FÜNFUNDZWANZIG JAHRE SALMANN INVESTMENT MANAGEMENT

Investment Report – 30th June 2010

Finance Crisis turning into a Sovereign Crisis

It is only about a year back since many industrialised and emerging countries were almost outdoing each other with economic stimuli packages. Twelve months on, a much larger bill has been received than anticipated by most pundits. Faced with an iceberg emerging from the fog by the name of government debt, the command from the political bridge is now "Full speed astern!" The parallels to the Titanic could even be extended further. Then too, the crew knew that the super steamer was crossing an area with icebergs at full throttle. That such behaviour could invoke a life-threatening constellation was then, as today, totally disregarded.

From stimulus to austerity package in only 12 months

As the slamming on the brakes comes just at the end of one of the deepest recessions of the last decades and much earlier than expected, financial markets caught a severe cold during the second quarter 2010. In addition, discord on the course of action amongst governments on important issues, such as the taxation of the financial sector or world trade, weighed on prices. On both issues, the liberalisation tendencies of past years appear definitely to be broken.

Average **growth and inflationary forecasts** from „The Economist"'s June poll of economists:

	Real GDP Growth		Inflation	
	2010	2011	2010	2011
Germany	1.7%	1.6%	1.0%	1.3%
Euroland	1.1%	1.3%	1.4%	1.5%
United Kingdom	1.3%	2.1%	3.0%	2.0%
Japan	2.7%	1.7%	-1.0%	-0.2%
Switzerland	1.9%	1.9%	1.1%	1.1%
USA	3.3%	3.0%	1.9%	1.8%

When, on top of all this, attempts are made to pass the buck at the highest political levels and one head of state lectures another that he or she should entice the population to increase consumption or promote this or that behaviour, it borders on naiveté. Consumption is driven by wealth which in turn emanates from prosperity and trust in the economy and politics of the respective home country. Trade barriers and higher taxes are ill-suited to foster this condition. Whilst trust is lacking, consumption cannot be decreed by the authorities.

The participants of the recent G8 and G20 summits in Toronto reached consensus at least on one point: A road map for the reduction of the deficits in government coffers. Industrialised nations are to halve the deficit by 2013 and start reducing their debt ratios from 2016 onwards. To what degree effective measures will follow this lip service remains to be seen. Firstly, these measures only apply to the industrialised nations. Secondly, they are not even binding. Thirdly – and this is particularly important – the electorate so far is showing little willingness to cooperate, as the recurring strikes in Greece prove.

Euro down, but not out

Are these circumstances suited to supporting equity markets or the Euro? Surely not! As a consequence, the past quarter was characterised by the European debt crisis. During its course, the single currency came under significant pressure. Particularly against the Swiss Franc, the Euro fathomed new depths.

The currency union is increasingly being called into question. At an address to celebrate our 25th anniversary, the renowned publicist Dr. h.c. Beat Kappeler examined the Euro's set of problems in greater detail. "The problems of the Euro zone lie in its flawed construction. It is a currency without a country, a child born of reason" in his view, and cited the exit of some countries from the currency union as one possible solution. "Europe's true character, namely the diversity and the competition of solutions along national patterns is embodied by EFTA, not the harmonisation roller and the communitarisation of the EU", Kappeler reiterated. However, thanks to its global alignment, the free trade agreement with EFTA, its WTO membership as well as its sober and rational approach, Switzerland is well positioned for the future.

You will find the original German text of his deliberations on our homepage www.salmann.com under the heading "News/Archiv News" with the title "Der Euro – ein Unheil ohne Heil"[1]. To what degree the single currency's drop has been exaggerated in the meantime remains to be seen. As its demise is a foregone conclusion to most observers by now, a surprise recovery would not astonish. Viewed on the basis of its purchasing power, the Euro currently appears to be undervalued. Financial markets have never been one-way streets.

[1] "The Euro - a calamity without salvation"

During the course of the year, the **yields on 10-year government bonds** declined in all countries:

	Dec. 2009	Jun. 2010
USA	3.8%	2.9%
Europe	3.4%	2.6%
Switzerland	1.9%	1.5%
United Kingdom	4.0%	3.4%
Japan	1.3%	1.1%

Old Mother Hubbard's cupboard reigned supreme on the exchanges. Whereas buyers demanded significant yield premiums from PIIGS countries when compared to core Europe, corporate debt of good quality and issues of strong countries continued to be very popular. To many, a safe haven was the measure of all things during the second quarter. Accordingly, yields on government bonds of high quality nations continued to drift markedly lower.

Compared with the end of 2009, these are now between 15% (U.K., Japan) and 21 to 24% (Switzerland, Eurozone, USA) lower. The public sector of the periphery countries has to dig significantly deeper into its pockets than in solidly rated central and northern Europe. In Greece, yields on ten-year government bonds are currently in excess of 10% and with that at a level above core Europe never seen before.

Parallel to this, prices for default protection on Greek government bonds (Credit Default Swaps) shot up, in spite of a joint EU and IMF rescue operation to the tune of 750 billion Euros. Unchanged, the market continues to harbour doubts as to Greece's ability to one day repay its debt. Trading at 45 and 47 respectively, neither Germany nor Switzerland managed to be among the top five countries at the quarter-end.

Credit Default Swaps (CDS) for five-year government bonds as of 30th June 2010[2]:

Low insurance premiums, considered save by the market:

Norway	25
Finland	35
USA	38
Denmark	40
Sweden	42

High insurance premiums, considered unsafe by the market:

Venezuela	1335
Argentina	970
Greece	909
Ukraine	629
Dubai	497

Market sentiment worse than the actual situation

Looking at equities, one cannot escape the impression that sentiment is worse than the actual situation. Most equity markets corrected markedly in the three months period from April to June and, with the exception of Germany, are currently trading below levels at the beginning of the year. Economic data are currently embracing the entire spectrum between "disappointing" (e.g. US housing market and employment) via "not too bad" (e.g. European Purchasing Managers Index) to "booming" (e.g. ifo Business Climate Germany). Whereas the purchasing managers' index is currently at the levels of 2005 and 2007, in spite of a slight decline, the German ifo Business Climate Index is in boom territory. Readings in this quadrant are generated when survey participants rate both the current situation as well as the expectation as "upturn".

[2] Source: Credit Suisse Research, Technical International Chart Pack

Change in **Equity Markets since beginning of the year:**

		Dec.2009	Jun. 2010	Change[3]
Asia ex Japan	DJ STOXX A/P	436.7	385.7	**-11.7%**
Germany	DAX	5'957.4	5'965.5	**0.1%**
Europe	DJ STOXX 600	253.9	243.3	**-4.2%**
Japan	TOPIX	907.6	841.4	**-7.3%**
Switzerland	SPI	5'626.4	5'407.8	**-3.9%**
USA	S & P 500	1'115.1	1'030.7	**-7.6%**
World	MSCI World Index	299.4	268.3	**-10.4%**

The **equity funds employed by us** achieved the following returns in the current year[4]

Aberdeen Asia Pacific (USD)	**1.1%**
Invesco Asia Infrastructure (USD)	**-7.7%**
Nomura ETF Toppix (Yen)	**-6.3%**
Performa Fund - Asian Equities (USD)	**-7.6%**
CIIM European Stock Portfolio (EUR)	**3.3%**
Performa Fund - European Equities (EUR)	**-3.4%**
Neuberger Berman US Equity Value (USD)	**-11.3%**
Performa Fund - US Equities (USD)	**-6.6%**

Other funds employed by us developed as follows:

BlueBay High Yield Bond Fd. (EUR)	**3.8%**

Changes in Asset Allocation

At its meetings, the investment committee decided upon the following changes to the asset allocation for medium-risk balanced portfolios not subject to client's restrictions:

Liquidity: As a consequence of the reduction in the European equity allocation (see European Equities), the money market allocation was increased. The target allocation currently is about 11.5% compared to 8% earlier. The money market allocation acts as a parking position as well as a tactical reserve. As a consequence of the unchanged loose Central Bank policy, yields in all major currencies continue to be negligible.

Bonds: We still rate purchases of sovereign debt issued by countries of prime quality as unattractive. In contrast, we focus primarily on corporate bonds of the mid and upper quality segment, plus an addition in high-yield-bonds. The target allocation for bonds overall in a balanced portfolio remains unchanged to our last quarterly report, at about 37%.

US Equities: With a price/earnings ratio of about 15 based on historical and 12.6 based on estimated earnings, US equities are attractively valued. We did not make any changes to the allocation during the past quarter.

European Equities: At the end of May, we reduced the European equity allocation by 3.5% percentage points. Reasons for this were, on the one hand, signs of a weakening in the recovery previously observed in the economy and on the exchanges. On the other, thanks to the rising prices in the preceding months, the European allocation had grown to exceed the size targeted in our strategy. Currently the share of European stocks in our "recommended portfolio" amounts to about 21%.

In spite of rekindling concerns on the exchanges, one should not forget that European equities are valued attractively from a fundamental point of view. Should the economy not drift into a second recession, which we do not currently anticipate, the current level of dividends is likely to remain more or less stable. The current dividend yield of the index of 3.5% is based on this. Consequently, investors do not only get 90 basis points higher revenues than on 10-year government bonds, but also an opportunity to participate in higher dividends in the future. Amongst others, the weak Euro is providing Europeans with a significant competitive advantage in export markets.

Asian Equities: In the long-term Asia remains one of the most promising regions for equity investors. The development of an affluent middle class provides growth rates the West can only dream of. Naturally, globally-active companies in the West also benefit from this effect. Local companies however, have the advantage of participat-

[3] Development of index in local currency. Exceptions DJ STOXX Asia/Pacific ex Japan and World in USD.
[4] Performance in currency of fund. Source: Bloomberg.

ing directly in the growth, whereas the results are always watered down by less dynamic developments in other regions with greater turnover. Our allocation to Asia (including Japan) remains unchanged at about 15%.

Non-traditional Investments: We are currently not exposed to this sector.

Summary of our current asset allocation:

Investment Category	
Money Market	overweight
Bonds	underweight / short Duration
Equities USA	underweight
Equities Europe	neutral
Equities Switzerland	neutral
Equities Japan	neutral
Equities Asia	overweight
Non-traditional assets	underweight

Measured on the **price/earnings ratio**[5] using the latest 12 months profit figures, all equity markets have become more attractively valued (green):

	Dec. 2009	Jun. 2010	Change
MSCI Word Index	32.1	15.5	**-52%**
DAX Index/DE	60.2	14.8	**-75%**
DJ STOXX 600 Index/EU	58.2	14.8	**-74%**
S & P 500 Index/USA	24.3	14.9	**-40%**
SPI Index/CH	37.8	12.3	**-67%**
TOPIX Index/JPN	n.a.	30.5	n.a.

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

	Price / Book	Div. Yield
MSCI World Index	1.7	2.6%
DAX Index/DE	1.4	3.2%
DJ STOXX 600 Index/EU	1.5	3.5%
S & P 500 Index/USA	1.9	2.1%
SPI Index/CH	1.8	2.8%
TOPIX Index/JPN	1.0	1.9%

Salmann European Stock Portfolio continues to be ahead

Indexed investments have experienced a great boom in recent years. "Why make the effort and bet on individual shares when the passive replication of an index yields the better results over the long-term?" is the argument often put forward. Really always better results? Not in the case of the European Stock Portfolio (ESP), which we have applied to larger, equity-oriented portfolios since 1992, selecting the 25 most attractive European stocks according to value criteria.

In the period from 1992 to 2009, this portfolio beat its reference index in 11 out of 18 years. In the year to date, the ESP is equally ahead of its benchmark, the Dow Jones Stoxx 600. Cumulatively, the result is quite presentable. Whereas the benchmark delivered a performance of 154.3% over the 18.5 year observation period, the ESP managed a cumulative performance of 413.4%. Expressed as an annual average, the result was +5.18% for the index versus +9.25% for the European Stock Portfolio.

Alfred Ernst
Vaduz/Zurich, 30th June 2010

[5] Source: Bloomberg

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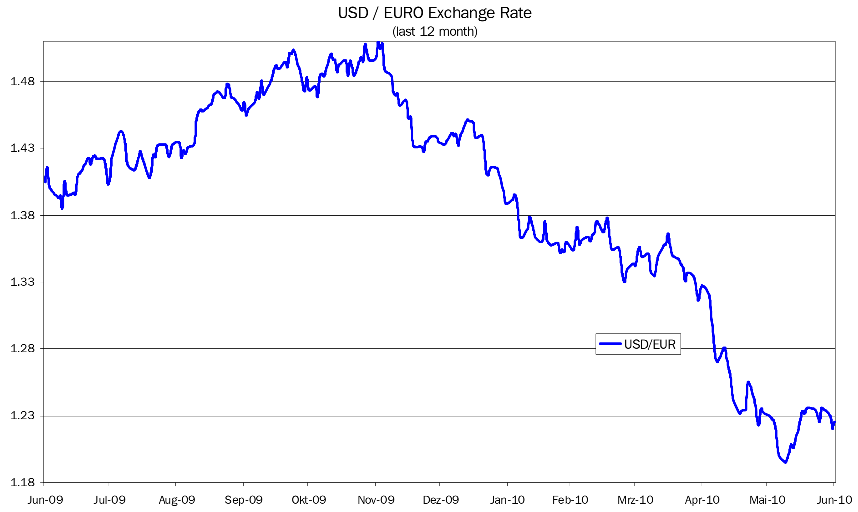

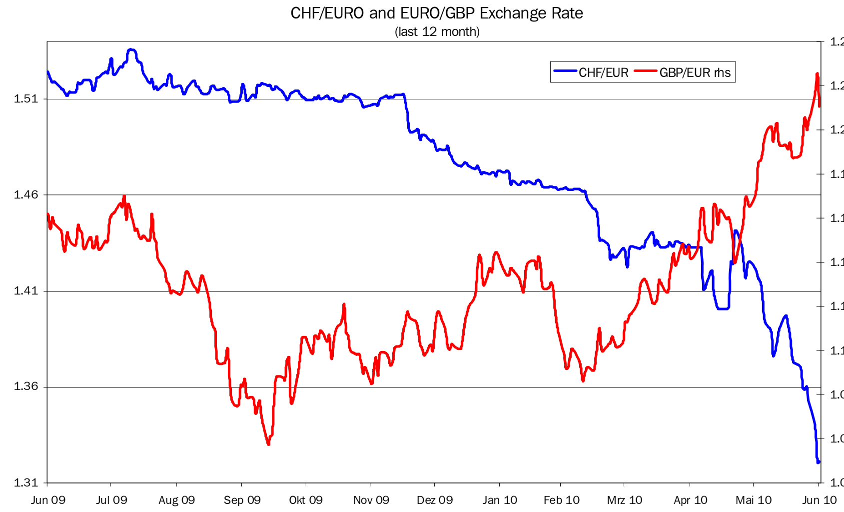

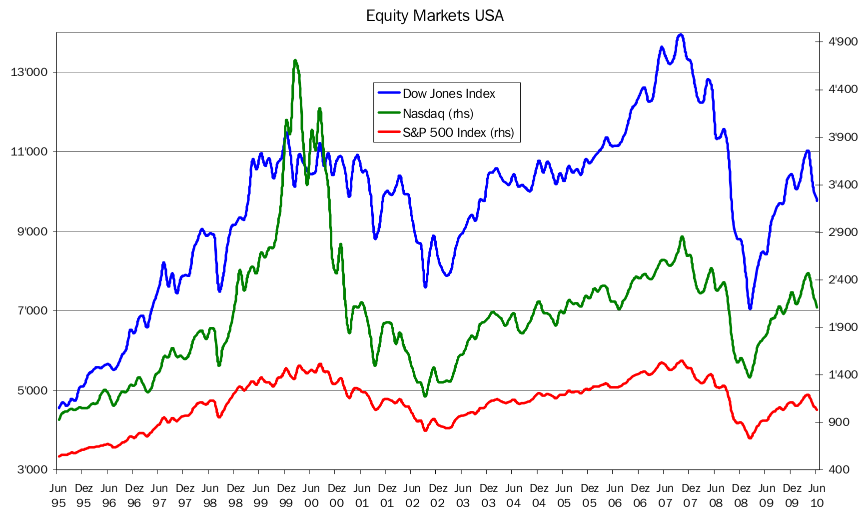

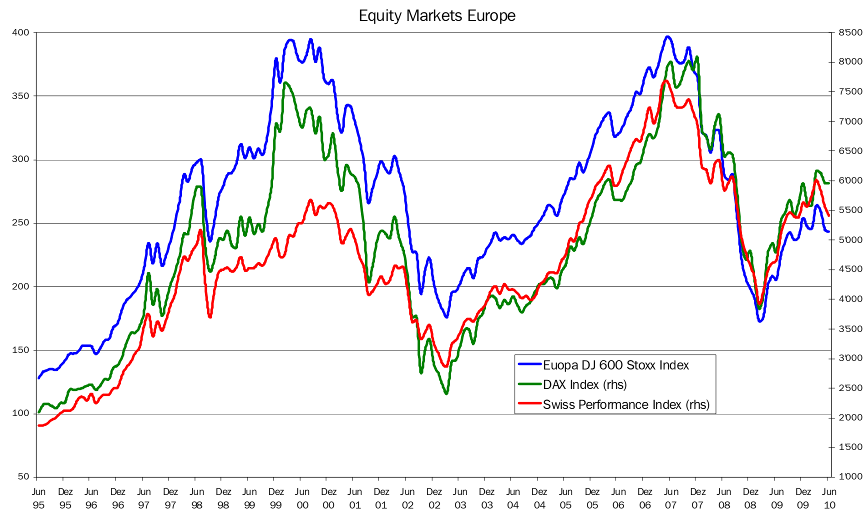

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