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# FPM Ladon Comment **Reducing the Noise**

**Raik Hoffmann – 3/2017** dated 31.08.2017

## Sticking with equities – and with active management

**Raik Hoffmann – Fund Manager FPM AG**

- Experience in German equities since 1997
- Funds: mutual funds FPM Funds Stockpicker Germany Small/Mid Cap, FPM Funds Ladon – European Value, special mandate for Sycomore Asset Management, Paris

- The fundamental environment for European equities is still good
- The balance sheets of the major central banks will start to contract – so interest rates should rise
- Valuations of many asset classes are currently too high to generate upside potential
- Only at first sight ETFs offer a solution to this challenge
- Still enough undervalued shares on the German equity market



**For FPM Funds Ladon – European Value:**

- Equities are still the preferred asset class
- Sovereign and corporate bonds are still unattractive
- Potential returns are higher in Europe than in the USA
- Still promisingly positioned in value stocks

## Fundamental economic situation

### *Conditions remain positive for euro-zone equities*

The fundamental environment for euro-zone equities is still very favourable. Alongside a positive credit cycle, which is finally pointing upward after many years, consumers are the main force driving the European economy. The increase in purchasing power is due to the steady drop in unemployment in the euro zone: it is currently 9.1 %, the lowest level since 2009. In countries with full employment, e.g. Germany, significant pay rises are becoming apparent. In addition, it should be noted that the main period of austerity in Europe is over and, following the upsurge of various populist parties, the pendulum seems to be swinging back towards a somewhat more relaxed budget policy. Even in Germany, tax cuts are being promised again.



**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

This positive economic scenario is also fuelled by the ECB's fear of deflation (bond purchases), which is currently reflected in growth in the M1 monetary aggregate of around 9 % in the euro zone as a whole. All in all, there are good prospects that growth will be around 1.5 – 2 % in 2017, with potential for more. In fact, the slight population growth and 1 % productivity increase are actually slightly above growth potential. That is nothing very spectacular and global demographic and debt trends suggest there is little likelihood of a big improvement in the long term; but it is not a disaster either. One positive factor is doubtless the fact that the upswing is finally fairly synchronised worldwide.

## *Balance sheets of major central banks are changing – interest rates should rise*

In fact, things sometimes happen faster than expected. A comment by Draghi that almost anyone with an interest in the economy would have dismissed as a commonplace triggered a sharp rise on the bond market. Although the situation rapidly relaxed again thanks to the Korea crisis and a flight to safety, this is a fairly good illustration of what we could face in the next few years: assuming the world doesn't end and there is no new crisis, the global liquidity situation of the major central banks (Fed, ECB, BoE, BoJ) was and remains "as good as it gets". The aggregate balance sheet totals of the major central banks will continue to rise for a while, but the pace will slow. Alongside further tapering by the ECB in 2018, the Fed will probably start to scale back its balance sheet this year. Every step will be measured and excessive haste would be out of place, but the moment when the balance sheets of the major central banks start to contract is approaching (sometime in 2018). Accordingly, interest rates should start to head north.



## *Large swathes of the capital market "on drugs"*

This coincides with a situation where large swathes of the capital market are "on drugs". As we have frequently pointed out, the bond market is in a giant bubble, unless one assumes permanent economic stagnation. Emerging market debt? Even serial bankrupt Argentina has placed a 100-year bond on the market – with a coupon of 8 %. Credit spreads are at multi-year lows, which is probably okay in light of the present economic situation, but what about further upside potential? Wild speculation has been observed in digital "currencies" such as bitcoins, where the intrinsic value of the "assets" seems reminiscent of the tulip speculation in the 17th century. Until the brief North Korea intermezzo, volatilities were at all-time lows. Real estate is still booming in many German cities, and other places besides. Equities are cheap compared with bonds but in absolute terms they are higher or even considerably higher than the historic averages. That applies first and foremost to US equities, while German and European equities are still the most attractive in terms of valuation. The valuations of some equity categories that are especially popular, e.g. the much-touted FAANG stocks and the bond proxies we have often listed, are well above-average.

The list could no doubt be extended, but it should already be clear that the valuations of many asset classes are challenging as they are slightly to well above average. There seems to be little scope for further increases in multiples, indicating a downside risk – especially if one subscribes to the view that interest rates are edging northwards.  The future could prove challenging for balanced funds comprising bonds and



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quality stocks (Germany's top sellers). Moreover, another investment class that has recently been hailed as the holy grail could prove disappointing.

## *Are ETFs really the "holy grail" of our age?*

ETFs respectively passive investments are the new panacea for both private and institutional investors. Their superiority is supposedly demonstrated by the guarantee that they will not significantly underperform the index and have in fact often outperformed active mandates in recent years. The often considerably lower fees for ETFs are probably the best argument in favour of them because the massive outperformance compared with actively managed funds could prove a cyclical rather than a permanent phenomenon. Hence the question: how can actively managed funds stage a comeback?

The more money flows into ETFs, the more inefficient the capital allocation of an economy is. Under communism, capital allocation is at least managed by a central planning authority (which does not necessarily mean that it takes efficient decisions; but at least it addresses the problem). In a world with nothing but passive management styles, both good and bad companies would be treated equally. That means capital allocation based on index weighting! In this constellation, market capitalisation weighted by free float is normally the sole valid criterion. Companies with anchor investors (for example, family-run companies), which often have a long-term business policy, would be placed at an additional disadvantage. It is easy to imagine what that would mean. The weighting of companies that grow through equity-financed acquisitions would rise, so excessive purchase prices would be the rule rather than the exception. Size would be all that matters. At the same time, there would be cut-backs in banks' research departments and active investment managers, further undermining the basic assumption of passive investment, i.e. efficient capital markets. Thus, the success of ETFs would increase the chances of outperformance of actively managed investments.



Since the low fees of the indexed funds are becoming increasingly less attractive for ETF providers, there is a growing trend towards "smart beta strategies". Instead of indices, there are now also value, growth, high-quality and many more "esoteric" ETFs. The fact that such ETFs are no longer passive but follow defined selection criteria is self-evident. However, that the investment decisions they take are better than those of active investment managers is anything but given.

Inflows into ETFs prompt them to buy past top-performers with their higher index weighting, which drive them up further. The intuitive investment principle "buy low, sell high" is turned into "buy high(er)" or – in the event of outflows – "sell low(er)". ETFs strengthen trends and the herd mentality may even be one of the reasons for the underperformance by active managers in recent years. The increasing trend to passive investments is underpinning the current relative valuations, so inflows into such funds ensure that the present highly weighted stock market favourites with their high valuations remain the favourites in the future. The lower the proportion of active managers, the more pronounced this trend will be or the longer it will take to correct a trend. If money should one day be withdrawn from the equity market (ETFs), this would result in disproportionate sales of all these high-weighted and expensive stocks. But who would then



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be the natural buyers? Probably not active managers. Incidentally, in a world in which there was only passive management, there would be only buyers or only sellers and no market any longer. Logically, the higher the proportion of passive investments, the lower the market liquidity. It will be interesting to see whether the promised liquidity of ETFs can withstand this if the flows reverse one day – especially in the case of illiquid asset categories. Looking at the sell-offs in recent years, it is clear who has been wrong-footed: at the low points there were always massive outflows from ETFs.

The supporters of ETFs will naturally point out that the proportion of passively managed funds is not high enough to cause such negative side-effects. That may appear to be the case at first sight, but many actively managed funds are not all that far from passive management styles due to their adherence to criteria such as tracking error or corresponding sector or country criteria. Probably, it will only be clear with hindsight when the disadvantages outlined here outweigh the benefits of ETFs.

In an age when future return expectations are far lower than in the past, ETF investors voluntarily surrender any chance of outperformance. At the same time, they buy the overpriced average capital market valuations at a time when it is clear that the global flow of liquidity will soon ebb. ETFs were doubtless a good tool after the financial crisis, when valuations where so low that it was simply important to buy market risk.  However, in the present situation this approach no longer works in the same way.

Let us return briefly to the subject of fees: in our view index-huggers are not a solution because the fees are far too high relative to their performance. Truly active management has its price – but above all, a chance of earning additional returns.



### *Enough undervalued shares for our portfolios*

Since we can still find enough undervalued shares on the German market, the question of overvaluation does not arise for our portfolios. Although that does not rule out interim corrections, the very positive economic situation suggests that these should be limited. We are sticking to our style: no benchmarking; instead we focus on active value investing.

## Pricing and absolute valuation of the equity portfolio

In view of the valuation spread outlined above, we still see selected equities – but also the entire market – as the preferred asset class. In particular, equities where not everything is going “smoothly” or with slightly lower visibility are still trading on very attractive valuations.

With real growth of around 1.5 – 2 % in the euro zone, government bonds remain uninteresting from a fundamental viewpoint and are completely overpriced. Thanks to the ECB, this now also applies to corporate bonds with high credit standing.



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The DAX is currently valued at a PER of just under 13, about two points below the EuroStoxx. Germany's valuation is still at a multi-year low compared with Europe, which does not seem entirely logical to us given the upturn in global growth and the German equity market's higher cyclical exposure. We therefore still see an above-average number of favourably valued equities on the German market.

## Technical market data

Ultimately, the markets have had to bear the brunt of the lack of breadth we complained about. Looking at sector performance, especially in the USA, the need for consolidation does not yet seem to be over.
The credit side (junk bond yields, spreads, etc.) still looks good and mitigates against major problems in the immediate future. Europe looks considerably better than the USA and is also more interesting from a valuation point of view.

## Fund positioning

### Asset allocation

In view of the positive backdrop outlined above, we are remaining fully invested in equities, especially as many stocks still have very favourable valuations. Government bonds are absolutely overvalued so we continue to hold a short position in the bund future, which will deliver a positive performance when interest rates rise.



### Individual stocks

During the reporting period we took new positions in Rocket Internet SE and TUI AG.

### Outlook

At present we do not see any significant need for portfolio adjustments. As we have explained, we are relatively positive about the future economic trend and many of the shares in our portfolio are trading on very low valuations. We are therefore sticking to our positioning and will be using selective opportunities to raise our holdings. In particular, we consider our position in value stocks, which most investors are avoiding, to be very promising. Derivatives are used to address short-term market risks.

Sincerely yours,

Raik Hoffmann



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