FPM-Comment Reducing the Noise

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Of winners and losers and the resulting opportunities

Martin Wirth – Fund Manager, founder and Member of the Board FPM AG
•Experience in German equities since 1990
•Funds: mutual funds FPM Funds Stockpicker Germany All Cap

- Index level says little about valuation of the broad market
- Extreme differences in the impact of the pandemic lead to opportunities and risks
- Outlook: Consistency of human behavior and opportunities for stock valuation

Recovery with restrictions

In the third quarter, further gains were recorded on the stock markets at index level. However, the swings decreased significantly and are now back to normal levels, after extreme levels in the first half of the year. The new frameworks caused by the pandemic are now much easier to assess. The worst fears did not come true. However, a number of rules have become standard practice to contain the pandemic, which were still unimaginable at the beginning of the year.

Some companies can benefit from the changed conditions. The vast majority are working their way through the crisis with more or less light to medium hardships, as long as the extreme restrictions such as those imposed by the lock-down in the second quarter are not repeated. Now that distance rules have proven to be one of the most effective measures, on the other hand, companies whose business model relies on short distance between people, both directly and indirectly, have come under significant pressure. In addition to the usual suspects, these are also companies that, like insurance companies, are hit by second-round effects.

Of winners ...

On the stock markets, three aspects had a particularly positive impact on prices, leading to significant gains and to share price levels higher than at the beginning of the pandemic.

Logically, the crisis profiteers did very well and recorded significant price gains. These are not only the digital companies, but also companies from the healthcare sector. The first group was able to grow into their high pre-crisis valuations thanks to a massive growth surge despite rising share prices. Moreover, the shift in favor of these companies is likely to be permanent. In other companies, on the other hand, share prices have to some extent rushed ahead of business development, often driven by the hope of making a relevant contribution to the breakthrough in the

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

fight against the pandemic. Sustainability here is still open.

Secondly, shares of companies whose business model is very stable, which were not affected by the pandemic and which were driven by the expectation that interest rates would more or less cease to exist for a very long period of time, once again benefited. Accordingly, valuation also rose here.

The third factor that had the strongest impact on the share price performance after the liquidity-driven sell-offs in the first quarter was that of earnings surprises. In particular, companies whose business had not been as badly affected by the pandemic this year as initially feared and which, following the lockdown, reported a reasonably rapid business recovery, were able to achieve massive share price gains, even outperforming their "pre-corona prices". It can be assumed that the changed conditions did however not have a positive impact on these companies either. Which means that these companies either had a valuation that was clearly too low before the crisis, or that more and more investment decisions are being made using algorithms, in this case based on profit momentum, not valuation.

... and losers

All in all, this meant that a large part of the losses due to the corona crisis were made up at index level, albeit with a considerable imbalance. This means that looking at the index alone obscures the view of the individual developments. Those who did not benefit were the companies whose business was adversely affected by the crisis to varying degrees, and these are in the majority. A distinction must also be made here.

Shares of companies whose regular business suffered massively only during the lockdown, but has improved significantly since then, look expensive: The second quarter destroyed the entire year, which obviously can only be compensated to some extent. Unless the recovery is significantly better than expected and merely runs in the direction of normalization, the valuation on the basis of normalized profits or measured by the company's net asset value will remain at a very low level.

The second case is more difficult: companies whose business is de facto still under a lockdown due to the current rules have practically not recovered at all. In this case, the end of the pandemic alone is the prerequisite for recovery. Until then, companies will need to survive, with or without new capital.

No reason to speak only of deficits and doom

Not surprisingly, these two groups include candidates of above-average attractiveness from a valuation point of view, while in the group of companies that have achieved significant price gains this year, the valuation of at least some companies is likely to be exhausted. And since a cyclical upswing already gained breadth at the beginning of the year, one should perhaps not count on a permanent economic weakness.

Since there are enough doomsday scenarios, the more positive possibilities are presented here.

For one thing, the statement "worst recession in xy decades" is nonsense, since it is precisely this kind of recession that governments have imposed. Naturally, a significant recovery, often V-shaped, is seen after the regulations have been relaxed. Various industries that are not crisis profiteers have already reached pre-crisis levels, but as

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described, without making up for the losses of the first half of the year. The recovery is partly driven by catch-up effects, but this is unlikely to change the fundamental trend.

It should also be noted that public attention is primarily focused on the companies that are suffering particularly badly at the moment. Little is reported about the shift in demand. Since people take fewer vacations, but many people have an unchanged income, this flows into other uses. So the crafts and the hardware stores are booming.

Furthermore, in all countries, a larger share of income was used for savings, at least in the second quarter. These huge volumes of savings contrast with the increased state budget deficits. If one looks at the case of Germany - admittedly particularly strikingly - the rising volume of savings accumulated by the state in the form of transfer payments has been largely offset here. It is not clear when the states, with their enthusiasm for bringing money to the people and not taking very much care of the growing debt, will row back again. It can be assumed that this will happen more slowly than the economic recovery. In this respect, one should not assume that demand will start to weaken.

Cautious optimism

But the most important driver will of course be the end of the pandemic. Not for several years, if there is no vaccine, otherwise gradually over the next year. Almost everything that can be read speaks for the latter. There will not be a starting signal. It is already clearer today how to reduce the risk of infection, who is at risk, how to treat sick people better and thus reduce mortality without having a precise therapy. Accordingly, economic and other activities have already picked up again significantly. In China, new infections have been kept at a very low level by a longer, consistent containment of the virus, with the result that the economy is already growing again compared to the previous year. So this could be a look into the future: No pandemic means that the pre-crisis level could be reached relatively quickly.

Trends, all too human behavior patterns and what we can conclude from them

One should not bet on the fact that many things will have changed after the crisis. There are obvious trends like digitalization, for which the crisis was only an accelerator. The same applies to sustainability, which would have become a dominant issue anyway if the consumption of resources had been correctly priced. But that human behavior should be fundamentally different is at least doubtful: You should not assume that your fellow human beings are simply too stupid to know what is good for themselves. One rather has the impression that behind the wish that many things change, there is rather the unspoken thought: Now everyone will be as smart as me and behave accordingly. If one does not believe in it, one may assume that - negatively formulated - the old behavior patterns will again be established. Or positively: People will do what they think is right. We do not know anybody - even if there may be such people - who says: It was a mistake to have made that many long distance journeys in recent years. Rather the opposite is the case. Which one encounters however more frequently is the opinion that other people made too many journeys, and from there perhaps also comes the view that this should change.

So we are also keeping our eyes open for the losers of the crisis. In retrospect, some companies

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are likely to be among the winners in the end due to a changed supply structure, especially based on current share prices. For many, however, the funds will not be sufficient to reach the rescuing shore. In such a situation, a solid balance sheet is therefore of paramount importance in order to take advantage of the resulting opportunities.

What is completely open is the question of how the states want to cover the deficits that have emerged. Not surprisingly, the political circles, to whom before the crisis increasing debt already seemed to be a value in itself, are now the first to talk about tax increases (only for others, of course). Since they always do so, perhaps this should not be over-hyped. Our tip: a so-called special fund, to be repaid in various decades, when inflation, which, contrary to what is often read, still exists, has repaid a large part of the real burden. Naturally on the back of the savers. One will see.

The financial markets show (once again) that even the pandemic cannot harm a stable system of society

To summarize, we see a gradual normalization of the situation, with a dynamic development over the next 12 to 18 months. Perhaps 10 to 20 % of the stocks have a high or exaggerated valuation. In absolute terms, the broad stock market is valued normal to low, not to mention in comparison to the bond market. If the trend of the last few months continues, this will gradually become clear not only in terms of fundamentals but also in terms of profits. Thanks to the improved handling of the pandemic, there is unlikely to be a second lockdown, apart from selective measures.

Risk aversion on the financial markets has increased permanently over the last twenty years. The last two waves to new highs were caused by the global trade disputes and, once these had been gradually dealt with, by the pandemic. The pandemic has seen new highs, which is not surprising given the individually perceived threats. Unless an even worse event is about to happen, the focus could gradually shift once again towards opportunities beyond the obvious issues. As we can see, mankind can also handle problems of this magnitude. Knowing that neither a financial crisis, nor a trade war, nor a pandemic would be the end of history could lead to the realization that social systems are much more stable than is conveyed by the continuous clamour of the media. This could also reduce the fixation on short-term loss avoidance, which in view of current interest rates is more or less a guarantee of loss in the longer term. The fact that many shares, including those from the ranks of non-crisis profiteers, have performed better than current business indicates could be an indication of this.

Sincerely yours,

M. Wirth

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