FPM-Comment Reducing the Noise

Martin Wirth – 1/2020 dated January 20th 2020

Stock market recovery in 2019 – why we are confident about the future despite higher market valuations

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- Experience in German equities since 1990
- Funds: mutual funds FPM Funds Stockpicker Germany All Cap

- 2019 offset the previous year's losses
- The flight to safety and quality trend continues – regardless of price
- Valuation spreads hit new records
- The recipe for our portfolio mix in the light of the general trends

The market struggles upwards despite political and economic uncertainties

The international equity markets posted significant price gains in 2019 following the previous year's losses. Those losses were largely offset at index level and in some cases new records were set. That may seem surprising at first sight given the political uncertainty and the associated economic weakness. Consequently, many market participants are once again pointing to above-average risks. At first glance, that does not seem implausible given the long rally since 2009 and the present equity market valuation. Despite the general situation, for a variety of reasons, we see more opportunities than risks.

Security still has top priority for many investors

Let us start by looking at how the market developed. Once again, interest rates were the key parameter. In view of the uncertainties, there were recurrent periods of flight into what are perceived to be the safest types of investment – first and foremost sovereign bonds from issuers with above-average credit standing (and as a special feature, high-yielders with negative interest rates were on offer for the first time). Once again, second most popular were shares in companies that have above-average quality or that are able to generate above-average growth in a low-growth environment. Below-average price trends were recorded by shares in companies that are considered to be cyclical, are adversely affected by low interest rates, or simply do not have a striking investment story. Despite the sharp price hikes, even in absolute terms, things

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did not go well for companies that failed to deliver on expectations, regardless whether their quality was believed to be above or below average.

A tough environment for value investors

Once again, it made no difference whether shares in a company were cheap or expensive based on normal valuation parameters. As value investors, it was therefore difficult for us to generate a performance that was satisfactory by our standards – just as it had been in the previous year. We have to reiterate the comments we have frequently made in recent years about valuation spreads between individual shares - although we have to point out that the spreads have widened to a record level. Yet that will not necessarily prevent them widening further.

Keeping our eyes on our goal

It might be tempting to say: forget about the valuation and look at ... well, what? Growth, stable profit expectations, or return on investment? We are not purists: we are happy to take all such criteria on board – in fact, the more the merrier – but only on condition that we do not have to pay double or triple for them. However, we get the impression that that is the case for various assets.

A general penchant to (overly) expensive investments

Sovereign bonds can be held up yet again as an extreme case. In the middle of last year, we reached a situation where the nominal yield on first-rate sovereign bonds with a duration of decades was close to zero. Swiss sovereign bonds actually guaranteed capital erosion on a 45-year perspective. Given Swiss inflation over the past 45 years, exceptionally sunny disposition would be required to make that palatable. Even if we assume that inflation rates will remain around zero in the coming decades (which was not the case even in the ten years following the financial crisis), that postulates a productivity trend of zero, or a drop in value in real terms, in other words, failure to participate in the general development of prosperity. Leaving cash in the safe would be a better proposition then: at least it would not be exposed to price risk. Therefore, it seems hardly likely that anyone would have purchased such bond with a "hold to maturity" strategy. Rather, they are likely to have been driven by regulatory requirements, investment rules or simply short-term speculation. To those who are called on to explain their investment decisions to investors or in a court of law in the face of claims for compensation following an interest rate turnaround – which is, of course, completely unthinkable at present – that takes interest rates to lofty heights of say 1%, we can only say: good luck! Or else congratulate them on their foresight: it is quite something to predict decades without significant salary rises, with a declining or constant labour force and no productivity gains, accompanied by the dynamic development of knowledge out there in the real world.

On the risk that favourites could disappoint and expectations not be met

Be that as it may, certain groups of shares benefit from the apparent compulsion to buy stable, first-rate assets regardless of their price, while those that do not meet such criteria perform less well. What makes us believe that valuation is still

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relevant despite this clear trend, which is still unbroken (even though last autumn's developments were a clear warning in our view)? Our stance can be explained by those companies that fail to meet expectations. In such cases, double-digit price corrections are the rule rather than the exception, even if there is no reason to doubt the company's actual business or its sustained quality. Quite simply, expectations were too high, profits not quite as sustainable as had been thought, business parameters changed.
In short: there was no "margin of safety" that prevented valuations plunging. Examples are companies like 1&1 Drillisch, Fresenius and Jungheinrich, whose valuations rose steadily in the recent years on the back of constantly rising profits, until they reached a point where they had quite simply become too expensive. Experience shows that such a fate generally awaits securities that are seen as "one decision stocks".
Nevertheless, the strategy of placing one's faith in stable and growing quality stocks has become increasingly popular. Consequently, valuation spreads have continued to increase and with them, in our view, the risks associated with market favourites.

Remaining true to our style

An appropriate strategy in our view is a mixture of standard shares with fair to slightly low valuations (standard shares in the sense that they are not particularly susceptible to debates in one direction or another) and stocks that are bombed out from a technical viewpoint, with low price risks but considerable upside potential. In this way, we achieve a portfolio mix where the valuation is on the low side judged by the common parameters, despite record market valuations. That enables to take a relaxed view of the near future.

Reasons not to be sceptical in the face of all-time highs and "permanent rallies"

Here are some thoughts on the record equity market levels to put the general scepticism into context.

1. All-time highs are actually quite normal on the stock market. Most companies earn money year by year, often day by day, so it is hardly surprising that their shares rise as time passes – theoretically every day. Of course, that does not prevent occasional corrections if the share is overvalued.

2. The duration of a rally says little about whether prices are appropriate. If the present rally is considered to have started in March 2009, its duration has set a new record. But that fails to take account of two aspects: in the past, the same price gains would have been achieved in a far shorter time. More importantly, if we are being pernickety: since 2009 there have been two real bear markets, which were recognised as such at the time but have since been forgotten, probably because of the distortions that occurred in 2009 but which have not been seen since. In 2011, prices dropped more than 30% on the German equity market, followed by another drop of around 30% in 2015/16. Most recently, the German equity market dropped by 20% in 2018. All that reflects the post-crisis era: a below-average recovery accompanied by permanently high risk aversion, leading to above-average price volatility.

3. If the start of the bull market is taken not as the low-point during the crisis of 2009, but the height of the previous bubble, the DAX index has achieved a return of around zero (in other words,

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what bond investors could now be facing; incidentally, back then sovereign bonds yielded a good 5%, which was considered very low). Moreover, that calculation includes reinvesting of over half of the gains. The dividends paid have pushed the DAX performance index up by over 50%. By comparison, German GDP has increased by 60% in the same period. That is what happens when people invest in overpriced shares.

4. The most important aspect from the perspective of an investor who does not track the index: the valuation spreads mentioned earlier are not reflected in valuations at index level, which lump together overpriced glamour stocks and average shares trading on a low valuation. In other words, shares whose valuation is expensive can quite simply be avoided by investing not in the index, but in companies with a low valuation.

So what does that tell us? Perhaps not much, one way or another. Statistics can almost always be interpreted to prove what we want to prove. What counts in the longer term is each individual investment, comprising the quality of a company and the price paid. And there we see more than enough interesting investments – even though indices are at record levels.

Sincerely yours,

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