ARVEST
FUNDS AG

Monthly Report for May 2009

Fund manager's strategy report

Too good to be true

Since March 9, 2009, stock prices have once again been rising across the board. Many investors have had little confidence in this phenomenon, as in recent months the stock market has seemed to know only one direction, namely down. On balance, however, the losses incurred so far this year have been recouped. The S&P Global index, which had lost 27% of its value since the start of the year, has risen by nearly the same proportion since March 9.

The most important issue being discussed worldwide in this regard is the question of whether we are dealing with a permanent trend shift or just another bear market rally. In answering this question, it helps to dig deeper into the causes of this price increase.

The most important driver of these price recoveries is said to have been the surprisingly positive quarterly results of financial institutions. After banks were hit hard by the crisis, like Citigroup or Bank of America, reported quarterly profits in the billions, hope became widespread that the crisis might have hit the bottom, suggesting a signal to buy.

As I said in my interview with the newspaper Finanz & Wirtschaft in December of last year, many pessimistic expectations are already reflected in the stock prices of many companies. However, in the case of securities from the financial sector, great caution continues to be called for. In accordance with our value strategy, all ARVEST analysts pay special attention to the solidity of a company's balance sheet prior to making any investment decisions at the end of the analysis process. However, despite positive quarterly results, the criterion of a solid balance sheet has by no means been fulfilled in the case of many financial securities.

Softening of accounting rules

Evaluating a bank's balance sheet is no simple task as it is; to make matters worse, the figures available for analysis are now anywhere from limited to completely meaningless. The softening of accounting rules is not far removed from the legalization of what Madoff did with his investment fund: Assets are no longer valued at their current market prices, but based on an individual's own wishful thinking. Less critical voices would favor the term *model calculation* in this case. Many financial institutions remain on such shaky ground that many appear to want to solve the problem by once again allowing for illusory balance sheet evaluations. However, concealing risks and losses will not lead to their disappearance now or in the future.

Operationally, banks have always generated a profit, at least in traditional business sectors. Even in the interest rate differential and commissioned trading businesses, most banks were able to generate ample profits last year. Citigroup, for example, earned operating income in these two areas of nearly 76 billion USD. The problem in past quarters wasn't operating profit, but primarily the write-off of balance sheet assets.

Despite the near-abolishment of the mark-to-market rule, the financial sector isn't yet anywhere close to being out of the woods. Added to the extraordinary write-offs are the completely ordinary write-offs from credit losses that become necessary in any recession. Banks prepare for this regularly recurring storm by building reserves for these credit losses. While Citigroup had established reserves totaling 4.5% of outstanding loans by the end of March, Bank of America's reserves were just 2.5% (at the end of December). However, given the severity of the crisis, default levels of up to 10% of all outstanding loans are not unlikely. According to this figure, Citigroup would need additional reserves of at least 45 billion USD; BoA would need over 75 billion USD.

Crisis far from over

Clearly, the financial sector will continue to deal with significant price fluctuations in the future. The ARVEST Investment Committee thus sees no reason to again invest heavily in the financial sector, with few exceptions. For the time being, yesterday's biggest losers will very likely remain the losers of tomorrow. There are also enough companies outside the financial sector that have had to deal with equally sharp price drops but that show a much better opportunity-to-risk profile thanks to solid balance sheets and business prospects.

Our conclusion: Don't be dazzled by isolated positive quarterly results, as these figures are no longer comparable with prior data. The basis for any investment decision remains sound analysis and, in the future, an even greater dose of skepticism.

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