FPM-Comment **Reducing the Noise**

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Our understanding of the right way to invest – even when security is the key driver

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- Funds: mutual funds FPM Funds Stockpicker Germany All Cap

- The flight to presumed security is increasing the valuation gap between market segments
- Value investing underperforms in such conditions – review
- Nevertheless, such extreme valuation gaps generated good results in the past

Valuation gap between market segments is increasing

For investors on the international equity markets, the first half of 2019 proved a good period. Last year's heavy losses were recouped to some extent, and some markets and shares more than made up for the losses and actually rose to new highs. Yet once again there was a discrepancy in the price performance of different market segments. Growth and quality stocks and companies with stable cash flows performed very well. By contrast, cyclical stocks and shares in companies dogged by uncertainty about quality and stability underperformed, and some actually fell. Companies previously regarded as quality and growth stocks that lost their shine also had a hard time with reduced profit expectations accompanied by lower valuation parameters. And since nothing lasts for ever, that can affect any company, even – to take one sector as an example – health-care companies.

There were two main drivers in the first six months of this year: a global economic downturn combined with a collapse in interest rates on safe investments, which was exacerbated by the central banks and also strengthened their resolve to ease monetary policy again, to bring interest rates down to even lower levels. In our view, the reversal of the boom, which started with a normalisation of growth in early 2018, has been intensified by a wide range of politically driven uncertainties, first and foremost among them the trade dispute between the USA and China. Following several flare-ups, this resulted in gradual restraint by industrial companies and consumers. In addition, since 2017 the Chinese government has been dampening the previously unchecked credit boom. That has already had the desired effect of reducing growth. Together, these two factors impacted both the industrial sector and, more generally, companies with cross-border activities. That had an above-average effect on Germany because of its heavy

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dependence on industry. In addition, as in all European member states, this was compounded by concern about the stability of the EU.
None of these factors was dramatic on its own, but together they proved too much to allow the emergent downtrend to stabilise.

Trade disputes are not sufficient to trigger a recession

Looking back over the past ten years, a recurrent pattern can be seen: a two-year upswing followed by an equally long period weaker phase. In each case, the weakness was caused by factors that were relevant but not sufficient to send the economy into recession: the debt crisis, especially in Europe, in 2011/12, the sharp drop in commodity (especially oil) prices in 2015/16, and now the trade disputes. The fact that this has not triggered a recession is an indication that the global economy has become more robust in the wake of the 2008 crisis. Nevertheless, the downturns did leave their mark on profits at more cyclical companies.

Uncertainty in the real economy and on the financial markets led to a further rise in risk premiums

The first six months of this year have been another difficult period for the FPM funds. Although the funds posted price gains overall, they significantly lagged the market as a whole and were therefore unable to recoup last year's losses. While the first four months of the year were very satisfactory, the renewed flare-up of the tension between the USA and China since the start of May has led to a massive rise in uncertainty, both in the real economy and on the financial markets. With China applying the brakes again, global interest rates imploded, and that had repercussions on various segments of the equity markets. In the search for security, everything regarded as unsafe was offloaded. Since we consider that the latest development was already more than priced into equities, the funds were overweight in shares that are out of favour again. Ultimately, that is a result of our investment style: value investing.

Our understanding of value investing

Has this style really passed its sell-by date, meaning that it will no longer work in the future, as we read from time to time? That is a view we feel needs some clarification.

For us, value investing does not mean buying the shares with the lowest price/earnings ratio or simply investing in everything that is trading at a discount to book value. Rather, value investing means focusing on the sustainable valuation of companies when making investment decisions. In short, decisions should be based on average profitability or average growth. It certainly does not mean that the valuation should ignore growth, for example. On the contrary, it means endeavouring to factor in all aspects that have a lasting influence on the value of a company. Aspects such as the stability of profits, growth, capital intensity and so on therefore have an important role to play. Since we cannot foresee the future, we naturally have to work with expectations and scenarios – and ideally price in a safety margin. However, even that cannot guarantee that the underlying figures reflect true reality.
However, we do not have anything better. Value investing is not: claiming to buy growth or quality or specific topics regardless of price. Ultimately, a price – the share price – is paid and the return on the investment is calculated on that price. However, buying on the assumption that it will be possible to find someone who is also hooked by the positive investment story and will be prepared to pay a higher price is pure speculation. Anyone

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can come to their own conclusion about why investors are prepared to buy 10-year government bonds with a yield of minus 0.4%. There are similarities with "condo-flipping" in the USA before the financial crisis: buying an expensive apartment with the intention of selling it at an even higher price. However, that does not work for ever because – like any investment method – sooner or later valuation becomes an irresistible force.

Value investing does not rest on the expectation that the price of a share will rapidly close the gap to its fair value. Often it does not, even if the long-term expectations prove correct. The price has moved away from the fair value for a specific reason and the gap will not be closed while that reason dominates investors' perceptions. Moreover, investors' considerations could be based on quite different factors: the weighting of liquidity or security may vary over time, and topics that are currently running well may be extra-polated and expected to continue for years.

The search for quality and security has driven prices to undreamt-of heights

In our view, that is exactly the crux of the matter: the global economic environment since the financial crisis has been dominated by structural uncertainty. Demand for security has therefore sky-rocketed. Yet that is often only the case on paper, as can be seen from the modest quality of some fixed-income securities. The only thing that counts here is the expectation of receiving the promised coupon. Whether it is actually paid remains to be seen. At the same time, regulation plays a far broader role than it did in the past, equating low volatility with greater security. Moreover, the low interest rates guarantee the survival of companies that would have failed in more normal circumstances, and that in turn reduces the productivity of the economy as a whole and therefore curtails growth.
That ensures that interest rates remain low, even without the central banks, and fuels further uncertainty. Added to this, unlike the situation in the past, low interest rates do not provide an alternative to compensate for fluctuations in equity market prices. Therefore, the need for security and the willingness to pay a substantial price for it have been driven to undreamt-of heights.

Risk aversion has exploded since 2018 – a mathematical view

We expected that to see some degree of normalisation in interest rates, growth and, above all, the general appetite for risk from 2017, in other words, ten years after the start of the financial crisis. In fact, the opposite has happened. We can only speculate on the reasons for the deep-seated structural uncertainty accompanying the anxiety triggered by the trade disputes. Presumably there are many causes – political, social, technological, and media-driven. The fact is that last year there was a sharp surge in risk aversion, which hit a low at the height of the technology bubble 20 years ago.
Consequently, alongside the slowdown in the real economy, the shift in valuations has led to considerable distortion on the equity markets, even though this is not visible at index level.

Mathematically, this can be described as follows: the present value of a company's future cash flows, in other words its share price, is calculated from the expected cash flows discounted using a safe rate plus a risk premium. The divergence in the performance of different segments of the equity market can therefore be explained by shifts in these parameters. The safe discount rate has imploded, which has mainly helped companies

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with a reliable cash flow and, above all, above-average growth rates. Price-earnings ratios of 40, 50 or even higher for companies with stable growth rates are no longer rare. In the past, the same companies traded on p/e ratios of less than 20. At the same time, the risk premium has risen considerably due to the significant increase in uncertainty, and that has put pressure, for example, on the share prices of cyclical companies. From our vantage point, the lower average valuation is entirely appropriate: volatility has its price. However, the low valuation is currently coinciding with a cyclical drop in profits. Therefore, pressure is coming from two sides. There are now companies trading on a p/e ratio of well under 10 and considerable discounts to book value – including companies with sound profits. As a result, the already wide valuation gap between the market segments has increased.

Present equity market situation almost comparable to the year 2000

In our view, the equity market is now in a situation comparable to the year 2000: extreme valuation gaps between some market segments. Back then, extremely high prices were paid for growth rates, now they are being paid for security. However, that is not necessarily a sign that a trend reversal is on the cards in the near future. It merely shows that the probability has increased considerably. As usual, that raises the question as to what will trigger the trend reversal. And, as always, we will be wiser with hindsight. Nevertheless, it can be assumed that, as at the peak in 2018, economic momentum will turn at some point.

Focus of the FPM funds

Our focus is as follows: by and large, our investments are split 50-50 between companies with fairly normal valuations and solid and basically stable profitability, and companies subject to doubts about their sustainable profitability, resulting in some cases in extremely low valuations. We do not have any exposure to equities that have an extremely high valuation (rarity value) due to their high quality. That would not be compatible with our investment approach. We see them as highly risky: if anything should go wrong, there would be a risk of significant losses. Nothing against such companies, which are often first-class. However, such investments are only quality investments if the price paid for their quality is not unreasonably high. And here is a reminder for really long-term investors: we were invested in many of these high-quality shares after the financial crisis. Back then, they were not just good, they were also cheap.

Trends are far advanced - turning point likely in the coming months

Looking ahead, to justify the present valuation gaps there would have to be a recession and – barring shocks – the conditions are not currently in place for that (leaving aside China, which is a black box). Consumer spending is not at risk (consumers do not have excessive debt and unemployment is low), nor is there a credit bubble in the western economies, or even in most growth regions. That does not mean that we consider stagnation for two or three quarters to be unlikely, for example, in Germany due to the cyclical nature of the economy. However, the shock that has caused the tangible weakening of the economy, i.e. the trade war, would have to be compounded by a further economic deterioration to justify current prices. A reduction in the downward momentum would already be an improvement. The same goes for stabilisation of interest rates at the present level.

Although the downward momentum has slowed in recent weeks, there is not yet any sign of a

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turnaround. That said, experience indicates that we should not rely on hard economic data: the financial markets are the best barometer. A stabilisation would be the first sign of change. That would be the precondition for considering making broader use of the valuation gap. However, so many companies already have a ridiculous valuation by historical standards that value investors cannot ignore them. That explains the focus of our portfolio, which also includes companies where we consider a profit warning to be likely.

Considerable opportunities for solid shares with a low valuation – even in the event of only partial normalisation

To reiterate what we have already said: in our view the situation on the equity markets is almost diametrically opposed to the situation 20 years ago, not in terms of the broadly based valuation but in terms of risk appetite and confidence about the next few years. Back then, interest rates were 6% and no-one found that ridiculous.
The expected growth rates were over 20 percent at quite a few companies – naturally accompanied by expectations of rising profitability. Today, people are regarded as optimists if they consider that interest rates of zero percent are appropriate for the euro zone. Looking at the political situation, it is often said that the central banks have no ammunition left. By contrast, the European countries have not wasted their ammunition and seem set to make use of it. Not in the next quarter, but there is a rising probability that things will change over time. The USA, which is light years away from balancing its budget, is a good example: it shows that there is considerable potential here, without turning up the heat on the bond markets. However, that is an issue for the coming years rather than the coming months. More relevant are the valuation gaps resulting from expectations that the trends of the past 20 years will continue. At the present level, we consider such expectations to be rash. By contrast, an only partial normalisation would bring considerable opportunities for solid shares with low valuations.

Sincerely yours,

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