

Invest now if you have the guts, nerves — and money

Equities are cheap and offer long-term value, while despite the worsening economic outlook, inflation remains a big threat for fixed income investors, says Erwin Heri, chairman of Swiss private bank Valartis, and chair of the investment committee of Publica, the Swiss government pension fund. Molly Guinness spoke to Heri about his investment philosophy.

Traditional asset managers have witnessed value destruction on a once-in-a-generation scale during the financial crisis, but says Erwin Heri, one of the grand old men of the Swiss financial services industry, 2009 will go down in history as a great year for investors.

Amid the debris of collapsing global equity markets the former chief financial officer of Credit Suisse is far from upbeat about the economic climate. However, he remains a determined long term investor who still believes in equities, even in the battered banking sector.

“Selling products that are totally not transparent attracts crooks. The business model for a crook is opacity”

“When we look back in five years’ time,” he said, “we’ll say 2009 was a good year to buy. If you have the courage, the guts, the nerves and the money, invest now. Invest in a broad index. I would shy away from individual financials, but they are a good idea within a broad index.”

He takes comfort from history, pointing out that in the last 200 years the equity markets have never lost more than about 50% — around today’s levels — before recovering.

“I’m not saying it will turn now,” said Heri, “but some companies are trading at 20 cents on the dollar. Buying a dollar for 20 cents is not bad — though buying one for 25 cents looked pretty good a few months ago. And perhaps it will look good at 15 cents in a couple of weeks’ time.”

One of his biggest worries as a fixed income investor is the old enemy itself — inflation. He is dubious about the prospects for bonds because he believes that central banks will act fast to put up rates as soon as the business cycle turns.

“Inflation has a tendency to explode once it’s started,” he said. “Once the cycle turns central banks will have to go through the valley of tears and increase rates immediately or there will be five to 10 years of huge inflation. I’m very optimistic the central banks understand this.”

The quick pace of rate increases that Heri envisages will, at the time, seem premature for some eurozone countries, but he believes the advantages of the single currency still outweigh the disadvantages.

“Imagine what would have happened to the Spanish peseta in this crisis. At least they’ve been saved currency volatility. Look what’s happened to sterling. I see Brits in Spain — actually I don’t because they can’t afford it any more.”

Low yields — Swiss two year mid-swaps hovering around 0.9% for most of the year — and miserable equity conditions have made life tough for pension funds, many of which face widening deficits. But Heri, who is chairman of the investment committee of the Swiss government pension fund, Publica is not overworried.

“It’s an unpleasant situation, but it’s not dramatic,” he said. “Pension funds have a lifespan of 35 to 40 years.”

Publica has a Sfr30bn portfolio of which Sfr18bn (60%) is invested in bonds. And while Heri says that corporate paper is in many ways attractive, liquidity concerns dictate its focus on government paper.

“The corporate bond market in Switzerland is not that liquid,” he said. “We need to buy big tickets and the only place we can invest in government bonds.”

Where Publica does buy corporate bonds, it maintains minimum rating criteria at the single-A level, though Heri said he sees real value in the spreads available on triple-B corporates.

Practice what you preach

For his personal investments, he bolsters return with alternative, non-correlated investments — and is so keen on matching assets and liabilities in his own household that he proudly tells of buying a General Electric sterling bond with the same ma-

turity as his daughter’s expected college graduation date in London.

Valartis, like other Swiss asset managers, offers alternative investment products in order to deliver non-correlated returns. Heri points, for instance to the bank’s fund that trades electricity futures. It returned 4.5% last year and 0.9% so far in 2009.

“It’s nothing to dream about, but it has made money, unlike most assets,” he said.

But his approach to equity and debt products is conservative. For instance he does not invest in fixed income in currencies where there isn’t a matching liability

“The mistake every carry trader makes is to think he can take advantage of the rates without losing out with the currency. Theory tells us that the difference in the interest rate is the expected depreciation of the currency. And once again the real world has shown that theory is not that dumb.”

Fools and villains

Heri recommends a passive investment strategy, putting 80% of assets into indices, using low-

cost exchange traded funds, and 20% into actively managed satellites. He says that 90% of active long managers underperform their index.

“It’s not because they’re stupid, but because when they buy an instrument they’re betting against everyone else, who are at least as clever.

Market efficiency dictates that theoretically active managers should underperform — all the available information is already reflected in prices. The next datum is random. Investing in exchange traded funds saves a lot of money, too,” he said.

Market efficiency and transparency are two of Heri’s investment principles, and this is why he has criticised hedge funds for many years.

He predicted that the hedge fund industry would throw up some villains and has been invited to many hedge fund conferences to give a view from the industry’s enemies.

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As for victims of the hedge fund industry’s black sheep, Heri is philosophical: “People say they’ve learnt their lesson,” he said. “But we’ll see what products they don’t understand in the next bubble.”

Curriculum Vitae Erwin Heri

Born: March 6, 1954

1980-1983 PhD thesis (*summa cum laude*) on the *Determinant Factors of Short Term Exchange Rate Fluctuations*.

1985-1986 Associate professor for statistics at the University of Basel and senior consultant at the economics department of Swiss Bank Corp.

1987-1994 Swiss Bank Corporation — deputy chief economist (1987-1988), head of investment research and investment funds (1989-1991), global head international private banking, investment funds and asset management (1991-1994).

1995-2002 Winterthur Insurance Group/Credit Suisse — chief financial officer and member of group executive board of Winterthur (1995-1998), chief financial officer and chairman of CSFB Germany (1998-2002), chief investment officer, CS Financial Services (2002).

2002-2009 Valartis Group, chairman



Other positions: chairman of the investment committee of Publica, chairman of audit committee of Ciba Specialty Chemicals and on advisory board of Infrasuisse.

Publications: Author of several books on financial theory and practical applications on academic level but also for practical investments. “*Die acht Gebote der Geldanlage*,” [Eight Principles of Investing] 1999 was a bestseller in Switzerland and translated into several languages including Chinese.

Other: Former member of Swiss national table tennis team, several titles as Swiss champion in the 1960s and 1970s.