Dear Clients,

The Swiss National Bank (SNB) surprised markets with its decision to cut interest rates on 22 March, becoming the first of the world's leading central banks to do so. There are encouraging signs on the inflation front, but the fight against high inflation is proving to be stubborn. In the US, hopes that the Federal Reserve would announce a cascade of interest rate cuts this year have been dashed. Nevertheless, the first half of the year was marked by many strong corporate results and an exceptionally positive stock market performance. Swiss equities also performed well, although for once they were below average by international comparison. This was mainly due to the temporary weakness of heavyweights Nestlé and Roche, which were also unable to benefit from the weakening of the Swiss franc, although that should have boosted exports.

As of mid-June, at the time of going to press, portfolio returns were very encouraging. Interest rate cut speculation and better-than-expected US economic data created a positive sentiment in international equity and bond markets. The sentiment surrounding artificial intelligence (AI) stocks was almost euphoric. The development of the Magnificent Seven has been breathtaking: Apple, Amazon, Alphabet (Google), Meta (Facebook), Microsoft, Nvidia and Tesla represent a cumulative market capitalisation ten times that of all listed Swiss stocks. The market capitalisation of Nvidia alone is significantly higher than that of all companies on the German and Swiss stock markets combined.

As responsible and conservative asset managers, we believe it is essential to strictly limit the risks of our investments. So during spectacular bull markets, we don't mind being outperformed by some competitors who take full advantage of the risks. We tend to overcompensate in difficult market phases. This was also the case in the bear year of 2022, when we outperformed our peers by up to 10 percentage points due to our more defensive positioning.

For once, the mood among our German clients is somewhat subdued at the halfway point of the year. Although their returns have been encouraging, they have lagged behind both the German DAX and, with an identical portfolio structure, Swiss investors. Through the middle of June, the DAX outperformed the Swiss SMI, which was weighed down by the temporary weakness of heavyweights Nestlé and Roche. The first half of 2024 is thus one of the rare periods in which international diversification with a particular focus on Swiss equities did not pay off for German investors. In addition, the first half of the year was one of the few periods in which the euro appreciated significantly against the Swiss franc. This meant that investors with the euro as their reference currency had to accept currency losses on equities denominated in the Swiss franc. The strength of the DAX and the euro is remarkable given the economic and political

challenges Germany is currently facing. From a long-term perspective, it remains clear to us that international diversification of equity investments is a compelling proposition, even for German investors, and that the Swiss franc will tend to strengthen against the euro again sooner or later.

Investment policy lessons from the Benko case

As you know, we are committed to a straightforward and transparent investment policy. We are suspicious of unnecessary and sinfully expensive complexity. We therefore avoid structured products, hedge funds, private equity investments and cryptocurrencies. This pays off for our clients in the form of superior long-term performance.

> "I can't tell you how to get rich quickly. I can only tell you how to get poor quickly: by trying to get rich quickly."

André Kostolany, American-Hungarian speculator, stock market guru and writer (1906 – 1999)

The dramatic fall of failed Austrian property mogul René Benko illustrates the dangers of investing in opaque constructs. His Signa Holding, which had invested heavily in real estate and well-known department stores such as Galeria Karstadt Kaufhof, Globus, KaDeWe and Selfridges with a lot of borrowed capital, collapsed with a big bang at the end of 2023. Signa encompasses some 1,000 investments, sub-investments, sub-sub-investments and sub-sub-sub-investments – the chain could go on and on, so intricate and intertwined is the construct orchestrated by Benko. After the collapse, the receivers tried to draw up the Signa Group's organisational chart – they needed 46 A3 pages. Any sensible businessman should have been alarmed by this lack of transparency. But not Klaus-Michael Kühne (Kühne + Nagel), Ernst Tanner (Lindt & Sprüngli), the Peugeot car dynasty, the Rausing family (Tetra Laval, Tetra Pak), the management consultant Roland Berger, the former Metro boss Erwin Conradi, the construction entrepreneur Hans Peter Haselsteiner (Strabag) and the Thurgau coffee machine king Arthur Eugster. They all fell victim to the completely opaque construct of a talented but risky operator.

> "I introduced meticulous reporting at Lindt. At Signa, I hold myself to the same high standards."

Ernst Tanner, Chairman of the Board of Lindt & Sprüngli, after joining Signa Holding

How was this possible? In all likelihood, one or two prominent people decided to invest first. Others probably followed them like lemmings, along the lines of: If the highly respected X or the extremely successful Y is investing, they must have checked it out thoroughly – so we should invest too, or we could miss out on a great opportunity. Herd mentality at a high level, as it were. It is precisely this herd mentality that also exists among the lending banks. When two or maybe three banks decide to lend money to a budding entrepreneur or company, other banks quickly follow, not wanting to miss out on big business. They join the illustrious circle of lenders, and the great wheel of entrepreneurial prodigies begins to turn. It was the same with "Wunderwuzzi" René Benko. Why Bank Bär risked CHF 600 million remains a mystery. Philipp Rickenbacher, who was the CEO of the bank and had promised a change of culture after the Boris Collardi era, was forced to resign.

> "Complexity has probably been interpreted as a sign of genius."

Sergio Aiolfi, business editor of the NZZ, 5 January 2024

Those who do not ignore history know that there have always been such examples. Perhaps the most famous example in Switzerland, as reported in a remarkable

article in the NZZ on 5 January, concerns the former whizz kid Werner K. Rey. After securing a majority stake in the Bally shoe company in 1975, he raided its cash reserves and saddled it with a mountain of debt. Rey then applied his miraculous money multiplier to the Selve metal works in Thun, the Inspectorate testing company, the Ad Interim (now Adecco) temporary employment agency, the Sulzer industrial group and Omni Holding. Werner K. Rey was hailed as a financial genius, only to be convicted of fraudulent bankruptcy. Many banks, shareholders and creditors lost billions. As with René Benko, it remains a mystery how big banks, cantonal banks, private banks, German regional banks, savings banks and well-known investors could throw their money at a shameless financial juggler. Greed and a certain naivety probably played a role. But they certainly fell victim to a complex, convoluted and opaque structure. They got lost in the fog of opacity.

> "A bank that gives hundreds of millions to a snotty investor brat like Benko to squander should simply have its licence revoked."

Peach Weber, Swiss comedian

In the case of both Werner K. Rey and René Benko, there were warning signs right from the start. From the mid-1960s, Rey worked for American playboy Bernie Cornfeld. He was accused of running a kind of Ponzi scheme through an opaque fund-of-funds structure. Countless investors lost their money. A school dropout, Benko once worked for AWD, the financial advisory firm of flamboyant German entrepreneur Carsten Maschmeyer. It was there that he learned to sell. AWD's advisers were known as "pressure salesmen" because they were often trained in a crash course and peddled the occasional risky insurance, stock, bond or property product at a fat commission.

> "I learned from my grandfather to only buy what you can afford."

René Benko, in an interview with the business magazine "Bilanz", when he was still riding a wave of success

If there is a lesson to be learned from the cases of Benko and Rey, it is this: Beware of opacity and only invest in assets you understand.

Scientific evidence supporting our equal weighting bias

Alongside transparency and quality, our tendency to equally weight our stocks in general is an important feature of our investment philosophy. This differs from market weighting, which leads to inherent cluster risks in common indices, and allows us to achieve a more balanced distribution of risk. Nestlé, Novartis and Roche account for almost 50 per cent of the Swiss stock market index SMI. Although we have included these blue chips in our portfolios for decades, we do not give them such an extreme weighting – nevertheless, the three large Swiss companies have a slightly higher weighting than the other holdings in our portfolios. Our decision to embrace generally equal weighting is not driven by the expectation of outperforming the market every year, as this is simply impossible to forecast. Rather, it is a risk-based or prudent decision. We want to avoid cluster risks at all costs. Fortunately, our experience has shown that this cautious approach has enabled us to outperform the relevant benchmark indices over the long term. This was also the case in the first half of 2024, when the temporary weakness of heavyweights Nestlé and Roche impacted the Swiss stock market. By avoiding cluster risks, we prevent potential "accidents" that could lead to irreversible damage.

> "There is only one possibility: win, draw or lose."

"Kaiser" Franz Beckenbauer, German World Cup winner (1945 – 2024)

Our philosophy of generally adopting an equal weighting is underpinned by a long-term comparison of the returns of the US capitalisation-weighted S&P 500 – the usual benchmark – and the equally weighted S&P 500. From 2000 to 2023, the capitalisation-weighted index increased by 225% in the reference currency of the US dollar (71% in CHF), while the equally-weighted index increased by 459% (195% in CHF). This is a significant performance difference in favour of equal weighting, even in the case of slightly higher short-term volatility risks. What are the reasons why the general equal weighting produces better long-term returns than the industry standard weighting by capitalisation? From our perspective, there are two main reasons for this. First, the countercyclical element: Those who tend towards equal weighting will rebalance periodically, buying stocks that have underperformed and taking partial profits on positions that have done well. This periodic rebalancing ensures that equity positions are returned to a normal position. Acting countercyclically against the herd mentality is also known as "buy on bad news" and "sell on good news". Secondly, the fact that shares in SMEs tend to be weighted more heavily in the case of equal weighting than in the case of capitalisation-weighted investments is likely to play a role. It is scientifically and empirically undisputed that this is how the "small and mid cap effect" comes into play. Over the long term, the shares of small and medium-sized companies generate an excess return in the form of a so-called risk premium. We remain committed to our proven and balanced policy of generally equal weightings.

Is "Hotz" purely a value asset manager?

Another feature of our investment policy is that we take a conservative approach to value. We rigorously avoid risks that we do not like and equities whose valuations are inflated. As a result, we are often referred to as value investors, which we generally feel comfortable with. However, we would like to emphasise that we also confidently hold shares in companies with attractive growth potential. Examples include technology companies such as Apple (which even value legend Warren Buffett owns), Alphabet (Google), ASML and Microsoft, but also industrial giants such as ABB and Siemens, which are growing steadily rather than spectacularly. However, we would never focus solely on companies that promise the highest growth rates. The only certainty with such companies is that they are extremely expensive to buy, while their potentially high future growth is anything but certain. The potential for disappointment in companies such as Amazon, Nvidia, Meta (Facebook) or Tesla is huge. Just look in the rear-view mirror. In the late 1990s, technology stocks such as AOL, Cisco Systems, Dell Computer, Hewlett-Packard, IBM, Intel, Microsoft, Oracle, Qualcomm and Sun Microsystems were the stars of the stock market. And then the tech bubble burst at the turn of the century. How have the former high-flyers of the tech boom fared since? Modestly: Of the 1990s growth stocks mentioned, only Microsoft outperformed the US S&P 500 from 2000 to 2023.

> "Value investors have nothing against growth stocks. But they must be offered at attractive valuations."

Thomas Shrager, managing director of Tweedy Browne, a value boutique in New York, in an interview with "The Market" online newspaper, 27 November 2023.

The whole debate about whether you are a value or growth investor is, in our view, largely academic, as the following example illustrates. Apple has the second largest weighting, behind Microsoft, in the MSCI World Growth Index at 8.37% as of 31 May. This undoubtedly suggests that Apple is an outstanding growth stock. Looking at the MSCI World Value Index, Berkshire Hathaway has the third highest weighting at 1.73%. Not surprisingly, the holding company of the legendary Warren Buffett is classified as a strong value stock. However, it should be noted that almost half of Berkshire Hathaway's total listed equity holdings are in Apple alone. This then raises the question of whether Apple is a growth or a value stock. As with

many companies, the truth is probably somewhere in between.

Furthermore, it would be foolish for a supposedly prudent and conservative investor to focus exclusively on companies that have a low price-to-book ratio and are therefore supposedly undervalued. Some bankers and asset managers believe they can make money almost without risk by buying shares in a company with a book value of 100 francs at a market price of 50 francs. This hunt for supposedly undervalued gems is extremely dangerous, as the fate of the failed Credit Suisse showed once again last year. Shortly before its demise, the big bank had an extremely attractive price-to-book ratio – its stated equity exceeded its market capitalisation many times over. The stock looked ridiculously cheap to many investors – even banking legend Oswald Grübel, who ran both CS and UBS, succumbed to the lure. A few months before the collapse, Grübel bought shares in "his" bank at a bargain price of around CHF 4, as he publicly announced. Like the bank's top management, the regulator FINMA, the Swiss National Bank (SNB) and many politicians, Grübel believed right to the end that Credit Suisse's book value of around CHF 20 per share and its equity would hold up in an emergency. A fallacy: If this had been the case, Credit Suisse could have been liquidated according to plan and without any risk of loss to the Swiss taxpayer. International pressure and emergency legislation caused the Swiss Federal Council to reject this option for fear of contagion to other financial institutions. The Federal Council's decision was wise: If a bank's assets have to be sold in a liquidation, potential buyers will naturally demand a substantial discount – whether on mortgage or real estate portfolios. Credit Suisse's thin capital cushion would never have been sufficient for a liquidation without recourse to the taxpayer. To prevent a fiasco for Switzerland's financial centre, the Federal Council "urged" UBS to take over its competitor. Any other option would have been too risky.

> "The probability that the last major international bank in Switzerland will also run into trouble one day is quite high."

Tobias Straumann, economic historian and professor at the University of Zurich, on his assessment of UBS today.

The conclusion to be drawn from the remarks above is that it is not helpful to focus too much on whether one is a value or a growth investor. Firstly, the distinction between value and growth is difficult to make on a case-by-case basis, and secondly, a rigid focus on one approach or the other is one-sided and dangerous. We believe it is more important to focus on quality, an attractive and sustainable business model, a fair valuation, reliable and honest management, a healthy balance sheet and a sustainable dividend policy. Whether an individual company's focus is ultimately on value or growth is irrelevant. Both are equally important.

Tokyo jubilant as stocks hit record high – but beware!

On Thursday 22 February, there was jubilation in Tokyo. After an almost unimaginable 35 years, the closely watched Nikkei 225 index surpassed its previous high of 38,957 points, set on 29 December 1989. After the rash Nippon euphoria that gripped investors around the world in the 1980s, the bubble burst and the shockwaves reverberated for decades in the Land of the Rising Sun. The Nikkei closed 2011 at 8,455 points, almost 80% below its previous peak. Another 13 years later, the gloom is finally over and the Nikkei has hit a new record high. The European Stoxx Europe 600, Germany's DAX, the UK's FTSE 100 and the US S&P 500 also reached all-time highs in the spring, while the Swiss SPI had not quite reached its peak of 28 December 2021 at the time of writing. Anyone who concludes that the international stock markets have outperformed the Swiss stock market is making a cognitive error, as the important influence of the currency is not taken into account in this analysis.

> "There are so many things in life more important than money… but they cost so much!"

Groucho Marx, American comedian and actor (1890 – 1977).

Any Swiss investor calculating in Swiss francs will easily see that the Nikkei still has to double to reach its 1989 peak. This is simply due to the weakness of the yen, which has fallen by 50% since then. The situation is similar in the European stock market. Due to the weakness of the euro, the Stoxx Europe 600 still has a long way to go before Swiss investors can reach the old high. What can we learn from this? Firstly: Comparing stock market levels on a non-currency-adjusted basis is pure nonsense. Unfortunately, this is exactly what analysts and journalists continue to do. Secondly: With identical portfolios, the returns of our German clients, measured in euros, are consistently higher than those of our Swiss clients, who see their performance figures in the strong Swiss franc. On a currency-adjusted basis, they perform the same or at least similarly. In other words: if the long-term equity performance of our German clients averages 9% per annum and that of our Swiss clients averages 7% per annum, but the euro depreciates by 2% per annum over the same period, it is the same. In the rock-hard Swiss franc, it is naturally more difficult to generate high returns than in countries with weaker currencies.

The Norwegian Government Pension Fund: no private equity

As you know from previous client letters, we use the Government Pension Fund of Norway – also known as the Norwegian Sovereign Wealth Fund or the Oil Fund – as a model for investing. The world's largest pension fund has assets of around CHF 1.4 trillion (CHF 1,400 billion), 70 per cent of which is in listed equities, 27.5 per cent in bonds and 2.5 per cent in real estate. Accordingly, its documented long-term performance is outstanding – something that Swiss pension funds can only dream of, partly because of questionable regulatory barriers. Some time ago, the management team led by current Chief Executive Nicolai Tangen requested that an additional 5 per cent of total assets be allocated to private equity within the oil fund's portfolio. On 12 April, however, the Norwegian parliament rejected the proposal. At a press conference, Finance Minister Trygve Slagsvold Vedum explained the decision as follows: Firstly, it would dramatically increase the fees within the fund. Secondly, transparent performance measurement is almost impossible in private equity. Thirdly, there is a lack of transparency in this asset class, and fourthly, there is a lack of political and social support for inclusion. These are solid arguments that confirm our decision to continue to avoid private equity investments that tend to be massively overvalued in terms of high margins and returns – no matter how lucrative they may be for providers and intermediaries.

Higher margins at Nestlé: Is CEO Mark Schneider doing the right thing?

Mark Schneider has been at the helm of the world's leading food company, Nestlé, since 2017. He has recently come under pressure. Bank analysts and investors are urging Schneider to shed businesses with low margins and health problems in favour of high-margin, high-growth ones. Ultimately, the strategy is intended to lead to a value-enhancing reorganisation of the portfolio. In the US, Schneider has already divested the rice peanut drink, ice cream, water and processed meat businesses. Since he took over, about a quarter of the product range has been restructured. Nestlé's objective is to focus on the lucrative businesses of coffee, pet food and dairy as well as high-quality nutritional supplements and health products, with the aim of becoming a global leader in these areas. Many analysts believed this would eventually lead to a higher valuation of the stock. Has this really worked? What seems plausible at first glance has turned out to be the exact opposite in practice: In recent years, Nestlé's share price has underperformed the market and, contrary to analysts' expectations, its valuation is at its lowest level in years. How can this be explained?

> "We have not learned to solve difficult problems in business. What we have learned is to avoid them."

Warren Buffett, legendary investor and Oracle of Omaha, Nebraska

The argument that swapping low-margin business for high-margin business will almost automatically lead to higher share valuations is a fallacy held by many analysts. This can be illustrated by an example that, although fictional, is close to reality. Suppose Nestlé wants to divest its unhealthy, low-margin frozen food business, such as pizza, with total sales of CHF 10 billion. On these sales, Nestlé achieves a modest margin of 5 per cent, resulting in a profit of CHF 500 million. Of course, potential buyers also know that the pizza business has low margins, so they pay a low price, which is assumed to be ten times the profit. The sale will generate CHF 5 billion for Nestlé. Nestlé intends to use this CHF 5 billion to acquire more lucrative businesses in the nutrition sector, which promises a 25 per cent margin. The key question now is: How much in lucrative nutrition sales can Mark Schneider buy with the CHF 5 billion sale proceeds? Another CHF 10 billion? No, of course not, because the lucrative business is naturally much more expensive than the sluggish, low-margin pizza business. If Nestlé were to buy only CHF 1 billion of nutrition sales, a margin of 25 per cent would yield a profit of CHF 250 million. Furthermore, as the growth prospects in nutrition are much higher than in pizza, Nestlé will probably have to pay twenty times the profit for the high-margin business. In other words, for nutrition sales of CHF 1 billion, Nestlé is paying exactly the equivalent of the CHF 5 billion that the low-margin CHF 10 billion in frozen-food sales brought in – combined with a temporary halving of profits from CHF 500 million to CHF 250 million.

> "We would all be better investors if we just made fewer decisions."

Daniel Kahneman, Israeli-American psychologist and Nobel laureate in economics (1934 – 2024)

What is the conclusion? It is an illusion to believe that swapping low-margin business for high-margin business will somehow, almost divinely, lead to a higher valuation of a stock. The market and the market prices of transactions are very efficient: Much higher prices are paid for high-margin businesses that promise higher growth – there is no free lunch. In the case of Nestlé, the result of the restructuring will, at least temporarily, be a company with lower sales and profits, but with more attractive margins and higher, albeit more uncertain, growth prospects. Whether Mark Schneider's strategy will be successful can only be judged in a few years' time. As a result, our thoughts here are neither a criticism nor an endorsement of Mark Schneider's strategy. Contrary to the unanimous call of many bank analysts, we believe that in Nestlé's case it may make sense to stick with the confectionery business, including Kitkat bars, frozen products and high-sugar drinks such as Nesquik or Milo, and to make a differentiated assessment of the opportunities and risks of a change in strategy. There is no question in our minds that Nestlé, as a leading food company, belongs in every equity portfolio, and that long-term and interim price weaknesses can be used to build countercyclical positions.

Nick Hayek and the Swatch Group: a dilemma for investors

As advocates of diversification, we recognise that in a broadly diversified equity portfolio there will always be a few stocks that disappoint. One of the biggest disappointments in recent years has been the performance of the Swatch Group share. Clients rightly ask us about the disappointing share price performance compared to other luxury goods stocks – especially LVMH and Richemont – and why we do not sell this position. In fact, we are in a dilemma with this company. The big problem with Swatch is its CEO and major shareholder, Nick Hayek, who treats his fellow shareholders, who own the majority of the company, like dirt. When Michael Niedzielski, fund manager and Chief Investment Officer of ROCE Capital in Paris, expressed his frustration on behalf of many other shareholders at

the development of the Swatch Group share price in a conference call on 23 January, Nick Hayek responded: "The largest shareholders of the Swatch Group are my family and myself. We are not frustrated... You, by contrast, are irrelevant. You are free to sell your shares."

> "Arrogance is weakness masquerading as strength."
>
> Michael Dur, German author, aphorist and management consultant

The conference call culminated in a tirade by Hayek against analysts and investors. He runs the company like he owns it. The Hayek family controls "only" 43.3 per cent of the votes and a good 25 per cent of the capital. That's no way to treat your co-owners – it's a glaring weakness in the leadership and character of the charismatic and headstrong CEO. All in all, there are good reasons to sell the stock. However, it is important to emphasise that – precisely for the reasons mentioned above – Swatch shares are basically dirt cheap. Property, cash and inventories alone are worth more than the entire market capitalisation. Added to this is the high value represented by brands such as Breguet, Blancpain, Longines, Omega and Swatch.

> "Arrogance is the fertiliser of self-esteem."
>
> Sonja M. Grass, Austrian writer, aphorist and ghostwriter

Our hope for Swatch is essentially that there will eventually be a rethink or a change in the management of the company in order to make better use of the dormant potential for shareholders. The Swatch Group has a high intrinsic value and low debt, which we like. Aware that our hope is fraught with risk, from today's perspective it is not an option for us to pro-cyclically throw in the towel, even if Nick Hayek's manners and behaviour are a major thorn in our side. We will stay the course and continue to review our decision.

Sergio Ermotti and UBS: they never learn

More than a year has passed since the Swiss Federal Council effectively mandated the emergency takeover of Credit Suisse by UBS. President Colm Kelleher and CEO Sergio Ermotti are working hard to keep the new super-tanker in the Swiss financial marketplace afloat. There are encouraging signs that they are on the right track, although there is still a long way to go. However, there was an outcry at the end of March when it was disclosed that Ermotti had paid himself CHF 14.4 million in the first nine months of his tenure as head of the bank. This is incomprehensible because UBS is a quasi-governmental bank that had to be rescued from collapse by the state in 2008. The bank benefits from an implicit state guarantee, although Ermotti has claimed the opposite in various media appearances – does he seriously believe that after the experience in the past? Shifting the risk of bankruptcy to the taxpayer should be a compelling argument for those in charge to show some restraint when it comes to pay. No such luck: By refusing to embrace any moderation, they become the gravediggers of the free market economy to the horror of the political left.

It is incomprehensible that bankers like Colm Kelleher and Sergio Ermotti, despite all the banking scandals, continue to claim that today's capital requirements for systemically important banks like UBS are sufficient. Urs Birchler, Professor Emeritus at the Institute of Banking and Finance of the University of Zurich, vehemently disagrees. The long-standing director of the Financial Stability Unit at the Swiss National Bank (SNB) and head of the research group of the Basel Committee on Banking Supervision at the Bank for International Settlements (BIS) is in favour of significantly higher capital ratios for systemically important banks.

> "Three things are needed: capital, capital and capital... The implicit state guarantee discourages banks from taking risks with their own

capital. This is why the big banks complain about the supposedly expensive capital. Capital is only expensive for those who have too little of it and leave their risks to the state… Many banks face an uphill struggle. UBS can cruise downhill thanks to the implicit state guarantee."

Urs Birchler, Professor Emeritus at the Institute for Banking and Finance of the University of Zurich, in an interview with the financial portal "Cash" on 2 April 2024.

You could be forgiven for thinking that the implosion of UBS during the financial crisis and the collapse of Credit Suisse last year were just fairy tales. The seeds of further trouble are being sown today: When certain bankers present themselves as heroic saviours of the Swiss financial marketplace and then lose touch with reality, alarm bells start ringing. Unfortunately, financial history teaches us otherwise: After the banking crisis is before the banking crisis – we just don't know when the next shock will happen. The behaviour of bank executives does not change the fact that our contacts at UBS, one of our main custodian banks, do an excellent and dedicated job in their day-to-day work.

There are also amusing stories from UBS. In the early summer of 2023, Bosco Ojeda, Head of European Small Caps, rated the shares of the Bernese electricity company BKW as "Sell" – which resulted in a temporary price drop. According to the online media portal IP, this led to BKW CEO Robert Itschner personally approaching Sergio Ermotti and complaining. BKW is a major UBS client and pays an additional five-figure sum to cover the bank's research. Which begs the question: What is the value of a bank's research if it is paid for by the company itself and is therefore not independent? A few months later, Bosco Ojeda wrote on his LinkedIn profile: "I am happy to share that after 25 years in UBS I am starting a new position." Ojeda no longer works at UBS – and the bank has since upgraded the shares of its client BKW from "sell" to "buy".

We have been somewhat amused in recent months by the number of UBS/CS client advisors who have approached us asking whether we have any larger corporate clients who would be willing to transfer shares in their family businesses free of charge at fiscal value into the securities portfolio we manage. UBS/CS would be able to record this as net new money in their reported assets. It is almost unbelievable: You could transfer the shares in your garage, carpentry or industrial company at fiscal value to the portfolio managed by us – and the custodian bank, which has nothing to manage in this case, would then boast of having increased its assets under management. Of course, we never offer our support for such "smarty-pants". The astonishing creativity in inflating numbers is, to say the least, remarkable bordering on the bizarre.

Bitcoin: out of the dingy corner?

January saw a dream come true for cryptocurrency enthusiasts. The approval of bitcoin exchange-traded funds (ETFs) by the US Securities and Exchange Commission (SEC) was a historic moment for them. ETFs allow people to speculate in bitcoin without having to deal with the technical challenges of a bitcoin wallet or securing access keys. This makes bitcoin more accessible to everyone, not just pension funds, banks and asset managers. ETFs make cryptocurrency easy and cheap to trade. Accordingly, the value of bitcoin has risen significantly since the approval.

The SEC and its anti-crypto chair, Gary Gensler, made the decision reluctantly and under pressure after a ten-year battle with the industry. Ultimately, a US court ruling in August last year made approval inevitable. However, the SEC has made it clear that, despite the green light, it does not see any value in digital assets. Even the former head of the SEC's Office of Internet Enforcement, John Reed Stark, described the applicants for bitcoin ETFs on X (formerly Twitter) as "opportunistic cartels". According to Reed Stark, they are trying to profit from a product that

"has no inherent value and is fundamentally fraudulent". Indeed, the price of bitcoin continues to be set in unregulated markets where manipulation is part of the business.

> "The whole crypto business is given a veneer of respectability, even though it is ideal for shady deals. Now banks have good reason to use this freshly elevated speculative instrument and risk life and limb. No problem, it's not their life and limb".

Peach Weber, Swiss comedian, in a column published on 8 January 2024 in the regional newspapers "CH Media"

Since 21 February, clients of state-owned Postfinance have been able to trade numerous digital currencies. It is "a milestone in our company's history", Alexander Thoma, Head Digital Assets, announced to the media at the launch. Postfinance speaks of "access for all to the crypto market" and a real "democratisation" that will now take place. Its chief investment officer, Philipp Merkt, is equally enthusiastic: "Alongside traditional asset classes such as cash, bonds and equities, cryptocurrencies are an attractive investment opportunity within alternative investments such as real estate and commodities." Bitcoin and the likes on par with equities and real estate: Digital currencies have finally found their way into the portfolios of mom and pop investors. The fact that many banks advise their clients to allocate "only" 5 per cent of the assets in their securities portfolio to this vaunted investment, and not much more, raises the question of whether they really believe in it. One might ask ironically: If the expected annual return on bitcoin is really 20, 30 or 50 per cent, then the recommended allocation should be 50 or even 80 per cent – so why only 3 or 5 per cent?

It is amazing how popular bitcoin and other cryptocurrencies still are with investors, even though several leading figures in the industry have been arrested or have had to stand trial. They include FTX founder Sam Bankman-Fried (or Bankman-Fraud to his victims), who was sentenced to 25 years in prison, and Binance mogul Changpeng Zhao. Zhao is accused of violating US anti-money laundering regulations and failing to report more than 100,000 suspicious transactions linked to cyber attacks, child sexual abuse, drug trafficking and terrorist groups such as al-Qaeda and IS. The Chinese-Canadian founder of the world's largest crypto exchange is also accused of moving billions of customer deposits into privately managed, unregulated funds and artificially inflating crypto prices. Because Zhao pleaded guilty and paid a huge sum of money, his sentence is "only" four months.

> "Now is the time to build trust."

Changpeng Zhao, founder of the crypto exchange Binance, at a crypto conference in St. Moritz in January 2023, where he was invited as a special guest.

Soccer star Cristiano Ronaldo and American football legend Tom Brady are also facing trial for their high-profile promotion of Binance and FTX. With all this fraud going on, it is surprising that financial giants such as US-based Blackrock, the world's largest asset manager, are pushing hard for the approval of bitcoin ETFs. Just remember: As recently as 2017, Blackrock's charismatic boss, Larry Fink, said "bitcoin shows how much demand there is for money laundering in the world". Since then, he has gone from sceptic to believer, now talking about "digital gold" and a "flight to quality" – has greed clouded his judgement? Sam Bankman-Fried's parents were both professors at the prestigious Stanford University. His mother, Barbara, is an expert in legal ethics. In an article published in 2013, she wrote that in the United States, parental income and education are the deciding factors in whether a child ends up in the boardroom or in prison. Her son has achieved both.

Switzerland has its own academic proponent of bitcoin in Dr Peter Meier, a former lecturer at ZHAW Winterthur. In an article for the pension fund

magazine Schweizer Personalvorsorge in November 2023, he wrote: "Even if the growth trend in the value of bitcoin declines significantly in the future, the returns achievable with bitcoin are still extremely high compared to traditional investments". He believes that, although pension funds are still reluctant to get involved in crypto investments, there are no fundamental objections to such investments. Well, if "academics" are so uncritical of these controversial investments, we shouldn't be surprised if many college and university graduates finish their studies as investment illiterates.

Nevertheless, persistent critics of cryptocurrencies are still out there. For example, the head of America's largest bank, JP Morgan Chase, Jamie Dimon, railed against bitcoin and other cryptocurrencies during a speech at the Senate Banking Committee's annual oversight hearing on Wall Street, suggesting that cryptocurrencies should be banned.

> "The only real use is for criminals, drug dealers... money laundering, tax evasion. If I were the government, I would shut down the cryptocurrency industry".

Jamie Dimon, CEO of US bank JP Morgan Chase

Remember the euphoria surrounding non-fungible tokens (NFTs)? NFTs are digital assets, such as images, that are bought and sold in cryptocurrencies and whose ownership is secured by the blockchain. The NFT bubble peaked in the summer of 2021 – for example, a digital rock without any use or benefit was traded for a million dollars. The NFT craze was mainly based on the cheap money that central banks had been flooding the financial markets with for years. Quick profits were tempting. In 2023, the NFT market collapsed. According to crypto analysis firm dappGambl, over 95% of existing NFTs are now virtually worthless.

> "We have not endorsed or supported bitcoin. Bitcoin is primarily a speculative, volatile asset that has also been used for illegal activities such as money laundering and terrorist financing."

Gary Gensler, Chair of the US Securities and Exchange Commission (SEC)

Originally, bitcoin was hailed by libertarian enthusiasts as a way to escape government control, the threat of national bankruptcy and the traditional monetary system. The same fans celebrated the approval of ETFs earlier this year, which now integrate bitcoin into the very traditional financial system it was designed to bypass – a classic paradox. Hilary J. Allen, a law professor at the American University Washington College of Law in Washington, points out in an interview with NZZ that bitcoin was originally created as a payment mechanism. With this experiment failing utterly, some began to see bitcoin as an "asset". The values being traded were created from thin air, which is why the whole crypto scene has no meaning and no value. She is also sceptical about the highly touted blockchain technology itself: "Blockchains are inherently much less efficient than other databases and payment methods. So the only purpose of the scene seems to be to allow anyone who might be interested to place bets". Like Jamie Dimon, Hilary J. Allen advocates a ban on cryptocurrencies in light of the economic and environmental damage caused by mining activities.

> "Yes, to a certain extent. Unlike the hacks and thefts in the crypto scene, a player in Las Vegas at least knows that no one is going to steal chips from the table... I naively

underestimated how fraudulent the crypto scene is."

Hilary J. Allen, Professor of Law at the American University Washington College of Law in Washington, in response to the NZZ journalist's question in the 29 December 2022 edition: "So can the business be compared to a casino in Las Vegas?"

Fortunately, Switzerland also has reasonable figures in academia. In an article for Finanz und Wirtschaft on 21 December 2022, Hans-Joachim Voth, Professor of Economics at the University of Zurich, wrote: "Many early investors saw in cryptocurrencies the promise of a new financial system without central banks, without government supervision... Cryptocurrencies are only really useful for illegal transactions. Because cryptocurrencies are hard to trace, they are popular with drug dealers, money launderers, arms dealers and blackmailers... The idea of using blockchain to trigger secure, automated transactions is attractive, but despite all the investment in the sector, there is no technological breakthrough in sight that is superior to traditional clearing houses."

Smart Valor, the cryptocurrency trading platform launched by "Crypto Queen" Olga Feldmeier just over two years ago, has vanished into thin air. After shedding more than 99 per cent of its market value, the stock was delisted. Nevertheless, a final press release repeatedly emphasised the "successful execution of an oversubscribed IPO". What a mockery for all the investors who have suffered a total loss of their investments.

"Cryptos are pure speculative gambling, and in the 14 years they've been around, they've shown no use beyond pure speculation and illegal money transfers."

Michael O'Rourke, Chief Market Strategist at US trading firm Jones Trading

The European Central Bank (ECB) has a scathing view of bitcoin. In their blog "ETF approval for bitcoin – the naked emperor's new clothes", published at the end of February, Ulrich Bindseil, Director General of the Directorate General Market Infrastructure and Payments, and his colleague Jürgen Schaaf are highly critical of the cryptocurrency and warn of a total crash. The fair value of a bitcoin, which is widely used for criminal purposes, is zero. It is only a matter of time before it becomes worthless. The ECB insists on stricter regulation, or preferably an outright ban, to protect retail investors. The authors of the blog explain the zero fair value of a bitcoin as follows: It generates no cash flow (like property), no dividends (like shares), cannot be used productively (like raw materials) and provides no social benefits (like gold for the jewellery industry). On the contrary, crypto funds terrorism, money laundering and cybercriminals. Bindseil and Schaaf draw an uncompromising conclusion: "The market capitalisation of bitcoin quantifies the social damage that will occur when the house of cards collapses".

"Today, bitcoin transactions are still complicated, slow and costly. Outside the darknet, which is used for criminal activities, there are hardly any legal payments."

Ulrich Bindseil and Jürgen Schaaf, ECB, in their blog "ETF approval for bitcoin – the naked emperor's new clothes", February 2024

When you ask experts in the crypto scene about the reasons for bitcoin's meteoric rise, you always get the same answers. Firstly, it offers excellent diversification from traditional assets; secondly, the supply is limited to 21 million units; and thirdly, the number of newly issued bitcoins is halved approximately every four years (the so-called "halving"). None of these arguments are remotely convincing. Rather, we believe there is one primary reason for bitcoin's price explosion: FOMO – Fear Of Missing Out! In the rush to the upside, many investors simply fear that they will miss out if they remain on the

sidelines. Let's not forget that at its launch in 2008, one bitcoin cost 0.8 centimes. Three years later, the cryptocurrency crossed the CHF 10 mark – an increase of more than 1,000 times. In June the price was over CHF 60,000. When stocks rise significantly over time, there are fundamental reasons for this: The company's revenues and profits increase, allowing it to pay higher dividends to shareholders. What has happened to bitcoin since its inception in 2008? Nothing! A bitcoin is a bitcoin – with no intrinsic value, no productive background, no dividends, no interest, but a lot of hot air.

Is everything related to crypto really worthless? No, we don't think so. As Myret Zaki, Head of the Communication Department at the School of Journalism and Media in Lausanne, points out in an article for the online newspaper The Market, there is one type of crypto investment that is solid: Real World Assets (RWA). This involves tokenising assets that exist in the physical world and putting them on the blockchain. Zaki writes: "Tokens allow investors to own real assets of proven value in the safest way possible. There is little doubt that the tokenisation of physical assets such as property, credit, bonds, commodities or art is the future of ownership and investment". Myret Zaki's point is understandable. We are excited to see what the future holds. In any case, exuberant euphoria is not warranted from today's perspective, and cryptocurrency investments are off the table for us.

The stock market has its own pipe dreams

In "defence" of crypto fans, we should point out that pipe dreams are also commonplace on the stock market. Let us recall the hype around so-called meme stocks during the corona period. Back then, for example, video game retailer GameStop was pushed to dizzying heights before the house of cards collapsed – although the meme hype has not completely died down.

> "The most beautiful of all secrets is to be a genius and to know it alone."

Mark Twain, American writer (1835 – 1910)

At the end of March, controversial US presidential candidate Donald Trump listed his 2022 social network, Truth Social, on the NASDAQ technology exchange. Truth Social has less than 5 million users. By comparison: TikTok has over 2 billion and Facebook has over 3 billion. In 2023, the company generated only USD 4 million in revenue and posted a loss of $58 million. Nevertheless, the market capitalisation of the Trump Media & Technology Group reached an absurd USD 10 billion after the IPO. This was possible because ardent Trump supporters organised themselves via social networks to inflate the share price with hot air. It is pure speculation, and the share price, like that of cryptocurrencies, has no fundamental basis.

The controversial role of the supervisory authority FINMA

Since 2023, we have been regulated by the Swiss Financial Market Supervisory Authority (FINMA). It is quite obvious that our bureaucratic burden has increased exponentially as a result. Detailed risk disclosures and extensive key performance indicator calculations in the context of client relationships, painstaking reviews by internal and external compliance and risk managers, and regular meetings of the management board and executive committees are part of our daily routine. This "bitter pill" is not always easy to swallow for a company that has never been in trouble with the law or with clients, and has never been legally prosecuted (what bank or asset management firm can say that?), as it incurs significant costs without any benefit to our valued clients or ourselves. The law is the law – we cannot change it and must accept it. What is illuminating in this context, however, is a statement made by FINMA in its report on the downfall of Credit Suisse, published at the end of last year. According to the report, FINMA spent an average of 37,000 hours (!) per year on the supervisory audit of the big bank. Since 2012, FINMA has opened 14 enforcement proceedings, 16 criminal complaints and 43 preliminary investigations against the bank. None of this seems to have changed the thinking at Switzerland's second largest financial institution. On the contrary: Those in charge were notoriously defiant.

And what did FINMA do? All was well, as they publicly announced on the evening of 15 March 2023: “Credit Suisse meets the capital and liquidity requirements imposed on systemically important banks”. Four days later, Credit Suisse was history.

> “It was no use. The world’s most reckless big bank had hopelessly overwhelmed the regulators.”

Dirk Schütz, Editor-in-Chief of Bilanz, in his book “Too Close to the Wind – Why CS Had to Go Down”.

In an interview on Radio SRF’s “Samstagsrundschau”, Marlene Amstad, Chair of FINMA, said that a total of 60 employees of the authority were now solely responsible for supervising the “new” UBS – a massive increase in staff. This is puzzling. 37,000 hours of supervision per year did not help CS. Now an estimated 100,000 hours per year will do the trick? The question arises as to what this supervision is really for, and who is ultimately supposed to manage the banks – management or the regulator? One thing is certain: decency, honesty and strength of character cannot be mandated by a regulatory body. As advocates of liberalism, we therefore believe that it would be more effective to impose much higher capital requirements for systemically important banks and to allow institutions with notoriously incompetent and incorrigible management to fail. This would greatly simplify the task of auditors, and competition would ensure that the fit survive and the incompetent disappear from the market. However, we agree with FINMA Chair Amstad on one point. She calls for the regulator to be able to impose fines on errant banks and bankers, in addition to public reprimands. This is not currently provided for by law.

> “The question must be allowed: If you park incorrectly, is it enough of a deterrent if you just have to move the car? Because that’s the way it is with banks today.”

Marlene Amstad, Chair of FINMA, in an interview with the NZZ on 19 September 2023

Kickbacks, conflicts of interest and money laundering: still commonplace in the financial industry

In 2006, the Swiss Federal Supreme Court ruled for the first time that all retrocessions or kickbacks of any kind belong to the client. Since then, there have been further court rulings confirming and clarifying this decision. It is all the more incomprehensible that these reprehensible and mostly secret fees are still common practice in the banking and finance industry. Clearly, this leads to unacceptable conflicts of interest at financial institutions, which are not in the best interests of clients. We recommend that you read the attached editorial by the author, which was published in Finanz und Wirtschaft on 15 June.

> “It is possible. I didn’t look away, but I didn’t look either.”

Sepp Blatter, former FIFA president, on whether he looked the other way when the World Cup was awarded to Qatar, allegedly through corruption.

According to the Money Laundering Reporting Office Switzerland (MROS), there were a total of 11,876 suspicious cases of money laundering and corruption in Switzerland in 2023. This is surprising given that both the Federal Council and the Swiss Bankers Association announced the “white money” strategy many years ago. Shockingly, the number of reports has increased by 56 per cent since last year and has increased tenfold in 10 years. We ask ourselves: How much money from dubious investors is still sitting in Swiss bank accounts? In the interests of full transparency, and with a certain pride, we assure you: In the 38 years we have been in business, we have never had to report a client

for any suspicious transaction or activity. Not one. We will do everything in our power to ensure that this remains the case in the future.

Looking back and ahead

As you know, we do not believe in short and medium-term stock market forecasts, but rather in a reliable long-term investment strategy that focuses on suitable and promising investments of the highest quality. A look back shows how uncertain forecasts can be: On 13 November 2023, Bhanu Baweja, Chief Strategist at UBS Investment Bank, speculated that the Federal Reserve could lower its target range for the federal funds rate from between 5.25 and 5.5 per cent to between 2.5 and 2.75 per cent by the end of 2024. UBS predicted that US inflation would fall precipitously, that the economy would cool sharply and that there would even be a slight recession during the course of the year – in hindsight, a monumental error. We stick to the facts and remain optimistic about stock markets in the long term, although it should be remembered that in an uncertain world there are always risks, despite the current upbeat sentiment. In November, the United States will hold its eagerly awaited presidential elections – the duel between Joe Biden and Donald Trump has surreal aspects that we do not wish to comment on here. However, we think it is important to note that the question of whether a Democratic or Republican president would be better for stock markets is overrated. Experience shows that presidential decisions have only a very limited impact on stock market performance. Let's not forget that after Donald Trump was elected president, the stock market's initial reaction in the autumn of 2016 was shockingly negative. Stock markets crashed, only to rise to new highs in euphoria shortly afterwards.

> "Trump could just as easily end up in prison as in the White House."

Tina Fordham, Anglo-American pioneer of geopolitical analysis and owner of Fordham Global Foresight in London.

Regardless of the outcome of the US elections, we believe that amidst all the optimism, there is a particular risk that has been somewhat overshadowed in times of corona, wars and geopolitical tensions: burgeoning sovereign debt. Of particular concern is the exploding US debt. The US national debt, for example, has risen by a staggering USD 10 trillion, from USD 24 trillion to USD 34 trillion, since 2019 – and is continuing to rise fast. Whoever wins the US presidential election this autumn: this reckless debt policy can be expected to continue. Before the COVID crisis, US debt service was about USD 1 billion a day. Now it's USD 2 billion. This horrendous debt will have to be reduced sooner or later. This process will not be without pain for the economy and the public – and is likely to have an impact on financial markets. One thing is clear to us: Over the long term, equities are the best way to protect assets from inflation, debt policies, wars and other crises, and to grow wealth in the long run.

> "I love politicians on election posters. They are portable, quiet and easy to remove."

Vicco von Bülow, known as Loriot, German comedian (1923 – 2011)

We round off our half-yearly review and outlook with a funny and downright incredible reminiscence. In the May issue of Bilanz, Daniel Lüchinger, Chief Investment Officer (CIO) of Graubündner Kantonalbank (GKB), was asked how he sees the future of stock markets. His answer: "I feel we are entering a bubble in the US. Other markets are likely to follow. From an investor's perspective, this is not a problem. Periods of exuberance are the most exciting ones for investors because that's when the most money is made. That is when prices rise the most. It's best to be invested in a bubble." These are not the words of an inexperienced gambler, but of the chief investment officer of a major state-owned bank. You rub your eyes in disbelief: A cantonal bank's chief investment officer advises

his clients to invest in a bubble because it's the best thing to do. The president of the GKB is Peter Fanconi. Fanconi was in close contact with René Benko and got "his" bank to make dubious loans to the fallen property tycoon. This bubble, which has cost the bank dearly, has finally burst.

Dear clients, we look forward to continue working with you in the future and would like to take this opportunity to thank you for the trust you are placing in us. We wish you and your loved ones a pleasant summer and, above all, the best of health!

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

Dr. Pirmin Hotz

FINANZ und WIRTSCHAFT

Bank shares for gamblers

Pirmin Hotz

Investors are well advised to steer clear of the shares of big banks. The investment risks are too high and their long-term performance is weak. This is unlikely to change in the future.

Less than a year after the disgraceful collapse of Credit Suisse, another internationally respected Swiss bank, Julius Bär, has made negative headlines. The people in charge took a gamble on the failed Austrian property mogul René Benko and extended presumably ill-advised loans to his opaque corporate construct.

Not surprisingly, the shattered confidence of investors led to the departure of Julius Bär's CEO. However, unlike Credit Suisse, there is a good chance that the resulting setback in the share price was temporary and that those responsible will learn their lessons.

From an investor's perspective, the question is whether bank stocks have any place in a securities portfolio. For decades, the industry has been under fire. Let's not forget that during the 2008 financial crisis, UBS had to be bailed out by the government because it had backed the wrong horse and invested in supposedly safe financial products in the subprime swamp.

Since then, the banking world has been plagued by numerous scandals. Examples include the money laundering and corruption cases involving FIFA, the Brazilian oil company Petrobras, the Malaysian state fund 1MDB, the Venezuelan state oil company PDVSA and the tuna saga in Mozambique. In addition, multi-billion dollar losses from risky deals with Archegos and Lex Greensill have seriously damaged the reputation of the banks involved.

That bank executives are nevertheless among the highest paid managers in the economy is at least questionable. Credit Suisse apparently employed more than a thousand so-called key risk takers who received salaries in the millions. This number is absurd, especially since the real risks are borne not by management but by shareholders.

Fallacies about salaries

Managers lack the will to exercise restraint. The oft-repeated argument that high salaries are necessary to attract the best talent is a fallacy that fails to convince even when it is constantly repeated. Banks need solid performers at the top, not superhumans. What is particularly disillusioning for shareholders of Europe's big banks is that, in the wake of all these scandals, "special factors" in accounting and toxic legacies have become the norm. Yet each generation of managers comes in promising to clean up their predecessors' messes and create a new culture. Improvements are promised, just to be quickly overtaken by the ghosts of the past. From the shareholder's point of view, two questions arise. Firstly: Does the bank's business model meet my qualitative requirements? If we take UBS, the last remaining Swiss big bank, as a benchmark, there is hope. The management team led by Colm Kelleher and Sergio Ermotti is determined to steer the bank towards a solid and promising future. But they and their successors will have to prove that they consistently put shareholders' interests first.

> "It lacks the willingness to exercise restraint among the responsible managers."

We will know more in five or ten years' time. In the meantime, UBS's reserve cushion, which currently stands at less than 5% tier 1 common equity, is far too thin to withstand any severe crisis without government support. Sergio Ermotti would also be wise to abandon his target of an 18% return on equity by 2028. High returns on far too little equity creates dangerous incentives, as history has shown.

Restraint is also called for in the dividend policy and share buybacks. UBS still has a long way to go to

FINANZ und WIRTSCHAFT

regain its former glory. Although the share price has risen significantly in the recent past, it is still almost two-thirds below its peak before the financial crisis.

Secondly, there is the question whether I, as a holder of bank shares, receive adequate compensation for my risk over the long term? A comparison of European bank equities with the overall market provides some insight. For example, in the period 2014 to 2023, the Stoxx Europe 600 Banks sub-index in Swiss francs generated a cumulative return of −0.7% (−0.1% p.a.), while the overall Stoxx Europe 600 generated a cumulative return of 51.8% (4.3% p.a.).

Over a longer period of twenty years, the situation for banks is even worse. The cumulative performance of bank equities was −32.2% (−1.9% p.a.), while the overall market returned 140.4% (4.5% p.a.). Investors' money seems to melt away like snow in the sun when it comes to bank equities. The situation is better for cantonal bank shares. Over the long term, many of the state banks' participation certificates have not only kept pace with the Swiss Performance Index (SPI), but have far outperformed the big banks. So if you want to grow your wealth with bank equities, you would be well advised to invest in cantonal banks rather than big banks.

But watch out for cantonal banks too

From a liberal and free-market perspective, it may be frustrating to realise that it's not the managers of the big private banks who look after the interests of their shareholders, but the representatives of majority state-owned cantonal banks. Beware: Anyone who believes that shares and participation certificates issued by the cantonal banks are essentially safe "widow-and-orphan investments" that allow you to sleep peacefully is mistaken.

The fact is that not so long ago several cantonal banks got into trouble due to mismanagement, and bad mortgages, had to be rescued with state funds or disappeared from the market. These include the cantonal banks of Appenzell Ausserrhoden, Berne, Geneva, Glarus, Solothurn and Vaud. Traditionally, these regionally active banks are heavily involved in the mortgage business, which is why their performance is in part dependent on the real estate market. Given that the last major real estate crisis in Switzerland was thirty years ago, it is difficult to estimate what shock waves a new crisis would trigger. But it is quite likely that it would also hit the cantonal banks' shareholders hard.

Not good enough

According to American professors Carmen Reinhart and Kenneth Rogoff ("This Time Is Different: Eight Centuries of Financial Folly"), there have been eight banking crises in Germany, fifteen in France, twelve in the UK and thirteen in the US since the beginning of the 19th century. In other words: On average, the banking world faces an existential crisis every twenty to twenty-five years.

Is there any reason to doubt that the future will be different? Not according to the facts. Anat Admati, professor of finance at Stanford University, once put it this way: "Today, every banker talks about what has improved. But better compared to very bad is not good enough".

PIRMIN HOTZ is the founder and owner of Dr. Pirmin Hotz Vermögensverwaltungen, based in Baar, Switzerland.

Investment Strategy and Diversification

Core satellite approach a dud

Thomas Hauser

In recent years, many pension funds have added new asset classes to their strategic allocations. The goal is to improve diversification. However, this hodgepodge of investments not only fails to deliver, it also costs a lot.

In the past, the strategy of a typical pension fund consisted of liquidity and Swiss bonds as anchors of stability in nominal terms, and equities and real estate as drivers of returns in real terms. If you believe today's studies and expert advice, this is outdated. But is this really the case?

Alternative investments, politically driven

Looking at the average pension fund today, one finds a variety of relatively new asset classes, each with a modest but gradually increasing weighting. A look at the allocation of the representative UBS Pension Fund Index at the beginning of 2024 confirms this: 2.1% hedge funds, 4.1% private equity, 1.8% infrastructure and 1.3% commodities (see table). How did this hodgepodge of alternative investments evolve historically?

After the bursting of the monumental dotcom bubble at the beginning of the century, pension funds were receptive to the promises of marketing artists: Hedge funds promised to avoid the recently suffered equity losses, and private equity promised more attractive returns than publicly listed equities.

As a result of the financial crisis that followed a few years later (2007 to 2009), interest rates fell so low that pension funds began to look for alternative sources of returns. This is how infrastructure investments came onto the radar. At the same time, financial lobbyists in Bern managed to expand the nonsensical investment corset according to BVV2 to such an extent that it almost sounded like an official recommendation to actually invest in the permitted alternative asset classes. Authorities like such guidelines because it's easier to check quantitative admissibility than economic suitability.

These BVV2 provisions (in particular Art. 53 and 55) should be abolished and replaced by a "Prudent Investor Rule": Permissible is what is appropriate – those responsible determine this independently. If they act incompetently, they bear the liability.

Nothing but costs

What has this hodgepodge of alternative investments achieved in terms of diversification? To examine this, the returns and risk are calculated over 20 years using monthly data and a simplified allocation of the UBS Pension Fund Index (from early 2004 to late 2023) (see table). Fixed-income securities are allocated to Swiss bonds, and infrastructure is split equally between hedge funds and private equity due to a lack of long-term data. This makes sense in terms of risk and returns. Over this period, the annual returns are 4.53% and the volatility is 6.15%.

The almost 10% of alternative investments are now allocated to CHF bonds and Swiss equities to achieve the same returns (Variant A) or risk (Variant B) as the alternative investment allocation.

In Variant A, despite the apparent reduction in diversification with fewer asset classes, the risk can be lowered from 6.15% to 5.67%. This is not surprising, as the investments are subject to the same economic cycles.

In illiquid assets such as private equity or directly held real estate, fluctuations only seem lower because there are no constantly observable market prices. The risk of economic loss is therefore no lower. An example: The volatility of indirect real estate is 8.4%, while that of direct real estate is an unrealistic 0.6% due to the accounting smoothing of the estimated values – only a fool would believe they are safer with direct real estate in a real estate crisis. The same applies to other illiquid assets.

You can also increase the returns for the same risk by omitting alternative investments (Variant B): The annual return then rises from 4.53% to 4.75%. Over 20 years, this will result in an increase in wealth of around 10%. But this is only half the truth. After costs, the difference in final wealth after 20 years is a staggering 25%.

Risk and Return with and without Alternative Investments

Asset class	UBS PK Index Jan. 2024	Simplified allocation of the UBS PK Index	*Variant A Same returns	**Variant B Same Risk	Data series used
Cash	3.75 %	3.76 %	3.76 %	3.76 %	Money market rates 3M
Bonds (incl. mortgage-backed)	34.19 %	34.27 %	38.90 %	34.27 %	Swiss Bond Index
Swiss equities	9.35 %	9.37 %	14.00 %	18.62 %	SPI
Equities abroad	19.76 %	19.81 %	19.81 %	19.81 %	MSCI World net
Real estate direct	9.17 %	9.19 %	9.19 %	9.19 %	KGAST Index
Real estate indirect	14.31 %	14.34 %	14.34 %	14.34 %	each ½ WUPIX A und F
Hedge funds	2.09 %	3.00 %	–	–	HFRX Global HF
Infrastructure	1.80 %	–	–	–	–
Private equity	4.08 %	4.99 %	–	–	LPX Direct Listed PE
Commodities	1.26 %	1.26 %	–	–	S&P GSCI
Other	0.25 %	–	–	–	–
	100.0 %	100.0 %	100.0 %	100.0 %	
2004–2023					
Returns per annum		4.53 %	4.52 %	4.75 %	
Volatility		6.15 %	5.67 %	6.12 %	
Worst month		–8.23 %	–6.96 %	–7.08 %	
Best month		5.85 %	4.54 %	4.89 %	

* ½ of the alternative investment is allocated to Swiss equities and the other ½ to bonds.
** The weighting of the alternative investments is allocated to Swiss equities.

Why is this? The manageable proportion of alternative investments has a significant impact on costs: The asset management costs for a strategy with alternative investments are estimated at 0.66% p.a. and without alternative investments at 0.31%.[1] The allocation of almost 10% to alternative investments thus doubles the costs.

In this respect, the core satellite approach is a dud: What's the point of paying attention to cost effectiveness for traditional investments when there is a massive cost disadvantage for alternatives? This can hardly be justified by good diversification or higher returns, as the above calculation shows.

[1] According to the c-alm document "Cost Transparency in Capital Management" dated 7 September 2023, a cost rate of 0.2% p.a. is assumed for mandates of CHF 20 million for equities and bonds. The cost rate of 0.7% for property is based on the TER for typical Swiss real estate investments. 5.0% is assumed for private equity, based on the 5-6% range mentioned by PPCmetrics in FuW in October 2017, and the same applies to hedge funds. In the case of infrastructure, a survey of pension funds revealed a cost rate of 2.5%. 1.5% is assumed for commodities. To validate the overall cost rate, reference is made to a statement by Iwan Deplazes, Head of Asset Management at ZKB, indicating that the average asset management costs were 0.54% ("NZZ", 15 November 2023). This is consistent with the 2019 c-alm cost study, which shows a total cost of 0.5%.

SCHWEIZER PERSONAL VORSORGE
PREVOYANCE PROFESSIONNELLE SUISSE

What are the implications for the strategy definition of pension funds?

- An investment strategy should be based on transparent asset classes for which there is historically verifiable evidence of risk and returns characteristics. Listed equities are the undisputed driver of returns. Good Swiss bonds outperform alternative investments when it comes to long-term solid diversification. Their correlation with equities over the observed period is also significantly lower at 0.16 than with private equity at 0.80 or hedge funds at 0.68.
- Asset classes that meet this basic requirement should be used with conviction, ideally with at least 5%. Otherwise, the complexity of the implementation will only increase without achieving any effect.
- Investing in illiquid assets on the basis of diversification does not work in most cases. It is an accounting pseudo-diversification based on smoothed “net asset value” estimates.
- Investment managers should recognise that avoiding unnecessary complexity helps to reduce costs and dependency on consultants and providers.
- The asset class specifications according to BVV2 are neither a recommendation nor an indication of meaningfulness.
- Even if the marketing for an asset class sounds good, investment managers must always ask themselves whether they would make the same investment with their personal assets. Who would sign a draconian contract for their own money at a cost of 2% to 5% a year for ten years or more?

TAKE AWAYS

In recent years, many pension funds have expanded their engagement in alternative investments and infrastructure.

This often morely achieves accounting diversification due to delayed model valuation – in terms of return and risk, the investments bring no added value.

The cost of a portfolio with alternative investments is twice that of a portfolio without them.

Thomas Hauser
Dr. rer. pol., Managing Partner, Dr. Pirmin Hotz Vermögensverwaltungen AG

wir
Das Magazin für Unternehmerfamilien

Independence over illusions

Pirmin Hotz & Thomas Hauser

When investments in stocks and bonds yield minimal returns even during good market phases, the underlying issue could be due to misguided incentives.

There is a saying in financial circles: “How do you make a small fortune? Give a large one to a banker to manage.” There is a kernel of truth in this statement, because in practice most portfolios are riddled with expensive financial products. Many products lack transparency, so it is not easy to see how funds are actually being invested. There is a clear reason for this plethora of products – over 14,500 funds are registered for distribution with Bafin – and the artificially created complexity: the wrong incentives. According to UBS’s Global Investment Returns Yearbook 2024, equities provided returns of 5.1% per annum in real terms, i.e. net of inflation, from 1900 to 2023. Value creation primarily stems from successful entrepreneurship, reflected in stocks, not from financial advisors. Yet many bankers, asset managers and investment gurus promise dazzling returns with their supposedly accurate forecasts and so-called financial innovations. Through complex products, they convey an illusion of superior competence by offering the seemingly best products for every need.

No added value

But scientific facts are exposing this marketing machine: The forecasting ability of professionals is very poor, as various studies have shown: For example, Jeffery Busse studied the “performance and persistence in institutional investment management” and published the results in the Journal of Finance in 2010. His study of more than 4,600 investment products found that, on average, their market positioning based on forecasts did not add value. Hedge funds also promise to outperform the market through timing and selection. However, data from early 2004 to late 2023 reveals that hedge fund performance lags the market by 7.2% (per annum!), according to the HFRX Global Hedge Fund Index, which tracks the returns of the MSCI World. The artificially created complexity of the investment world creates a dependency on advisors. The root cause is misguided incentives: The financial industry profits from expensive products – the more specialised and complex, the more expensive. Meanwhile, customers are gradually and almost imperceptibly bled dry, because they do not directly pay the high fees hidden within the funds. The costs only become apparent over time in the form of unsatisfactory net returns.

More transparency, less complexity

Financial advisors are in a constant conflict of interest between their clients’ welfare and that of their employer or their own bonus. So what should asset owners be looking out for? Firstly, the financial service provider must be independent. They are only independent if they charge their fees transparently and do not profit from products. As soon as indirect fees are embedded in the products, independence in decision-making is comprimised: A bank will tend to favour its own funds as an investment over others, earning additional revenue from the product fee, regardless of whether this is the best choice for you as an investor. Secondly, in addition to cost, complexity can be reduced by investing directly – in equities and bonds. Packaging investments into products is common today, but is not advisable. A simple investment strategy is cheaper, more transparent and yields a higher net return in the long term. Thirdly, attention should be paid to the security of the financial service provider: What is their reputation, how often have they been involved in legal disputes, and how much of its balance sheet is equity?

> “The artificially created complexity of the investment world leads to dependency on advisors”.

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A critical approach

Long-term success does not require overpriced financial products or the illusion of secure forecasts. The key success factors for long-term wealth accumulation are a consistently transparent and low-cost investment strategy, an independent provider without conflicts of interest, and a critical mindset of the asset owner.

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FINANZ und WIRTSCHAFT

Maldives instead of kickbacks

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Many banks and asset managers continue to collect retrocessions, although they are frowned upon. This creates conflicts of interest that are not in the best interests of clients.

Anyone who books a holiday to the Maldives through a travel agent without having to pay a fee knows that the service provider does not live on love and air alone. They receive reimbursements from hotels and airlines to cover their wages and expenses.

It's different in the world of finance. In 2006 the Federal Supreme Court issued its first landmark ruling. It ruled that kickbacks or retrocessions of any kind belong to the client, regardless of whether the service is asset management or investment advice. Subsequent court rulings have confirmed and clarified the decision.

Anyone who thinks that the financial sector has now been cleaned up and that there are no more kickbacks is mistaken. According to experts, it is common for 80–90% of banks and "independent" asset managers to charge retention commissions on investment funds, structured products, hedge funds, private equity, infrastructure and real estate products. In addition, there are one-off distribution fees, reimbursements on stock exchange transactions and finder's fees for funds that asset managers refer to selected banks on behalf of their clients. It is believed that billions of dollars in kickbacks are still being paid in Switzerland. How is this possible when there are high court rulings that have long banned this practice?

Unlike the more restrictive MiFID II rules in the European Union, the acceptance of retrocessions is not explicitly prohibited in Switzerland, but is legally uncertain and often contestable. The local financial industry successfully lobbied against a general ban on retrocessions by highlighting the maturity of investors. Many banks and asset managers have simply amended their "general custody terms and conditions" and contracts so that the client agrees to waive the fees owed to them.

Like a mild drug

Excerpts quoted from UBS's fundamental contractual conditions are representative of many other financial actors: "UBS typically receives monetary benefits from these product providers on a periodic and/or upfront basis, such as distribution fees/retention commissions, rebates and similar benefits, as payment for the distribution and/or custody of these financial instruments." And further: "Benefits may create conflicts of interest for UBS. They may provide an incentive for UBS to favour certain financial instruments with higher benefits over other financial instruments with no benefits or financial instruments with lower benefits."

It is clear from the major bank's separate information sheet that these "benefits" or "kickbacks" are not marginal. The retrocessions they receive can be up to 2% per annum on bonds, equities, investment strategies, private equity, real estate and hedge funds. These are huge maximum rates, sometimes several times the transparent fee charged to the client. For structured products, the reimbursement comes with a one-off "upfront fee", which can be up to 3%.

> "Kick-backs eat through portfolios like cancer."

Hidden and non-transparent fees, as well as the kickbacks paid for them, eat away at bank clients' portfolios like a cancer. They act like a mild drug, with the "patient" barely noticing how they are being slowly and almost imperceptibly bled dry – who actually reads their bank's "general custody terms and conditions" in detail, which now run to dozens of pages? Hubert Schwärzler, CEO of Liti-Link, which specialises in the recovery of retrocessions, was quoted in "Finanz und Wirtschaft" on 23 January 2021 as saying: "Swiss banks collect retrocessions as if there had never been a Federal Court ruling." It is clear that kickbacks are not ultimately paid by the product providers themselves, but by the end clients, which also has a negative impact on their performance.

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In a legal grey area

Those who collect retrocessions operate in a legal grey area. This is illustrated by the following sentence in UBS's fundamental contractual provisions: "The client acknowledges that this arrangement differs from the reimbursement obligation set out in Article 400 paragraph 1 of the Swiss Code of Obligations and any other legal provision with similar content." Clearly, the bank is aware that it is behaving at odds with current law. That is precarious at the very least. In the United Kingdom and the United States, kickbacks are prohibited. The most important currency in the investment business is trust. When you entrust your money to a bank or asset manager, you assume that it will be handled in your best interests – it's no different from going to the doctor. However, this fundamental cornerstone of trust is now being undermined by the inherent conflicts of interest that kickbacks create.

Those who collect retrocessions are not independent and are often under pressure to meet the ambitious and bonus-driven sales and profit targets of senior management. It goes without saying that this is not in the best interests of clients. How can a client trust their banker or asset manager if they are constantly in a conflict of interest?

Pressure to sell creates false incentives

A money manager is only truly independent if he or she lives solely on client fees, has no perverse incentives and does not collect retrocessions. This is the only way to ensure that their actions always put the client's interests first and negotiate the best possible terms for them. Otherwise, there is a latent risk that they will be sold the products with the highest margins and kickbacks. Let's not forget that kickbacks of up to five percentage points were paid to brokers for Madoff funds and Lehman products. This stinks to high heaven and should have raised red flags from the start.

The primary goal of a banker or asset manager must be to manage clients' money without conflict of interest as if it were their own – this is a matter of morality and integrity. According to German author Gerhard Schick ("Die Bank gewinnt immer" / "The Bank Always Wins"), accepting kickbacks is like being represented by a lawyer employed by the other side.

Anyone who thinks that an invitation to a luxurious golf event is a generous gesture from their banker to thank them for their loyalty to the financial institution is deluding themselves. On closer inspection, the client is actually paying for the event through the purchase of expensive products – usually several times over.

Investors who rigorously avoid high-margin products and do not allow their financial advisers to receive kickbacks will achieve better performance – and with the money they save, they can treat themselves to a "free" holiday in the Maldives.

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