Dear client,

What was long considered unthinkable has become reality. Schweizerische Kreditanstalt (SKA), founded in 1856 by Alfred Escher, the powerful “railway king” of Zurich, has quietly given up the ghost. Several generations of managers have plundered and ruined Credit Suisse, as it is now called, through their incompetence.

In July 1856, the newly founded SKA offered the public 9,000 shares for purchase. Interest was huge – the offer was oversubscribed fifty-fold. A spirit of optimism prevailed in the Swiss Confederation, which was established in 1848. Private railway construction was of central importance for the development of modern, internationally connected industry. From the outset, the bank had its ups and downs, with losses that threatened to bring it down and numerous reorganisations. In the seventies, the bar was raised, with the introduction of ambitious goals. According to economic historian Dr. Luca Froelicher, who published an article on the bank’s history in the “NZZ” on 28 March 2023, the President of the Executive Board Bernhard Reinhardt said to a new employee in 1972: “Put SKA on the map of international business.” That new employee, on whose shoulders so many big hopes were resting, was the Baar-born Rainer E. Gut. The Chiasso scandal, which shook the bank in 1977 and brought it a loss running into billions that threatened its existence, resulted in Gut taking the helm of the bank. The urbane-seeming Gut, who was trained in the global financial metropolis of New York, made a cooperation deal in 1978 with US investment bank First Boston. A fatal decision, as we have long known. The dream of the bankers from Zurich’s Bahnhofstrasse – of playing a relevant role in the partnership with the dominant and successful US investment houses – turned into a nightmare.

> “How did you go bankrupt?” Bill asked. “Two ways,” Mike said. “Gradually and then suddenly.”

Ernest Hemingway, US author (1899–1961)

What many people don’t know is that the decline of Schweizerische Kreditanstalt, which has traded under the name Credit Suisse since the nineties, had already begun in that period. In 1988, the bank acquired a 45 per cent stake in US investment bank First Boston as part of a bailout, before absorbing it completely in 1990 – or rather had to absorb it because First Boston had hugely over-speculated with junk bonds. Since that time, the problem faced by Credit Suisse, but also by its competitor UBS, which had to be rescued from bankruptcy by the state in 2008, has basically always been the same. It has used the dream salaries of the champions of Wall Street as a benchmark, while playing with small fry from the second or third division. Up against the nimble colts of the cowboys of Manhattan, the sedate bankers in Paradeplatz had no chance whatsoever. Flop followed flop, and scandal followed scandal. This was accompanied by adventurous speculations, such as with Lex Greensill and Archegos, grubby transactions with oligarchs, corrupt dictators and officials, as well as sinister money laundering incidents resulting in fines running into billions. The history of the last few decades describes a systemic failure of countless boards of directors and group CEOs on Zurich’s Bahnhofstrasse.

> “In bad times one has no use for them, and in good times there’s no need for them.”

Christoph Blocher, former member of the Federal Council and entrepreneur, on the usefulness of boards of directors

Not only the conduct and notorious incompetence of the management raise questions, but also the role of the regulatory authority FINMA. Its President Marlene Amstad stated in the 26 March 2023 edition of “NZZ am Sonntag”, one week after the collapse of Credit Suisse: “Ultimately it was a bank run, the bank ran out of liquidity.” She was certainly not wrong in that assessment, but just a few days before that she had declared that the bank was well capitalised and its liquidity situation was also very solid. Clearly something isn’t right here. The FINMA president added that the “bank has failed to cooperate adequately and refused to take the necessary action”. The mismanagement of Credit Suisse has been going on for years, she argued – and in the case of the Lex Greensill scandal, FINMA asked critical questions. However, they were not answered by the bank itself, but by people from Greensill.

> “It was like simply asking a fall-down drunk if he can drive home.”

André Müller, Economics Editor of the NZZ, 1 March 2023

After all, what use is a financial market regulator if, despite criticising the misconduct of a *systemically relevant* bank over a period of many years, does not in fact have any effect on the persons in charge of it? Any *non*systemically relevant financial institution would probably have long been wound up after all the transgressions and flops racked up by Credit Suisse over the years. The Swiss taxpayer was temporarily exposed to a maximum risk of CHF 259,000,000,000 – over CHF 30,000 per inhabitant.

In the wake of the collapse of Swissair in 2001 and the downfall of UBS during the financial crisis of 2008, this is a further disgrace for Switzerland in international financial and business circles.

> “The first thing one learns in the banking business is respect for zeros.”

Carl Fürstenberg, German banker (1850 – 1933)

A particularly disturbing aspect of the recent federal bailout is the unspeakable “whatever-it-takes” policy, which has been the fashion at least since the time of former ECB president Mario Draghi. If states and banks are “too big to fail”, they will effectively be bailed out by taxpayers at any price. Inevitably, this leads to a “moral hazard” – states and managers of systemically relevant banks can spend other people’s money irresponsibly and at their leisure and conduct adventurous speculations, money laundering and fraud. All this without consequences, because these institutions can never be allowed to go under. And each generation of bankers that takes the helm refutes any fault, with the oft-repeated excuse that unfortunately they have to grapple with a heap of inherited debts. This mantra-style self-absolution by the responsible managers of Credit Suisse began in 1977, when the infamous Chiasso scandal brought it a loss running into billions. Following 50 years of bankruptcies, misfortune and mishaps, the history of the 167-year-old bank and its incompetent management has now come to an end. Its last president, Axel Lehmann, assumed office as a saviour. Now he plays the role of gravedigger. Is there any sign of self-criticism? No. This is also a tradition. SKAndal.

> "Switzerland actually always sees its financial centre as being threatened from outside, particularly by envious competitors in London and New York. But the biggest risks are closer to home, in the carpeted corridors of the Zurich banks. They are called arrogance and stupidity."

Markus Städeli, Economics Editor at "NZZ am Sonntag", 19 March 2023

Now the erstwhile coma patient UBS has taken over CS, making it more "too big to fail" than ever. It is alarming that, already in his first term of office, new and former head honcho Sergio Ermotti coined the motto "Better too big to fail than too small to survive". With all due respect for the healthy self-confidence of the experienced manager, it must not be forgotten that "his" UBS was also unequivocally criticised in the annual report of financial market regulator FINMA on 28 March this year for its "considerable weaknesses in the area of risk management and risk control" in connection with the bankruptcy of US hedge fund Archegos. "UBS knowingly entered into a business relationship with a non-transparent client with a questionable reputation and potentially increased willingness to take risks," the report states. Furthermore, the bank was guilty of "considerable shortcomings with regard to risk models and methods". Okay, the loss sustained by UBS amounted to "only" USD 861 million, while that incurred by its former competitor amounted to USD 5 billion – but this is only like a non-league team knocking a third-division team out of the cup. One may wonder how long it will take before the megalomania of the bonus-driven bankers next ends in disaster. Who knows, perhaps Switzerland will then put together a rescue package running into trillions (1 trillion = 1,000 billion).

> "The time for firefighting is over."

Axel Lehmann, President of Credit Suisse's Board of Directors, in an interview with the "NZZ" on 30 April 2022 (less than a year later, the bank went under in a sea of flames)

With the collapse of Credit Suisse, mandatory convertible bonds of the bank, so-called AT1 bonds or CoCos (contingent-convertible bonds), with a value of USD 17 billion also became worthless. Such high-interest junk bonds, which can be used for financial recovery in the event of a crisis, were also on the books of institutional investors. Pimco, the fund subsidiary of German insurance group Allianz, reportedly lost over USD 800 million with CS CoCos. The pension fund of retail giant Migros also took a hit. According to its Managing Director Christoph Ryter, the pension fund suffered a loss amounting to hundreds of millions on CoCo bonds due to the CS debacle. Added to this are huge losses on shares of the bank, which have become virtually worthless. We cannot stress enough the advice we have been giving for years and decades: stay away from high-risk bonds and junk bonds.

We remain adamant with regard to the quality and risks of bonds. In our 37-year company history, we have never suffered a single debtor default. We were not involved either in the bankruptcy of Swissair or in the debacle surrounding Gazprom or Russian Railways, where owners of high-interest bonds actually incurred a total loss. It goes without saying that we had not invested a single franc in the Credit Suisse CoCos either. What for us is out of the question even for clients who are *willing* and *able* to take a risk, is seen differently by the fund manager of Zurich Cantonal Bank, Thomas Kirchmair. In "Finanz und Wirtschaft" from 10 May this year, one can read how Kirchmair recommends to *conservative* (!) clients of the state-owned bank extremely speculative, high-interest CoCos of Geneva Cantonal Bank and UBS. It's hard to get one's head around the fact that Zurich Cantonal Bank recommends CoCos, which have recently been the subject of inglorious headlines in the context of the fall of CS, to its *conservative* clients. Furthermore,

Kirchmair recommends bonds of insurance company Helvetia with an *unlimited* term (perpetuals). That is very bold, but perhaps also foolhardy, as the bank's *risk-averse* clients assume very high interest rate risks with perpetual bonds, without getting their capital back at a fixed point in time.

> "If you see a Swiss banker jumping out of the window, jump after him. There is surely some money to be made there."

Voltaire, French philosopher (1694–1778)

Now for some good news. Most forecasters and analysts assumed at the beginning of 2023 that equity markets would continue to falter, particularly in the first half of the year. There were plenty of reasons for this. Rampant inflation all over the world, skyrocketing interest rates, recession fears, falling company profits, the war in Ukraine and threatening rhetoric on the part of China with regard to Taiwan were among the most compelling arguments for a generally pessimistic attitude. As so often happens, things worked out differently, and we saw once again how much attention we should pay to short- to medium-term forecasts: none at all! At the time of going to press in mid-June, global equity markets were in much better shape than at the beginning of the year. It is particularly gratifying in this context to see that the performance results of our clients are significantly better than those of the relevant indices and our key competitors. All this after we ended 2022 in great, close to record-breaking shape based on a relative cross-comparison. This good news is amazing in view of the fact that so far this year, in contrast to the previous year, growth stocks have left value stocks, as preferred by us, far behind. Although we are defensively oriented, we have therefore not only proved in the downturn that our strategy is resistant, but also that it is successful in the recovery phase that we have now entered. Both we and our clients are very pleased with this outcome. How did this gratifying development come about this year? The reasons are primarily related to the fact that with our anti-cyclically managed industry and stock selection, we are superbly positioned and for many years have foregone holdings of bank shares.

> "Experts do not make forecasts because they know, but because they are asked."

John Kenneth Galbraith, Canadian-US economist (1908–2006)

Many private and institutional investors passively invest their money in index products. This is undoubtedly a justifiable and often promising strategy, as with index investments or so-called exchange-traded funds (ETFs) the Swiss or German equity market can be replicated as well as the global equity market or specific bond markets. Furthermore, ETFs are low on fees. The use of index products results in broad diversification, and investors don't have to worry about selecting individual securities. Nevertheless, we are convinced that passive investment in ETFs is not the best investment strategy, not only in terms of returns but also in terms of *risk*. The deficiencies of index products became particularly acute in the difficult financial year of 2022, as bluntly revealed in our editorial published in "Finanz und Wirtschaft" on 19 April, which is attached to this letter. Anyone who had money invested in ETFs at the beginning of last year most probably also held Russian bonds or shares. Institutional investors like banks, pension funds and insurers, but also private investors, were caught off guard with such worthless securities, including the bonds of Gazprom, Russian Railways and VTB Bank issued in Swiss francs. The outcome was largely a total loss. Furthermore, many East European and Russian funds were closed or even liquidated. Compenswiss – the institution in charge of managing the Swiss social security funds for old-age and survivors' insurance, invalidity insurance and the loss of earnings compensation scheme – lost more than CHF 200 million from Russian investments. As if our retirement pension scheme didn't already face enough challenges in securing its future.

Yes, passive or indexed investing has attributes that we too greatly appreciate. This includes a long-term, cost-conscious mindset. We prefer to purchase shares of top-quality companies and hold them in perpetuity. However, passive investment involves inherent cluster risks and is extremely procyclical. In 2022, index-oriented investors were caught off guard by these risks. They held a high proportion of overvalued technology shares, while being underrepresented in low-valued raw materials and energy shares. Investors who follow a passive indexing approach have suffered almost record losses with fixed-income bonds, due to the considerable extension of terms and the greater inclusion of questionable borrowers in the indices during the low interest rate phase. This led to historical upheavals. A glaring example of this is the 100-year Austria Bond, which was issued in 2020 and bore interest at 0.85 per cent, a phenomenal rate in the negative interest environment prevailing at that time. The rate reached a peak value of over 137 per cent near the end of 2021. In the course of the interest rate turnaround, it fell by over 70 (!) per cent to 40 per cent.

> “Index funds systematically buy too high and sell too low.”

Rob Arnott, founder of US asset manager Research Affiliates, Newport Beach, “Finanz und Wirtschaft”, 3 July 2021

With the publication of the Pictet index returns, the Genevan private bank Pictet provides a representative overview of the results of passively managed assets. According to this, a share component of 25 per cent generated average returns of approximately –14 per cent in 2022. While the average return for a share component of 40 per cent amounts to approximately –15 per cent, for a share component of 60 per cent it amounts to approximately –16 per cent. In the past year, it was therefore virtually immaterial how high the share component of the pension funds was – both conservative investors and those willing to take a risk were hit hard, with double-digit losses of –14 to –16 per cent. Our experience and the results we obtain for our clients show that with an *active, anti-cyclical investment policy that avoids cluster risks* a majority of these losses were avoidable.

> “Investors are procyclical. They do what would have worked well in the past. They ought to do exactly the opposite – they should invest counter-cyclically.”

Thorsten Hens, Professor at the Institute for Banking and Finance of the University of Zurich, interview in “Finanz und Wirtschaft” on 28 January 2023

The largest Swiss pension fund is Publica, the pension fund for federal employees. It serves over 100,000 actively insured persons and pensioners. The investment portfolio amounts to over CHF 45 billion. Publica’s returns in 2022 amounted to –9.7 per cent. Publica is advised by leading pension fund consultants, namely the Dutch ORTEC Finance and Swiss calm and PPCmetrics. Taking a closer look at Publica’s investment portfolio raises questions. How can it be explained that barely 3 per cent of the funds are invested in solid Swiss shares, while the proportion of high-risk emerging market shares amounts to 7 and 8 per cent? Added to this are a further 7 to 8 per cent invested in no less risky emerging market bonds. Scientific studies prove that the high risks inherent in these markets are not adequately compensated for in the form of returns. It is also astonishing that the current share of private equity, illiquid infrastructure investments and low-yield precious metals is similar to that of Swiss shares. Another salient question is why a total of only around 25 per cent of the total assets are invested in shares, easily the most attractive investment class in terms of returns. Based on a hope and belief that Switzerland and its state employees will still be around in 100 years, the following question arises: does this really make sense for a pension fund with an almost never-ending investment horizon? We come to a critical conclusion: a share component of 40 or 50 per cent

would probably be optimal. Bearing in mind that yields and risks are 90 per cent dominated by the investment structure, there is optimisation potential at Publica.

The Norwegian state fund, which is set up in a similar way to a pension fund and, with investments of over CHF 1,200 billion, is the most important shareholder worldwide, shows how to do it better. It adheres to the scientifically founded principle that, as productive real capital, shares are by far the most attractive investment class in the long term. Thus the Norwegians invest approximately 70 per cent in shares, 25 per cent in bonds and 5 per cent in real estate. The state fund has been extremely successful for decades and is virtually exemplary in terms of long-term returns. Based on the example set by the Norwegian state fund, we believe it is possible to significantly increase the risk/return ratio of many Swiss pension funds and insurance companies. Instead, an army of consultants and risk and compliance managers ensure, albeit in a virtually perfect way, that anything and everything is measured and monitored, while risking losing sight of what is important. The cynical might claim that consultants have an interest in complexity, as it allows them to increase their fees. Thus, in the name of diversification, investments are made in every conceivable investment category, where investors basically have no need for them. Finally, in order to evaluate the “specialist” hedge fund, private equity or emerging market managers, the consultants offer elaborate, expensive “searches” – ultimately at the expense of the investors’ performance. Our goal is the opposite of this: we aim to reduce complexity for our esteemed clients as much as possible. Our objective is to optimise net performance. We reject the “hope for the best” policy that is so common in the financial world. We maintain a clear position for the benefit of our clients, even if some bankers and consultants do not always like to hear it.

Emerging markets, which are heavily represented in passively managed index mandates, are a good example to substantiate our argument. As you know, we have long foregone investments in so-called emergent countries or emerging markets. Through the multinational companies that we keep in our portfolios, we already cover emerging countries to optimal effect, as corporations like Nestlé, Holcim or Siemens generate a significant portion of their revenues in those markets. In previous client letters, we have discussed in detail the political and economic shortcomings in countries like China or Russia – the corruption and risks of expropriation in totalitarian countries are huge. Now India too is being targeted by critical financial analysts, after US financial institution Hindenburg Research published a report in the first quarter of this year which accuses the Indian Adani Group of committing the “biggest fraud in economic history”. Gautam Adani is considered an industry mogul and figurehead of the Indian economy, controlling a highly diversified raw materials and industrial conglomerate. He is the biggest airport operator in the country and owns the biggest harbour and logistics company, as well as the largest energy corporation. Allegedly Adani has for decades been involved in share manipulation and debt concealment and been guilty of large-scale corruption, money laundering and tax evasion. After the publication of the Hindenburg Research report – the company is named after the German airship which went up in flames over New Jersey in 1937, killing 36 passengers – the shares of the Adani Group plummeted on the stock exchange. Although the price has recovered in the meantime, for us this story is further confirmation of the wisdom of foregoing risky investments in emerging markets, whether in the form of direct investments or high-margin funds.

> “Those who have a lot of money can speculate; those who have little money should not speculate; those who have no money must speculate.”
>
> André Kostolany, US-Hungarian stock market player and speculator (1906 – 1999)

Of course, we are not immune to the effects of certain risks on our Western-oriented companies, which generate a significant share of their revenues in emerging

markets. This can be clearly seen in the example of German chemical company BASF, which has been particularly hard hit by the West's sanctions against Russia. Its subsidiary Wintershall Dea, in which BASF holds a 70 per cent stake, holds shares in gas fields in Western Siberia. There is also a connection with Gazprom through the two pipelines Nord Stream 1 and 2, which have or were supposed to carry Russian natural gas through the Baltic Sea. While deliveries via Nord Stream 1 were discontinued in September 2022, Nord Stream 2 could not be put into operation at all. For BASF, this resulted in a write-down of EUR 7.3 billion, which naturally weighed heavily on its share price. However, unlike Russian direct investments such as Gazprom, the share price of BASF has strongly recovered from the low point it reached at the end of September 2022. The broad-based BASF is one of the global market leaders in its industry.

Many experts buy shares or funds from emerging countries because their valuation is much lower than those of established markets. In fact, the price-to-earnings ratio for many emerging markets is far below 10, while in the United States, Germany or Switzerland it lies between 15 and over 20. On 22 May, the online newspaper "The Market", of which we are avid readers, reported that due to their low valuation emerging markets could be expected to yield particularly high real annual returns for the next 10 years ("The Market" cites a study of Research Affiliates). Someone who invests in Brazilian shares, for example, can expect annual returns of 19.3 per cent (!). While emerging markets as a whole will generate an annual return of 8.2 per cent, for the industrial countries no more than 3.3 per cent can be expected. The forecast calculations are, of course, nonsense. When examined in the cold light of day, the apparent attractiveness of the "cheap" emerging markets is a mirage, as the *notoriously* low valuation is a logical consequence of the much higher inflation rate and therefore the much higher interest rates in those countries. As a result of this, currencies like the Brazilian real, the Philippine peso, the Turkish lira and the Russian rouble depreciate hugely in the long term, so that in the end, after adjusting for exchange rate effects, only a fraction remains of what the apparently low valuation leads one to expect. In other words: emerging markets *must* be systematically valued lower than established markets in order to anticipate the long-term depreciation of the currency. And even this is often insufficient: before the war against Ukraine, Russian shares were valued at a price-to-earnings ratio of 4, and seen in that light were thus dirt cheap. This did not protect them from total collapse.

We feel much more comfortable with multinational companies that have a strong presence in upcoming markets but have their registered office in a democratic country, than we do with direct investments or funds in emerging markets. Our attitude is borne out not only in terms of risk but in terms of performance too. While the performance of emerging markets (MSCI Emerging Markets) from 2010 to 2022 in the reference currency Swiss francs stands at 1.3 per cent per annum, for the developed countries (MSCI Developed Markets) it amounts to 7.5 per cent. The difference is vast. Furthermore, studies by British scientists Elroy Dimson, Paul Marsh and Mike Staunton, who analysed the period from 1900 to the present date, show that the very long-term performance of emerging market shares also clearly lags behind that of developed countries. Nevertheless, many consultants preach to their clients that with high-margin investments in emerging markets one can profit disproportionately from their high growth rates – looked at in the cold light of day, this is a fairytale.

> "There are countless ways people can be successful, but failure usually follows similar patterns. We can therefore learn more from the stories of those who have failed than from those who have succeeded."
>
> Warren Buffett, legendary investor from Omaha, Nebraska

Every now and then, we are asked what "Hotz" actually stands for: are we an active or passive asset manager? Actually, it is customary among banks, asset managers and consultants to divide the investment world, rather rigidly, into "active" and "passive". Either one hunts excess returns like big game through (for example) hedge funds, or one invests in boring index products. We have no time for this rigid subdivision – for us, the key thing is to stress the central importance of *combining the advantages of the active and passive investment worlds in the "Hotz philosophy"*. We are therefore neither decidedly against passive investment nor for it. Likewise, we are neither decidedly against active investment nor for it. Our aim is to *actively* decide what interests we wish to hold *long term* (i.e. rather *passively*). We are consistently *active* when it comes to separating quality from junk, with regard to both bonds and shares (please note that all the junk is also present in the passive indices). We also aim to *actively* avoid cluster risks for risk-related reasons – such risks are assumed by those who invest in indices. Thus, the three securities Nestlé, Novartis and Roche alone represent over 50 per cent of the Swiss Market Index (SMI). We hold all three of these qualitatively first-class securities, but never with that weighting. We also take an *active* approach in our handling of the maturity terms of our fixed-interest bonds. Thus, contrary to the passive indices, we have anti-cyclically kept our risks in the form of duration very short in times of negative interest rates. This has protected us against major bond price losses following the interest rate turnaround, while passive investors incurred huge losses. We are also active and proceed *actively* when, in the event of market setbacks and upheavals, it's time to take *anti-cyclical opportunities* in order to shore us up against potential exaggerations and excesses on the markets. However, we are never activist based on extremely uncertain forecasts, for example. We therefore like to describe our investment philosophy as *semi-active*. Because we have no interest in unnecessary reallocation, we follow the principle of as little as possible, but as much as necessary. And above all, we prefer to *actively* decide what we want and do not want.

"Never ask a hairdresser whether you need a haircut."

Warren Buffett, legendary investor from Omaha, Nebraska

Once in a while, we are also asked what we think of the legendary Warren Buffett and whether he is a model for us in terms of his investment policy. Put simply: we have the utmost respect for the business achievements of Warren Buffett and his almost 100-year-old partner Charlie Munger, but they are not role models in terms of our investment policy. What we surely have in common is our high affinity for first-class shares of companies with a convincing business model that is successful in the long term. Like Buffett, we are also value-oriented and essentially conservative. We also share with the old master a deep scepticism for all kinds of alternative investments like hedge funds, private equity, structured products and cryptocurrencies. However, we differ quite fundamentally in our views of how a share portfolio should be put together. While for us the most important thing is broad, internationally balanced diversification with, depending on the size of the portfolio, 30 to 70 shares, Warren Buffett places huge bets. This is confirmed by a glance at his current portfolio structure. Thus, approximately 40 per cent of his entire Berkshire-Hathaway portfolio consists of a single share, that of Apple. Despite our affection for this marvellous company, which is also among our securities universe, we would never assume such a huge cluster risk. Broad diversification and risk spreading for the investments is sacrosanct for us, as even the best companies in the world are not immune to unforeseeable risks and setbacks. Besides Apple, Warren Buffett's "residual portfolio" predominantly consists solely of the six securities Bank of America (11.2 per cent), Chevron (9.8 per cent), Coca-Cola (8.5 per cent), American Express (7.5 per cent), Kraft Heinz (4.4 per cent) and Occidental Petroleum (4.1 per cent). Furthermore, Buffett invests almost exclusively in US companies. Even though his investments are in multinational corporations, we distance ourselves

from such a one-sided approach. Furthermore, contrary to Warren Buffett's policy, we do not take out loans in order to leverage the managed assets of our clients.

> "I consider it nonsensical that it is currently taught at universities that broad diversification in share investments is absolutely obligatory. It's crazy."

Charlie Munger, 99-year-old business partner of Warren Buffett, at the 2023 Annual Conference of Berkshire Hathaway in Omaha, Nebraska

The past teaches us how a concentration of securities risks combined with leverage can end in an extreme case. Martin Ebner, the Swiss banking star of the 1990s, learned a painful lesson at the turn of the millennium as to what it means to lack diversity and borrow excessively. After his financial fall in the wake of the collapse of the dot-com bubble and the 9/11 crisis, he had to be supported by fellow travellers to get back on his feet (particularly by the entrepreneur and former federal councillor Christoph Blocher, according to informed sources). No, esteemed clients: although we appreciate the witty sayings of the legendary Warren Buffett and his associate Charlie Munger, in terms of the technicalities of investing they are not role models for us. We adhere, with great conviction, to the "Hotz" philosophy, which with regard to shares relies on broad diversification of globally leading companies and generally equal weighting of the securities. Balanced risk spreading is of fundamental importance for us.

Ashish Lodh, Ana Harris and Foties Kassianidis from leading index provider MSCI broke down the shares of MSCI Europe according to performance drivers and made an important finding: "In the last 20 years, countries have accounted for an average of 15% of performance, while the sectors have accounted for 51%". As you know, we manage our share allocations primarily according to sectors or industries and only secondarily according to countries, also because it is increasingly difficult to classify multinational companies according to countries. Some have their registered office in country A but generate most of their revenues in country B, while their shares are listed in country C – in the list of securities, should these companies be ascribed to country A, B or C? This can be a very tricky decision in some cases. The practice we have followed for many years of managing shares according to industry is backed up by the MSCI study. Our practice of not weighting shares according to market capitalisation but generally equally is also scientifically confirmed. Alexander Swade, Sandra Nolte, Mark Shackleton and Harald Lohre from Lancaster University published an interesting article in the well-known "Journal of Portfolio Management" in November 2022. For the US equity market and the period from July 1963 to December 2021, the researchers found that share portfolios which are equally weighted generated higher returns by a margin of 2.2 to 3.5 per cent per annum (the range depends on the selected equity universe or index) than capitalisation weighted portfolios. The avoidance of procyclical cluster risks is given as a key reason for this.

> "Invest in a share only if you understand the business behind it."

Warren Buffett, legendary investor from Omaha, Nebraska

As is explained in the author's book "Über die Gier, die Angst und den Herdentrieb der Anleger" (On the Greed, Fear and Herd Instinct of the Investor), we attach great importance to getting our priorities in the right order in our investment policy. We are believers in real value, particularly in qualitatively first-class shares. This conviction is confirmed by the book "Stocks for the Long Run" by Professor Jeremy J. Siegel, who teaches at the Wharton School of the University of Pennsylvania. In October of last year, the sixth edition was published, which we strongly recommend. Siegel calculated the yields of the most important investment classes for a period covering over 200 years. Despite the many wars

and upheavals that have occurred in that long period, US shares (adjusting for inflation) have yielded a *real return* of approximately 7 per cent per annum since 1802 – far more than any other investment class. The real return amounts to 3.6 per cent per annum for bonds and a mere 0.6 per cent for gold. Besides shares, we recommend a significant portion of real estate investments, given that private investors in Switzerland and Germany often have excessive holdings of real estate, owning apartments, houses or a holiday home, so there is no need for additional "concrete gold" in the securities portfolio. Our clients' portfolios are rounded off by cash and first-class bonds intended to support the livelihood of the investor for the coming years.

"If you have ten years, invest 100% in shares and be done with it."

Thorsten Hens, Professor at the Institute of Banking and Finance of the University of Zurich, "Finanz und Wirtschaft", 28 January 2023

With our low-fee, transparent policy, we firmly resist the industry trend of investing increasingly in all conceivable investment alternatives: in non-transparent, illiquid, high-margin hedge funds and private equity leveraged with a lot of borrowed capital, in high-risk emerging market investments and junk bonds, in often opaque infrastructure projects and in cryptocurrencies. The main argument of the proponents of these investment categories is essentially always the same: one should aim at broad diversification of investments. As you know, we are big believers in broad, balanced diversification, as there's no such thing as a certain forecast. A broad distribution of shares and bonds is therefore an absolute must for reasons related to risk. However, diversification into all conceivable investment classes for whose products the providers charge annual fees of 1, 2, 3 or even over 6 per cent is definitely not in our interests, and most certainly not in the interests of our esteemed clients. After all, with a majority of high-pressure marketed alternative investments, only the providers get rich, while investors are scammed. This is clearly demonstrated by a recent example, which made headlines in the financial industry. The 87-year-old US-American Carl Icahn has gained a worldwide reputation in the past decades as a shareholder activist and hedge fund manager and built up a fortune running into billions. However, for almost 10 years he has speculated on falling equity markets, and since 2014 he has squandered, for his investors and for himself, assets amounting to USD 9 billion. According to his succinct explanation for his downfall, he simply forgot to stick to his own principles. Well, we stick to our principles. Speculation is not our thing. We see ourselves as investors.

"In the area of private equity, there will probably be more losses that come out of the blue."

Megan Greene, Global Chief Economist at the US Kroll Institute, New York, special issue "The Market" in "NZZ", 17 March 2023

As a firm believer in shares, we essentially have a soft spot for private equity. What is involved here is productive real capital, which promises phenomenal long-term yields in the spirit of entrepreneurship. Many providers in this industry also boast annual yields of 10 to 30 per cent, which increasingly attracts institutional, but also private investors to this investment class. Recently, however, criticism has massively increased in scientific circles with regard to this promise of dream returns. Ludovic Phalippou, Professor of Financial Economics at the renowned University of Oxford, has been conducting research in the area of private equity returns for many years. In a cynical LinkedIn commentary on 28 February 2023, he made a statement on the industry and its US private equity market leader KKR: "Congratulations to KKR, which in its report of yesterday announced a gross IRR (internal rate of return) of 25.6 per cent per annum for all its private equity and real estate funds since its launch date. This is the same return thatKKR announced last year, the year before last, and so on. The yields for the funds that were launched before 1996 are also disclosed at 26.1 per cent. This means that

KKR has now reported annual yields of approximately 26 per cent for at least 20 years. The other private equity companies do the same."

The scientist was mocking the fact that for over two decades KKR has reported for each individual year virtually the same returns which, in view of the various crises that overshadow that period, seems totally unrealistic and impossible. In a tweet on 21 March 2023, Phalippou upped the ante. He wrote that consulting companies like McKinsey treat IRR as true returns, even though everyone knows they are nonsensical. No one in the industry achieves the oft-vaunted 25 or 30 per cent returns. "Walking on water is more realistic," writes the researcher. "But consultants take these figures, love them and say: Dear client, don't invest in private equity, where you're left to fend for yourself. Look at the differences in the yields that the sector generates, as the selection of the managers is important. You need someone with experience like me, and don't ask how much I'll charge you because it's irrelevant. I reckon… have a look: 30 per cent!" Ludovic Phalippou is merciless in his judgement on private equity and openly says that the yields vaunted by the industry are just hogwash, which corresponds to our experience.

> "In the private equity business, there is no shortage of fraud. The yield calculations are total deception."

Warren Buffett, legendary investor from Omaha, Nebraska

Warren Buffett shares the view of Professor Phalippou and stated at an investor conference in January 2023 that the way private equity companies calculate yields is absurd. While the calculation of their fees also *takes into account* the client funds that have not been drawn on yet, those exact same funds are *left out* of the yield calculation in order to tweak performance. In fact, private equity companies juggle figures like crazy and sugar-coat their performance results. Anyone who would like to know what returns private equity has actually generated over a long period of time is best advised to have a look at listed private equity companies, whose performance can be clearly tracked via the stock exchange. For a private equity basket which includes, among others, the stock-exchange listed Princess Private Equity (Partners Group), Private Equity Holding (Alpha Associates) and Castle Private Equity (Fürstenbank LGT), we calculated the performance for the period from 1 January 2000 to 30 April 2023. The results are sobering – the annual return of the private equity vehicles amounts to a pitiful –0.7 per cent (minus!). This is far worse than the yield from listed Swiss shares, which in the same period generated a return of 4.8 per cent per annum.

> "Private equity is not as good as it looks. If I were a pension fund manager, I'd look very carefully at what I'm offered."

Warren Buffett, legendary investor from Omaha, Nebraska

Anyone who has grasped the compound interest effect knows what this difference means. CHF 1,000 invested at the beginning of 2000 in a basket of private equity holding companies would have dwindled to CHF 849 by the end of April 2023 – with listed Swiss shares, the investment would have grown to CHF 2,986. What a difference! The clearly trackable results of private equity are galaxies away from the yields that the sector boasts about in its ingenious marketing brochures and slide shows. It is also interesting that in the difficult year of 2022, for example, the net inventory value calculated by Princess Private Equity only lost 1.6 per cent, while its share listed on the stock exchange plummeted by a whopping 42 per cent. This glaring discrepancy between the yield vaunted, totally legally, by the provider and calculated according to accounting principles and the effective market return is no isolated case – the same "phenomenon" can also be identified in other representatives of the sector, like Private Equity Holding. The market therefore gives a clear indication of what

it thinks of internal yield calculations (IRR) of private equity companies: nothing. Nevertheless, the pension fund of the City of Zurich, for example, enthusiastically invests in private equity and other non-transparent investments like hedge funds.

> "The market is the only democratic judge that there is in the modern world."

Ludwig Erhard, German Minister for Economic Affairs and Federal Chancellor (1897 – 1977)

At the IPEM Private Equity Conference in Cannes in autumn last year, Mikkel Svenstrup, Chief Investment Officer at the biggest Danish state pension fund ATP, went so far as to compare the private equity investment segment with a Ponzi scheme. He is not alone in that view. Vincent Mortier, Chief Investment Officer of the biggest European asset manager Amundi Asset Management, also sees characteristics of a Ponzi scheme ("Amundi warns that part of private equity markets resemble Ponzi schemes", "Financial Times" on 1 June 2022). Both critics point out that buyout companies increasingly sell their shareholdings to each other in order to make their business look better. In his own private equity funds, Svenstrup found that in 2021 more than 80 per cent of portfolio sales either went to another buyout company or were so-called "continuation fund deals". In these deals, a private equity company sells a company shareholding of one fund to another, while the private equity company in question controls both funds. Mikkel Svenstrup knows what he's talking about. After all, with ATP and its approximately 150 buyout funds, he has a broad overview of the business. According to Svenstrup, it is also typical for IRR to be massively manipulated in the private equity business. This allegation is backed up by a report by the "Financial Times", which states that performance fees are driven up through targeted transactions. These are serious allegations that aim to cut the industry to the quick.

The example of Theranos shows that there is no shortage of fraud in the private equity segment, as affirmed by Warren Buffett. The American Elizabeth Holmes was the founder and CEO of this infamous biotech start-up, whose peak valuation reached almost USD 10 billion. Her ingenious business idea was based on a service whereby a patient can be analysed for all possible ailments, quickly and cheaply, with a pinprick on their finger and a drop of blood. Elizabeth Holmes succeeded in surrounding herself with an elite of powerful investors, including media mogul Rupert Murdoch and the founder of Oracle Larry Ellison. The former US foreign minister Henry Kissinger sat on Theranos' executive board. But there was a problem: it turned out that the entire business model was based on fraud. Elizabeth Holmes was recently handed an 11-year prison sentence.

> "Fake it till you make it."

Jia Tolentino, US author and journalist, in an essay on fraud

Based on almost four decades of experience, we conclude the following with regard to the performance of private equity: On average, its annual yield *before costs* probably lies around 1 to 2 percentage points over that of listed shares. However, since the all-encompassing costs of private equity, according to consulting company PPCmetrics, are estimated at approximately 6 percentage points, the annual performance *after costs* lies approximately 3 to 4 per cent below that of listed shares, for which the total costs generally do not exceed 1 per cent. For these reasons, we consistently steer clear of private equity and also any other form of alternative investment.

> "Private equity investments are like a mirage."

Dan Rasmussen, Verdad Advisors, Boston, "NZZ", 20 November 2019

We also continue to stay away from bank shares, having abandoned them many years ago. We have never regretted that decision. This is backed up by a review of the historical yields of that industry. In the five years from 2018 to 2022, the index of European bank shares (Stoxx Europe 600 Banks) generated a *cumulative* EUR yield of –6.1 per cent (minus!), while the overall market (excluding banks) achieved a cumulative return of 33.9 per cent. Over the long-term period of 15 years (2008 to 2022), things look even worse. Bank shares achieved a cumulative return of –40.6 per cent (minus!), while the overall market (excluding banks) achieved a cumulative return of 131.1 per cent. With bank shares, investors' money clearly melts like snow in the sun. But the money can also be gambled away by reading the wrong financial books. Marc Friedrich is well known in Germany as a bestselling author and star of the speaking circuit. In "Weltwoche" No. 50/2022, he was asked what the best advice is for an investor with 10,000 francs. Friedrich advises investors to invest a third of the money in each of gold, silver and Bitcoin. Not only is the advice given by this "expert" total lunacy, but so is the fact that this nonsense is actually published.

> "I find television very educating. Every time somebody turns on the set, I go into the other room and read a book."

Groucho Marx, US comedian and actor (1890–1977)

With regard to the further development of the capital markets, it will be exciting to watch how the leading central banks of the world behave in the coming six months. Although the sky-high rates of inflation in the United States and Europe are falling, they still remain at a high level. The central banks are torn between the battle with inflation and the danger of recession. The former scenario speaks for higher base interest rates, the latter for lower ones. Added to this are the continuing war in Ukraine and a fragile banking industry, parts of which have been wrong-footed by the substantial increase in interest rates. On 3 May, the US Fed raised the base rate for the tenth time in 14 months, to 5.25 per cent. In general, it should be assumed that the central bank will call a halt and contemplate interest rate decreases no later than next year in order to ease the pressure on the economy, the banking industry and the national budget, even if the inflation target of 2 per cent has not yet been reached. The European Central Bank and also the Swiss National Bank will follow suit, but with a time delay. There are thus indications that the peak of inflation and interest development will soon be behind us, though the central bankers' target is far from being achieved.

> "I do not believe that anyone knows whether we will have a recession."

Jerome Powell, Chairman of the US Fed

It is widely argued in both print and visual media that the attractiveness of fixed-interest bonds compared to shares has increased after the substantial rise in interest rates. This is a misconception. It's a fact that the interest yield of bonds has massively increased in the US, Europe and Switzerland. For example, the annual return of 10-year Swiss federal bonds, which reached their low pointin August 2019 at –1.2 per cent, has increased in the past months to over 1 per cent. But beware: The 2 to 2.5 per cent higher return is accompanied by *even sharper price increases.* The inflation rate in Switzerland up to and during the pandemic stood for a long time at around –1 per cent, while in the meantime it has reached the 3 per cent mark. Therefore, after adjustment for inflation, the attractiveness of bonds has not increased but actually decreased. This is particularly clear if we take into account that the stock market adjustment triggered by the interest rate turnaround also makes the valuation level of the equity markets more attractive.

> "History teaches us that equity markets often begin to rise before a recession, because they have already factored in the possibility of an economic downturn."

Katie Koch, former Share Investment Director at Goldman Sachs Asset Management, New York, "NZZ", 25 June 2022

Because the interest burden has skyrocketed in the United States and Europe since the interest rate turnaround, the coalition of states and central banks has a vested interest in keeping interest rates below inflation, which is nothing less than a continuation of financial repression. Anyone who has longer-term funds in their account or invests them in bonds will be gradually bled dry on a real or inflation-adjusted basis. Investors who in the long term wish to preserve their money in real terms or, even better, multiply it are "condemned" to take risks. They can't escape the need to invest a considerable portion of their assets in shares which are attractive in the long term or in real estate – though in the case of real estate, warning signals of a price bubble are coming from various "hot spots". There are clear signs of a cooling off. According to consulting firm Fahrländer Partner, market prices of Swiss apartment blocks fell by over 12 per cent relative to the previous year in the first quarter of this year alone. Real estate experts from Wüst Partner estimate the market value of all apartment blocks in Switzerland at approximately CHF 2,400 billion. On this basis, around CHF 290 billion has evaporated in that segment alone, with corresponding consequences for pension funds and insurance companies, which invested heavily in "concrete gold" in the low interest rate period. Clearly, the rise in interest rates is also impacting the prices of real estate. In the eurozone, the European Central Bank goes so far as to warn of a "disorderly adjustment" of property prices. Based on experience, the price adjustment in this segment will be delayed compared to shares, because the market is much less liquid. Besides shares and real estate, many investors nevertheless also need fixed-income investments. Bonds of outstanding quality are and remain the best and safest investment in terms of securing one's livelihood or for investments planned for the short to medium term.

> "The property market is toppling"

Article about falling property prices, Jürg Zulliger, "NZZ am Sonntag", 21 Mai 2023

The last few months have been challenging on the capital markets. In this unstable environment, our prudent investment policy has proved particularly successful, as confirmed not least by our outstanding performance results, which in the past 18 months have been way above market and competitor levels. It should therefore come as no surprise that we reiterate our dedication to a strategy centred on quality and conservative values, and that we remain focused on investing in high-quality value and dividend stocks, as well as secure bonds.

> "There isn't a single study anywhere in the world which has proven a permanent increase in performance due to bonus systems. Short-term performance-boosting effects can only be demonstrated for highly repetitive work (humping sacks)."

Reinhard K. Sprenger, philosopher and management consultant, "NZZ", 27 March 2023

Regarding our own case, please also note: over 200 client portfolios that we handle are with Credit Suisse. The weeks and months before the regrettable downfall of this long-established bank were a challenge for us too. We knew that the assets of our clients invested in shares and bonds are protected as special assets and therefore

are not and never have been at risk, and that the funds in the accounts exceeding the state guarantee amount of CHF 100,000 would be ceded to the bankruptcy assets in the event of the bank's insolvency. Because March is the peak season for dividend payments and thus there is a significant additional inflow of liquidity, in the days and weeks before the bank's downfall our portfolio management was engaged on a daily and at times hourly basis in keeping an eye on the balance of the CS client accounts in order to keep it, as far as possible, below the guaranteed limit of CHF 100,000. With this rigorous liquidity control, we ensured that our clients were always on the safe side with Depotbank Credit Suisse. The takeover of Credit Suisse by its rival UBS ordered on 19 March by the Federal Assembly by emergency law was, from our perspective as an asset manager, a relief. However, if we consider the solution from the point of view of a citizen or taxpayer, in which roles we will potentially have to bear the consequences for the bankers' failure, our mood is quite different. This further bailout of a major bank by the state is a disgrace for Switzerland in terms of regulatory policy.

Although, in our assessment, the downfall of Credit Suisse began to make itself felt already towards the end of 2022, the transfer of all client portfolios to other custodian banks was no alternative. Quite the contrary, because that could have meant risking chaos, as on the one hand with so many securities portfolios to process Credit Suisse would have been completely overloaded (phone calls were not even answered in the relevant departments for a certain period), and on the other hand the new custodian banks would not have been able to record the new accounts within a practical time limit – after all, towering heaps of fiendishly bureaucratic administrative documents have to be processed these days to establish a client relationship.

> "Bank robbery is a game for amateurs. True professionals open a bank."
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> Bertolt Brecht, German playwright and lyricist (1898 – 1956)

As we have already informed you in a previous client letter, the new Swiss Financial Services Act (Finanzdienstleistungsgesetz – FIDLEG) and the Financial Institutions Act (Finanzinstitutsgesetz – FINIG) require us to be subject to the regulatory authority FINMA, in the same way that banks are. This is primarily because we are permitted to manage large assets of pension funds, as well as extensive private funds. Following an intensive, at times unmanageable and bureaucratic review of countless regulations and paragraphs, we hope to obtain FINMA approval this spring. Are we pleased about that? Yes. Does it make us proud to obtain that licence? No. Regulation by the Swiss supervisory authority brings no benefits whatsoever for us and our clients, except for mega-expenses on risk clarifications, risk checks, discussion recordings and the drafting and revision of regulations. A glance at the transgressions, court cases and fines in connection with money laundering or fraudulent manipulation in the world of banks, which have been regulated since time immemorial by FINMA, is enough to see that even strict regulation achieves very little. For example, in the period of 2010 to 2022, CS alone spent almost CHF 17 billion and UBS more than CHF 12 billion on legal cases. And the financial market regulator FINMA recently announced that there is a suspicion of money laundering relating to a former governor of the Central Bank of Lebanon against 12 (!) Swiss banks – this is not what the legitimate money strategy proclaimed many years ago by the Swiss Bank Association had in mind. We cannot emphasise it enough: decency and morals cannot be prescribed or regulated by the state. They are a question of character.

> “The reserve currency of the democratic system is trust.”

Dominik Meier, founder and Managing Partner of Miller & Meier Consulting and Chairman of Deutsche Gesellschaft für Politikberatung, “NZZ”, 8 February 2019

Transparency and honesty are also required with regard to the business model being implemented and in the handling of fees collected from clients. As we experts confirm, it is still common practice in the Swiss financial centre to collect retrocessions or kick-backs on stock exchange transactions, depository fees and investment products of all kinds. This is not just improper – to put it mildly, it is a disgrace. Our principle of *independence* guarantees that we consistently protect the interests of our clients and rely solely on their fees for our earnings. Unfortunately, these and similar questions and deliberations do not interest the regulator, any more than the question of whether the bank or asset manager serves a decent, honest clientele or a questionable one. The main thing is that the formalities are in order, lists have been drawn up and the right box is ticked. The supervisory authority FINMA has come under heavy fire in connection with the collapse of Credit Suisse. It is to be hoped that in future the authority will ask fewer questions, but the right ones.

> “If I myself as an investor were to look for an asset manager, and during the evaluation I could only ask it one question, it would be this: besides the direct fee that I pay you, are there any other amounts that you collect in connection with my mandate – such as retrocessions on stock exchange transactions and depository fees, retrocessions on third-party products, finder’s fees or indirect fees on own funds and structured products? If the bank or the asset manager cannot clearly answer this question in the negative, this indicates that the institution is not independent and there are conflicts of interest which are detrimental to the client. Unfortunately, around 99 per cent of financial market players would probably have to answer that question in the affirmative. Even if they do not collect retrocessions, as a rule they at least earn money on their own products.”

Pirmin Hotz, “How savers and investors can protect themselves against high bank fees”, “NZZ”, 21 February 2023

Dear client, we look forward to continuing our fruitful relationship with you. We would like to thank you for the trust and confidence you have shown in us. We wish you and your loved ones a great summer and, above all, good health!

Yours sincerely, on behalf of the entire Hotz team,

Dr. Pirmin Hotz