SALMANN INVESTMENT MANAGEMENT

# Investment Report – 31st December 2014

## Pleasant déjà vu

A year back, we quoted Mark Twain's "It is difficult to make predictions, especially about the future." Today we may confidently reiterate this, nothing has changed in this respect, nor will it in the future.

For example, slow growth and low inflation were forecast for the macroeconomic environment by the economists' guild a year ago. As it turned out, these predictions were not all that bad. True, in the majority of cases the speed of expansion did not reach the values the wise men predicted and regularly published in the magazine "The Economist" (and quoted here in the table below). However, on the other hand, there was hardly any inflation either, as it too remained way below expectations. The trend forecast, namely a whatever-you-want-to-call-it recovery of the global economy and almost no inflation, was correct and that's half the battle.

Average **growth and inflation forecasts** from "The Economist's" December poll of economists:

| | Real GDP Growth | | Inflation | |
|---|---|---|---|---|
| | 2014 | 2015 | 2014 | 2015 |
| Germany | 1.4% | 1.3% | 0.9% | 1.2% |
| Euroland | 0.8% | 1.1% | 0.5% | 0.8% |
| United Kingdom | 3.0% | 2.6% | 1.5% | 1.4% |
| Japan | 0.5% | 1.1% | 2.7% | 1.7% |
| Switzerland | 1.6% | 1.8% | 0.0% | 0.2% |
| USA | 2.3% | 3.0% | 1.7% | 1.6% |

Today the picture looks quite similar. For 2015, economists expect slightly higher growth (with the exception of Germany and the UK), and for inflation to remain very modest. That is the good, and simultaneously bad, news. For though the slight expansion of gross domestic product is better than a recession, (which is likely to hit Russia, the Ukraine, Venezuela, as well as maybe Argentina, and Italy in 2015), for debt-ridden and reform-resistant countries such as France, Greece, Italy and others, growth will simply be much too weak to allow them to, in Münchhausenesque fashion, pull themselves out of the mire by their own pigtails. In other words, someone else will have to help them.

Change in **Equity Markets in 2014:**

| | | Dec. 2013 | Dec. 2014 | Change[1] |
|---|---|---|---|---|
| Asia ex Japan | DJ STOXX A/P | 506.4 | 486.7 | **-3.9%** |
| Germany | DAX | 9,552.2 | 9,805.6 | **2.7%** |
| Europe | DJ STOXX 600 | 328.3 | 342.5 | **4.4%** |
| Japan | TOPIX | 1,302.3 | 1,407.5 | **8.1%** |
| Switzerland | SPI | 7,838.0 | 8,857.0 | **13.0%** |
| USA | S&P 500 | 1,848.4 | 2,058.9 | **11.4%** |
| World | MSCI World Index | 408.6 | 417.1 | **2.1%** |

In view of the lack of political will, as well as a lack of willingness to acknowledge the situation on the part of the electorate, it is primarily the central banks that will be required to step up to the plate. Even though this will be in some part against their better judgement, they will have no choice but to continue the generous monetary policy. Mario Draghi of the European Central Bank (ECB) has stated repeatedly that the ECB will do everything to keep the supply of money flowing smoothly and cheaply. The Swiss National Bank (SNB) will also be obliged to follow a very relaxed monetary policy if it does not want the appreciation pressure on the Swiss Franc to increase. Negative interest rates on current accounts, as well as the enormous expansion of the SNB balance sheet, reveal how tense the situation already is.

Gaping monetary floodgates remain wide open

"Print money" is the motto of the British, the Japanese, and even the Chinese Central Bank too, even though the "Land of the Dragon", expects economic growth of 7% in 2015. Despite the economic engines turning over well, the US Central Bank (Fed) too is nevertheless not expected to make any hasty or drastic corrections to the ship's course for the moment. It is interesting to note that the markets do not appear to believe in the rise in interest rates talked up by central bankers. According to the "Financial Times", Fed officials expect the federal fund rate (overnight interest rate for

[1] Development of index in local currency. Exceptions Asia ex Japan and World in USD

prime institutions) to be about 1.25% by the end of 2015. On the exchanges, however, futures contracts imply market participants expect a rate of only 0.5% at that point in time. The same picture applies for the end of 2016; central bankers are reckoning with a federal fund rate of about 2.75% at that point in time, whereas the market only anticipates 1.5%. At the end of 2017, the Fed is expecting a rate of 3.75%, which is massively above the expectations of investors who, as implied by futures contracts, are anticipating an interest rate of only about 2% then. This gap points to potential risks as regards fixed interest instruments that must be borne in mind.

The **equity funds employed by us** achieved in 2014 the following returns[2], with some beating their benchmarks:

| | |
|---|---|
| Aberdeen Asia Pacific (USD) | **2.1%** |
| JB Japan Stock Fund (CHF hedged) | **10.5%** |
| JB Japan Stock Fund (EUR hedged) | **10.7%** |
| Performa Asian Equities (USD) | **-5.0%** |
| Black Rock Swiss Small & Midcap Opp. (CHF) | **13.6%** |
| Raiffeisen Futura Swiss Stocks (CHF) | **11.1%** |
| Performa European Equities (EUR) | **7.7%** |
| Performa US Equities (USD) | **5.4%** |
| Perkins US Strategic Value (USD) | **8.6%** |

Talking of risks; as usual, there is no lack of circumstances these days to dampen the desire to invest. For example, the ghost of “Grexit” (synonym for the exit of Greece from the Eurozone) once believed to have been frightened off, has raised its ugly head once more prior to the elections to be held there soon. However, it is not just the sabre-rattling of the presidential candidates which is alarming, it is the statements by Germans politicians giving the impression that Berlin would not fight “Grexit” with all available means that give rise to concern. “An exit from the Eurozone is not provided for in the treaties”, is the laconic comment from Brussels.

The collapsing price of oil and the rouble has also unsettled the markets. On the one hand, oil demand may be weak because of the slowing economy and possibly also due to increased fuel efficiency. On the other hand, oil extraction in the US has been rising surprisingly quickly and the cards have been reshuffled in the oil sector. So far, OPEC has not resisted the erosion of prices decisively, maybe deliberately. It is feasible that the falling oil price may permit Saudi Arabia to kill two birds with one stone. It weakens firstly the competition from Russia and Iran, amongst others, and secondly, the Americans producing oil by fracking with its high production costs, and both factors might bolster the Saudis’ position in the long term. Whether such a plan would work is uncertain. The innovative strength of the US oil industry should not be underestimated in this respect.

**Other funds employed by us** developed as follows[3]:

| | |
|---|---|
| Acatis IfK Value Renten Fond (EUR) | **3.9%** |
| Acatis IfK Value Renten Fond (CHF) | **3.4%** |
| BlueBay High Yield Bond Fund (EUR) | **2.3%** |
| Lyxor ETF Euro Corp. Bond Fund (EUR) | **6.6%** |
| New Capital Wealthy Nations Bond Fund (EUR) | **5.3%** |
| New Capital Wealthy Nations Bond Fund (CHF) | **5.0%** |
| New Capital Wealthy Nations Bond Fund (USD) | **5.4%** |
| Pictet CH-CHF Bond Fund | **6.6%** |
| Swiss Rock Absolute Ret. Bond Fund (EUR hedged) [4] | **0.8%** |
| Swiss Rock Absolute Ret. Bond Fund (CHF hedged)[4] | **0.5%** |

There are other dates and developments on the agenda that could mean turbulent times for investors. Elections are top of the list, not only in Greece but also in the UK, as well as other countries. Developments in Libya and Syria, the unscrupulous advance of the IS, Russia’s conduct in the Ukraine, as well as the paralysis of the Russian economy, and disputes over the sovereignty of islands off the coast of China and Japan, are all examples of a not exactly peaceful world. Never before have so many people been displaced as there are today, be it for political or economic reasons. Quite apart from the human suffering involved, this can only lead to rising social unrest and political upheaval lurching in the direction of populist ideas.

[2] Performance in fund currency. Source: Bloomberg or respective fund company
[3] Performance incl. re-invested dividends where applicable
[4] Performance since purchase July 2014

Overall, fear factors appear to dominate. Over long periods, exchanges took these in their stride, as the developments on the equity markets, or of the crisis barometer, gold, have illustrated. For equity and bond owners, 2014 was a good year.

Equities are still trumps

Will 2015 be able to continue in the same vein? We are sticking to our positive scenario, which implies a relatively high equity weighting. Apart from the low interest rates, oil prices too are now acting as a support to the economy in many places. What could be the alternatives to equities? Government bonds with more or less zero or even negative interest rates are not it. High-yielding corporate or emerging market bonds may only be regarded selectively as complementary at the most.

In 2014 **yields on 10-year government bonds** fell in all countries:

| | Dec. 2013 | Dec. 2014 | Change |
|---|---|---|---|
| Europe | 1.93% | 0.54% | -72% |
| United Kingdom | 3.02% | 1.76% | -42% |
| Japan | 0.74% | 0.33% | -55% |
| Switzerland | 1.07% | 0.32% | -70% |
| USA | 3.03% | 2.17% | -28% |

Commentary on asset allocation

At its meetings, the Investment Committee decided on the following changes to the asset allocation for medium-risk balanced Swiss-Franc portfolios, not subject to client's restrictions (mandates in different reference currencies at times display different nominal weightings and weighting changes):

**Money Market**: The relatively high level of liquidity reflects, on the one hand, our restraint in reinvesting maturing bonds, and on the other, the sale of a high-yield bond fund towards the end of the year added to the increase. The background to this is in the following paragraph.

**Bonds:** Having held the BlueBay High Yield Bond Fund for almost six years, we sold that position in December. This fund pleased our clients with a cumulative performance of in excess of 100% in Euro and over 65% in Swiss Francs over the years. Two reasons lead to the sale; firstly, the yield advantage of European high yield bonds vis-à-vis prime government bonds has turned lean. It is at such a low level that has not been seen in years (see chart "Credit Spread EU 10 years" on page 6). Secondly, since our first engagement in February 2009, the organisation which runs the fund has blossomed from a financial boutique into a major corporation, which makes it noticeably more difficult for us to maintain the close contact to the fund manager that we would like. The evaluation of a compensatory investment is underway.

Measured on the **price/earnings ratio**[5] using the latest 12 months profit figures, some equity markets have become dearer during the course of the year (red) while others have become more attractive (green):

| | Dec. 2013 | Dec. 2014 | Change |
|---|---|---|---|
| DAX Index/DE | 16.3 | 17.2 | **+6%** |
| DJ STOXX 600 Index/EU | 21.6 | 21.3 | **-1%** |
| MSCI World Index | 17.9 | 16.9 | **-6%** |
| S & P 500 Index/USA | 17.4 | 18.2 | **+5%** |
| SPI Index/CH | 19.2 | 19.5 | **+2%** |
| TOPIX Index/JPN | 17.3 | 16.1 | **-7%** |

**Equities Switzerland:** The Swiss equity market was among the best of the established world markets during 2014. The neutral allocation remained unchanged during the fourth quarter. For the directly-invested "Swiss Stock Portfolio" (SSP), we sold the stocks of Kuoni and Bucher Industries during the fourth quarter, for the time being without replacement. The stock of Helvetia Insurance already dropped out in the third quarter due to a takeover. This was replaced with a position in Vaudoise. In 2014 the SSP achieved a performance of 10.32%. The Swiss Performance Index rose by 13% (both numbers include dividends). Since 2010, the annual total return of the SSP has amounted to 9.65% per annum, and with that, lying above the performance of its benchmark of 9.49%. Transaction costs and withholding taxes have been deducted from the SSP's figures whereas the benchmark naturally does not bear any such costs.

**Equities Europe:** European equities we were neutrally weighted too. We sold the stock of OMV and Sainsbury from the directly-invested "European Stock Portfolio" (ESP) during the fourth quarter and replaced these positions with BHP Billiton (raw materials)

[5] Source: Bloomberg

and Subsea 7 (oil services). During the past year the ESP achieved a total return (price change plus dividends) of 7.29%. The Dow Jones Stoxx 600 Index has achieved a return of 7.2% during the same period. Since 2004 the average annual performance of the directly-invested portfolio amounts to 8.91%, compared to 6.71% for the benchmark. The figures for the European Stock Portfolio are net of transaction costs and taxes withheld on dividends, whereas the benchmark does not bear any such costs.

**Price/Book** and **Dividend Yield** of major equity markets:

| | Price / Book | Div. Yield |
|---|---|---|
| DAX Index/DE | 1.7 | 2.7% |
| DJ STOXX 600 Index/EU | 1.0 | 3.7% |
| MSCI World Index | 2.0 | 2.5% |
| S & P 500 Index/USA | 2.8 | 2.0% |
| SPI Index/CH | 2.4 | 2.9% |
| TOPIX Index/JPN | 1.3 | 1.7% |

**Equities USA:** American Stocks experienced a strong boost during the fourth quarter, propelling the calendar year performance of US indices into the double digits. In addition, the greenback gained in value. The allocation of US stocks in a balanced portfolio amounts to about 9%.

**Equities Asia (excluding Japan):** Asian equities largely marked time in 2014. The big exception is China, where, after a prolonged sideways movement, prices took off in a breathtaking spurt after the central bank lowered interest rates during the fourth quarter, making the Chinese equity market the strongest performer of the main global markets. We have not made any changes to our Asia allocation and, with an approximate 5% weighting, are slightly overweight vis-à-vis the strategic target.

**Equities Japan:** During the final quarter, stocks on the Kabutocho rose impressively rescuing the calendar year performance of the Topix Index. The position stands unchanged in our portfolios. With a share of 4% allocation, we are neutrally weighted in the Land of the Rising Sun.

Summary of our current **Asset Allocation**[6]**:**

| Investment Category | |
|---|---|
| Money Market | overweight |
| Bonds | underweight/short duration |
| Equities Switzerland | neutral |
| Equities Europe | neutral |
| Equities USA | neutral |
| Equities Asia | overweight |
| Equities Japan | neutral |

We thank you for the trust placed in us and wish you a healthy, happy and successful 2015.

*Alfred Ernst*
Vaduz/Zurich, 31st December 2014



[6] For a Swiss Franc referenced portfolio

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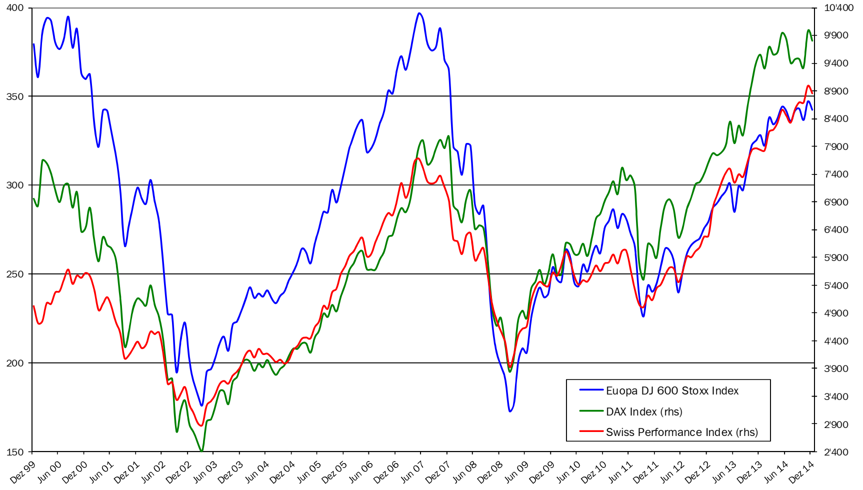
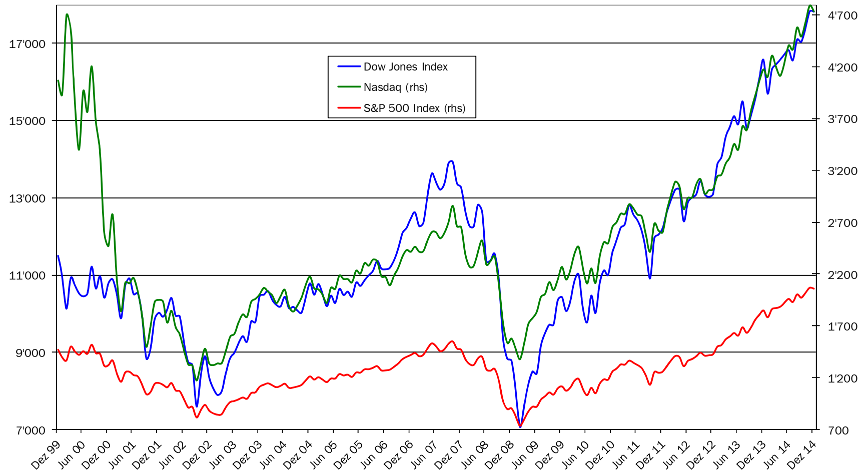
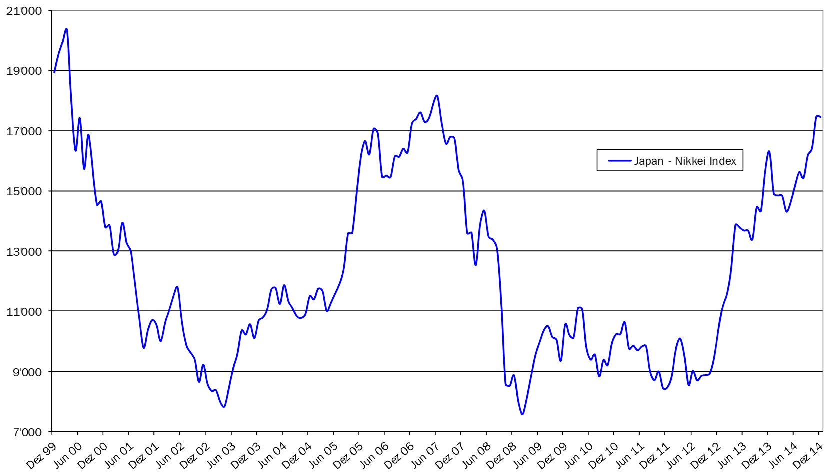
Equity Markets Europe



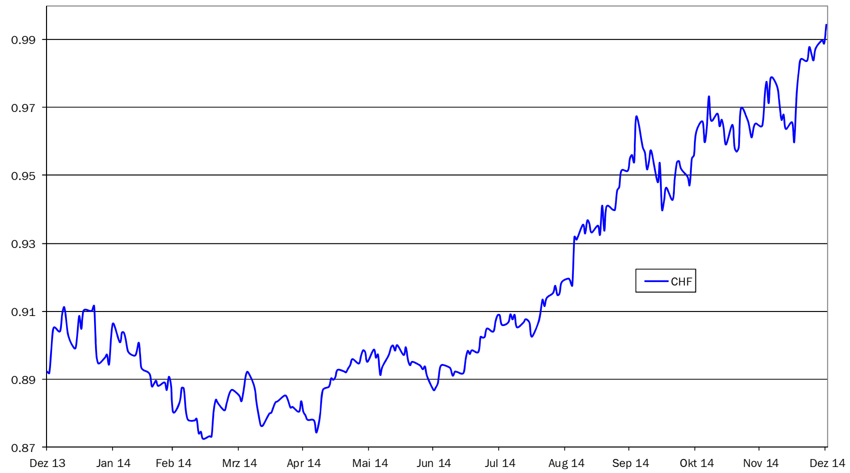

Equity Markets USA




Equity Market Japan




CHF/USD Exchange Rate
(last 12 month)



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