FPM Comment **Reducing the Noise**

Raik Hoffmann – 2/2018 dated October 15, 2018

Good reasons to invest in our funds

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- 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

- Our views on 2018 – and our funds
- Massive divergence between value and quality/growth
- A good time to buy our funds

Divergence between our – essentially correct – view of 2018 and the performance of our funds

A review of the year to date shows a substantial divergence between our outlook for equities in 2018 and the performance of our funds. While our outlook has been more or less correct, the performance of our funds has been extremely disappointing. So what has gone wrong?

Our core assumptions for this year can be summed up as follows: weaker growth (momentum) in the EU, resulting in more sluggish equity markets, at least in the first half of the year, but not the slightest danger of a recession. Rising inflation and therefore rising interest rates, especially in the USA, with successive rises in Europe as well. As a consequence of this: higher volatility coupled with the expectation that a relatively big correction could also include the increasingly speculative elements (bitcoin, tech shares, IPO boom, etc.), providing a sounder basis for the equity markets, which we expect to generate average returns as they are fairly valued (value stocks tending to be cheaper, growth stocks more expensive). Based on these expectations, we started the year with higher cash holdings/hedging, enabling us to invest when valuations fell following the rapid downturn at the start of February.

This comment is intended for fund analysts, consultants and asset managers only. No supply to retail clients.

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Diverging valuation of value and quality/growth stocks

While indices such as the DAX, MDAX and SDAX are slightly higher than they were after the correction in early February, our funds are far lower. The main reason for this is the massive divergence between value stocks on the one hand and quality/growth stocks on the other. Or, to put it another way: cheap shares have become (considerably) cheaper, while shares that were already expensive have become even more expensive. The best example of this is TecDAX, which has risen around 15 % since February. Looking at the other German indices, shares in companies where growth can (it is assumed) be predicted easily (quality shares) have risen significantly against the trend, while many other shares have dropped, in some cases substantially. For example, many shares included in the TecDAX are now trading on p/e ratios of 50 or higher. Many companies in the quality category are trading on p/e ratios of 20-30 or even considerably higher. Alongside real estate shares, these include, for example, shares like MTU, Rational and Symrise, whose growth rates are not exactly highly dynamic. If a few of these often highly weighted shares were factored out of the indices, the small and mid cap indices would also be far lower. Incidentally, the situation is not much different in the USA: even there, a few heavyweight tech stocks are driving the market. The last time there was a similar divergence of segment performance was during the dotcom boom at the end of the 1990s. Since many of these shares had p/e ratios of 20-40 at the start of the year and therefore did not meet our valuation criteria, we did not include them in our portfolios. And since their valuations have risen further, they definitely do not qualify now.

A good time to buy our funds

The divergence in valuations is so extreme that now is actually a good time for anticyclical investment in our funds, despite their present rankings. Capital markets return to the mean in the long term, but sadly this adage does not provide any indication of the timing. Or, as John Maynard Keynes put it: “The market can remain irrational longer than you can remain solvent!”. In autumn 1999, it was doubtless clear that the valuations on the New Market were crazy, yet they continued to rise for another six months. A similar situation can evidently not be ruled out entirely now, but the probability seems lower than it was back then. While Greenspan continued to pump money into the market in 1999 because there were fears that the switch to the year 2000 could cause technical problems for computers, this time the central banks are applying the brakes. We are sticking to our positioning. In fact, we are stepping up the alignment of our funds to this situation by raising our exposure to shares that have dropped significantly and reducing exposure to those that are between the two extremes and have therefore held up better.

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Reasons for the divergent valuations

There is probably no single reason for the extreme divergence of valuations. On the contrary, it is probably due to a range of uncertainties in recent months (as outlined in detail by my colleague Martin Wirth in his October commentary, which you can read at www.fpm-ag.de/en/comments). Reasons for the heightened uncertainty since the spring include, for example, the unresolved Brexit problem, Italy's confrontation with the EU and, in particular, Trump's trade disputes. Even though these factors have so far only had a marginal impact on the real economy, they leave a sour taste. Exacerbated by the turbulences in the emerging markets, they naturally have the potential to extend the present "weakness" of the European economy, which we had expected to peter out at the end of the summer. Leaving aside China, the trade disputes will probably calm down again, as shown by the rapid agreement reached with Canada and Mexico. A few minor concessions for Trump voters should (hopefully) also be the blueprint for the negotiations with Europe. While surveys show that the majority of Americans consider trade with Europe, Canada and Japan to be fair, public opinion on China is completely different. For years, China has only been opening its market insofar as this suits its own interests and massive obstacles are placed in the way of foreign firms in order to support domestic industry. That is well-known, but no-one dares to be too critical in order not to jeopardise their "business". One need only think of how Daimler kowtowed to China after quoting the Dalai Lama.

However, Daimler was in good company. Various other firms have found themselves in similar situations. If trade issues were the only problems, they could probably be resolved - just not very quickly. However, if the US administration's objective is really geopolitical, i.e. if it aims to at least slow China's rising influence, the dispute could have repercussions for a long time to come. China cushioned the first round of customs duties by devaluing its currency by 10 percent. If tariffs are increased by another 15 % in January and China responds by devaluing its currency further, the emerging markets turbulence seen to date is likely to be only the beginning. That would naturally have an adverse effect on the market as a whole, but shares with high valuations and high expectations are likely to suffer most, especially as very negative scenarios are already priced into many value stocks.

Still pro value: rising interest rates

In the short term, rising interest rates are an argument in favour of value stocks. In view of the mounting price pressure, further interest rate rises are highly likely. In the USA, in particular, the upward trend in interest rates is relatively clear and probably only massive market weakness

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would interrupt the FED's course. With yields of nearly 3 % on two-year bonds and over 3.2 % on ten-year maturities, bonds are increasingly competing with shares. At some point, that is likely to put pressure on the stable and expensive growth stocks, while value shares are more likely to benefit (e.g. pension liabilities decline when interest rates rise).

Sincerely yours,

Raik Hoffmann

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