FPM-Comment **Reducing the Noise**

Martin Wirth – 3/2018 dated July 10th 2018

The delusion of flight to perceived safety in times of uncertainty

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- Experience in German equities since 1990
- Funds: mutual funds FPM Funds Stockpicker Germany All Cap, institutional special mandate for NBIM

- Negative performance for value investors as a result of increasing performance divergence
- Normalisation of economic development and uncertainty resulting from the political situation
- Memories of the dotcom era are resurfacing
- We anticipate a correction but not a bear market
- Many reasons to stick to our investment style and values

Performance divergence is coming to a head; last year's outperformance is being eroded

The German stock market showed a divided picture in the first six months of this year and the performance of all FPM funds was unsatisfactory. As a result of the weak trend, most of last year's outperformance versus the market has been eroded. This was caused by the increasing performance divergence between "normal" and very good/very stable companies. There was some divergence in valuations in recent years and this has now increased again - unlike the situation last year when the global economy regained confidence after years of uncertainty. This situation was not due to the present economic development but to fears and uncertainty caused principally by politicians. As a result, risk premiums rose, but momentum meant that the worst case scenario was priced into the usual suspects, while demand for shares perceived as being stable led to record highs in some cases.

Shares in some companies fell substantially, despite their evident quality. On the other hand, the main winners were not companies whose profit trends were better than expected but those whose business development is stable across cycles. Even companies whose profits were on the disappointing side were among the winners.

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Normalisation of economic developments at the end of 2017 and political uncertainty

There are two reasons for this: Firstly, the robust economic development at the end of 2017 was not sustainable, so sooner or later normalisation was inevitable. That was what happened, but it only had a slight impact on share prices. Overall, economic growth remains at a very good level, especially in the USA. There are some clouds in the EU but these did not have a big impact on numbers, which remain solid.

The second reason was politics. Contrary to old stock market adage, this time politically driven market movements have not proven short-lived. Moreover, unlike the past, this time the uncertainty was not triggered by the Middle East or Europe but mainly by the USA. One cause was the upward interest rate cycle, which was appropriate, or maybe overdue and was expected, but which resulted in a need for adjustment at a lower level. More important for sentiment and possibly ultimately for the real economy are the new customs duties introduced by the USA, the retaliatory moves by other states and the fact that this situation could escalate in the coming months. The implications are not clear. The disputes, which are taking place in the public arena and are below the belt at times, mean that market uncertainty has increased significantly. Issues such as the tortuous Brexit negotiations, the debate about migrants in the EU, and China's ad-hoc decisions on investments in photovoltaics have basically been ignored, although the consequences for various companies have had an impact on their share price.

As a result, investors sold off cyclical shares and shares in industries that figure high on the list of potential candidates for customs duties. Since our portfolios contained a number of undervalued companies in these industries whose potential had not been priced in - on the assumption that the economy would be fairly stable - we sustained above-average losses in this segment.

Our approach to the present challenges

Maybe it would make sense to switch into other market segments? Evidently, that is true as of now. However, this could lead to a problem that became clear in the first half of the year: if a valuation is too euphoric, driven by the momentum of a share, the result is often substantial and sustained losses. For example, last year several companies posted a very positive performance, resulting in record stock market valuations based on record profits. Now, some of these companies have landed in the wrong, i.e. cyclical, category, and may possibly be hit by the customs duties. Therefore, some of them have seen a sharp drop in their share price this year. That was not caused by a deterioration in their business situation; it was principally due to the higher valuation, with a thin safety margin, and gradually rising uncertainty, which undermined support for the investment case.

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Memories of the dotcom era

The shares that performed well in the first half of 2018 only include a few companies where the share price was driven by good profit trends. Essentially, the already high valuation of stable companies rose further. If these companies give even the slightest grounds for disappointment, or perhaps if the general tension were to ease somewhat (as could happen, for example, after the congressional elections in the USA in the autumn), prices could drop sharply (analogously to last year's favourites). Naturally, it is not possible to rule out a situation analogous to 1998 to 2000 when the market as a whole stagnated or fell slightly and only telcos, media and technology stocks posted a good or rather an extremely good performance. Since we know how that ended, we have no desire to try to be cleverer than the others. However, that does not mean that our stamina will not be tested further - for a week, a month, a year. However, it should be noted that at best large parts of the market have been stagnating since 2015 and there has been a retrenchment in some areas even though many companies have developed positively since then. Accordingly, their valuations have been reduced considerably. That does not simply apply to cyclicals and financials. It also applies to basically stable, high-quality companies where not everything has developed as expected. So maybe we are closer to the end of the valuation divergence than may appear at first sight.

The debate about customs duties

If the debate about customs duties is taken seriously, which it should be, shares in industries targeted by the US side are naturally the first victims. Since the rest of the world will not put up with this, the other side is also likely to impose customs duties instead of talking about how they could be abolished completely. As a result, it could even be that cyclical industries are not the worst hit. If there is no domestic alternative, the customs duties will simply be added to the price of the product, e.g. in the mechanical engineering sector, which is increasingly becoming a global oligopoly. Car producers already have production facilities in the USA, so it could make sense to extend these to models that have been imported up to now and to manufacture the models exported from the USA in the countries where they are sold. This has worked well in China and only entails a fraction of the customs duties that would be due if distribution policies were to continue unchanged. That is what Harley-Davidson plans to do, even if it comes as a surprise to the US President. The assumption that 100% of the customs duties would be borne by the producers is naive, but seems to be already priced into valuations at present market prices.

On the other hand, companies could run into problems where prices are regulated in the importing country. Here, it will probably not be easy to pass the duties on to customers.
That would apply to large sections of the health-care market. And in case anyone thinks this is not

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relevant for German companies: 12% of German exports to the USA are pharmaceutical products. That is just one example to show that from a fundamental viewpoint investing in stable industries does not always make sense in times of uncertainty.

The reflex of seeking a sense of security in the face of uncertainty

Consequently, we look at the developments in recent weeks not as correctly pricing in a new fundamental situation but as a reflex of seeking a sense of security in the face of uncertainty. As a result, prices of safe assets are rising while prices of those assets that are deemed to be less secure are falling. In our eyes, the biggest risk is that the valuation risk plays no role in the flow. Pricing security excessively does not breed security: if my insurance premium is higher than the potential damage, insurance makes no sense. Therefore, we will be avoiding this as we believe that a high risk buffer is already priced into our investments.

A correction but not a bear market

Overall, we assume that in the present situation we are facing a correction, not a bear market, despite hefty price declines in some cases. The difference for us is that in a bear market the price declines are not recouped within a short time; they are either permanent or can only be compensated over a long period. Several of the preconditions for a bear market are missing. Alongside the valuation and comparatively low mis-allocation of capital resulting from the uncertainty stemming from the financial crisis, the main reason is that many indicators point to a continuation of the upswing. The main condition for a bear market is generally a recession. And there are no signs of that at present - unless politics goes completely crazy, which seems unlikely but sadly cannot be ruled out entirely.

That does not mean that the correction will automatically be over in a short time. However, the normal course is for rising risk premiums to be priced into all shares. So far that has mainly occurred in cyclical sectors and those considered to be uncertain. Our assumption is that sooner or later it will reach the rest of the market. Therefore, we do not believe it makes sense to increase holdings of shares that are considered safe. Quite the contrary: We are already seeing the first signs of a correction in these segments. And the problem here, as experience shows, is that a break in the flow means that momentum investors have to get out of a share, there are sell-offs as long as the price trend continues, until it reaches a level where value investors are prepared to invest again. That can be a long haul. Until then, the shares that have already been sold will have plenty of time to gain new investors with a steady business trend.

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Expectations for the corporate sector are more positive than in politics

An even better scenario would be for the politicians, who are responsible for the latest chaos, to rapidly reach agreement on a sensible solution. For example, customs duties for US imports to Europe could be waived. According to the EU, the US import duties will mainly affect US consumers, so conversely European consumers and thus Europe would benefit from the abolition of European import duties. But such ideas seem absurd in the face of political reality. Therefore we are sticking to the considerations outlined above, retaining our style, our focus, and would be pleased if the politicians were to come up with a positive surprise for once. Otherwise, companies will have to make the running. Here, our expectations with regard to valuations are far more positive.

Sincerely yours,

Martin Wirth

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