FPM-Comment **Reducing the Noise**

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On the capriciousness of the market – and its current implications for us as value investors

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- A divided market: expensive stocks even more expensive, cheaper ones even cheaper
- Focusing on growth and quality stocks is not a universal remedy
- Review of 2018 - a disappointing year for FPM so far
- Reasons why sentiment has turned
- Normalisation of risk premiums: considerable opportunities

Market remains divided

This year, the German equity market has shown two completely different sides, as it has in the majority of recent years. Compared with last year, when value stocks with low valuations significantly outperformed highly valued quality and growth stocks as a result of the stable economic development, the tide has turned. The stocks that have performed particularly well – whether by chance or not – are large caps with a high weighting in the various indices. As a result, insofar as index performance has been positive it has been driven by a comparatively small number of companies, while the majority of shares have been among the losers, and some share prices have fallen significantly. Prime examples are SAP and Airbus, which are by far the largest stocks in the DAX and MDAX respectively. Neither are really cheap any more.

Is focusing on growth and quality stocks a cure-all?

With hindsight, it may seem that the best results would have been achieved by applying a simple strategy: buy growth and quality stocks. However, there is one key factor that needs to be taken

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into account, namely, which are the growth and quality stocks? And that can change fast. If the valuation is high due to high growth expectations or because the share is seen as a quality stock, the risks associated with the valuation may also be very high, irrespective whether the company's quality and growth prospects are fairly stable. If expectations are not (entirely) met, there may be a rapid change of direction, and that may be very pronounced in some cases. There does not have to be any lasting change in the underlying business model for that to occur. Contrary to the impression given in recent years, identifying high growth rates and above-average quality is not the end of the investment process. Just two examples among many are Osram and Jungheinrich, both of which are included in the MDAX: shares in Osram fell nearly 60 % as a result of profit warnings, although it was touted as a lasting growth story last year. Shares in Jungheinrich dropped 30 %, even without a profit warning. Both shares are now fairly valued again relative to the market but, despite the losses, they do not seem exceptionally cheap. That is due to the quality that the market still sees in both companies.

We also have a preference for good companies, but we are not interested in their shares if there is no room for error in expectations. We focus on shares which we consider to be underestimated due to their low valuation. Sometimes these are shares in companies that may seem boring, sometimes they are shares that have a negative perception for reasons we do not consider to be lasting, and sometimes, although rarely at present, they are companies whose growth potential, earnings potential or quality is underestimated.

Review of 2018 to date

What has made this year disappointing for us? On the one hand, as we have already said, almost the only shares with which investors have been able to generate profits in 2018 were growth stocks that already had high valuations. While we are invested in shares in companies that have a reasonable valuation despite their above-average quality, for example, SAP, Sixt and Merck, we were not invested in the shares whose p/e ratios have risen from 30 to 60. In addition, we continue to avoid real estate shares, as the interest rate reversal is hanging over them like the sword of Damocles. That has spared us losses on highly valued shares when market support collapsed, as in the case of the two shares already mentioned. Nevertheless, we have had to bear some painful losses, especially on shares that were among last year's big winners. They include some turnaround candidates and companies with a relatively chequered past that were trading on low valuations but had a clear and consistent strategy for achieving a long-term improvement in their earnings position. These losses were mainly due to a loss of price momentum: as a result, earnings prospects, which are based in some cases on the period from 2020, were considered to be too far in the future, resulting in a sell-off. (By contrast, the winners include some shares that

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have already declared their targets for 2025, to the great delight of the market: in these cases, the market bought into the targets because of the companies' positive history.) As usual in momentum-driven markets, it was irrelevant whether the valuation was expensive, fair or low.

News were made again by declining stock prices. At times some imagination is needed to justify the present low valuations, but for seasoned members of the investment community, it is not difficult to see p/e ratios of 5-6 as fair. It simply has to be assumed that the next major crisis is around the corner, although that was a scenario that was dismissed as unconceivable a year ago, and that it will naturally have absolutely no impact on the favourites in the quality camp.

Is there a bubble? Compare apples with apples!

In our view, structurally the situation is comparable with the late 1990s, but the dimensions are quite different. Back then, valuations of everything related to technology, the media or telecoms were absurd, but the rest of the market was cheap. Today, there are only a few companies with extremely high valuations. At the same time, there are many with very low valuations and a lot trading on normal valuations. If there is a bubble, maybe it is on the bond market. The opinion that the market valuation is normal by historical standards ignores the fact that there has been a fundamental change in market structure. The valuation of SAP, which is by far the largest company in the DAX, is more than twice as high as that of all utilities, banks (one) and mechanical engineering/plant engineering/steel companies (also one) together. The normal situation would therefore be a valuation slightly above the historical level, even if we ignore the fact that interest rates are at a historically low level.

Assuming that not all margins are stable during a phase of weakness, the overview could be extended to include the book values of companies. Here the picture is comparable. On a sustained basis, this means either that a recession is coming and is already priced into many companies, or that these shares are quite simply cheap.

Reasons why sentiment has turned

So what has caused such a rapid and massive reversal of sentiment?

On the one hand, we feel that the rising computerisation of investment is raising the significance of momentum: if all investors apply comparable rules (only stable growth, sell out completely following a profit warning, apply ESG rules without any economic understanding, etc.), more and more capital is channelled into the same shares. That works, until something goes wrong - see Osram and Jungheinrich. Analysing individual companies is regarded as fruitless, valuations no

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longer play a role (at any rate, until they become relevant again: as an example, we can look at one company that has not underperformed despite the catastrophic news flow in the sector and despite a profit and dividend warning: BMW, which has a p/e ratio of 7, less than its reported equity, while the net cash held by the industrial business is 50 % of the share price).

Momentum is built up and reversed on the basis of fundamental factors and, as we have seen, does not stop when the fair valuation is achieved. There have been various reasons for the change of direction and momentum in 2018. These are:

1. Declining growth momentum outside the USA, although Europe is still within its growth potential. This normalisation is welcome in terms of sustainable growth, but the consequence is that the at times high expectations could not be met and, above all, sentiment has clouded.

2. An above-average number of profit warnings, due in some cases to slowing economic momentum, but in many to rising factor costs (inflation is becoming visible again: raw material costs, oil prices, pay rises) and in some cases as a result of point 3.

3. Politically induced uncertainties on a scale that has not been seen in a long time:

    - Brexit: the absurdity is becoming more evident by the day but that does not prevent the British government continuing doggedly along the path it has chosen, probably out of fear of the vociferous populists. This is not yet visible in numbers, but unless a reasonable solution is found the consequences will be felt. The market is already pricing that in.

    - Italy: here the government evidently believes that there are various reasons for the present problems, none of which is caused by Italy, and that economic laws do not apply to the country. If the Italian bond market forces the government to focus on economic laws again, this will also have an impact on other sectors of the financial markets. We have already come some way towards this.

    - In Germany and other countries, there are no signs of an attempt to promote growth. On the contrary, there is a wave upon wave of redistribution, presumably to appease the populists.

    - Court decisions that cost companies sums running into triple-digit millions, either directly or as a result of political pressure, as in the case of the car producers. That does not simply reduce profits, it also reduces valuations, but it only affects certain companies.

    - The change to the WLTP standard of measuring exhaust emissions, which is really only a formality and would have taken place smoothly if more time had been allowed, is reducing the profits of German car manufacturers by over €1 billion, which in turn reduces German tax revenue by at least several hundred millions. Apparently,

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tax revenues are sufficient - except when the debate turns to tax cuts. Moreover, it is having an adverse impact on sentiment.

- And naturally, the most important point, the USA: trade disputes, which have clear consequences for companies either through customs duties or through adjustments in production. The associated countermeasures, especially in China, have contributed, for example, to the profit warnings issued by Daimler and BMW. The entire debate is having a highly damaging impact on general sentiment, even though the action is currently being toned down, because what is at stake is a key pillar of the global economic structure.

4. The last but perhaps overriding reason why market sentiment is clouding is the interest rate turnaround in the USA and thus probably in the rest of the western world. Interest rates are back at a level that in the eyes of many investors makes them seem worthwhile again after a long period of drought, even though rising inflation means that real interest rates remain relatively modest. Consequently, pressure to reinvest liquidity quickly, especially in the dollar zone, has declined. Moreover, this is affecting countries (especially some emerging markets) that were happy to obtain funding in dollars while rates were low and now have to contend with rising interest rates and the appreciation of the dollar.

Last year, the global economy ran smoothly, with the possible exception of some after-effects of the financial crisis, which has led to a far higher need for actually or perceived security than in the past. In the years before 2017, this was reflected in substantial demand for high-quality investments and correspondingly high risk premiums for investments whose quality was regarded as below average. In 2017, the risk awareness in the real economy appeared to be normalising for the first time in years. Now the uncertainty has returned and is reflected in a further rise in the risk premiums required for “less certain” cash flows.

FPM’s view and positioning

That is not what we had expected. We anticipated that a normalisation of growth expectations would be inevitable and in no way dramatic. Rising raw material costs are normally passed on to customers, albeit with a time lag, so following a slight jolt, margins normalise again - with the exception of occasional windfall profits. In particular, we saw rising inflation and interest rates as a risk for shares in companies with high valuations and stable and rising cash flows. Ultimately, the present value of an asset declines as interest rates rise. Real estate is a good example of this. It is not quite clear why one should invest in companies that are not in a position to pass rising inflation rates on to their tenants. Similarly, if companies are expected to generate far higher profits in the distant future than they do now and a higher discount rate is therefore applied,

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their present value is lower. By contrast, "more normal" companies with a good market position are able to pass rising costs on to their customers relatively quickly. If that were not the case, inflation would not be rising. So much for the theory.

Now for the actual situation. Our positioning was based on the assumption of a stable risk premium or, to be more precise, the assumption that the risk premium curve would be stable in relation to the underlying risks, especially as it was far steeper than in the past as a result of the traumatic experience of the financial crisis. After all, one in two members of the investment community was evidently anticipating an even bigger financial crisis in the near future. What happened was different: thanks to the growing uncertainty already mentioned, risk premiums did not normalise. Instead, the gradient of the risk premium curve became even steeper than it already was, as can be seen from the spectrum and divergence between share valuations in different market segments.

Even though this is annoying and we would have liked to avoid this situation, ultimately it is the result of our investment style. It is not our task to forecast extreme situations and align ourselves to such forecasts, for example, by anticipating the present massive divergence in valuations. Rather, our role is to respond to specific developments. The hallmark of extreme situations is that they rarely occur, otherwise they would not be extreme. If they were always taken into account, investment would not be an option: there is always something that can go wrong, even when investing in sovereign bonds, for example, because interest rates rise. And one thing is guaranteed if we hold liquid funds: in the end, our assets will be negated by inflation.

Considerable opportunities in our view

We see the present situation as a big opportunity, but only if the economy continues to develop more or less normally in the coming quarters, in other words, in line with the present consensus, which is also the most likely outcome. If the political uncertainties normalise or the new situation becomes the new norm and there is a new way of dealing with it, risk spreads should normalise again. Given the low p/e ratios (5-10 for "standard companies"), we feel that rising interest rates are already priced into the valuations of normal companies. Naturally, that would no longer apply if there were a further escalation, another massive hike in oil prices or an increase in the financing problems in individual emerging markets (countries for whose bonds there was enormous demand among western investors a few years ago due to their low levels of debt). However, that is probably already priced in today. One relatively positive development is currently emerging: the prices of shares trading on relatively low valuations may have bottomed out in recent weeks, while shares trading on high valuations are weakening. That could be a sign that the correction is already well advanced and is already in the final phase.

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The biggest risk that is currently brewing in our view is that the US economy could overheat: 6 % nominal growth, interest rates of just over 3 % and a budget deficit of 5 % (and rising) are in no way sustainable. But that hardly disturbs anyone in 2018: the party is in full swing and the rest of the world can merely look on. Clearing up afterwards is only something for the post-2020 agenda. Until then, risk premiums and thus valuations have plenty of time to normalise. In both directions.

Sincerely yours,

M. Wirth

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