking at the "ted-spread"<sup>4</sup>

banks' confidence in one another has increased again, but is still far removed from normality.



Safety has its price: During the last weeks of the year, banks funded themselves with the ECB at the benchmark rate of 2.5% only to invest it again with the ECB at an interest rate of 2%. This is not a business model which is sustainable in the long-term. From mid-January onwards, the ECB will see to it that this discount increases to 1%.

Central banks globally intervened aggressively in the interest rate environment. Leading the way was the American Fed, with its historical step of reducing the benchmark rate to 0%. These interventions have left their mark on the yield curve for government bonds, with the result that mortgage rates are lower (4.5%). The aim is to stabilise the American housing market as soon as possible and in so doing, to have a positive psychological impact on investors.

<sup>1</sup> Performance since start of the year to end October 2008

<sup>2</sup> Change, except MSCI Europe incl. Div. re-invested, in local currency since beginning of the year

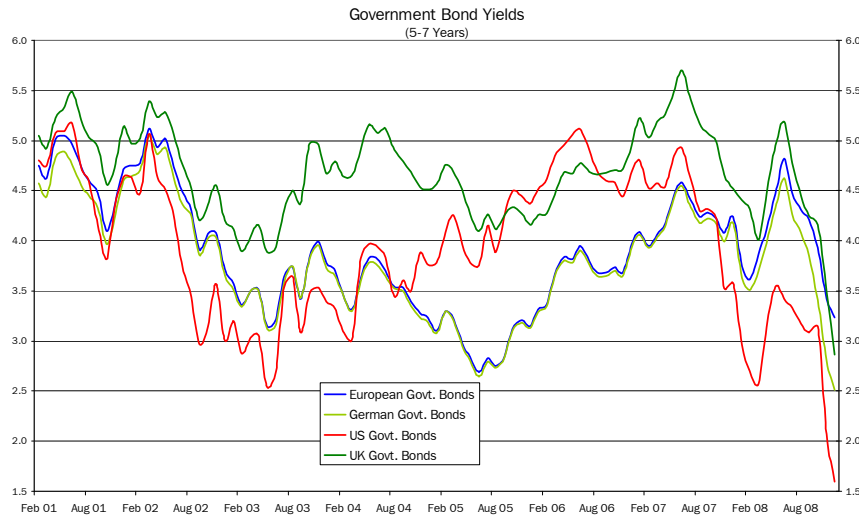
<sup>3</sup> Performance since start of the year in currency of fund

<sup>4</sup> Difference interbank interest rate and 3 month T-bonds

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These actions are reflected in government bond yields:

	<u>Dec 2008</u>	<u>Dec 2007</u>	<u>Yield Change</u>
USA	2.4%	4.0%	<b>-1.6%</b>
Europe	3.0%	4.3%	<b>-1.3%</b>
Switzerland	2.1%	3.1%	<b>-1.0%</b>
United Kingdom	3.1%	4.5%	<b>-1.4%</b>
Japan	1.2%	1.5%	<b>-1.3%</b>



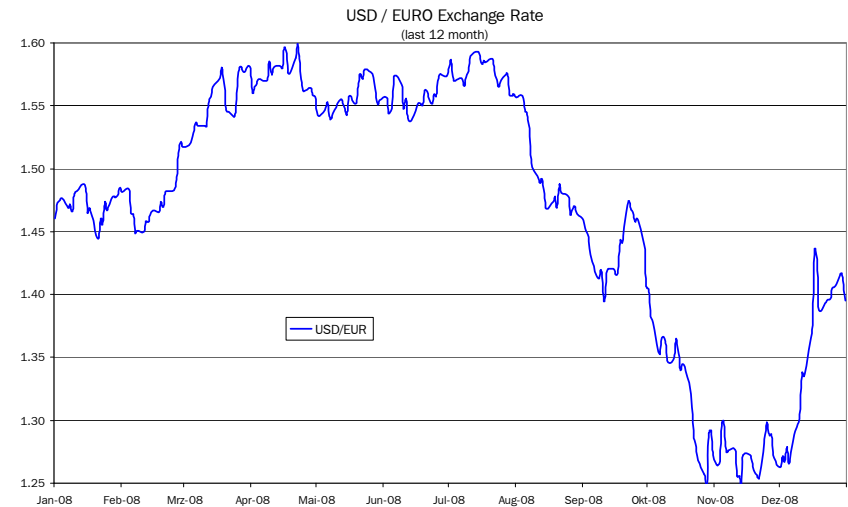
The USD against major currencies:

	<u>over the last 12 months</u>	<u>over the last 24 months</u>
USD/EUR	<b>-4.3%</b>	<b>5.8%</b>
CHF/USD	<b>-5.9%</b>	<b>-12.4%</b>
USD/GBP	<b>26.5%</b>	<b>25.5%</b>
Yen/USD	<b>-18.8%</b>	<b>-23.8%</b>

Once more the „Greenback“ has been confirmed as a safe haven. In spite of the United States being the origin of the crisis, the trade-weighted index managed to

gain, post the Lehman incident, and is currently at the highest levels recorded since the end of 2005. Amongst others, one of the reasons is the enormous volatility on currency markets, which has forced investors to unwind “carry trades”<sup>5</sup> and repatriate back into the USD.

Medium-term however, a larger current account deficit, as well as the enormous US government debt, will reflect negatively on the exchange rates.



### Financial Markets - Outlook

#### Economy

Without a doubt, the de-leveraging process in the finance industry is in full swing. The adjustment is likely to be most painful for US private households, as their savings rate is very low in both relative as well as absolute terms.

<sup>5</sup> borrowing in low interest rate currencies such as Yen or Swiss Franc to invest in higher yielding currencies

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The CDS<sup>6</sup> market is also of the opinion that banks in the US are in worse condition than their European counterparts:

<u>USA</u>	<u>CDS-Premium</u>
Morgan Stanley	354.0 Bp
Goldman Sachs	250.8
American Express	239.5
Citigroup	176.5
Wells Fargo <sup>7</sup>	111.0
<u>Europe</u>	
UBS	198.2 Bp
Credit Suisse	154.7
Barclays	130.8
Deutsche Bank	114.6
BNP <sup>7</sup>	53.7

The forecasters polled by the "Economist" now view economic growth for 2009 slightly less optimistically than in the last quarter:

	<u>Real GDP Growth<sup>8</sup></u>		<u>Inflation</u>	
	<u>2008</u>	<u>2009</u>	<u>2008</u>	<u>2009</u>
Germany	1.4%	-1.0%	2.6%	1.3%
Euroland	0.9%	-0.9%	3.2%	1.5%
United Kingdom	0.8%	-1.4%	3.7%	1.7%
Japan	0.3%	-0.9%	1.6%	0.3%
Switzerland	1.8%	-0.2%	2.5%	1.1%
USA	1.3%	-1.0%	4.1%	0.7%

<sup>6</sup> [www.wikipedia.org](http://www.wikipedia.org): "A credit default swap (CDS) is a swap contract in which the buyer of the CDS makes a series of payments to the seller and, in exchange, receives a payoff if a credit instrument (typically a bond or loan) goes into default or on the occurrence of a specified credit event (for example bankruptcy or restructuring)." In other words a kind of credit insurance, quoted in basis points. On a credit volume of 100 and a premium of 150bp the effective cost of insurance is 1.5 million

<sup>7</sup> Lowest CDS premium of region

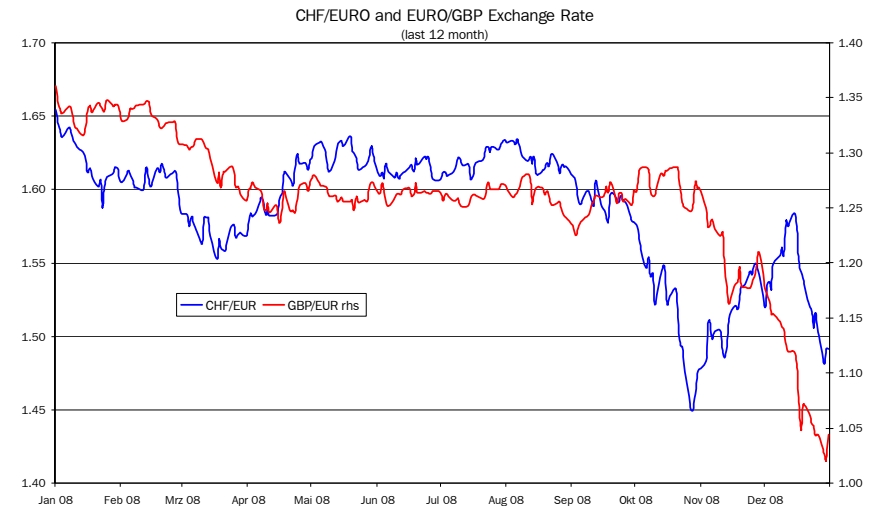
<sup>8</sup> The Economist, 4.12.2008

Much hope is pinned on the new President of the United States. At least he appears to be adopting a pragmatic approach and is planning to launch a further economic stimulus package to the tune of USD 775 billion.

The higher government debt arising from this measure carries an enormous inflationary potential. As prices fall during a recession, in other words have deflationary tendencies, this is insignificant for the short-term. Medium-term, however, the American economy and the Federal Reserve will have to fight higher inflation if the excess liquidity cannot be taken out of the system in time.

Listed below are the US government's funding activities<sup>9</sup>:

2006	USD 163 billion
2007	USD 229 billion
2008	USD 1'337 billion
2009/Q1 annualised <sup>10</sup>	USD 1'472 billion



<sup>9</sup> US Treasury, Office of Debt Management.

<sup>10</sup> USD 368 billion effective

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### Equities

We have to ask ourselves which asset classes will be able to produce respectable returns at reasonable risk. However, as long as there is no clear trend visible, high volatilities will have to be accepted. As mentioned earlier, we expect to see the first signs of returning calm in good quality corporate debt. Only then will other asset classes such as equities in the industrialised world and high-yield bonds be able to benefit from a sustained upswing. Once underway, this may happen very quickly.

Equities are very attractively valued on absolute as well as relative terms, with the US, Japanese and Swiss markets now displaying higher (dividend-) yields than 10-year government bonds.

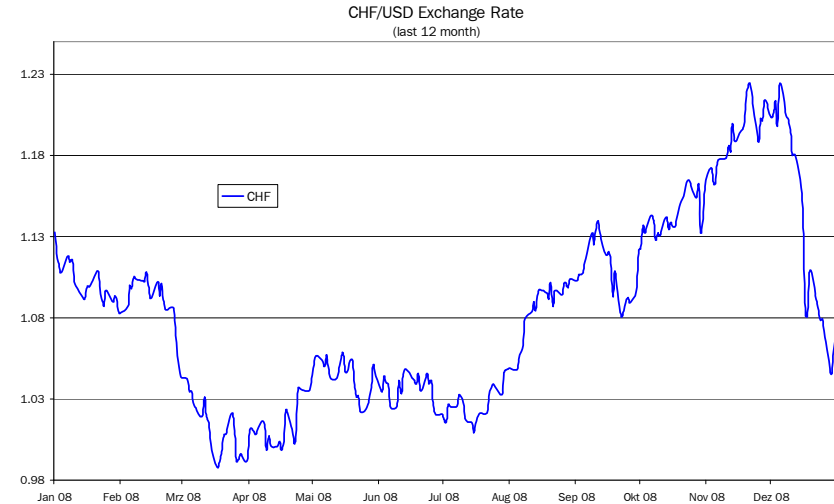
Today's equity valuations as measured by P/E compared to the beginning of the year:

	<u>30.6.2008</u>	<u>31.12.2007</u>	<u>change</u>
MSCI World Index	11.6	15.7	<b>-26.1%</b>
DAX Index/DE	10.7	13.6	<b>-21.3%</b>
DJ STOXX 600 Index/EU	9.6	12.4	<b>-22.6%</b>
S & P 500 Index/USA	20.8	18.3	<b>13.7%</b>
SPI Index/CH	28.1	15.8	<b>77.5%</b>
TOPIX Index/JPN	13.1	17.8	<b>-26.4%</b>
	<u>Equity Earnings</u>	<u>Bond</u>	<u>Risk</u>
	<u>Yield</u> <sup>11</sup>	<u>Yield</u>	<u>Premium</u> <sup>12</sup>
Germany	9.3%	4.3%	5.0%
Europe	10.4%	4.3%	6.1%
Japan	7.6%	1.2%	6.4%
Switzerland	3.6%	2.1%	1.5%
USA	4.8%	2.4%	2.4%

Sooner or later markets will return to old proven concepts such as P/E, P/B, P/S and others.

<sup>11</sup> Bloomberg per quarter end

<sup>12</sup> Average risk premium for American equities lies near 1,5%



### USA

The idea of creating or securing 3 million jobs with a sustainable economic stimulus program targeted at improving the infrastructure, argues in favour of the new president's pragmatic approach. It could even trigger a boom in stocks of companies specialising in infrastructure.

This all sounds rather nice, but the focus will continue to be on price stability and the quantity of vacant real estate. – The motto here has to be: “stop the bleeding!” – Consumer confidence has to return as soon as possible. This can only be achieved by employment.

The ISM index<sup>13</sup> in the US has risen from a low 37.3 to 40.6. But it is much too early to see a reversal of the trend as yet. Any reading below 50 indicates a contraction of the economy.

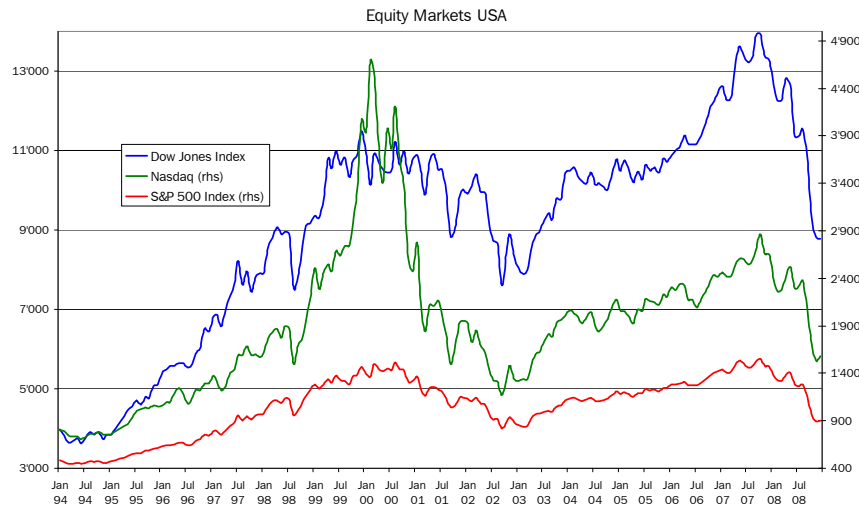
Positive sentiment comes from an observation of the Leuthold Group: Currently the equivalent of 75% of total market capitalisation of the US exchange is parked in

<sup>13</sup> Institute for Supply Management

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cash, the highest reading since 1990. In the past, the average year-on-year stock performance in the year following a record reading was 24%

On a relative basis, there are more attractive equity markets. This is why we prefer Japanese or European equities to American.



### Europe

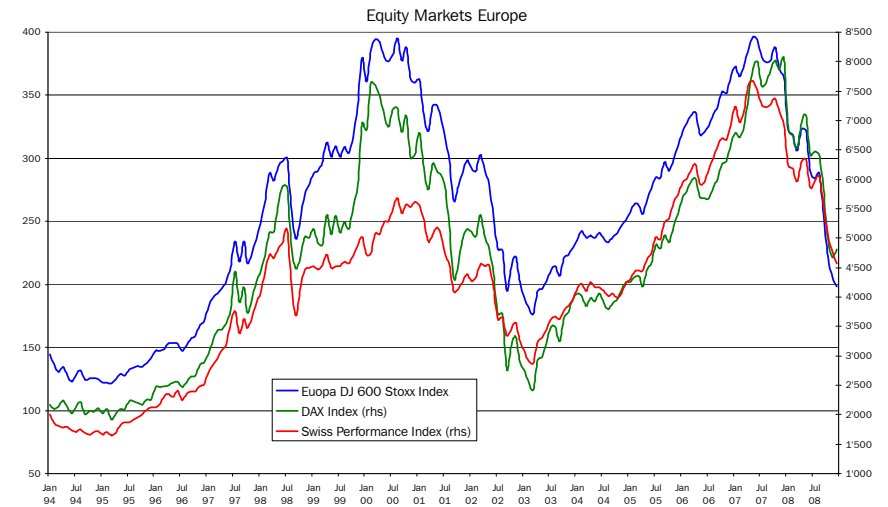
According to UBS research, net investments in European equities rose in the last two weeks of the year, though due to the holidays at a low volume. “Long-only” investors are thought to have covered themselves. Foreign investors on the other hand, in particular US investment funds, were faced with large redemptions and had to act accordingly. Here too, record levels of liquidity, last seen in 1998, have been observed.

But macro indicators are also pointing south in Europe. Rising unemployment, weaker consumer and economic confidence, as well as lower capacity utilisation, all point towards a further cooling of the economy.

European equities are trading at a discount both in relative as well as absolute terms.

### Germany

A study by Allianz says that, contrary to the United States, the German savings rate increased from 10.5 to 11.4%, despite decreasing wealth. Leading indicators also point towards a recession for the German economy. German equities are not held as a separate group but are part of the European equity allocation.



### Switzerland

When compared with Europe, although a rather optimistic economic prognosis is forecast for Switzerland, one has to anticipate that these assumptions will be revised downwards in the coming weeks. Here, leading indicators are also pointing to a slowdown in the economy. The latest reported unemployment rate of 2.7% is unlikely to be maintained.

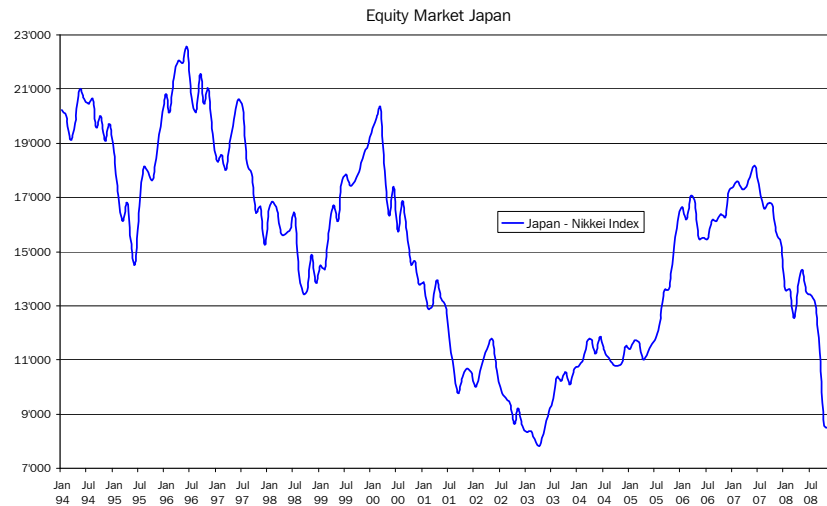
The valuation of Swiss equities remains unchanged at a relatively high level.

### Japan

Although just having resurfaced, the past is catching up with Japan again. “Back to square one” as a UBS report put it recently. Deflation has Japan in its grip again.

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Due to the global developments, it is not to be expected that this fight may be won in the near future. Nevertheless, Japanese equities are valued extremely attractively and have high price-potential.



### Emerging Markets (BRIC)<sup>14</sup>

As was to be expected, the situation of emerging markets' stock exchanges has worsened since our last report.

Even Brazil, which has a strong domestic market, is suffering more than average from the impact of the crash in commodity prices.

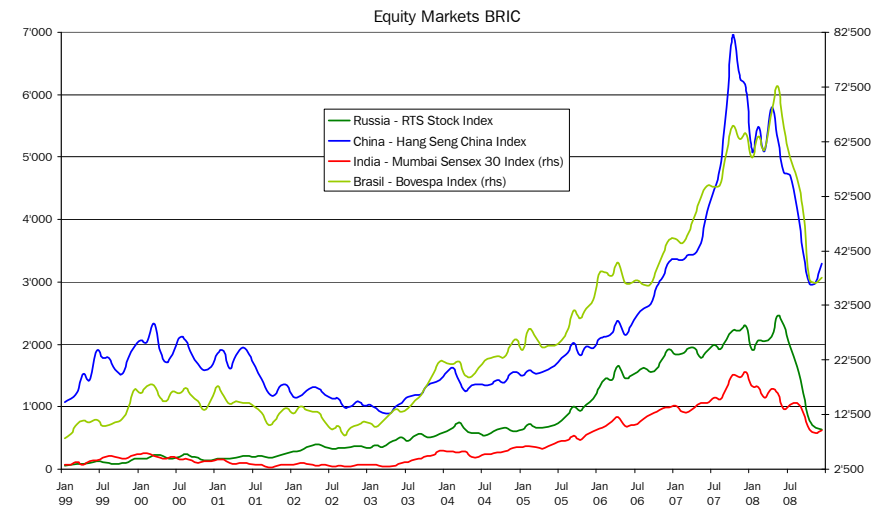
Russia missed the opportunity to reform its financial sector and develop its economy further during the commodities bubble. Rapidly rising commodity prices were convenient and tempted many an oligarch to stock up on foreign companies, as we now discover, on tick. Easy come, easy go.

Foreign investors and their rights were hardly of any concern in Russia. The equity market is now acknowledging this.

India's equity market is suffering from large capital outflows. As the government regulator SEBI reports, foreign direct investment of USD 17.4 billion in 2007 turned into a divestment of USD 13.5 billion in 2008. India is also suffering from the global economic weakness. Whereas industrial production rose by 12% in the previous year, during 2008 India experienced a decline for the first time in years.

In China, euphoria led equity markets to rise six-fold within the shortest periods of time. The rude awakening came in 2008, cancelling out two-thirds of this rise.

Even though valuations of these markets could be termed as attractive to fair, the chances of rises in these markets are rather dim. In times of high volatility, international investors demand quality, transparency and liquidity, apart from attractive valuations and outstanding opportunities. All characteristics which emerging markets by definition cannot deliver.



<sup>14</sup> BRIC = Brazil, Russia, India, China

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### Bonds

It is quite possible that in this environment, cash-flows will not be used for dividend payments any more but rather to repay debt. In addition, in uncertain times like these, bonds have the advantage over equities in that they rank higher in the creditors' schedule <sup>15</sup>.

Depending on quality, yields on bonds ranging between 7 to 25% are possible. The large rating agencies predict failure rates of up to 11% for bonds of lower quality. Bond prices on the other hand imply failure rates of up to 53%!<sup>16</sup> This contrasts with the cumulative five-year default rates on bonds we have had since 1920 of on average 1.7% for good and 16.7% for lower quality debtors.

	Dec 2008	Dec 2007	Diff. AAA – BBB	
			Dec 2008	Dec 2007
AAA Euro	4.65%	4.89%		
BBB Euro	7.64%	5.86%	2.99%	0.97%
AAA GBP	5.06%	5.43%		
BBB GBP	6.97%	6.22%	1.91%	0.79%
AAA USD	4.75%	5.25%		
BBB USD	7.95%	6.11%	3.20%	0.86%

### Commodities

Crude oil for cash delivery is trading at a 30% discount compared to 12-month futures contracts. Idle shipping capacity, at levels last seen in 1986, presents an attractive opportunity to store crude oil on board for a year and then subsequently deliver. The commodities bubble ultimately burst last summer. The record prices of nearly USD 150 per barrel crude suffered an unprecedented crash of in excess of USD 100 pbl.

After seven boom years, the party appears to be finally over. Speculative money did not play an insignificant role in this game. OPEC is now attempting to counteract but the question remains whether its members are disciplined enough to stick to their

targets. The Iranian and Venezuelan budgets are based on a crude price of USD 95 pbl, Russia bases its calculation on a price of USD 70pbl while the Arab Gulf Countries need a price of USD 50 pbl for their Black Gold.

A shrinking economy is going to deliver very little impulse for price rises in commodities.

### Conclusion

The de-leveraging process in the United States will take longer than in other places and hence, a driver of economic growth will be absent for some time. BRIC countries will reduce their currency reserves to support their local economies.

Corporate bonds, equities and high-yield bonds present opportunities such as are only rarely available. It is important however, not to be blinded by the potential returns, act in a disciplined manner and not to put all one's eggs into one basket, in other words to invest highly-diversely.

Summary of our current asset allocation:

#### Investment Category

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

We would like to thank you for the trust placed in us during these volatile times. To you and your family our best wishes, health and success for 2008.

*Stefan Riesen, CFA*  
Chief Investment Officer

Vaduz/Zurich, 31<sup>st</sup> December 2008

<sup>15</sup> The schedule drawn up by the Official Receiver or the local Receiver's office for ranking the creditors' claims

<sup>16</sup> Bloomberg end of November 2008