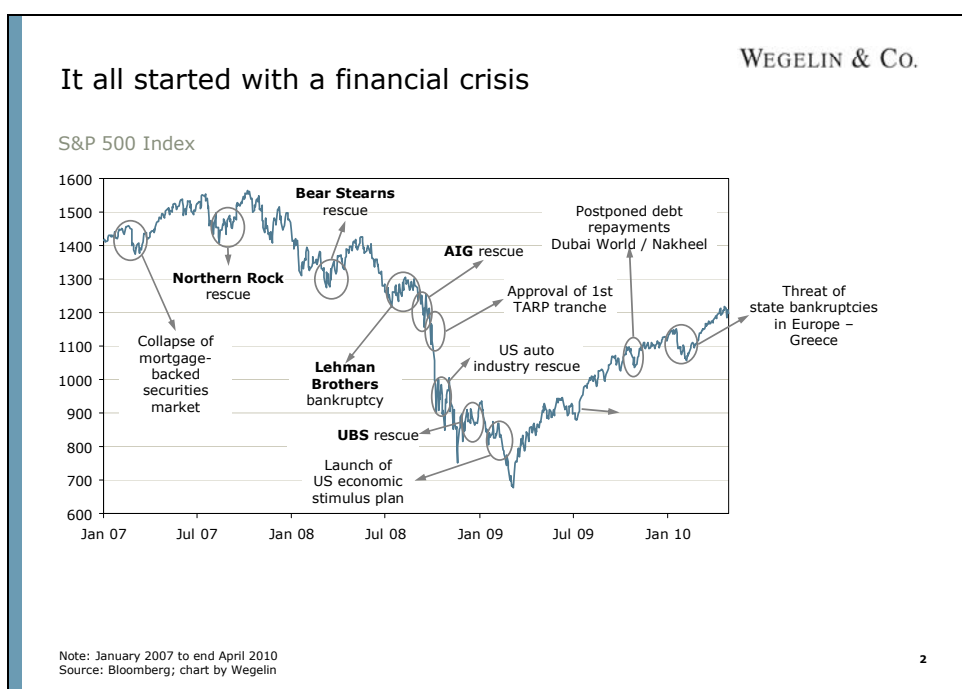


Wegelin & Co. Private Bankers is one of the 13 banks in Switzerland that are still privately owned. Within Switzerland, we are well-known and we have been a fast growing private bank for the last couple of years.

We feel that the situation today is much more difficult than it was in 2008. Yes, 2008 was violent and we saw the volatility charts in Christoph Schenk's presentation. But in 2008, you knew at least where to "hide", be it in cash or in government bonds. Those were safe places. Today, nothing is safe anymore.



The big conundrum for us is: How did we get into this situation, and how do we now get out again? By 2008 we had overextended ourselves, not only in the USA but in other markets, too. People were using their home as their ATM machine to consume more and more, and all of a sudden it all broke down.

We had the collapse of Bear Stearns as they were sitting on too much leverage. Bear Stearns was a rather small house but still, everyone was afraid that they would go bankrupt, and they nearly did. In a free market economy, bankruptcies ought to be normal. But Bear Stearns was rescued by selling it to JPMorgan (with a bit of persuading done behind the scenes...).

Unfortunately, Bear Stearns was only the first victim, with many more to follow. A few months later, it was Lehman's turn. Lehman was much bigger. There were again attempts to rescue Lehman, but nobody was prepared to swallow it. Lehman was let go bankrupt.

A bankruptcy of an investment bank with the size of Lehman had never been rehearsed, neither by the market, nor by the regulators and it created a big mess. In its aftermath, everyone was afraid to let another bank go bankrupt and from then on, the large banks had an implicit guarantee: "You are going to get rescued". That implicit guarantee distorted the economic world order. It is still distorted and we think that we now live in a more dangerous world. More rescue missions followed, and it was not only the rescuing itself that was a problem, but also how it was done.

We learned in business school that in a bankruptcy, the first people to pay the bill are the equity holders. They get wiped out. Once they are wiped out, the next group is the bond holders. They either get wiped out, too, or they have to accept a haircut until the debt is paid. And whatever is left first goes to the wiped-out equity holders as a leftover dividend.

What happened in those rescue exercises was very different. The governments decided not to wipe out the equity holders, nor the bond holders. They gave government help, be it in the form of capital or in the form of guarantees.

They should have wiped out the equity holders in exchange for putting in fresh government capital. The governments could then have put the bank again up to the stock market and made a profit out of it, because most of the rescued banks are still good firms that make money again and pay bonuses again. Had the governments wiped out the equity holders and put a haircut on the bond holders, the public would at least have seen the culprits losing their money and it would be less upset.

Why is this relevant today? For the simple reason that we now re-live the same thing, but on a much grander scale.

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### From Bear Stearns to Greece

Greece = Bear Stearns of world of states?

The diagram consists of several elements:
 

- A torn-edge Greek flag on the left.
- A blue arrow pointing from the Greek flag to the European Union flag and the International Monetary Fund logo.
- A blue square with the JPMorgan Chase logo below the Greek flag.
- A black square with the text 'BEAR STEARNS' on the right.
- A white arrow pointing from the 'BEAR STEARNS' square back to the JPMorgan Chase square.

5

Since the governments spent so much money to plug the big holes – dozens or even hundreds of billions of dollars or euro – the governments themselves are now in trouble. We are right now seeing what happens with Greece, but it is not only Greece. Instead of putting a haircut on Greece, it is now the larger governments, essentially Germany, fixing the hole. Why is that a problem?

Suppose I am a private banker and a client comes to me and asks me to invest his savings prudently. Until now that used to be cash and government bonds. But is this still safe?

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### Risk premia on government debt is real...

... and it's not just Greece

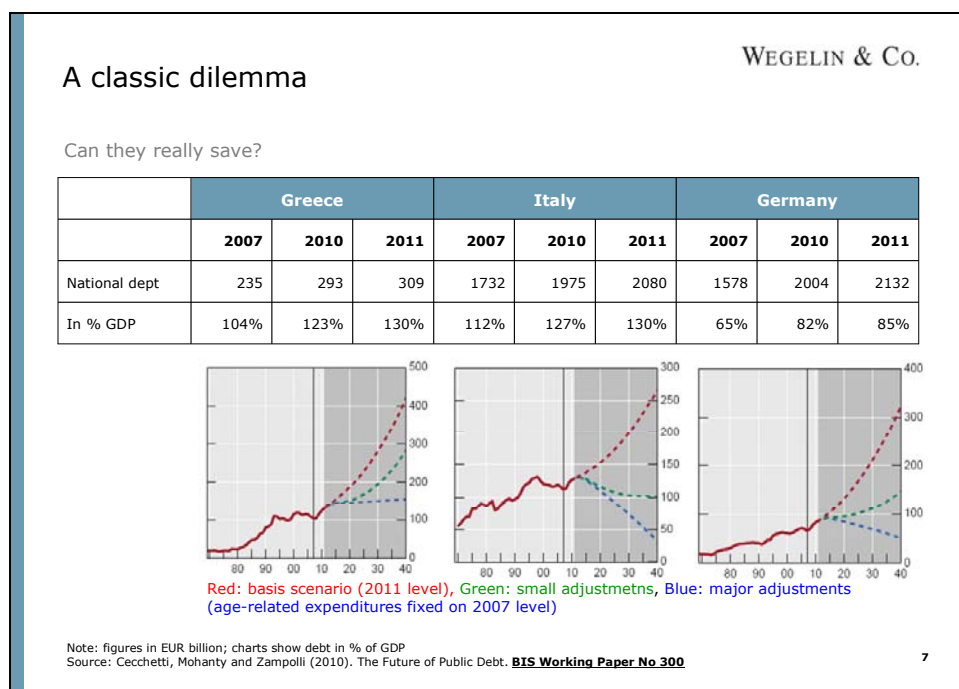
iTraxx CDS Indices (basis points)

Index	Maturity	Basis points	Absolute
iTraxx Sovereign Western Europe Index	5 years	110.5	110,500 Euro
iTraxx Europe Index	5 years	89.34	89,340 Euro

Note: "Absolute" is the premia to insure EUR 10 million in government and corporate bonds respectively  
 Source: Bloomberg; chart by Wegelin

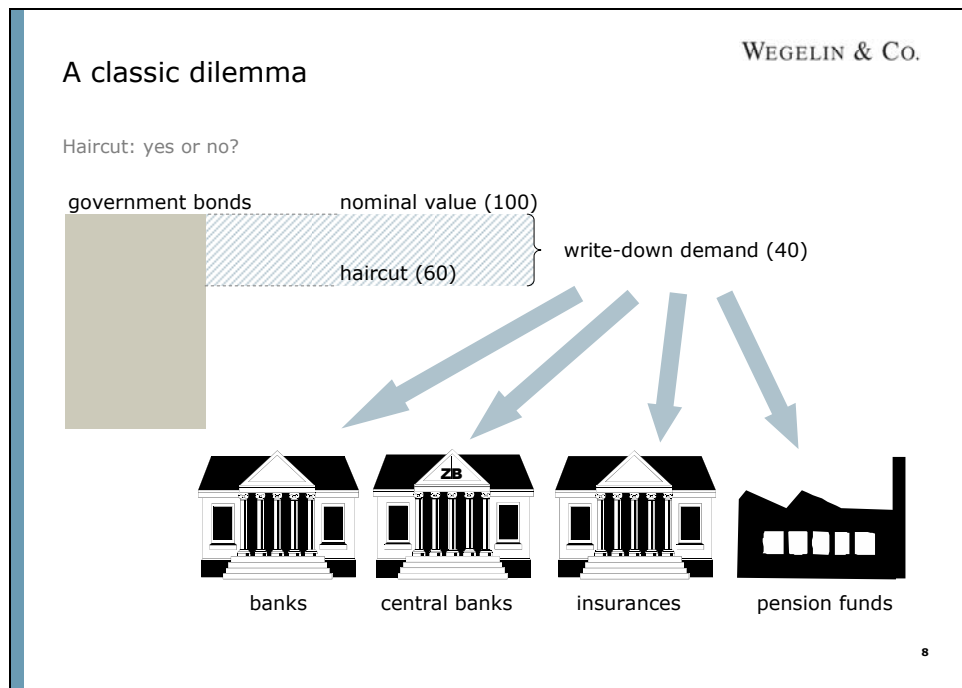
6

The market does not believe that it is safe. These are the CDS rates of European government debt versus the CDS rates of European large corporate debt. For the first time it is more expensive to insure government debt than corporate debt. The market would rather give Coca Cola credit than the US government because – even if everyone goes bankrupt today – people will still be drinking Coca Cola tomorrow. That is going to create a revenue stream for Coca Cola, allowing them to service their debt. Whether the US or the Greek taxpayers still have money to service their government debt, is a question. And even if they have it, can the government collect it, or have the citizens all moved it into some offshore accounts?



Now we have discussions whether and how the governments can reduce their costs and save on future expenses. History gives us evidence that, if you look at all major governments and their debt, they were not able to significantly reduce their payments. They only came out of heavy debt via two levers: One was economic growth – make the pie bigger. The other was inflation. Whether that was one big jump of inflation or a slow process that took fifteen years to complete, did not matter much in the end.

Governments generally do not like to put large haircuts on their bonds. Only very few of them do it.



The problem with haircuts is that some of them cut into people's ears. In other words: they hurt. We all know where our government bonds are. They are for instance in our pension funds. So suppose you are a German citizen and the German government decides to put a 20% haircut on its Bunds. Your pension fund savings go down immediately. The next stakeholder group that suffers is the insurance companies who are also large government bond holders – just look at their balance sheets – then the banks, and also the central banks.

Why is it so difficult to achieve a turnaround? Why is it so difficult for most governments to save? Look at Singapore and Greece as two very illustrative case studies.

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### It is a question of fundamental values

A deep rooted problem of general philosophy

**"No entitlement"**

**Singapore:**


- Foreigners not allowed to drive taxi
- As almost every man can drive a car. Taxi driving has become a first "wall of defence" before unemployment
- Result: Most taxi drivers in Singapore today between 45-65 year old local men – btw. as side effect they also know the city...



**"Entitlement"**

**Greece:**

- 580 dangerous jobs with right to receive pension at 50 (women) / 55 (men)
- 95% of your last salary paid as your pension
- Hairdresser, orchestra musician (trumpet) are qualified as dangerous jobs

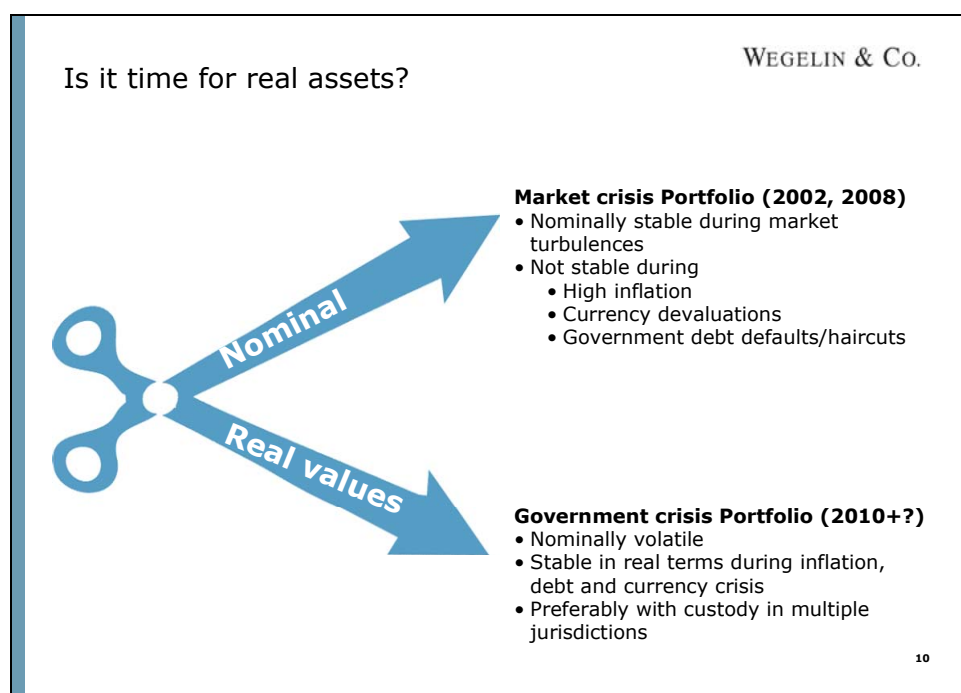


9

In Singapore, the Government passed a law forbidding foreigners to drive taxis. That may seem very strange. The government's strategic thinking behind it was that, if a Singaporean man became unemployed, he probably had a driving license. The intention is that unemployed men should become taxi drivers before they could seek government assistance. That is the mentality in many Asian emerging markets. You are expected to first look after yourself.

Contrast that to other countries, for example Greece. Greece once passed a law allowing people who worked in "dangerous professions" to retire at 50 (women) or 55 (men). No doubt, that law was well-intended and sensible when it was introduced many decades ago. It was targeted at miners, construction workers and similar jobs. Today, 580 professions qualify under that law as "dangerous", including hairdressers and trumpet players! Europe lives with a mentality of guarantees and entitlement. The expectation is that you are entitled and guaranteed to get child care, go to school for free, then to university. You are guaranteed unemployment assistance and pension. It is a system that makes only those look after themselves who are not content with a minimum standard of living. That is why we think it will be difficult for Europe to extract itself from the mess.

Now what does that mean for our asset allocation?



We share Peter Mathias' view that we are at an inflection point. Up to now, we lived in a "nominal" world and we geared up for tough times with what we call a "Market Crisis Portfolio": When markets go wild, or investors are afraid, you can always rely on fixed income government bonds. Let's assume now for a moment that governments implement haircuts on their bonds, or inflate themselves at some point in time in the future, or they devalue their currency. All of these options have happened.

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Realo® as the new “safe” portfolio

Some examples

**ANGLO AMERICAN**  
Anglo American is one of the worlds largest diversified mining and natural resource groups. The company mines precious and base metals, as well as coal and diamonds.

**ROYAL DUTCH SHELL**  
Royal Dutch Shell is a global group of energy and petrochemical companies. Aside from its main business in the exploration and processing of oil and gas, Shell is also active in the renewable energy sector.

**Fortum**  
Fortum is a leading energy company with a strong presence in Northern Europe. Its activities cover the generation, distribution and sales of electricity and heat, as well as the operation of power plants.

**gsk** GlaxoSmithKline

11

We currently have interesting discussions with our clients. We are telling them that we would like to replace implicit certainty or implicit guarantee, with explicit uncertainty. We tell them to move a substantial part of their money out of what we call “the old safe” into what we think is “the new safe”.

The main aim of the Wegelin Realo® strategy is to preserve wealth and real purchasing power in the long-term. The portfolio focuses on investments with real-value characteristics such as physical gold and stocks. As a precious metal, gold is inflation resistant and largely immune to political risk. Moreover, the demand for gold may well increase further considering the rising uncertainty surrounding paper money and the number of countries caught in the debt trap. In the stock selection process, the main criteria include pricing power, minimal indebtedness and strong cash-flows. For diversification purposes, currency reserves are also included in the portfolio, whereby the strategy focuses on countries with excellent fundamental data or countries that are rich in natural resources. Although the investments selected are measured in a defined reference currency and are thus subject to substantial price fluctuations, they nevertheless offer better protection against inflation and currency turbulences than apparently “safe” nominal value investments with lower price fluctuations.

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**Select issues from the question and answer part**

*Q: What is the time horizon for your new safe portfolio – two years, five, ten?*

A: Until we see clearer how the government debt situation develops. As soon as we are confident that things stabilize, this portfolio would become one component of the overall portfolio.

*Q: How will governments extract themselves from the problem?*

A: History tells us that inflation will be the most likely way, because that is least painful.

*Peter Mathias:* In the old days, government bonds were typically held by retail investors. They didn't know what inflation was, and by the time they realized it, it was too late. Today, most government bonds are held by sophisticated institutional investors. If governments try inflation, the cost of their debt raising will shoot up. Let's look at the U.S.: The average maturity of the US debt is four years, obviously to keep the interest rate low. Interest expense is already 10% of the US government budget. If you extend the maturity, it will rise quickly to say 20%. Someone wrote an interesting article stating that a great power declines when its interest rate expense exceeds its defense budget. The U.S. interest expense is now over 10% of the government budget, defense is 18% of the government budget. If we extend the maturity of our debt or do not handle inflation well, the deficit will go up immediately. Governments will need to downsize. This is what the UK is doing right now, and it is what corporate America started in the 1980s and corporate Europe ten years later. Today, those companies are in good shape. If we are able to innovate in the public sector in the same way as was done in the private sector, those credit default swap spreads will come down, and governments will be in a good shape.

The point for us is: The financial services industry has almost always had an implicit guarantee. If you look back at history, in the 19<sup>th</sup> century, it was very common for a bank to have 25% capital. When they created the Federal Reserve in 1913, the 25% standard was reduced to 18%. Then, the rating agencies emerged and the 18% came down to an average of 12%. At that time, banking became a growth business. If they did well, assets grew faster than GDP, and the banks attracted smart people who drove innovation. They invented new financial products and services to try to grow financial assets. And they did it with an implicit guarantee which allowed them to run down the capital base to 3%. When Citibank went down in the crisis, as we all remember, it had 3%. If you take the implicit guarantee away, banking is a very difficult business to produce the kind of excess returns and growth that we have gotten used to.

We ended the first segment with a look into and a rethinking of the relationship between governments and the financial system. The financial system cannot exist without governments, because it is using currency notes to store value. The governments control the interest rates. In effect, they control the value of financial assets. We all know that, if the price of milk goes up, that is bad as it means inflation. We are very good at controlling wages and price inflation. We know how to control interest rates and employment. But we do not control credit, and we do not control asset prices. There is no place for credit and asset prices, neither in the monetarist school, nor in the Keynesian school. Bank lending is like an exogenous variable. Rising asset prices do not exist in either monetarist or Keynesian theory. So, what we had over the last few years was actually quite predictable. Since it does not exist in any of the theory books, nobody paid it much attention.