Dear Clients,

Until the autumn, equity markets proved to be very robust and there was hope that the negative year of 2022 would be followed by a year of above-average returns. However, the situation changed temporarily following Hamas's surprise attack on Israel. In addition to the conflict in the Middle East, the war in Ukraine, persistently high inflation in leading industrial countries and rising interest rates have weighed on equity markets. The markets began to recover in late autumn. In this challenging environment, it is particularly important to pursue a long-term, storm-tested, high-quality investment strategy.

"I am firmly convinced that trying to outperform every year will not be successful. Instead, striving to achieve relative outperformance in bad times through discipline leads to less volatility and fewer significant losses that are difficult to recover. Slightly outperforming the average each year will ultimately lead to more success."

This apt and trenchant statement comes from Howard Marks. Marks is the founder of the US investment management firm Oaktree and is known for his legendary investment letters. The Oracle of Omaha, Warren Buffett, reads them with interest. Consistent with Howard Marks' opening quote, taken from the online newspaper "The Market", the long-term success of an investment specialist does not depend on whether they are the best of all investment advisers in a particular year, even if that happened to be the case for us in 2022. Anyone who *deliberately* tries to be number 1 out of, say, 100 experts in *individual* years will inevitably fail because they take on too much risk. In the long run, those who avoid big mistakes and losses will be first.

When it comes to investing, many investors wonder when is the right time to buy and sell, or which equity is the most promising at the moment. Such questions may sound exciting, especially in times of high market uncertainty and volatility, but they are fundamentally irrelevant, or at least secondary. What ultimately matters is defining the right investment strategy and focusing on the most promising asset classes over the long term. Achieving a consistently attractive return is not the result of prophetic predictions, but of a successful investment strategy. In this context, it is interesting to look at the investment strategies of family offices, which manage and monitor the large number of assets of wealthy families. In its "Global Family Office Report 2023", UBS provides insights into the asset classes in which wealthy families around the world allocate their funds. There are 230 family offices on the bank's radar, with total assets of around USD 500 billion. On average, global family offices invest 25% in developed market equities, 6% in emerging market equities, 11% in developed market bonds and 3% in emerging market bonds. Wealthy families allocate 19% of their assets to private equity, 13% to real estate and 7% to hedge funds. The remainder is split between cash (9%), private debt (2%), gold (2%), art (2%) and commodities (1%).

> “The difference between successful people and very successful people is that very successful people say ‘no’ to almost everything.”

Warren Buffett, legendary investor and Oracle of Omaha, Nebraska

What conclusions can we draw from the investment policies of wealthy families? Unsurprisingly, they invest almost two-thirds of their total assets (63%) in productive real assets, including equities, private equity and real estate. There is no doubt that long-term wealth creation and growth is best achieved through ownership of businesses and real estate. It is also worth noting that equities, whether in the form of listed shares or private equity, account for exactly half of the assets of wealthy families, while real estate lags far behind at 13%. This is consistent with our view that real estate is an attractive asset class, but is often overvalued in terms of returns and underestimated in regards to risks. In contrast to this finding, the share of real estate as a percentage of total assets of the average investor in Switzerland and Germany is much higher than the share of equities. Indeed, for many segments of the population, real estate represents the dominant share of total assets.

The fact that the share of private equity is as high as 19% may be surprising at first glance, as the corresponding shares of institutional and private investors are much lower. It should also be noted that we often express reservations about this segment. On closer inspection, however, this high share is understandable, as a significant part of it consists of direct investments by wealthy families in their *own* businesses (note: the author’s share of private equity assets is also very high – in the form of shares in the family-owned asset management company). This does not change the fact that we remain critical of private equity as an asset class, as underlined in the article “Private Equity – The Shine Is Gone”, which we published in “Finanz und Wirtschaft” on 7 October (only in German available).

What raises questions about the asset allocation of wealthy families, however, is the high degree of complexity. The share of high-margin and often opaque fund-of-fund structures is in the double-digit percentage range. This is surprising given that, in our view, these products are undoubtedly primarily expensive and low yielding. Nevertheless, wealthy private investors are attracted to such products, probably in part because of the well-oiled marketing machinery of banks and the finance industry. Complex products naturally generate the most money, so the industry markets them aggressively. Family office advisers also often have an interest in complex structures and products, as they justify more intensive advisory services, monitoring functions and consequently higher fees.

> “Playing football is very simple, but playing simple football is the hardest thing of all.”

Johan Cruyff, Dutch football player and coach (1947–2016)

In “UBS House View, Investor’s Guide” from June last year, the only remaining major Swiss bank recommends the following: “Finally, we believe that multi-strategy funds, which combine various hedge fund strategies, remain an important component of portfolios.” Ufff! We can only roughly estimate the true total cost of these crazy products, with no guarantee of accuracy, but we believe that, based on experience, it is likely to be more than 5% per annum. Therefore, in our view, it is highly uncertain whether investors can expect a return commensurate with the risks. Perhaps UBS also knows exactly the same thing, as it goes on to say: “Investors should be aware that alternative investments are subject to particular risks. These include lower liquidity, high costs and significant complexity.” One wonders whether the bank’s legal team has provided their colleagues from the marketing department with crash barriers and safety nets for their bonus-driven recommendations.

Wealthy families get a lot right in their asset allocation, otherwise they wouldn’t be wealthy. But we struggle with complex and expansive structures. Irrespective of the size of their assets, we are therefore committed

to finding simple, transparent and cost-effective solutions for our clients. It is understandable that not all advisers appreciate this, as the consistent elimination of complexity limits or even renders unnecessary the job profile of many advisers. We cannot stress this enough: Completely avoid complex, opaque and high-margin products – they make the providers rich and the buyers poor. In this regard, we recommend the article "Questionable Aspects of Asset Management", which we published on 5 August in "Finanz und Wirtschaft" (only in German available).

> "I propose that we simplify the investment world, and there are only stocks and bonds."

Harry M. Markowitz, founder of Modern Portfolio Theory and Nobel Laureate (1927–2023)

Since mid-December of 2022, the S&P 500 US equity index has risen 23%. Interestingly, around 80% of these impressive gains have come from the "Magnificent Seven". Tech heavyweights Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia and Tesla have been the real market rockets, while the broader market, comprising the "remaining" 493 stocks, has been more sluggish – a situation similar to what we have seen during the COVID-19 crisis. The new star among the tech giants is the American company Nvidia, a world leader in the development of graphics processors and chipsets for personal computers, servers and game consoles. Nvidia's products play a leading role in the application of artificial intelligence (AI). The weighting of the "Magnificent Seven" in US stock indices, which are used as a basis for passive investment, is immense. As at mid-December 2023, they represented a substantial 28% of the broad S&P 500 and as much as 47% of the Nasdaq technology index.

The "Magnificent Seven" account for around 19% of the entire MSCI World Index. That is more than China, Germany, France, Japan and Switzerland combined. Apple alone has a weighting of 5.2% – the same as all listed companies in Germany and Switzerland put together. While we are sympathetic to the inclusion of growth stocks in a high-quality equity portfolio, this cluster risk in a small number of equities runs counter to our principle of sound diversification. This is why we are convinced of the need for a more balanced portfolio of quality equities.

> "Make things as simple as possible. But not simpler."

Albert Einstein, German-American Physicist (1879–1955)

There has been a real hype around AI recently, starting with the launch of ChatGPT in 2022 by OpenAI, in which Microsoft has a significant stake. Competitors such as Amazon and Google have also jumped on the bandwagon with their own applications. There is no doubt that these developments will continue to make significant progress and revolutionise the world in many application areas. One question that arises for us as asset managers is this: Will AI, or a chatbot like ChatGPT, also revolutionise stock market forecasting and perhaps even make asset managers obsolete one day? Some financial experts, and those who think they are, are praising ChatGPT as the magic bullet of our time, claiming it to be the new "Oracle of the Stock Market". The article "The Wow Effect" by Philipp Frohn in the "WirtschaftsWoche" of 7 July last year amusingly informs us about the success of stock market predictions by AI from today's perspective.

The journalist investigated how well his dog Freddy, a Maltese mix, performed in stock picking compared to ChatGPT. Frohn wanted to know if his four-legged friend had a luckier paw than the 21st century's biggest hope: Artificial Intelligence. ChatGPT and Freddy were each given just over EUR 19,000 to put together a portfolio. They had to choose three sectors out of 15, and from each of these three sectors they had to choose five stocks out of 50, so that both portfolios ended up with 15 equities. An identical chunk of dog food was placed on each piece of paper that lay on the floor for Freddy with the corresponding sector or the name of the stock

to be chosen, and the choice depended on which chunk Freddy picked up at random. Freddy competed with the decisions of the chatbot, which used AI to select the 15 equities. The competition ended after six weeks. So who won? Surprisingly, it wasn't the "all-knowing" chatbot that came out on top, but Freddy. Freddy added Nvidia to his portfolio just a few days before the chipmaker's share price soared. While Freddy performed brilliantly with a return of 13.5%, ChatGPT's portfolio rose by just 3.5% and was clearly beaten by the dog. Even the global MSCI World index "only" rose by a comparatively modest 4.1% over the same period.

Although this experiment lacks scientific rigour, the result is far from surprising. In the world of finance where new information is incorporated into prices within seconds, even AI is always one step behind. While AI may know much or even all of what has been known in the past, an efficient market reflects all this information in prices instantly and at all times. That is why we believe that AI will change our lives in many areas, such as finding information or writing texts. However, we do not believe that it will one day be able to *systematically* predict stock prices – rather than randomly as Freddy did. This is in part because these chatbots already operate on the stock market in the form of high-frequency trading (HFT). Much of the world's stock trading has for many years been generated by intelligent and incredibly powerful high-performance computers that process transactions in milliseconds and nanoseconds thanks to inconceivable amounts of data. AI became a part of stock trading long ago. This fact ultimately benefits the average investor because it has made capital markets even more efficient and therefore fairer in their pricing.

> "Personally, I am sceptical about the hype surrounding artificial intelligence. I think old-fashioned intelligence works pretty well."

Charlie Munger (1924–2023), long-time business partner of Warren Buffett, at the Berkshire Hathaway Annual Meeting on 6 May 2023.

The irrationality of the AI hype was demonstrated by the famous Spanish Christmas lottery. As the "Zuger Zeitung" reported in early December, a Spanish newspaper announced that, according to ChatGPT, the big jackpot (El Gordo) could fall on ticket numbers 02 695 or 03 695. As a result, countless fortune seekers flocked to lottery shops. "It was madness. Everyone wanted those numbers," said Maria Irles, who runs a lottery shop in the Mediterranean city of Elche. The media report was a hoax, however, because AI can neither predict the future nor the lottery numbers.

Banks and other financial institutions like to use hype such as AI to encourage their clients to invest in thematic funds. The number of thematic funds, which focus on trends and megatrends, has exploded in recent years. In Switzerland, according to the business magazine "Bilanz", there are currently around 500 licensed funds covering around 160 (!) different themes. These include topics such as AI, water, rare earths, nanotechnology, clean energy, blockchain, battery technology, robotics, 3D printing, space exploration, forestry, cannabis, cloud computing, drones and an ageing society. Thematic funds provide the basis for good, coherent stories that are easy to market. As a result, more and more asset managers are using them. However, only a very small number of them have had success, according to a recent study by Morningstar, a US financial services company. The global success rate of thematic funds between 2007 and 2021 is low at 10%. "Over the past 15 years, more than three-quarters of thematic funds worldwide have closed, and only one in ten has survived and outperformed," Kenneth Lamont, a thematic fund specialist at Morningstar, told "Bilanz" magazine in August last year. This means that by the end of 2021 only one in ten megatrend thematic funds that existed in 2007 were still active and could be considered a success – a sobering result. In this context, Morningstar speaks of a "thematic graveyard". To be fair, the closure or death rate for "normal" equity funds is just as disappointing.

The stated annual fees for thematic funds typically range between a hefty 1.5% and 2.0%. When hidden, undisclosed costs are added, annual fees can easily reach 2% to 3%. Accordingly, bank marketing departments

are delighted with these exorbitant revenues. Take the Pictet-Global Megatrend Selection fund, for example. This Geneva-based private bank focuses on megatrends such as biotechnology, digitalisation, nutrition, robotics, clean energy, forestry and water management. With more than CHF 10 billion in assets, the fund alone generates a *disclosed* annual total expense ratio (TER) of more than 3%, or CHF 300 million. If you want to benefit from these megatrends by owning shares in companies such as Ecolab, Thermo Fisher Scientific, Visa or Waste Management, you can do so much more cheaply with direct investments – especially as the fund underperforms its self-defined benchmark. Our conclusion is clear: Firstly, we do not support expensive megatrend and thematic fund products, and secondly, we do not chase hype stocks such as Nvidia, which have an enormously high valuation. The rewards may be high, but the risks are at least as high. With reasonably valued stocks such as Microsoft or Alphabet, we are well positioned to benefit from revolutionary developments in areas such as AI.

> "You don't have to do extraordinary things to get extraordinary results."
>
> Warren Buffett, legendary investor and Oracle of Omaha, Nebraska

Do you remember the dramatic fall of Credit Suisse? Of course, this question is rhetorical because it happened less than a year ago. So it is all the more surprising that some financial experts have not learned their lesson. As is well known, the Swiss government and its supervisory authority FINMA communicated on 19 March of last year, when the forced merger with UBS was announced, that holders of subordinated and high-risk CS-AT1 bonds (so-called CoCo bonds) would lose their entire investment. The forced write-down of these bonds to the tune of CHF 16 billion strengthened Credit Suisse's capital, and thus that of the acquiring UBS. However, the obviously enormous risk of these high-yield bonds did not prevent Thomas Kirchmair, a fund manager at Zürcher Kantonalbank, from recommending AT1 bonds issued by UBS and Genève Cantonal Bank to conservative investors in "Finanz und Wirtschaft" on 10 May. We can only shake our heads in disbelief. Experienced portfolio managers should know that the risks of such bonds are tremendous. For example, Emira Marika, Head of Developed Market Bonds at Pictet Asset Management, lost a whopping 21.1% in one year (from the beginning of February 2022 to the end of January 2023) with her tips for conservative bond investors, which were also recommended in "Finanz und Wirtschaft". Over the same period, the losses for Marc Bourget, Senior Portfolio Manager at Vontobel, amounted to a staggering 32.9%. They advised *conservative* investors to invest in Russian bonds, which have become temporarely worthless.

We consistently reject all types of high-yield, subordinated and risky bonds. Instead, we prefer highly rated and safe bond issuers with the aim of returning the invested capital at maturity with a high degree of certainty. Our credo is this: We would rather earn less interest on fixed-income bonds in exchange for a strategic overweight in high-quality equities than take high risks on bonds. We believe that holding high-quality equities over the long term is more attractive and less risky than speculative bonds. The history of Credit Suisse has taught us that in a crisis FINMA enforces its decisions regarding CoCo bonds without prior notice or consultation with the bank's shareholders. We find this dependence on government authorities suspicious.

When it comes to bonds, we agree with Howard Marks, quoted at the beginning, who says: "Bond investors improve their performance not through what they buy, ...but by avoiding losers. There it is: a negative art". Discipline is particularly important with bonds because of the natural appeal of high yields. Many investment professionals try to buy bonds within a given credit rating class that offer the highest yields for their clients. What may seem plausible at first glance is dangerous on closer inspection. In general, according to the slogan "the market is always right", there is usually a reason why one borrower's interest rate is higher than another's – higher yields mean higher risks. In the spirit of "there is no free lunch", we therefore *prefer more safety* to higher rates when in doubt. We accept that this may lead to temporary underperformance in boom times

when the pursuit of high risk is rewarded. The safety of our clients' money is of paramount importance to us and we are proud that in our over 37-year history not a *single* bond has defaulted respectively gone bankrupt.

> "Markets are never wrong. Opinions often are."

Jesse Livermore, American investor and stockbroker (1877–1940).

Speaking of the collapse of Credit Suisse and its emergency takeover by UBS: In August, UBS announced that it would henceforth waive all federal guarantees related to the rescue of Credit Suisse – good news for taxpayers. Until then, the Swiss government had received CHF 200 million from UBS as compensation for a state-guaranteed emergency loan and a loss guarantee. This has led many market observers to conclude that the government and taxpayers have once again benefited from a bank bailout, as was the case with the rescue of UBS during the 2008 financial crisis. However, Pascal Böni, Professor of Finance at the University of Tilburg/Utrecht, comes to a different conclusion in his empirical study "Helvetia's Gift". He argues that the systemic risk posed by the mega-UBS is higher for Switzerland than the risk posed by any other global bank. This would result in massive costs for the Swiss taxpayers.

> "The main risk for the Confederation lies in the economic costs of too-big-to-fail. These have increased significantly with the merger of UBS and Credit Suisse."

Pascal Böni, Professor of Finance at the University of Tilburg/NL, in the "NZZ", 12 August 2023

Böni supports his thesis by pointing to the increased risk premium on Swiss government bonds following the emergency takeover of Credit Suisse by UBS. The cost of hedging against a default by the federal government temporarily rose by a whopping 60% – from 0.11% to 0.18%. In concrete terms, this means that to hedge CHF 1 million worth of Swiss government bonds against a default, you had to spend CHF 1,800 instead of CHF 1,100. As a direct result, the federal government will have to pay higher interest rates on its debt. According to Pascal Böni in the "NZZ", before the Credit Swiss bailout, Switzerland was the European leader in terms of low credit risk. This position is now in jeopardy. Böni concludes that the "too-big-to-fail" problem, which has been exacerbated by the merger of UBS and CS, could cost the Swiss government, and thus the taxpayer, billions in increased interest costs. According to Aymo Brunetti, Professor of Economics at the University of Berne and the father of the too-big-to-fail rules, a possible rescue of the "monster UBS" could seriously jeopardise the financial stability of the state and, in an extreme case, push the federal government close to bankruptcy. Brunetti is therefore right to demand that systemically important banks substantially increase their equity. The market-oriented professor also calls for the abolition of state guarantees for all cantonal banks. He believes they distort competition.

> "There is a high risk that we will end up in a similar situation to that of Credit Suisse at some point... After all, a carpenter's workshop will not be rescued by the state when it gets into trouble."

Aymo Brunetti, Professor of Economics at the University of Berne, interview in the "NZZ am Sonntag", 3 September 2023

At the beginning of September, the expert group on "banking stability", chaired by Yvan Lengwiler, Professor of Economics, presented its report with recommendations on the Credit Suisse disaster. They came to a surprising conclusion: Apart from the need to strengthen the Swiss Financial Market Supervisory

Authority FINMA, they saw no need for action – not even with regard to the equity of the mega-UBS. Ariel Jost, an economist and former employee of the Swiss National Bank, expressed his astonishment in the "NZZ" on 4 September: "The Swiss Bankers Association could have written this report." Jost called for UBS to have a strong equity ratio of 30%, five to six times its current level. The expert's demands may be high, but they are not unjustified. An International Monetary Fund (IMF) stress test found that of 900 banks in 29 countries, a third would face difficulties if the global economy entered a period of stagflation, with low growth and high inflation. It appears that a significant number of banks are vulnerable. Nevertheless, the powerful banking lobby will do everything it can to defeat demands for much higher equity requirements. Therefore: after the bang is before the bang.

> "The definition of insanity is doing the same thing over and over again and expecting different results."
>
> Albert Einstein, German-American Physicist (1879–1955)

As asset managers, we are known as advocates of real assets, which primarily include equities. However, in an environment of significantly higher inflation and potentially rising interest rates, the question arises: Are equities still the right choice? British professors Elroy Dimson, Paul Marsh and Mike Staunton provide interesting insights into this question in their "Global Investment Returns Yearbook 2023", published annually by Credit Suisse. In their research covering the period from 1900 to 2022, they show that equities outperformed bonds in 95% of all sub-periods examined, including periods of very high to very low inflation. Even in the top 5% of periods with the highest inflation, equities outperform bonds. In such high inflation periods, equities may lose value due to rising interest rates, but significantly less than bonds. Dimson, Marsh and Staunton point out that bonds only outperform equities in the most extreme 5% of low inflation periods. This was the case, for example, during the COVID-19 pandemic, when inflation in many countries was close to zero or even below zero and the economy was in recession. Interestingly, in such extreme periods, characterised by low inflation, falling interest rates and often recession, it is not only bond prices that tend to rise, but – somewhat counterintuitively – also equities, due to increasing valuations. However, the gains in fixed income during such periods are *even* greater than the gains in dividend-paying stocks. In summary, those who bet on bonds outperforming equities are essentially anticipating a recessionary scenario with falling inflation and a drop in interest rates. However, the odds are not in favour of this bet as such a nearly impossible-to-predict scenario rarely occurs.

One argument in favour of bonds is that they are safer than equities in the short term. Although there was a veritable bond crash following the 2022 interest rate reversal, bond price fluctuations are generally much less volatile than those of equities. But are equities riskier than bonds in the long run? To answer this question, Dimson, Marsh and Staunton calculated how long investors would have to endure a period of losses in *real* terms on an inflation-adjusted basis if they invested their money at the worst possible time, namely at a historical *high*. In other words: how long does it take for an investor to make a positive return on a *real* basis after investing pro-cyclically at a peak? For the global equity market and the time horizon from 1900 to 2022, the longest it took for investors to recoup their intermediate losses and break even in *inflation-adjusted* terms was 22 years. In other words, those who invested in equities at an inopportune time between the end of the First World War and the beginning of the Great Depression in the 1920s got their money back in real terms 22 years after the colossal stock market crash.

It could be argued that this long period of losses reflects the significant risks of equities, and there is some merit in this argument. However: the situation is (even) worse for bondholders. For the global bond market, the longest period of intermediate losses in real terms was an astonishing 82 (!) years. Those who invested in bonds at an inopportune time during the Great Depression had to wait more than eight decades to get their money back

on an inflation-adjusted basis. German bonds went bust during that period. So it is an illusion to believe that bonds are less risky than equities *in the long run*. On the contrary, bonds are riskier, especially when the spectre of inflation is taken into account. It's not a good idea for investors to keep a significant amount of money in their accounts or in bonds for many years during inflationary periods, because it will be eroded by inflation.

> "We now have a better understanding of how little we understand about inflation."

Jerome Powell, Chairman of the US Federal Reserve

The dream of many investors is to be invested in the stock market during bull markets and avoid bear markets, as was the case in 2022. But how realistic is this desire for successful timing? In the July issue of the business magazine "Bilanz", journalist Erich Gerbl examined the S&P 500 US stock market for the period from 1928 to 2022. He found that there were a total of 27 bull markets during this almost 100-year period. He used a common definition, which considers markets as bull markets until they have corrected by 20 percentage points from a previous peak. In his analysis, Gerbl found that, on average, bull markets last three times longer than bear markets. Bull markets lasted an average of 1,011 days, while bear markets (which persist until the market recovers 20 percentage points from a previous low) lasted an average of "just" over 300 days. Why do bull markets evidently last so much longer than bear markets?

Two factors are responsible, and they are crucial to understanding stock markets and the question of timing entry and exit. Firstly: When stock markets start to correct, the downturn is often faster and steeper than the rise. This is human nature, as people tend to panic in times of economic and political turmoil, especially when stock prices are falling. As investors rush for the exit, many others follow – the classic herd mentality. As a result, bear markets are often more intense but shorter-lived than bull markets. Secondly, and this is the simpler but more important reason why bull markets last longer than bear markets: Stock markets *rise* in the long run! Growing economies, productive companies and high value creation ensure that stock markets rise over the long term. In other words: bull markets *must*, on average, last longer than bear markets; otherwise, the long-term trend in equity markets – which is likely to remain the case unless the world comes to an end – cannot be upwards. Because of this important fact, we like to compare notorious crash prophets to swimmers who jump into the Rhine in Rotterdam and try to swim upstream (towards Basel) faster than someone who starts swimming downstream (from Basel towards Rotterdam). Those who bet on bear markets are swimming upstream, require much more effort and are guaranteed to lose the race against the current in the long run – this is bold, if not reckless. Those who try to time a bear market and get out are speculators who will fail in the long run. This is partly because, in efficient markets, it is simply impossible to predict exactly when a bear market will begin and end. For this reason, we *always* remain strategically invested, at least with the majority of our investments, and benefit from the long-term course of events.

> "If you love to constantly buy and sell, then I want to be your broker – but not your partner."

Warren Buffett, legendary investor and Oracle of Omaha, Nebraska

The idea that it is impossible to find the perfect time to enter and exit is underlined in a study by the investment bank Goldman Sachs. Those who invested in the US S&P 500 between 1900 and 2022 achieved an average annual return of 9.8% over that period. However, those who missed the best month of the year only achieved an average annual return of 1.8%. While the basis of the study may seem somewhat hypothetical, it shows that aggressive timing can be very risky because it risks missing the best times. We can assure you that

those who believe in the art of timing and choose to exit to avoid losses don't usually avoid losses, but miss out on significant gains. This is also a result of human psychology: most investors sell in panic when markets fall on bad political or economic news. Then they don't want to reinvest until the stormy skies have cleared. This is pro-cyclical and in any case far too late, as the fear-driven exit is followed by a rise in prices as soon as there is a glimmer of light at the end of the tunnel. Stocks tend to bottom out when the outlook is bleakest. When the sun comes out and the skies are clear, they reach new highs.

> "Buy stocks, take sleeping pills for 20 years and stop looking at the papers. After many years you will see: you'll be rich."

André Kostolany, Hungarian-American stock speculator, entertainer and author (1906–1999).

Having expressed our cautious view on emerging markets in our early July client letter, we would like to reiterate our critical perspective. The undisputed leader among emerging markets is China. After the end of the zero-Covid policy, the investment world was convinced that the Chinese dragon would be back in 2023. The reality was rather disappointing – the economy of the People's Republic has simply not picked up. However, it is the long term that counts when it comes to emerging market investing. In the "Credit Suisse Global Investment Returns Yearbook 2023", British professors Elroy Dimson, Paul Marsh and Mike Staunton provide a representative overview of the performance of emerging markets compared with established Western markets. Those who invested in emerging market equities between 1900 and 2022 achieved an annual performance of 6.8% – turning USD 1 into USD 3,249. Over the same period, developed market equities returned 8.2% per annum – turning USD 1 into USD 16,505, or five times as much. Moreover, the volatility risks of emerging market equities are even higher than those of developed market equities. Emerging market bonds are no better. They have returned 2.6% per annum over the long term – turning USD 1 into just USD 23. By comparison, developed market bonds returned 4.5% per annum – turning USD 1 into USD 217, almost ten times as much.

> "Compound interest is the eighth wonder of the world. Those who understand it earn from it, everyone else pays for it."

Albert Einstein, German-American Physicist (1879–1955)

The so-called BRICS countries (Brazil, Russia, India, China and South Africa) have long been trying to create their own BRICS trading currency to compete with the dollar. After all, 40% of the world's population lives in these countries, which account for about 26% of global GDP. Does the project stand a chance? British economist Jim O'Neill, who coined the acronym BRIC shortly after the turn of the millennium (South Africa joined later), expressed his opinion in the "Financial Times" in August. While not uncritical of the dollar's dominance, he addresses this question to the BRICS countries: "Do they want to create a BRICS central bank? How would they do it?" O'Neill describes the project as "ridiculous" because he says the BRICS have simply "achieved nothing" since their first meeting in 2009 – a damning, but probably realistic assessment. This assessment is borne out by the six countries that joined the BRICS club on 1 January this year: Saudi Arabia, Iran, the United Arab Emirates, Argentina, Egypt and Ethiopia. In total, some 40 countries are said to be interested in joining. We firmly hold that it is pure utopia to believe that a currency worthy of investor confidence can be conjured up from a horror cabinet of particularly inhumane authoritarian regimes.

In its Financial Stability Report published at the end of June, the Swiss National Bank (SNB) stated that single-family homes and condominiums are overvalued by 15% to 40%. Nevertheless, proponents of real estate have long hoped that, unlike bonds and equities,

real estate prices would be spared from the interest rate reversal. Now there is a growing chorus of voices suggesting that the bubble that has formed in various regions of Switzerland is deflating. Hopes of a continuation of the long-running bull market have now been dashed in both Switzerland and Germany. This shows that even income-producing real estate cannot escape the influence of interest rate changes. According to the consulting firm Fahrländer Partner, property prices in Switzerland have corrected by well over 10% – this applies equally to multi-family houses, office buildings and mixed-use properties. This picture is confirmed by the capital market: The majority of real estate investment trusts and publicly traded real estate companies are trading at a significant discount to their stated net asset value – the opposite was true just two years ago. It is likely that excessive book values will have to be adjusted downwards in the future.

> “It was clear that this turning point would come, we just didn’t know when.”

Ernst Schaufelberger, Chairman of the Board of the real estate company Intershop, “NZZ am Sonntag”, 13 August 2023.

Andreas Loepfe, real estate economist and CEO of the consulting firm Inreim, suggested in the “NZZ am Sonntag” that transactions in multi-family houses and office buildings had fallen by 50% to 80%, depending on the estimate: “Insurance companies and other institutional investors have reduced their investments in Swiss real estate or even temporarily stopped them.” Indeed, many market experts report that it has become more difficult to sell a property and that it often takes much longer to find a buyer, and frequently requires price concessions.

Whether the correction in the property markets has already bottomed out is at least questionable. The rise in key interest rates has so far had little impact on mortgage borrowers, who were able to take out loans at low interest rates. According to the Swiss Federal Office for Housing, the average interest burden on all outstanding mortgages was still as low as 1.5% last year. If these have to be renewed in the future at interest rates of 3% or more, a so-called “refinancing wall” or a doubling of the interest burden is looming. According to real estate consultant Moneypark, around CHF 130 billion in mortgages will be renewed this year, on which only 1.4% interest has been paid to date. In 2025 and 2026, another CHF 130 billion and CHF 140 billion, respectively, with a current average interest rate of 1.35% and 1.3%, respectively, will come up for renewal. Within three years, one third of the total Swiss mortgage volume, or CHF 400 billion, will come up for renewal. This is equivalent to CHF 1,200 billion, or one and a half times Swiss GDP, a world record – while the Swiss may be admired as a model of public debt, we love risk when it comes to private debt. It is obvious: The interest rate reversal in the real estate sector has been delayed, but it is coming – that much is certain. This poses risks not only for homeowners but also for the lending banks.

> “Overall, the residential real estate market is vulnerable – price sensitivity to shocks is elevated.”

Swiss National Bank, Financial Stability Report 2023.

Let’s not forget that in the 1990s, countless cantonal and regional banks went under or were taken over in the wake of a monumental real estate crisis. Foreclosures piled up and many banks involuntarily became owners of office buildings, single- and multi-family houses, commercial buildings and hotels. Although banks today insist that they have learned from history, according to a report in the “Zuger Zeitung” on 9 October, the Swiss supervisory authority FINMA has been observing for some time that numerous banks are not applying sustainable lending criteria for mortgages. They tend to violate the borrowers’ affordability guidelines. At an interest rate of 3%, FINMA considers 20% to 30% of all new mortgages to be unsustainable because all rental income would have to be used to pay the mortgage interest. These are truly bleak prospects that need

to be kept in mind. We cannot stress this enough: Do not overestimate the realistically achievable net return after deducting maintenance and renovation costs, do not underestimate the true risks associated with your property, and ensure that you are always conservatively financed – so that you are not pressured by your bank to pay off your mortgages at the worst possible time. Low or no leverage gives you peace of mind. As with equities, the same applies to property: Independence from banks and bankers isfundamental.

> "A banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it starts to rain."

Mark Twain, American writer (1835–1910)

According to experts, price corrections in Germany, Italy, Australia, Canada and the United States, where interest rates and inflation are much higher, have already been greater than in Switzerland. The difficult terrain in the German property market is illustrated by the example of real estate investor Peach Property. The company invests primarily in rental apartments in Germany's so-called B-cities. More than 90% of its EUR 2.5 billion portfolio is invested in over 27,500 apartments. Peach Property's stock has lost more than 80% of its market value since its peak in 2021 and is trading close to its all-time low.

At the end of May, the European Central Bank (ECB) warned of a "disorderly correction" in property prices following the reversal in interest rates. The World Bank, in turn, is concerned about European real estate companies that will have to roll over CHF 165 billion of outstanding debt at much higher interest rates in the years to come. The collapse of Signa Holding, led by Austrian property mogul and wonder boy René Benko, is particularly spectacular. What is astonishing in this case is that successful people such as Klaus-Michael Kühne (Kühne and Nagel), Ernst Tanner (Lindt & Sprüngli), Arthur Eugster, the coffee machine manufacturer from Thurgau, Torsten Toeller, the German founder of Fressnapf, the Austrian construction magnate Hans Peter Haselsteiner and the German management consultant Roland Berger were blinded and seduced by the opaque and highly leveraged construct of this department store tycoon. In Sweden, property giant SBB ran into trouble last May. In the United States, many house prices have fallen by around 20% and office property by 30%. In crisis-hit China, the property market is completely out of control. Two years ago, the already wobbling property developer Evergrande filed for creditor protection in August. At the same time, the heavily indebted Country Garden, with a debt of USD 194 billion, also ran into trouble. In China, where 70% of private wealth is tied up in property, there are an estimated 100 million empty homes. Since land in the People's Republic is owned exclusively by the state, it is only possible for individuals and companies to acquire rights of use. As experience has shown that it is not the concrete, but rather the land itself that adds value to a property in the long term, the pressure on property prices in China is particularly high.

> "The property bubble in China has been building for a long time; it is one of the largest in history."

Jim Rogers, American investor, commodities guru and former partner of George Soros.

Remember the many Eastern European developers who borrowed in low-interest Swiss francs during the financial crisis to finance their apartments and houses in Poland and Hungary? They thought they were being particularly clever because mortgage rates in Swiss francs were notoriously several percentage points lower than those in forints or zlotys. At the time, up to 80% of all loans in Poland and Hungary were denominated in Swiss francs – with disastrous consequences for homeowners. By the time they repaid their mortgages, both the Hungarian forint and the Polish zloty had lost half their value against the Swiss franc. As a result, Hungarian and Polish homeowners had to spend twice as much

in forints and zlotys to repay their Swiss franc loans. The interest advantage was more than wiped out, and the value of their apartment or house no longer covered the Swiss franc loan. Many homeowners went bankrupt. They ignored the simple rule of interest parity: Currencies with high inflation and therefore high interest rates are weak in the long run. According to this simple logic, the forint and the zloty weaken in the long run by the amount of the interest rate differential against the Swiss franc. If this were not the case, we could earn risk-free money by borrowing at 3% in Swiss francs and investing at 5% in dollars or 23% in Turkish liras.

> “Houses are for living, not for speculation.”
>
> Xi Jinping, President of the People’s Republic of China

Despite this law, history is more or less repeating itself. Many investors are borrowing in Swiss francs and especially Japanese yen in order to invest their borrowed money at higher interest rates. In Japan, the Bank of Japan’s persistent low interest rate policy has kept interest rates close to zero, in contrast to regions such as the US and Europe. The money borrowed on credit is then invested in higher-yielding currencies in Eastern Europe and South America. For investors who borrow in yen at 1% and invest the equivalent in Colombian pesos at 11%, this has recently been a lucrative business. Both the Colombian peso and the Mexican peso have appreciated significantly against the Swiss franc over the past year. The Polish zloty and the Hungarian forint have also appreciated significantly. The strategy of borrowing at low rates and investing in higher-yielding currencies is known in the industry as the carry trade. Will the carry trade play out well this time? We have our doubts. It is probably only a matter of time before the carry trade bloodbath repeats itself, as the notoriously weak currencies of Colombia, Mexico, Poland or Hungary are subject to the law of gravity: They tend to weaken in the long term due to high inflation and interest rates. Many carry traders and hedge funds are in for a rude awakening as currency depreciation wipes out their interest rate gains.

There is also speculation in cryptocurrencies. You know our view on digital money from previous client letters and published articles. Bitcoin has no intrinsic value, generates no interest or dividends, and merely reflects the hope that someone will buy the coins you bought at a higher price – this type of hope is derogatorily referred to as the “Greater Fool Phenomenon”. You hope that someone even crazier will buy your digital money at a profit. Now Zuger Kantonalbank, with whom we have a trusted and good working relationship as custodian bank for many of our clients, has become the first state bank in Switzerland to enter the cryptocurrency business. Since 1 October, clients have been able to buy and hold Bitcoin, Ethereum, Litecoin, Polygon, Ripple and Uniswap through the bank. When asked about the bank’s reasons for entering the crypto business, its CEO, Hanspeter Rhyner, was quoted in “Finanz und Wirtschaft” as saying: “Requests for investments in digital assets have increased recently” – especially from private investors. The answer is refreshingly honest and revealing. Banks primarily offer investments and products that are fashionable and in demand, rather than those that they believe in. Whether an investment makes sense from an investor’s perspective is of secondary importance. With its crypto offering, Zuger Kantonalbank wants to boost its commission business. According to press reports, the fees on transactions up to CHF 50,000 are a lucrative 1.3%. While Luzerner Kantonalbank has been wowing its customers with crypto assets since the beginning of the year, PostFinance is working on a service for its 2.5 million clients, which will be offered in 2024. Let’s hope it goes well. It is definitely not going well for the crypto trading platform SmartValor, which is based in the Crypto Valley of Zug and went public in February 2022 with a lot of marketing noise. Since then, investors have lost a whopping 97% of their money. As we all know, the hope for a better tomorrow dies last.

> "No one has ever been able to predict the stock market. It's a complete waste of time."

Peter Lynch, legendary American investor and fund manager.

What can we expect in terms of returns for the year that has just begun? You know the answer: We don't know, because we don't believe in short-term forecasts. But let's remain realistic about our return expectations. Based on the records of the Geneva private bank Pictet going back to 1926, we know that Swiss equities have delivered a positive return in about 73% of all years. However, in more than one calendar year out of four, Swiss equity returns were negative. It's precisely these negative results that we have to tolerate – without knowing when they will occur. They are the price we pay for the historically superior returns of Swiss equities, which over a 97-year period have averaged 7.7% per annum in nominal terms and 5.6% in real terms, compared with 3.9% and 2.0% per annum for bonds. Comparing these historical returns with the subjective return expectations of 8,550 private investors surveyed by Natixis Investment Managers, a French asset manager, reveals a startling discrepancy. While Swiss private investors expect an already utopian *real return* of 9.6% per annum over the long term, the corresponding figure for the international investors surveyed is a whopping 12.8% – in nominal terms even some 2 percentage points higher. This is obviously colossal, unreasonable wishful thinking and divorced from any reality.

Anyone who thinks that excessive return expectations are "only" due to the naivety of uninformed private investors is mistaken. Swiss life insurance companies – Swiss Life being the best known among them – are also promising much higher returns than their customers should realistically expect. This was revealed in a press release issued by the Swiss Financial Market Supervisory Authority (FINMA) at the end of August. In the case of fund-linked life insurance policies, the returns promised were systematically too high, according to the FINMA investigation, which covered the period from January 2020 to March 2021 and involved a total of 85,000 insurance contracts. "Over 90% of the sample calculations examined by FINMA show return calculations that are in some cases far too optimistic", says ad-interim Director Birgit Rutishauser. This applies, she continued, especially to unfavourable scenarios that should demonstrate how high the return is when there are significant increases in interest rates or stock market corrections impacting performance. "During the investigation period, the insurers even projected values that were far above the risk-free returns when assuming a poor investment performance," Rutishauser stated. In this dire scenario, some insurers had promised a return of 3.5%, even though the risk-free interest rate was negative during the same period. With all due respect, this is not only overly optimistic, it is simply unprofessional.

> "The world wants to be deceived, so let's deceive it – even the ancient Romans understood that."

Andreas Loepfe, Property expert and CEO of Inreim

Unfortunately, we regularly come across questionable practices in the world of banking and asset management with regard to expected or achieved returns. As you know, we are in fierce competition with major banks, private and cantonal banks and independent asset managers for potential new clients. Private investors, and especially institutional investors such as pension funds, typically want to know our expected future returns and past performance before considering a partnership. It is a matter of honour, honesty and integrity for us to provide realistic and truthful information and promises. We owe this to our clients, even if our approach makes us an exception in the industry. There is a surprising amount of bluffing, bragging, embellishment and outright dishonesty. For example: at a fundamentally serious bank, we manage portfolios for some clients who have entrusted their assets to both the bank and us for many years. At the end of each year, these clients tell us how our competitors have performed in terms of re-

turns. We meticulously record these returns in our files so that we can compare our investment performance with that of our competitors over time.

Some time ago, an entrepreneur became interested in our services. In the conversation, the entrepreneur informed us that their decision to award a mandate would be between us and the aforementioned bank. What we discovered in the acquisition process was nothing short of astonishing. The performance figures provided by the bank for previous years were, in some years, as much as *10 percentage points* (!) higher than what our records actually showed – an unbelievable exaggeration of the facts. Unfortunately, this is a common practice – potential clients are being sold false information. We cannot stress this enough: Of course, a manager's performance is ultimately of paramount importance and is the result of a successful investment philosophy. However, you should *never* choose a money manager on the basis of return promises or alleged past returns. There is a high probability that they will deny, distort and embellish the facts – especially as there is usually no consistent and measurable strategy in a bank, due to the "choose what you want" policy practised with clients. For example, in a sponsored interview with the "NZZ", the CIO of Zürcher Kantonalbank responded to the question of how many investment strategies ZKB has for different risk profiles by saying: "We now have around 2,300..." 2,300 investment strategies! Of course, there will always be a few strategies that outperform over a given period of time. To put it bluntly, if you ask 20 banks and asset managers whether or not they have delivered an above-average investment performance in the past, you will probably get confirmation from 100% of the 20 service providers that they are at least in the top half, and probably in the top 20%, of all providers. The result is likely to be even more impressive than surveys that measure how drivers rate their skills compared to the average population. In that survey, "only" about 80% of respondents say they are above average drivers – also a statistical impossibility.

> "Statistics are like a lamppost in a harbour. They serve the drunken sailor more for support than for illumination."

Hermann Josef Abs, German banker (1901 – 1994)

Let's stick to the facts and, above all, be honest about our expectations for future returns. In the reference currency Swiss francs, a nominal return (capital gains plus dividends) of 6% to 8% per annum seems realistic for equities – equating to about 4.5% to 6.5% in real terms, while high-quality bonds should produce a return of 1.0% to 1.5% – equating to break-even in real terms. In the reference currency euros, the expected returns are about 1% higher, mainly due to higher interest rates. To put it in the jargon of the Swiss national card game "Jassen" or the popular "Differenzler": We prefer to be realistic so as not to end up with a significant difference.

Realistic thinking is also required when it comes to sustainable investments. In previous client letters, we have discussed ESG (environmental, social, governance) and the problem of greenwashing. Now, according to reports in "Schweiz am Wochenende" and "Zuger Zeitung", Swiss Post has acquired one of the largest private forest areas in Thuringia, Germany, covering 2,400 hectares. The state-owned company has set itself the goal of becoming carbon neutral by 2023. The seller of the forest is Prince Michael of Saxe-Weimar-Eisenach. His daughter, Princess Leonie, no longer wishes to be involved with the Zillbach Forest, which consists of pine, larch, spruce and beech trees. According to press reports, the prince received around EUR 60 million for the sale, a multiple of the value estimated by market observers. Swiss Post believes that its German forestry commitment could sequester around 9,000 tonnes of carbon dioxide (CO2) a year. In September, it emerged that this area of forest had already been included in Germany's carbon accounting, raising suspicions of double counting. In an interview with the German weekly "Die Zeit", Sebastian Rüter of the Hamburg-based Thünen-Institut für Holzforschung (Thünen Institute

for Timber Research) called Swiss Post's actions "the worst kind of greenwashing" – for its part, Swiss Post prefers to talk about "different accounting categories". What exactly Swiss Post means by "different accounting categories", and what drives it to engage in forestry in Germany, remains unknown. What is certain, however, is that the environment is unlikely to see any significant improvement as a result of the acquisition, since the forest already existed – just under different ownership.

Persistently high core inflation, rising global government debt, a surprisingly robust US labour market and the end of the Fed's bond purchases have all contributed to a significant rise in interest rates in the leading industrialised countries over the past year. In Europe and the US, interest rates have returned to 2007 levels. So far, there has been little sign of an economic slowdown, let alone a recession, as many prognosticators had predicted at the beginning of 2023. As a result, 10-year government bond yields have temporarily reached around 5% in the US, around 3% in Germany and once again well over 1% in Switzerland. It wasn't long ago that these rates were close to zero or even negative. As a result of this rise in interest rates, we have seen a veritable bond crash. Anyone who bought 20-year US Treasuries in the spring of 2020 has now lost more than 50% of their investment. By comparison: during the historic financial crisis of 2007–2009, the US stock market lost only slightly more, falling by 55%. Those who decided to chase positive returns by buying 100-year Austrian government bonds in the summer of 2020 have lost around 70% since the peak. Our focus on investment-grade bonds with short to medium maturities has protected our clients from such losses.

> "The smarter one gives in! A sad truth. It establishes the global domination of stupidity."

Marie Ebner von Eschenbach, Moravian-Austrian writer (1830 – 1916)

As of mid-December (when this client letter goes to press), it has been a decent year for investors. The enthusiasm that the markets exuded at the beginning of the year after the losses of the previous year faded along the way, partly because high inflation proved more intractable than had been hoped. On the other hand, investors' fears were exacerbated when Hamas unexpectedly attacked Israel in October. As a result, equity markets came under pressure. From our perspective, it's gratifying that, following the record-breaking outperformance we achieved in relative terms against major indices and competitors in 2022, we continued to impress with our stock selection in 2023 – despite the boom in highly valued and risky technology stocks that we have kept underweighted. As far as the (uncertain) outlook for the future is concerned, it is a positive development that interest rates have risen sharply over the past two years. Firstly, fixed-income investments once again offer a significant yield – even if not much remains in real terms. Secondly, and crucially, the correction in equities that began in 2022 has also adjusted the valuation of dividend-paying stocks to the higher interest rate environment. Lower equity valuations therefore imply higher expected future returns. In essence, we all knew while interest rates were in negative territory for years that at some point rates would rise and we would have to go through the valley of tears. Rising inflation and interest rates temporarily weigh on valuations – it's just that no one knew when it would happen. This painful process typically affects the liquid equity and bond markets first. The adjustment process also occurs in illiquid segments such as real estate and private equity, albeit with a lag. Despite our lack of knowledge about the future, we are optimistic about the medium- and long-term prospects for equities, not least because the world's leading central banks appear to be on the right track in their fight against high inflation.

For the New Year 2024, we wish you and your loved ones all the best and, above all, good health. We would like to thank you for the trust you have placed in us and look forward to working with you in the future.

With kind regards, on behalf of the entire “Hotz Team”.
Your

Dr. Pirmin Hotz