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How to Build Your Own “Anti-Stock” Portfolio Abroad

Today’s commentary is by Karl Weber, Macroeconomist for Weber, Hartmann, Vrijhof and Partners WHVP, an independent asset management firm based in Zurich, Switzerland.

Dear A-Letter Reader,

Words like “banking system collapse,” “systemic risk” and “market meltdown” are no longer just topics discussed in glossy financial magazines.

No this is much closer to home. The recent failures of once respected financial institutions, like Bear Stearns, have drawn these very real concerns to the front pages of newspapers from Zurich to Tokyo.

Even your average investors are now asking if we’re facing a severe and prolonged recession.

The combination of an ailing banking system and an economy sliding into recession make a daunting pair. And banks are responding to this crisis by enforcing more stringent lending practices – just when they should open their gates and provide easy credit for anyone still willing to invest.

The Emergency Room Fed

In case you’re wondering: Yes, Fed Chief Ben Bernanke has studied the Great Depression. He knows he has to keep the banks functioning. He knows he has to stop any potential runs on banks by angry clients. So he’ll give banks as much liquidity as they need to keep lending.

These days, the Federal Reserve has turned into an emergency room, and Bernanke is the chief surgeon on call. He has already approved all available options to stabilize the sickly banking shares. He’s lent money to investment banks in exchange for mortgage-backed securities. He slashed interest rates in just six months from 5.25% to 2.25%.

Perhaps this is all too little, too late. These disrupted balance sheets leave the banks no choice but to dismiss numerous staff. Consumer sentiment has already been hit hard, not only by dimming job prospects but also by a substantive drop in house prices and stock market losses.

So Everyone Wants to Know: What Do You Buy Now?

At my company, WHVP in Switzerland, our asset management clients have been calling almost every day since this credit crunch began last summer. They all want to know if their wealth is still protected. And they also want to know, “should we be buying any stocks right now?”

Let me be the first to say: You are well-advised to let the dust settle before you start buying equities in this type of market. First of all, the classic price earnings ratios of the largest markets are not indicating a gross undervaluation yet. In other words, equity markets will have to drop a lot further before they can be considered “bargains.”

Also, the S&P 500 index’s average dividend yield currently stands at 2.2%. That is far too low to be considered a “peak” in this recession. Over the last 108 years, the market’s dividend yield averaged 4.2%. Its last major peak occurred during the recession 1990-1991 at 4%. We’re still far below that.

Banks Are Still a Mine Field

In this context, battered bank shares look like better deals – even though they're like a mine field and choosing the wrong one can be devastating. In the U.S., the banks' average dividend yield is 5.4% in U.K. 6.7% and in Germany 4.3%. However, transparency remains poor. Many large banks have inadequate equity or rely too much on short-term financing. For that reason, my company won't touch them.

Another problem with banks is that the credit crunch has moved far beyond sub-prime mortgages. Carlyle Capital recently defaulted on US$17 billion of its loans. It saw its market value evaporate within days – and that was with a portfolio deeply loaded with AAA-rated mortgage-backed securities!

Again, we won't touch the major banks until they have improved their capital base.

The "Don't Catch a Falling Knife" Swiss Portfolio

There's an old saying on Wall Street: "Don't catch a falling knife." And right now, that's how we're protecting our clients' assets: We're staying as far away from stocks as possible. Instead, we're focusing on currency diversification.

The currency asset allocation has been extremely important in managing multi-million dollar portfolios this year. We're focusing on major holdings in the Swiss franc (CHF), and the euro. Both of these currencies' strong performance lately should ease fears about a possible increase in Europe's inflation. Plus, recently the Swiss franc has once again proven worthy of its reputation as a traditional safe haven currency.

We like the Japanese yen from a strategic point of view. Solid fundamentals (such as an impressive current account surplus or the undervaluation regarding the purchasing power parity) support the Japanese yen case. As for the U.S. dollar, we usually don't hold U.S. dollars in our clients' portfolios, so our clients can diversify out of the dollar.

Besides currencies, we also keep a diversified portfolio for our clients with:

- High-quality short-term bonds (50%)
- Underweight of equities (10%-15%)
- Precious metals (10%-20%)
- Cash (around 15%)

But the day is coming when we'll start cherry-picking stocks again. We have our eye on single stock positions in very ultra-specific areas like Canadian oil trusts. But we have kept the powder dry for those days to come, when these equities will be screaming buys once again.

Until then, please be careful what you select out there – and don't bother trying to catch a falling knife in these volatile markets.

KARL WEBER, Macroeconomist,
Weber Hartman Vrijhof & Partners Ltd (WHVP)
Schaffhauserstrasse 418
CH-8050 Zurich
Switzerland
Tel: 41 44 315 77 77 (01141 44 315 7777 from U.S.)
Fax: 41 44 315 77 78 (01141 44 315 7778 from U.S.)
Website: www.whvp.ch

EDITOR'S NOTE: As Karl correctly points out, "banking system collapse," "systemic risk" and "market meltdown" are all too familiar terms these days. So what is the U.S. government doing to prevent such shocks to the financial system? NOT MUCH. Treasury Secretary Paulson announced a new government oversight plan this morning that shuffles around a few government agencies. In truth, it's doubtful this plan will result in effective regulations on investment banks or hedge funds – both of which have been at the center of this sub-prime shock. Bottom line: Expect more shocks to come in the months to come. **Discover the safe investment strategies** you need to protect your wealth in the meantime.

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THE SOVEREIGN SOCIETY Ltd.,
98 SE 6th Ave., Suite 2, Delray Beach, FL 33483
TEL: 888-856-1403

Send comments to editor@sovereignsociety.com

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