

Memorandum

To : FORUM Staff
From : BW
Copy to :
Date : July 7th, 2010
Subject : Macro Dashboard Q II 2010

1. Summary of Results

1.1 Profits and Valuations

Since our last Macro Dashboard the economy has continued to show signs of a strong comeback – but the picture starts to look a bit more mixed than before. In particular **profits** have continued their steep increase. Most of our metrics suggest **these profit levels are far above their historical means and there is a high probability that they will revert to the mean**. There is now a striking contrast between the warnings signals sent out by this Reversion to the Mean approach and the optimistic profit projections offered by the sell-side.

Whilst the profit-side of the economy is doing well **we do not see that there is a self-sufficient upswing in investments and consumption**. Companies appear to prefer to invest their funds into payouts to shareholders or into takeovers. And consumers are handicapped by the weakness in market incomes which has plagued the US economy for a decade now, generating only anaemic growth in this metric. **These developments point to what may be a structural problem with the US economy.**

In Q II 2010 **equity prices** have stopped their steep ascent and corrected significantly. As a result the overvaluations relative to historical averages which had built up in the previous quarters have become less significant. Thus we are more positive about the long-term return from equities – **although they are still below their historical averages. Due to the corrections in equity markets we also see less need to buy downside protection for our portfolio.**

1.2 Risks

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We still ride the topic of **debt at all levels** as the dominating risk. We are concerned that with the massive build-up of sovereign debt due to the various stimulus programs initiated in 2009 governments have lost their ability to manoeuvre.

At the level of **sovereign debt** we believe the focus on Greece is distracting. We continue to be concerned about the deficit – and the unwillingness or in some cases incapability to close them – in other countries, e.g. Japan and even the USA. This lack of firepower for governments also creates the – remote risk – of an overall financial panic if larger groups of market participants start to doubt the solvency of a major sovereign debtor.

At the level of **household and corporate debt** we continue to see the **need for more deleveraging** – which might prevent the start of a classical Keynesian virtuous cycle of government spending kick-starting a self-supporting recovery.

1.3 Conclusions and Recommendations

Compared with Q I 2010 our Dashboard signals two major developments:

- a) **Corporate profit levels** have increased even more above their long-term levels. This creates a risk that they will revert to the mean. As sell-side project profits to increase even above the present levels there may be a major disappointment in equity markets coming up.
- b) **Equity valuations** have come down to more reasonable levels. It looks as if the emergence of a major bubble has been stopped resp. prevented.

As a result we have left our major recommendations for tops-down asset allocation unchanged:

- Build up our **standard share of 20% cash to be able to take advantage of future opportunities**
- **Try to build up 5 – 10% of assets in short positions.** This recommendation has become a bit less urgent, so we should concentrate on good opportunities with single stocks we understand as opposed to buying index-based insurance.

As a result we target a net equity long exposure of ca. 70 - 80%.

2. Purpose of this Paper and Conceptual Basis

2.1 Purpose

We are value investors who spend most of their time looking for undervalued businesses by applying a bottoms-up approach company-by-company. We work like “**truffles pigs**” with our heads to the ground most of the time. **The purpose of this paper is to “invert” this perspective by taking a tops-down view on the economy, on financial markets and on the discussion of risks.** Specifically, it intends

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- a) to determine the “**Average Future Conditions**” in the economy to calibrate our expectations for the future profitability in the economy and in our portfolio companies;
- b) to **raise our awareness to “mental biases”** from working only at the “tree level of the economy”, e.g. Extrapolation Bias, Illusion of Control Bias or “Frog in hot Water Bias”. By raising our awareness of such biases we can eliminate them more easily;
- c) to recognize significant over- or undervaluation in capital markets to **position our asset allocation for a Reversion to the Mean. This aspect also includes recommendations on strategies for hedging risks.**

2.2 Conceptual Basis

The conceptual basis of most of the analysis performed in this paper is the recognition that **both the economy and capital markets are dynamic chaotic systems:**

- a) **dynamic**, because the weight of a variables changes constantly
- b) **chaotic**, because small changes in one variable can cause disproportionate variations in the outcome variables.

We associate ourselves with the mathematicians who claim that it is **impossible to predict the future status of such systems. (Other “investors” claim the trend is another pattern which money can be made from – we do not understand this pocket of “investing”).**

The only framework we have seen working in such systems is the Reversion to the Mean (“RTM”). In basing investment decisions on the RTM concept one has to keep in mind that

- a) the RTM process **only follows weak patterns or no patterns at all**
- b) the reversion happens in **undefined cycle times.**

In our analysis of these developments we review very long time series – extended to many decades and back to 1881 in one case. We concentrate on analyzing the status of a parameter relative to its long-term mean. **Thus the conceptual basis of our investing is “long-term/short-term arbitrage” based on RTM.**

Some readers have challenged the use of averages based on very long time series. They imply that the (business) world has become as better (business) world in the last few decades and both profitability and valuation should therefore be structurally higher today than in the past. **We think that this is a variation to the “This time it should be different”** theme which has cost investors dearly in a string of bubbles (e.g. Japan in the eighties, the technology bubble in 2000 and – last but not least – the banking bubble which just burst a few months ago). **We run when we sense a “this time it is different” argument, be it implicitly or explicitly.**

2.3 Limitations of the Approach

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Given the nature of the economy and capital markets as dynamic chaotic systems we think that the **probability of a Reversion to the Mean increases geometrically with the degree of deviation: we are really looking for dislocations in the market that exceed one standard deviation in statistical terms.** Such events occurred e.g. in 1974, 2001, or 2008. Smaller deviations should be ignored as “noise”.

This is illustrated in **Appendix 2.3** which evaluates the relationship between the degree of overvaluation of Shiller’s CAPE with investment returns in the periods following such overvaluations. The numbers suggest **that 5- and 10-year real returns are close to 0 once the overvaluation exceeds 1 standard deviation.**

This relationship **defines the limitations of this approach:** most of the time the macro variables will be oscillating within a band of less than 1 standard deviation around their mean – and in these cases we will abstain from any conclusions.

The second limitation of this approach is that the lack of pattern in the RTM process does not allow us to make any short-term predictions about the economy and capital markets. Thus we have to **restrict ourselves to expectations about very long-term developments and – most importantly – on expected risks and returns.**

3. Status of the Economy in the Cycle

3.1 Corporate Profits as % of GDP (Appendix 3.1)

In Q I 2010 US **after-tax Corporate Profits** continued on the upward trend which started in Q II 2009 and **increased to 7,5% of GDP, up from 6,7% in Q IV 2009.** This additional increase **brings the ratio up to 150% of its 80-year average of 5,0%.**

US after-tax Non-Financial Corporate Profits – eliminating the volatility of banking profits – increased as well in Q I 2010, in this case **to 5,3% of GDP,** up from 4,5% in Q IV 2009. The eighty-year mean is 4,0%. Thus in Q I 2010 US after-tax Non-Financial Corporate Profits stood **at 133% of the long-term average.**

3.2 US Corporate EBITDA (Appendix 3.2)

The second metric we use for assessing corporate profitability is **US corporate EBITDA** (Net Operating Surplus plus consumption of fixed capital divided by Gross Value Added). It eliminates any distortions from changes in interest or taxes.

As you can see from the **Appendix 3.2** we get similar results:

- a) **an ongoing recovery in Q I over Q IV to 33,8%** from 33,3% (revised)
- b) **...significantly above the 80-year average of 27,2% - to be precise, at 124%.** As pointed out in our last Macro Dashboard **a level above 131% was only reached twice:**
 - In 1929 – with the Great Depression following

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- In 1942 in the process of ramp-up to WWII – followed by a steep decline to 1946

c) reaching **another All-Time High**.

This is in line with the observations made in chapter 3.1. – not very comforting.

3.3 Non-Financial ROA (Appendix 3.3)

In Q I 2010 the Pre-Tax Return on Tangible Assets (“ROTCE”) of the US Non-Farm, Non-financial sector (as reported by the Federal Reserve) continued to **increase to 8,4% from (a revised) 7,3% in Q IV 2009**.

The **long-term average since the first publication of this time series in 1965 is 5,8%**. Thus as in the case of profits as a share of GDP this measurement of corporate profitability has continued its way to a level above long-term average: **the ratio reported for Q I 2010 implies a level of 145% of this average**.

Thus we have the same pattern as with the other two levels of profitability discussed above: **in this “so-called recession of 2009” ROA only dropped below its average during a single quarter and recovered to levels above its historical averages shortly thereafter**.

3.4 FORUM Conclusions on Expected Future Profitability

When viewed together, the four metrics for **corporate profitability in Q I 2010 show a consistent pattern when compared with historical averages**:

Metric	% of LT Average	Standard Deviations
Total Profitability as % of GDP	150%	1,38x SD
Non-Fin. Profits % of GDP	133%	0,71x SD
Corporate EBITDA Level	124%	2,66x SD
Non-Financial ROA	145%	1,65x SD

In our previous Dashboards we have expressed concern about this level of profits and warned against too positive expectations. If we define a standard deviation > 1x as a serious overvaluation and a standard deviation > 2x as a bubble **we can state that the US economy is getting into dangerous territory**.

As analysts predict further significant increases we are expecting that **there may be a rude waking-up in the future when these projections have to be corrected. The Extrapolation Bias of the Sell-side applies equally to the USA and Europe**.

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3.4.1 Implications for our Average Future Conditions Assumption

One of the three purposes of this analysis is to **define the Average Future Conditions (“AFC”) which are central to our valuation.**

To protect ourselves against getting carried away with the optimistic biases of any projections into the future we use the track record of a company for the last 5 – 10 years and assume that the levels of profitability and cash generation in the next 5 – 10 years will be close to the past. With other words we assume that AFCs will be more or less a repetition of the past – apparently a crude assumption, but in any case better than falling victim to the follies of forecasting.

At present this leads us to lower valuation than the sell-side which bases its valuations based on such projections. Based on the analysis of corporate profitability above we believe that it is even more important now than before to follow valuations based on a “rosy future”.

3.4.2 Awareness to Biases

The **biggest biases** we see misleading investors at this point of the economic cycle are:

- a) **Extrapolation Bias** because it is tempting to draw a line through the four quarters of recovery as the momentum appears to be carrying on at least until now. In fact the consensus predicts an increase in the earnings of the Eurostoxx 300 index of 37% in 2010 and another 25% in 2011. This implies a net profit margin of 8,3% - which has never been achieved in the past.
- b) **Illusion of Control** because the outstanding level of profitability re-gained after the short dip in 2008/09 suggests that governments and Central Banks are in control of the economy. In fact these numbers suggest that the stimulus measures taken so far have helped profits – **but there are few signs of a self-sustainable growth in investments or in consumer spending is on its way.**

4. Valuations

4.1 Cyclically Adjusted PE Ratios/Shiller’s CAPE (Appendix 4.1)

For a **tops-down calibration of valuations we prefer Shiller’s CAPE**, a metric introduced in his 2000 book “Irrational Exuberance”. It eliminates short-term earnings fluctuations by calculating a 10-year average, inflated to today’s purchasing power based on the GDP deflator. It is calculated based on all constituents of the S & P 500. We will refer to it below as Shiller’s Cyclically-Adjusted Price Earnings Multiple (“**Shiller’s CAPE” or just “CAPE”**).

Prof. Shiller reports a **CAPE of 20,0x for June 2nd, 2010**, his latest update. On that date the S&P 500 stood at 1098,38. This is down from a CAPE of 22,0x for April 15th, the time of our latest report with the S&P 500 at 1.211,67. By June 30th, 2010 the S&P 500 had dropped to

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1.030 points. Adjusting CAPE in proportion to the decrease in the index since June 2nd yields an **adjusted CAPE for June 30th, 2010 of 18,8x.**

Analysis of the data driving CAPE show that in Q II 2010 rolling 10-year earnings have decreased as expected, but the massive downward correction in market valuations has more than made up for that. **As a consequence CAPE is now much more in line with its long-term averages than in previous reports.**

The long-term average of CAPE since 1881 stands at 16,4x. This implies that **current valuations are at 115% of their long-term average.** In terms of deviation from the past this valuation implies a moderate standard deviation of 0,55x.

4.2 Tobin's q

Tobin's q is a ratio of the **value of the stock market relative to the replacement cost of net assets.**

The application of Tobin's q to equity market valuations has been introduced by authors Smithers and Wright in their 2000 book "Valuing Wall Street" and updated by Andrew Smithers in his book "Wall Street Revalued" published in 2009. For a validation we refer to an article by Harney/Tower in the Jan. 2nd 2003 edition of The Journal of Investing. Please note that **q is only calculated on non-financial companies.**

There are two generally accepted methods to calculate this ratio:

- the US Federal Reserve Flow of Funds accounts
- Smithers & Co consultants who apply an adjustment.

There are also numerous additional versions published by consultants and market participants, thus you may get diverging data.

Based on the latest **US Federal Reserve Flow of Funds** of June 10th, 2010 **the non-adjusted ratio has increased to 1,04 at the end of Q I 2010** from 0,99 (adjusted) at the end of March 11th, 2010. The non-adjusted average observed since 1900 based on our calculations is 0,75, **thus q is at 138% of its long-term average.** (We used to calculate this ratio based on an published average of 0,63 for q, but cannot replicate this number. We have therefore decided to switch now to the number of 0,75 which is based on our own calculations.)

After adjusting for the increase in the S&P 500 from 1.187 on March 31st, 2010 to 1.030 as of June 30th, 2010, i.e. by a negative 13%, **the level of q including statistical discontinuities as of June 30th, 2010 decreases to 121% of its long-term average.**

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Smithers & Co. adjust Tobin's q as reported by the Fed for statistical discontinuities beginning in 1983, mainly revaluations of fixed assets to market values beginning in 1984. At the end of Q IV 2009 **q ex statistical discontinuities (line 20 of Table R 102)** continued its steep increase to 1,75 (1,58/revised). Based on the long-term average of 0,86 this implies **a level of 203% of its long-term average.**

After adjusting for the increase in the S&P 500 by a negative 13% as outlined above **the overvaluation of q ex statistical discontinuities as of June 30th, 2010 decreases to 177% of its long-term average of 0,86.**

4.3 US Equity Market Capitalization as % of GDP (Appendix 4.3)

Based on the Fed data US market capitalization as % of GDP **has increased to 109%** at the end of Q 1 2010, up from 103% (revised) at the end of Q 4 2009. Applying an adjustment factor of minus 13% to account for the change in the S&P as the most significant index entering total market cap yields an adjusted value of 95%

As the long-term average since the beginning of this time series is 80% this valuation implies **a premium of ca. 19%.**

4.4 Qualitative Aspects of Valuation

In the past two quarters we have cited additional qualitative indicators which make our "psychosomatic markers" – vulgo belly – revolt **as they remind us vividly of experiences in previous bubbles.** WE still see sell-side optimism – but that is probably genetically engrained. The other phenomena mentioned in the last paper have become less evident:

- a) The **VIXX** index has increased sharply over its low of 15,9x achieved in Q I 2010.
- b) Several IPOs have either not made it or prices were more reasonable (that does not include the IPO of Tesla!)
- c) Most importantly the **credit markets** which started to show signs of risk aversion have become even more skeptical: money market rates, CDS and other credit-default-related instruments have all gone up.

All in all **this picture looks much healthier than three months ago.**

4.5 Correlation of Valuations

Similarly, correlations between valuations have come down. In particular the divergence between valuations in the equity and credit markets have become stronger as already mentioned above.

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This also suggests a **more rational market environment** in which participants make selective decisions based on their calibrations of risk and return – as opposed to a market sentiment of general greed.

4.6 FORUM Summary and Conclusions

Below please find a summary of the level of valuation metrics compared with their long-term averages and standard deviations as of March 31st, 2010:

	% of LT Average	Standard Deviation
Shiller's CAPE (as of June 30 th)	122%	0,55x SD
Tobin's q non-adjusted	138%	0,92x SD
Tobin's q adjusted for discontinuities	203%	2,05x SD
US Equity Market Cap. as % of GDP	137%	0,89x SD.

These data suggest that the increasing overvaluation which threatened to develop into a bubble **has come down significantly**. Below we will address some questions as to the implications for us.

4.6.1 Implications for Expected Long-Term Returns

If one believes in the Mean-Reversion characteristics of valuation the most likely assumption on expected returns on equities in the next 5 – 10 years would be **returns slightly below long-term averages. The long-term real return of the US equity market since 1900 including dividends has been 6,3% p.a.** The most likely expected return will depend on the time it takes for this overvaluation of ca. 20 - 40% as indicated by three of our four metrics analyzed above to unwind:

Years for Unwinding	Real Return p.a.
2	negative
5	-2 - 1%
10	1 – 3%.

Our statistical exercise – **correlating standard deviation** of Shillers CAPE with subsequent **nominal** returns without dividends – as presented in Appendix 2.3 would suggest **nominal returns of**

- a) **ca. 3% p.a.** in the next 5 years
- b) **ca. 4% p.a.** in the next 10 years.

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Assuming a long-term inflation rate of ca. 2% p.a. and dividends at the same rate **real total returns from equities would be the same. i.e. 3 – 4% p.a.**

As our investment results will always be based on the return of equity markets in general plus an annual outperformance of 5 – 10% p.a. created from our investment approach **these expected market returns make it very difficult for us to reach the targeted 15% p.a. return in equity markets of mature economies.**

4.6.2 Implications for FORUM Asset Positioning

By historical standards the degree of overvaluation in equity markets is moderate and has come down since our latest report. E.g., the **standard** deviation of CAPE decreased to 0,55x from 0,86x. **At that moderate level of “stress” we are not prepared to take a significant short position to protect ourselves against a strong negative development of markets.**

Based on the analysis performed so far we would limit our “hedge” to a negative market development to

- a) **sticking with our 20% standard cash allocation**
- b) **adding a short position amounting to 5 – 10% of our assets.**

This is unchanged from our last report.

5. Risks

5.1 Debt and the Need for Deleveraging

In the last Macro Dashboard we had discussed the risks in the economy from the required **deleveraging of Private and Sovereign Balance Sheets**. The final chapter read:

“The opinion of these authors and ours suggest that the next years carry more risk than the past 5 years. As a result risk premiums should go up and with risk-adjusted pricing this implies lower equity prices. We as Value Investors should require a higher Margin of Safety to compensate for the risk from the imbalances in the global economy, in particular the need for deleveraging.”

At the time of the last Macro Dashboard the focus was on Greece. We believe everything has been said about this specific issue. We agree with the consensus that at some point Greece will have to go through an orderly or disorderly default as it will not be able to save or grow itself out of its level of debt. **This will generate an event risk which will have negative second-order effects for international capital markets.**

We think an important contribution to the thinking on sovereign debt has been made by the Peterson Institute for International Economics in Washington. Author Jacob Funk Kirkegaard points out that the discussion is largely focused on the measurement of sovereign debt as a % of GDP – not taking into account the different levels of the government budget as a

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% of GDP. He did a calculation by how much governments would have to increase taxes resp. cut spending to balance the budget.

In addition to the relatively high level of unfunded debt for social security liabilities and the legislative problems at the state and local government levels in the USA **we think we may well see credit markets focusing on the USA as a critical issue. It is clear that if that happens there will be a real panic in world financial markets as there will be no other currency to flight to and no other government debt offering better quality and adequate liquidity.**

The average of the OECD countries would require an increase in income or a cutting of expenses by ca. 12%. **This appears hard, but still conceivable.** In the case of the USA would have to increase their revenues by 40% or cut their expenses by 35%. **This appears hardly conceivable.**

Another important aspect of sovereign debt in Europe we are worried about is **the decision of the EU to give up the “non-bailout clause”**. This adds a new type of potential liability to the Balance Sheets of European Governments which makes it very difficult to find a “safe haven” in the EU. We believe it is good commercial wisdom to segment risks – this principle has been given up now. It means that problems in individual countries might now drag down even the strongest partners.

A side effect is the **“Moral Hazard” issue** which will dampen efforts of weak members to continue budget discipline once the present market turbulences have settled down and the immediate pressure has become lower.

5.1.1 Update on the Process of Deleveraging

Appendix 5.1.1 gives an update on the process of deleveraging in the USA by showing the evolution of **Credit Market Debt per sector as % of GDP. As in the previous 2 quarters total debt declined slightly in the quarter to 357,2% from 362,0% (revised) in the previous quarter and a peak of 373,1% reached in Q I 2009.**

Once more, all private sectors deleveraged while the government (federal and state) built up its debt. On the positive side one can point out that the economy is presently able to generate growth which helps to decrease the overall level of debt as % of GDP.

5.1.2 Outlook for the Process of Deleveraging

In the last newsletter we pointed out that we saw surprisingly little effort by politicians to consolidate budgets. Please see **Table 5.1.2** for an overview over expected increases in sovereign debt. This has not changed. Thus our conclusion remains unchanged:

“.... we are afraid that these developments are time bombs which may lead to unpredictable distortions in financial markets in the next 3 – 5 years as their non-sustainability receives increased awareness and attention.”

5.2 Consumer Purchasing Power in the USA

This is another topic we raised several quarters ago (Macro Dashboard Q 3 2009). At the time we drew attention to the observation that so-called market-based personal incomes in the USA had been dropping for many years. **The spending spree by US consumers was facilitated by two sources**

- a) **Government transfers to market-based household incomes**
- b) **Increase in consumer debt**

with both factors being unsustainable.

As explained above consumer debt has been decreased slightly. But the problem with decreasing market-based household incomes is continuing. In Q I 2010 real market-based consumer income was 4% lower than a year ago – largely driven by increased unemployment. At the same time consumer spending corresponded to 130% of market-based household incomes.

As these numbers are non-sustainable we see a high probability of US consumer spending dropping again in the course of 2010. With consumer spending accounting for ca. 70% of US GDP this would be the trigger for a “double-dip recession.”

5.3 Deflation vs. Inflation

We discussed this topic shortly several quarters ago and said that

- a) it was not clear to us that the most likely scenario was inflation
- b) we were not prepared to make a bet either side as did not feel sure enough about our personal assessment (which was leaning towards a deflationary scenario).

We think that with at since then deflationary forces have gained force – the early reduction in government spending worldwide, free capacity worldwide and decreasing Purchasing Power.

We still do not feel sure enough about this outcome to take a financial position.

6. Summary and Conclusions: Combining the RTM and Risk Perspective

6.1 Expected Economic Conditions and Equity Returns

We draw the following conclusions:

- a) We should assume that **Average Future Conditions** of the economy will be at best as good as during the last cycle which we date from 2002 – 2008. **There is significant risk that we err on the downside. This is unchanged from the previous Dashboard**
- b) **Overall equity returns in the next 5 – 10 years** in the mature economies should be assumed to be below their long-term averages. An expectation of **1 - 2% p.a. in real**

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terms appears realistic. As valuations have gone down since our last report this projection has been increased slightly.

6.2 Range of Potential Outcomes

We have been saying for several quarters that we see present conditions in financial markets as the net effect of many strong countervailing forces balancing each other. We believe that the analogy with physics is reasonable that **such situations in dynamic systems create a wide set of potential outcomes.**

As a side effect we are **expecting an above average volatility in markets.**

7. Recommendations

7.1 Net Equity Exposure

Overall we have left our recommendations largely unchanged. As a consequence we should

- **target a cash quota of 20%** of AUM

- try to **build up a short position of 5 – 10% of assets.** This recommendation has become less urgent, so we should concentrate on good opportunities with single stocks we understand as opposed to buying index-based insurance.

7.2 Other Asset Classes

Unchanged from the last edition: Build up the deal flow in Private Equity as there may be forced selling or forced capital increases in the small-cap and mid-cap PE sectors due to the credit squeeze.

7.3 Hedging Risks I: Sovereign Debt

7.3.1 Sovereign Debt/Deleveraging via Straight Default

Prices for insurance against sovereign default in most European countries have gone up to levels which do not offer us an attractive risk/reward ration. At this point in time we focus on two sovereign entities where CDS prices resp. interest rates have no moved much:

- a) Japan
- b) USA, in particular state and local governments.

We will be looking for suitable instruments to buy this protection at a low total cost.

7.3.2 Sovereign Debt/Deleveraging via Inflation

We have been discussing **how to protect ourselves against the build-up of sovereign debt which we believe is non-sustainable in the longer term**. A hedging strategy will be different depending on the mechanism which will lead to the deleveraging. **One of these is inflation.**

In our last Macro Dashboard we suggested that an option to protect ourselves against inflation would be **investments into companies with “super-moats” and the associated pricing power**. I mentioned BNSF railways – acquired by Warren Buffett – and renewable energy. We still have not made much progress with this idea, mostly because we are not yet convinced that inflation will be a likely scenario.

7.4 Hedging Risks II: Double-Dip Recession in the USA

We have decided to hedge against this risk by trying to build up a small short position. We still have not made up our mind which route to choose

- a) **A short position on a US underlyer**, either a stock index or consumption related stocks, e.g. in consumer non-durables;
- b) **Short Positions on single-stock picks in Europe** where we understand the companies. This would be a rather indirect hedge against the associated equity market risk emanating from the USA, but we would feel more comfortable with it.

7.5 Other Opportunities arising from our Macro Assessment

We will continue to observe the VIXX as we maintain our hypothesis that the present balance within the economy and within markets is the net result of many counterveiling forces. **Together with the debt-related risks we expect this to generate sudden outbursts of volatility.**

We missed the opportunity to invest in a VIXX-based derivative when the VIXX was below 16 because we did not find a suitable instrument – the roll-over costs were too high. **We will continue to look for a suitable derivative.**

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Numbering system relates to chapters in text

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Appendix 2.3: Historical Relationship between Standard Deviations and Returns for CAPE

Stock Market Return as a Function of # Standard Deviations from Average PE/ 10

Status as of July 7th 2010

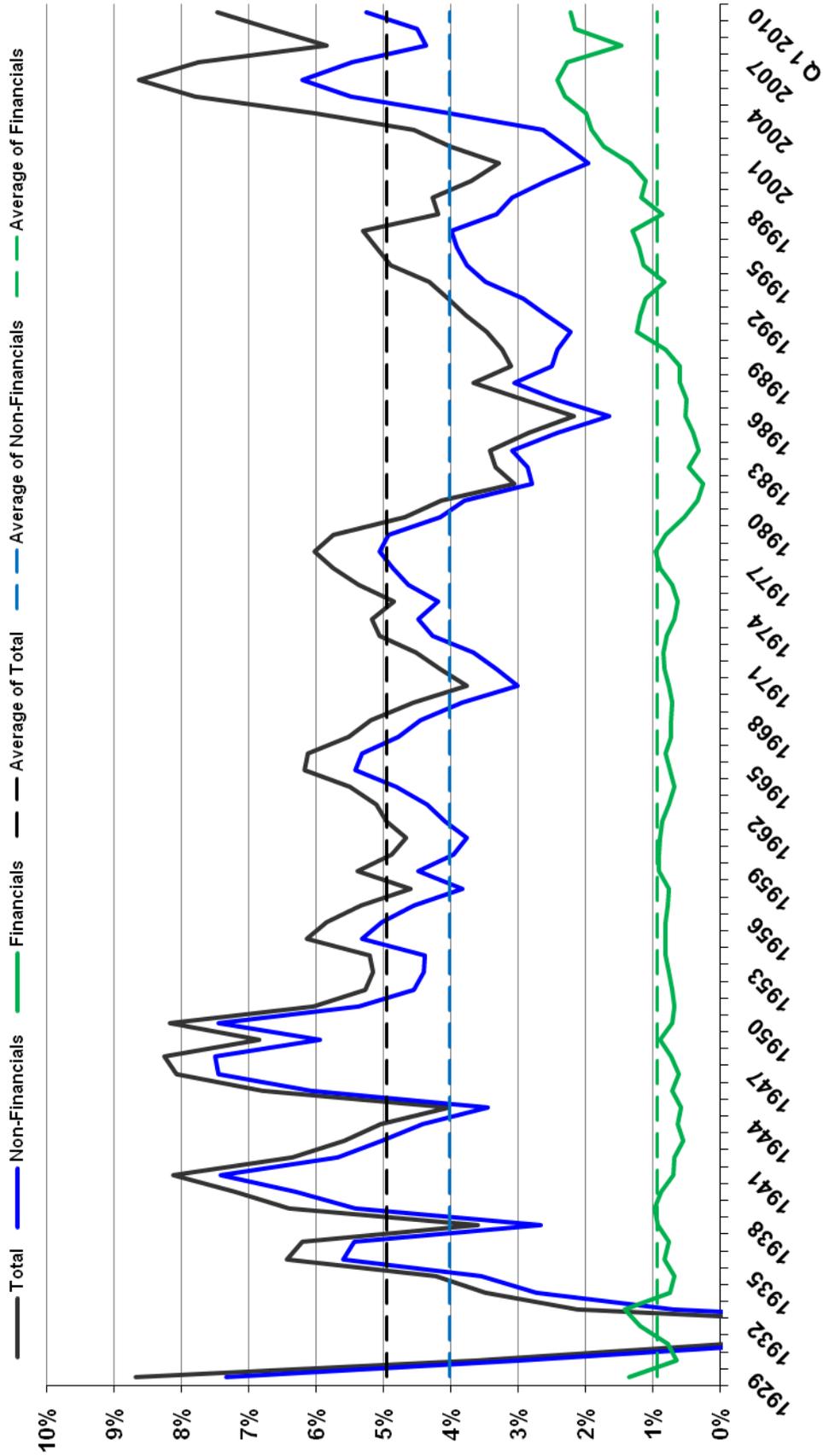
	Deviation from average as a # of standard deviations	# months	Nominal return		
			2 years	5 years	10 years
Negative deviations	Less than -3	1	14,5%	5,2%	9,9%
	Between -3 and -2	79	5,3%	4,8%	7,0%
	Between -2 and -1	294	7,8%	7,8%	4,6%
	Between -1 and -0.5	226	10,5%	6,8%	6,6%
	Between -0.5 and 0	159	7,8%	5,3%	6,3%
Positive deviations	Between 0 and 0.5	169	2,1%	3,6%	5,6%
	Between 0.5 and 1	178	2,1%	2,8%	4,1%
	Between 1 and 2	297	1,6%	3,8%	2,5%
	Between 2 and 3	71	1,1%	1,7%	2,3%
	More than 3	56	0,0%	-2,7%	-0,1%
	Total	1530	5,0%	4,8%	4,7%

Period covered: 1871-2010

Source: Shiller, FORUM Research

Appendix 3.1: Corporate Profits as % of GDP

US Corporate Profits as Share of GDP Q1 2010: 7,5%



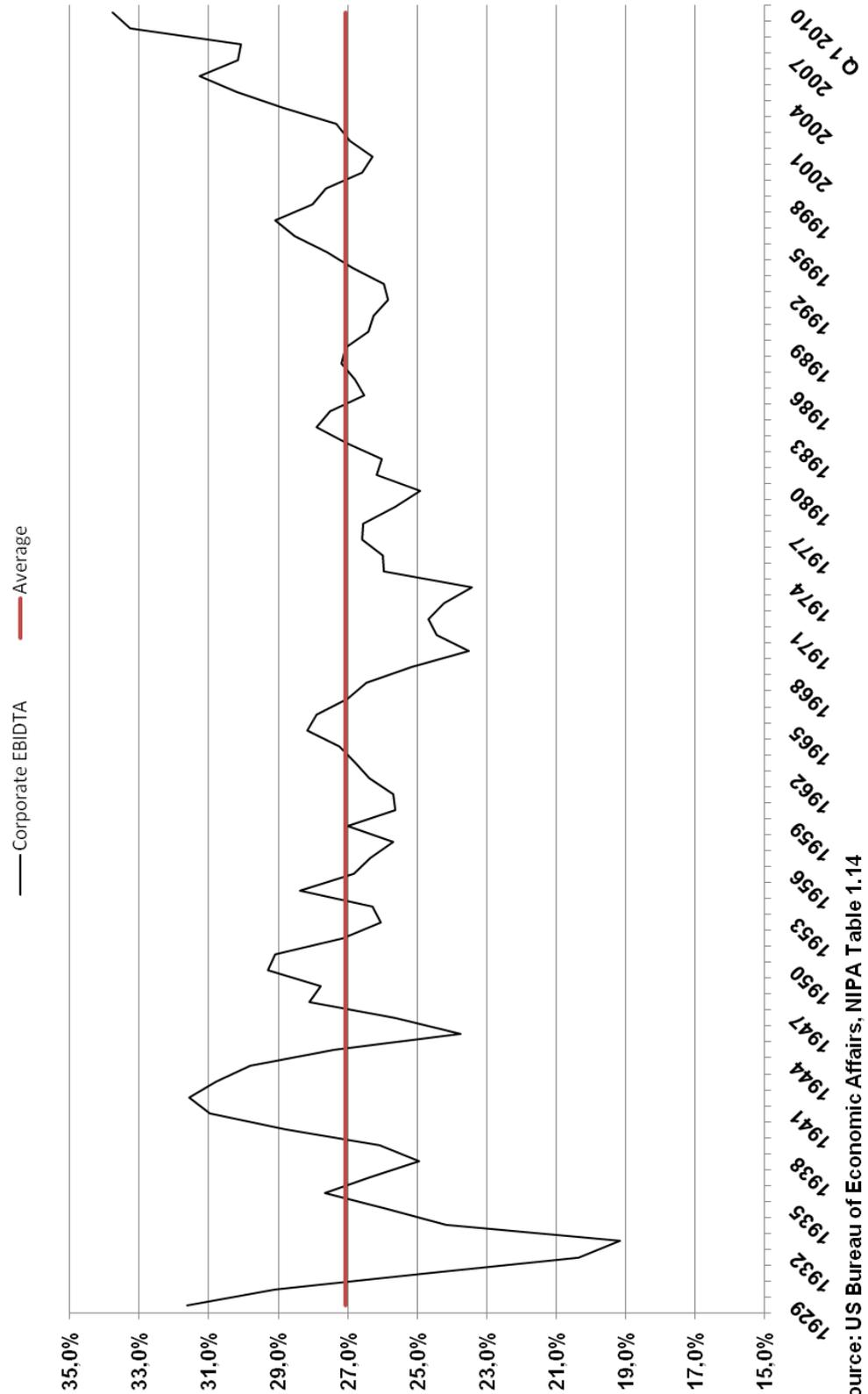
Source: US Bureau of Economic Affairs (BEA), NIPA Table 1.14

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Appendix 3.2: Corporate EBIDTA

US Corporate EBIDTA as % of Value Added,
Q1 2010: 33,8%

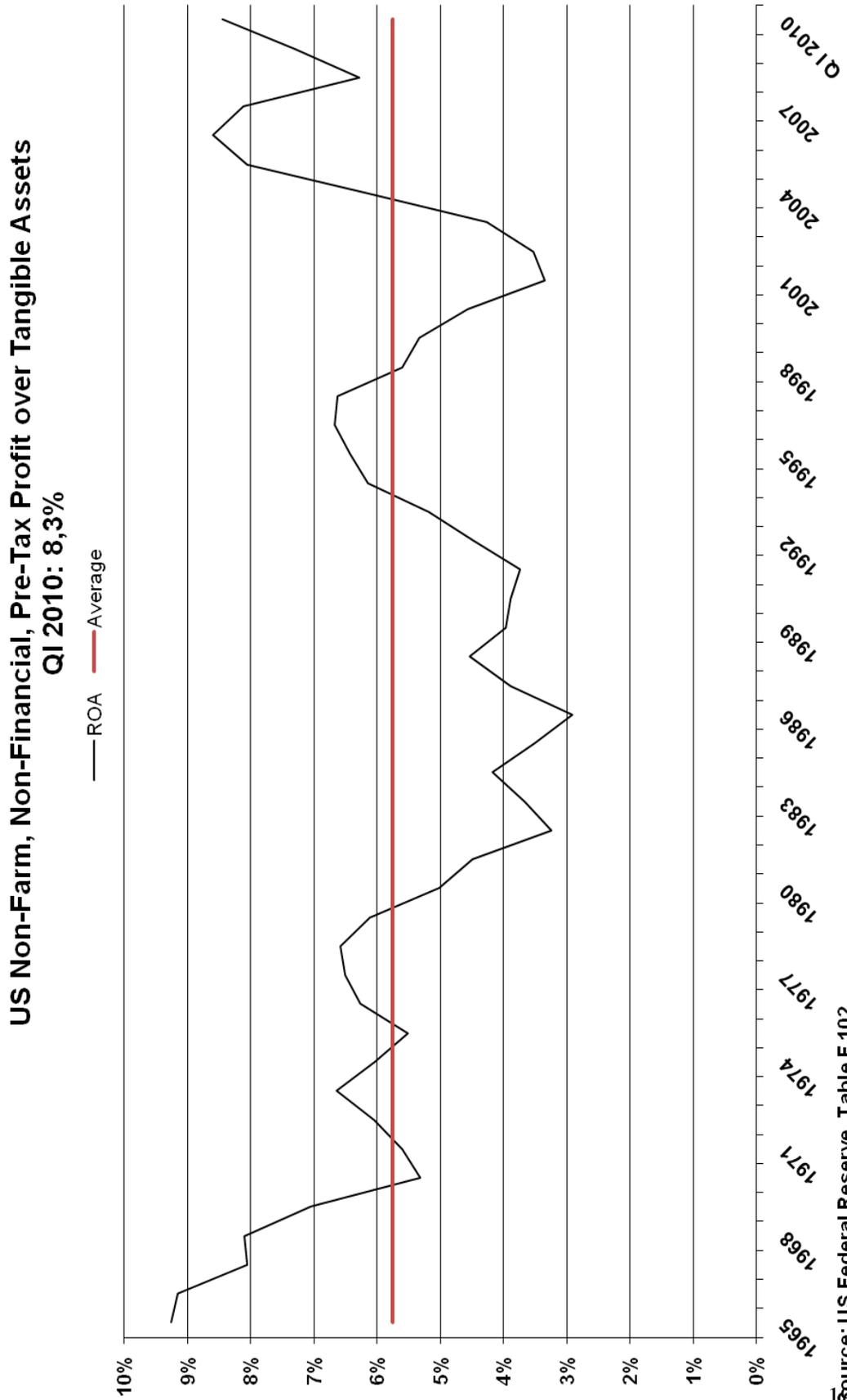


Source: US Bureau of Economic Affairs, NIPA Table 1.14

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Appendix 3.3: Corporate Profitability Measured as ROA

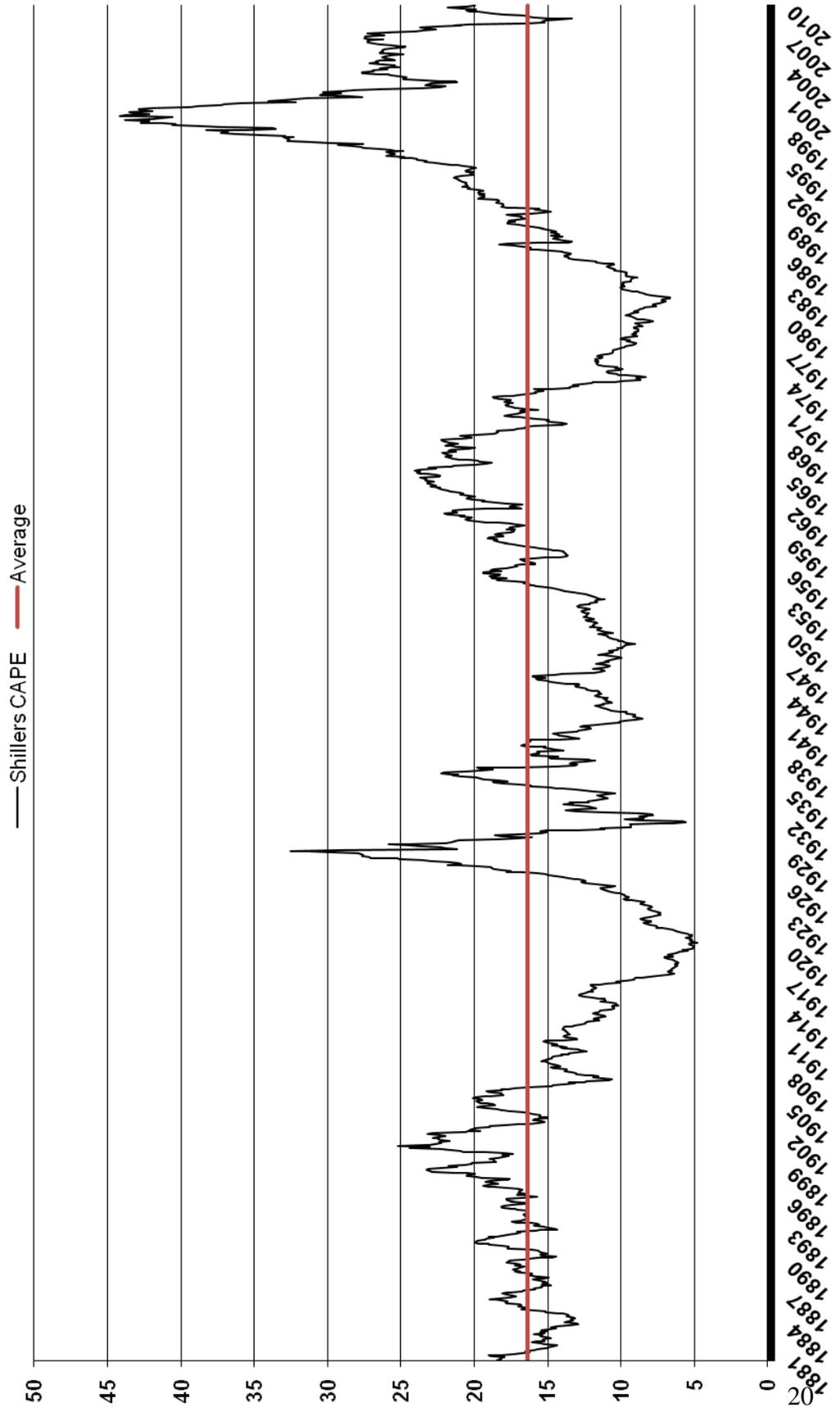


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Appendix 4.1: Cyclically Adjusted PE Ratios/Shiller's CAPE

Cyclically Adjusted PE Ratio / Shiller's CAPE
June 30th, 2010: 19,9x



Source: Robert Shiller

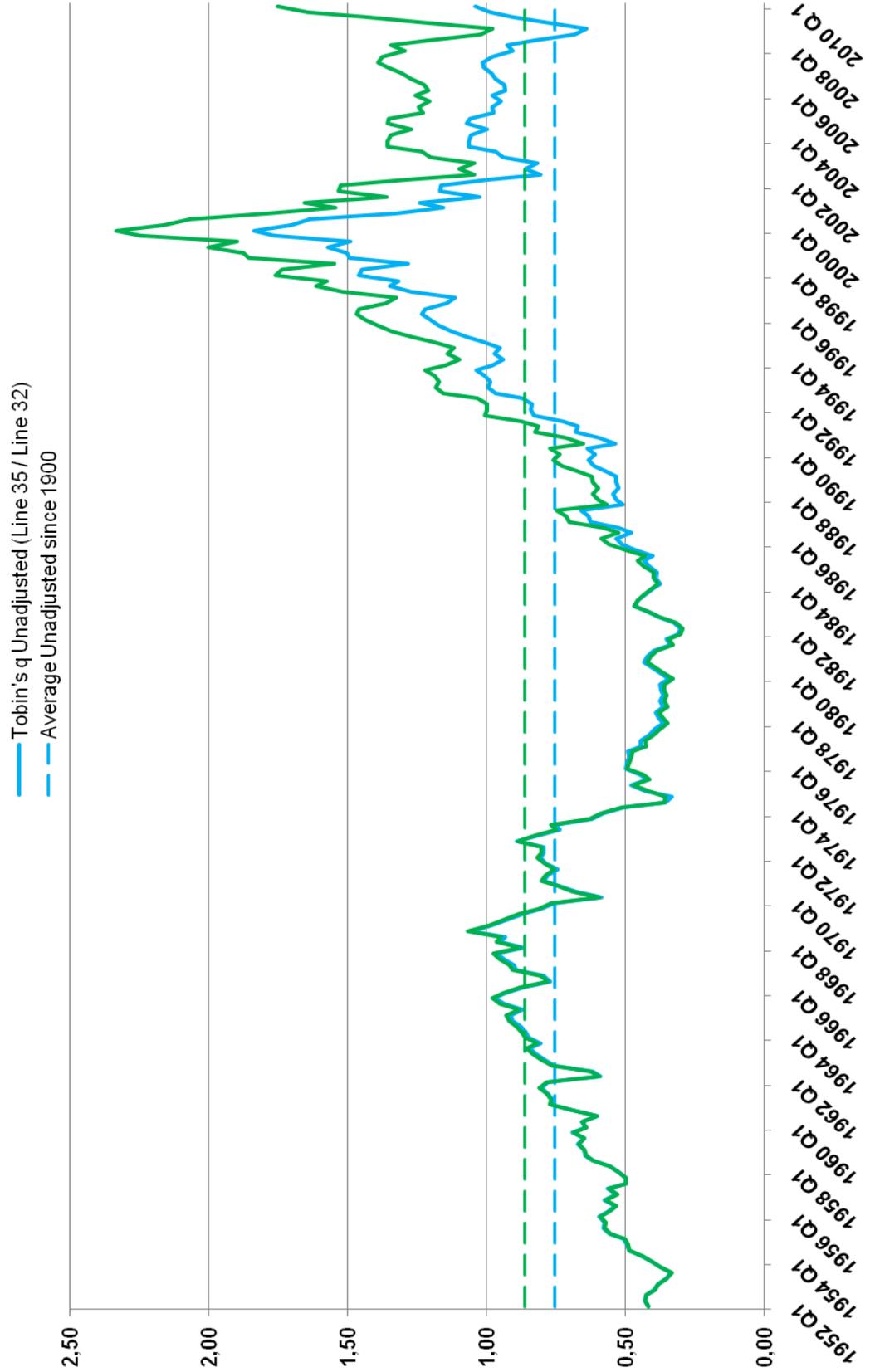
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Appendix 4.2 – Tobin's Q

Tobin's Q

March 31st 2010: 1,04x resp. 1,75x

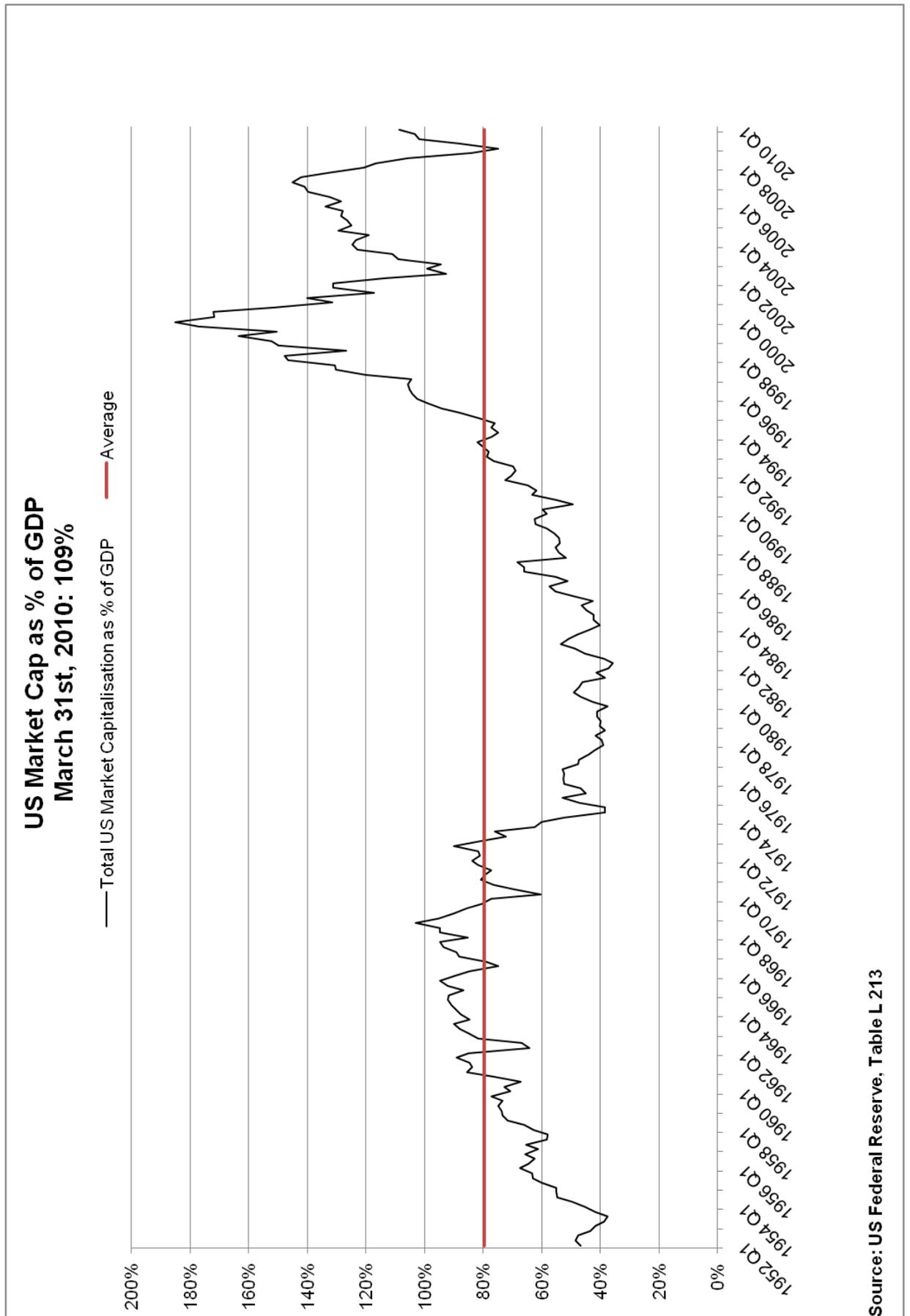


Source: US Federal Reserve, Table B 102, R 102 Line 20

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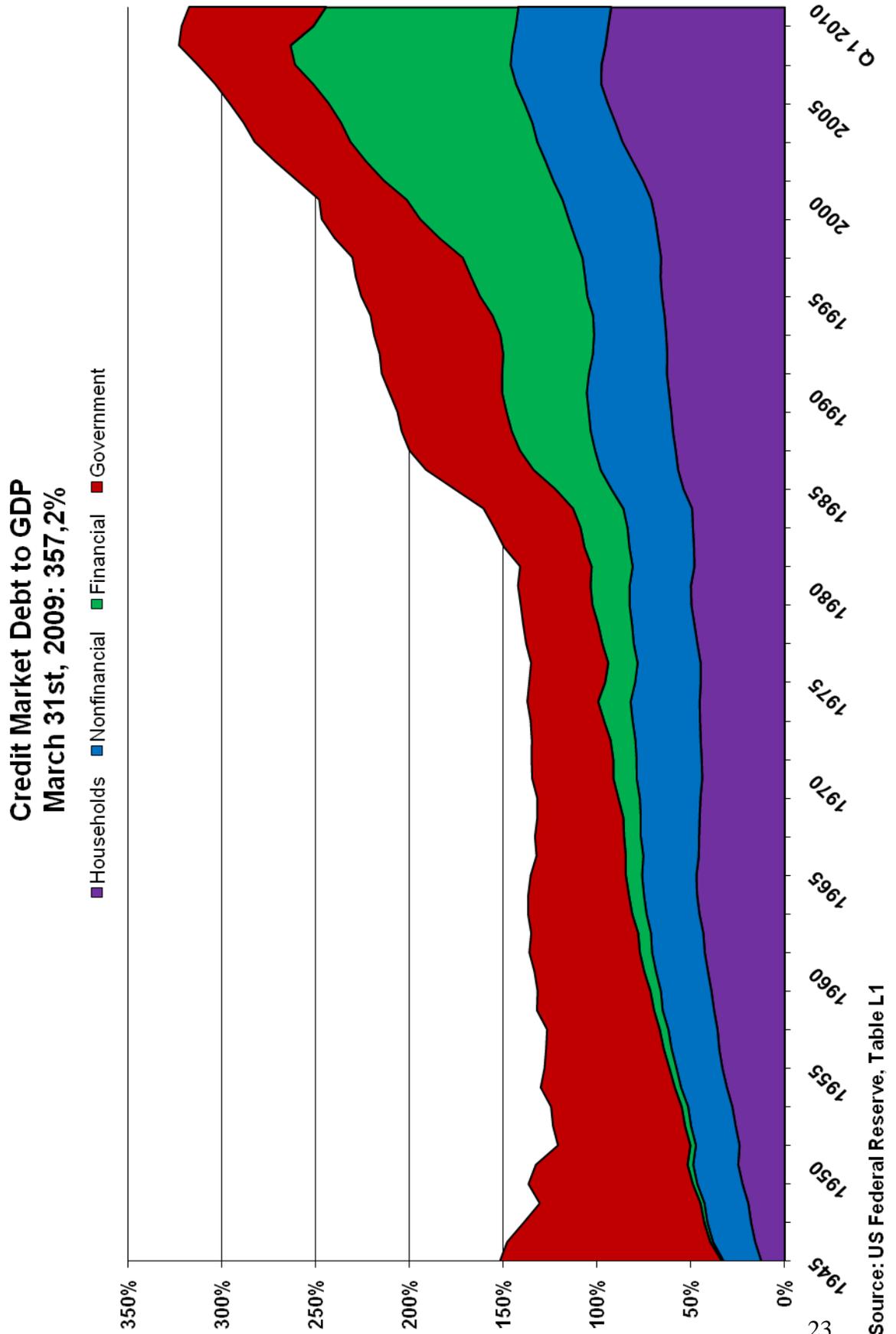
Appendix 4.3 – Capitalization of US companies as % of GDP



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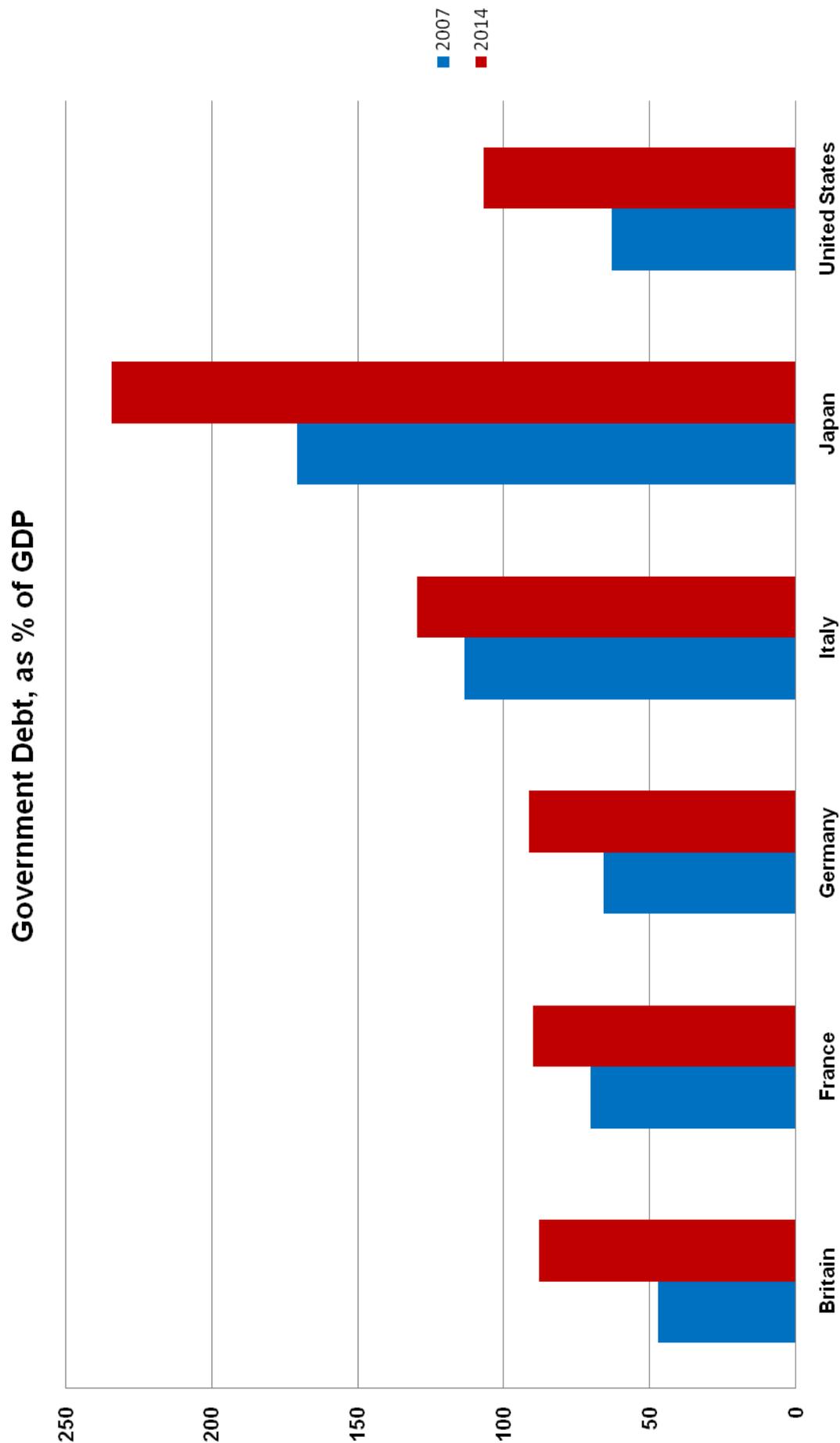
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Appendix 5.1: US Debt as % of GDP



Source: US Federal Reserve, Table L1

Appendix 5.2 Projected Evolution of Sovereign Debt



Source: The Economist, June 11th 2009