



FPM-Comment Reducing the Noise

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The hype in a few stocks is leading to low valuations on a broad scale, while poor politics make for good stock market prospects

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The first half of the year: AI creates euphoria - but not across the board

The first half of 2024 was largely positive on the stock markets in terms of the indices, but rather mixed to unpleasant looking at the overall market range. The general conditions are not easy, but they are not getting worse either: inflation is falling, which should also lead to falling interest rates in the future, albeit not to the extent that many investors are expecting, if not longing for. The economy in Europe and especially in Germany appears to have bottomed out. In the USA, where the economy has benefited for some time from a massive increase in government debt, there are signs of a slight slowdown, but there are no fears of a recession. In China and most other countries, there is some growth, albeit lower than has been the case in recent years. In this respect, therefore, everything is moving along cautious lines.

The topic of "artificial intelligence" dominated the stock markets. Almost everything has been said about this by everyone, so we won't go into further detail here. Except that, in our interpretation, this had a significant impact on the stock markets: many investors simply had to be present here. The number of companies playing the theme is moderate, so this could only be done by inflating the market cap. At the same time, these investments had to be financed from somewhere, which was done by selling positions in the broad market, regardless of the respective valuations. Furthermore, former favorites in other sectors were sold on a massive scale when targets were missed: In many cases, we have seen share prices halved and worse over the past two years. This showed once again that looking at the valuation can help to at least limit losses when favorites change on the markets.

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Politics is having an impact - bad policies lead to bad election results

This time something about the various elections in 2024, especially those for the EU Parliament and in France: it is obvious that the established parties do not like the election results. What is radical about the new competitors will not be assessed here. However, it is astonishing that the traditional parties have not come up with the idea that they may have made mistakes that their core voters no longer accept. It is always down to the difficult framework conditions or a lack of understanding for what are actually brilliant policies. The fact that politics could have contributed to the difficult framework conditions over the last 25 years: This is not taken into consideration. In Germany, this can still be blamed on the CDU by the government, after the SPD was not represented in the federal government for only four years in the last quarter of a century. Perhaps the SPD has forgotten this, but its former voters obviously have not.

You have to imagine that a company describes customers who switch to the competition, perhaps because prices are too high or services are poor, as being unable to understand the company's products properly, that they obviously cannot afford them and that many switchers are obviously trapped in precarious living situations. And the media then find examples that reflect this as proof. That would be completely absurd. If you lose your customers (here: voters), then you question your own product portfolio (here: politics). And then probably realize that cannabis legalization or the ability to change your biological sex every year might be appealing aspects. But even if a clear majority is not opposed to these options, this does not mean that there is satisfaction with government policy in general. There are enough well-known issues that concern most voters rather than what seems to be the focus of politics.

Also surprising for politicians and their voters seems to be realizing that political decisions have consequences that people actually have to deal with. And it is difficult to find anything that politicians have done that has made life easier for their voters. If they did, then they were only sensible measures at first glance, the consequences of which had to be borne later. Let's start with the shortage of rental apartments: Under these conditions, who should go through the trouble of building anything new to rent out to third parties? Higher construction costs due to additional regulatory requirements, building authorities with weak decision-making powers, higher interest rates thanks to increased inflation, more uncertain income thanks to the one-sided expansion of tenant protection. The fact that production costs are passed on to the consumer is also an unpleasant experience that no one thinks about when energy prices are increased, taxes and CO2 levies are introduced on energy, when there are more and more requirements for producers, and so on. The seven billion euro truck toll is not paid by truck drivers, nor does the gas station attendant pay the fuel tax. Rail tickets are squandered, even on people who can easily afford a fair price and are then surprised that the railroads and the public sector are short of money. Inflation was desirable among politicians for years, until the time came and they realized that someone had to pay the price; unfortunately, it was mostly those they wanted to protect the most. And now increased new debt is supposed to be the salvation? How this is to be paid off in the future under demographically more difficult conditions is completely unclear, but probably not part of the plan either. The problem here is the same: Someone is having to pay the bill, and in real terms it has been the brave savers over the last 15 years.

The bottom line is that constant dripping wears away the stone, and there has been a lot of that since the Lisbon Strategy was concluded a quarter of a century

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ago. Back then, the aim was to develop the EU into the fastest-growing region in the world. The result is a bureaucratic monster with a permanent underperformance against the rest of the world in terms of growth:

The everyday lives of citizens are regulated down to the last detail, right down to the way bottle caps are attached to plastic bottles (are there any plans for beer bottles?). Despite a shortage of labor, tens of billions are paid out as social transfers (in Germany), the recipients of which are often better off than if they were working - and then don't do so. There is a defensiveness that does not even vaguely correlate with the expectations and the money spent: 60 billion euros may not be two per cent of GDP, but it is a lot of money: where does it actually end up? No reasonable immigration policy has been achieved for years; instead, illegal migration is de facto tolerated and in some cases encouraged. Public administration, which is becoming ever more complicated in the face of ever more regulations, does not have the motto "How can we help you?", but "It's not that simple" and, in case of doubt, "If you don't do anything, you don't make any mistakes". All this is garnished with record high sick leave rates. Public sector ratios of more than 50 %, at which, according to former Chancellor Kohl, socialism begins. The EU – appalling in view of its economic prosperity – is afraid of being undermined by China and the USA and is not even remotely aware of its own strength. And so on and so forth, energy prices, infrastructure, education, you name it.

All of this costs growth, even if many politicians don't like it: This cannot be avoided if people, instead of working productively and efficiently, have to do things that do not lead to prosperity. If you create incentives to prevent work and investment, then you shouldn't be surprised when these incentives have an effect and these effects add up.

Expectations are low, which significantly reduces the potential for disappointment

The only good thing about this is that the problems are obvious and should therefore be priced in. Whether the fear of the mainstream parties of losing power is greater than the enthusiasm for pursuing special interests for special social groups remains to be seen. As the European population basically prefers things to be more comfortable than revolutionary (apart from a few vociferous "activists", usually from the left-wing spectrum, as well as the eagerly reporting media), it should not actually require any outstanding intellect to bring politics back into line with the interests of the majority. In Scandinavia, the Social Democrats have obviously succeeded in doing this, as can be seen from the election results. And a certain ability to learn can also be assumed in other countries without becoming euphoric.

However, it will be difficult for politicians to undercut expectations in the coming years. At the same time, even parties on the political fringes will have to subordinate their preferences to reality if they are elected. In our eyes, the current hysteria is only serving the purpose of improving one's own election chances rather than actually fearing the demise of the EU: As I said, Europeans like things cosy and not revolutionary. And why it doesn't make sense to just agitate against the EU instead of making it better: The Tories in the UK can deal with that from now on. So as long as the structures in Europe are even halfway the way they are today, the crucial point remains: You should not let political conditions intimidate you. Instead, it is crucial to be invested. After all, the current framework conditions also have positive aspects for investors on the stock market: Less optimism also means less willingness in the real economy to invest money, to intensify competition, to make existing structures obsolete. Rather, it secures existing positions. You only have to look at

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the real estate companies: Less new construction means less additional competition, which means rising rents while living space remains scarce – it could hardly be more convenient. The same applies to many sectors. And partly explains the still very solid margins despite the weak economic development. In China, we see the opposite: wild investment everywhere, overcapacity, price wars and, as a result, a share performance that does not even begin to reflect economic growth compared to Europe.

When quality stocks become value stocks: A painful metamorphosis

And now to the stock market:

Despite historically low valuations in general, some smaller caps have performed weakly. The main losers this time were not the rather average quality companies, but often the former favourites that fell victim to their previously high valuations. The problem with highly valued shares is always the same: once the trend and enthusiasm fade, it is a very, very long way until a new group of investors, namely value investors, shows sustained interest. If a share is no longer far too expensive, but just expensive, that still doesn't mean there is any buying interest. Not even if it is slightly expensive, or halfway fairly valued, or slightly undervalued, but only if it is significantly undervalued. This in turn often goes hand in hand with an operating business that is no longer as buoyant as it was in more favourable times. In other words, when a falling valuation meets falling results.

The problem for the former growth stocks that have undergone their metamorphosis into value stocks is exacerbated by the fact that there seem to be fewer and fewer value investors. After ten or more years of one-sided investing in quality and growth stocks, but first and foremost chasing price and earnings

momentum, the value style has simply run out of steam due to ever-shrinking assets.

Private equity meets publicly listed companies: Dramatic undervaluation becomes visible

Two takeovers last year illustrate the scale of "value" that is now being offered on the market: Software AG and Aareal Bank. Premiums of around 50 % each were offered on the stock market price before the takeover announcement, with the assurance that the company had now really gone to the extreme in several steps. Unfortunately, this was not quite the case.

After the takeovers, the development was as follows: Both companies sold the divisions considered to be growth areas, which were supposedly to be further developed outside the stock market without the usual quarterly pressure, after just a few months. And in both cases, although they represented the smaller segment of the companies, a price was realised that corresponded to the total purchase price for the acquired companies. This means a profit of more than 100 % on the allegedly exhausted purchase price within less than a year, after the shareholders had already been paid a premium of 50 % in each case. It is obvious that Software AG and Aareal Bank had low valuations, but they were not alone in this: There are enough other companies at this valuation level.

By the way: In a few years' time, we will probably see the sold divisions being offered at a multiple of today's takeover price in another IPO, and this will probably also take place, see the Douglas IPO. In the words of Warren Buffett: Buy a company, leverage it up, change the accounting, get it back to the market. Then, as in the case of Douglas, after a few medium-sized takeovers and a messed-up balance sheet, these shares come back at significantly higher valuations than when they went public. Sufficient numbers of investors are then suddenly willing to



listen to the cheering arias of the accompanying banks. The balance sheet is regularly messed up because a hefty payout is made shortly before the IPO, usually the repayment of a vendor loan, which is officially debt capital but was provided by the owner. The proceeds of the IPO are then used to enable growth, but usually a more or less large proportion is used to repay the vendor loan. In economic terms, this is a sale of a company, with the proceeds of the sale being distributed in advance. These companies only have equity because they capitalise goodwill and other intangible assets up to the pain threshold. It is always fascinating that nobody seems to be bothered by this, unless the share performs badly after the IPO.

There are always lame excuses for not investing in the stock market

All well and good. However, the question arises as to why investors do not invest in companies that are now listed on the stock exchange and often trade at record low valuations. The reasons given are the lack of liquidity, which is also not present in private equity or real estate investments, political uncertainty, which apparently does not affect private companies. The same applies to better growth prospects in the USA, which also no longer seem to play a role for private companies or property. In the end, there are two reasons that are really relevant: Firstly, regulatory causes, such as investors themselves associating share price swings with risk, but above all government supervision. In fact, the first time we read about risks in the Benko property empire was when the structure had already ended up in the ditch. Prior to that, no one had bothered about opaque structures and the valuations were completely stable, so everything was absolutely fine. Fascinating. On the other hand, investing via ETFs, where more and more money flows into the same themes without giving much thought to what you are buying and whether it is

reasonably valued. This is momentum investing in its purest form. The main thing is that the headline is thematically correct.

Value investing helps to avoid the risk of a downward spiral...

It only becomes unpleasant when a trend no longer continues and companies that we believe are still doing well but have had a few worse-than-expected quarters lose their supporters. Without the actual quality and business model of the company itself being called into question, profits accumulated over years are wiped out within a few quarters and the caravan moves on to the next topic. To name just a few names that have seemed overpriced to us for years and in which we have therefore not invested, at least not for some time: Aixtron, Compugroup, Sartorius, Carl Zeiss, Hugo Boss, United Internet, 1&1 Drillisch, Evotec, Teamviewer and, unfortunately, in HelloFresh, which we continue to hold in high regard. It is not uncommon for ten years' profit to be lost, and if not, sometimes the share is not yet at the bottom. In any case, the momentum that has driven the shares upwards can mean a fall into what feels like a bottomless pit if it disappears: No value investors (if they still exist), dropping out of indices, deteriorating press, critical, sometimes aggressive and frustrated shareholders, poorer earnings expectations, lower valuation multiples, short sellers.

...and occasionally being invested in an upward spiral

In this respect, we will continue to focus on unloved stocks with solid business models that have a low valuation and are therefore better protected against downward pressure. As long as nothing very dramatic happens. And unloved doesn't mean permanently unloved, of course, but just at the moment. This has applied to a larger, fairly stable group over the last ten years. What has changed

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over the years: valuations have continued to fall (investors needed the money to chase the Mag 7 and Bitcoin), dividend yields of six, seven or eight per cent are no longer uncommon (yes, and you can cut them, but that applies to all companies), free cash flow yields of well over ten to sometimes twenty per cent are also available, and the best thing is: companies are increasingly using the money to buy back shares. And less to expand their empire, with often overpriced takeovers, as seen in the past, which after ten years lead to (attention, standard excuse:) non-cash write-offs, mostly by the subsequent management. And every write-down is non-cash-effective, but unfortunately the money is gone anyway, namely at the time of the takeover. If Daimler had refrained from taking over Chrysler, and Bayer from taking over Monsanto, and instead occasionally bought back their own shares... oh, let's not go into that.

⁶ Of course, the supreme challenge remains finding a few companies that can spiral upwards instead of downwards: rising profits with rising valuations. In a market in which investors are focussing on fewer and

fewer companies with ever higher valuations, one thing is pretty certain in our eyes: finding these companies that can spiral upwards is becoming easier thanks to the increasing number of candidates. What you still need to bring to the table is time. However, as mentioned above, this is often compensated for with substantial dividend payments and, in the best case, is further enhanced by share buybacks.

In summary: a lukewarm economic environment, certainly not overheated, inflation tending to fall, which is a prerequisite for interest rate cuts by the central banks, companies with unexciting but largely stable expectations and decent profitability, investors who are rather sceptical when it comes to hype topics and shares with a frequently very low valuation: the outlook is encouraging.

Sincerely yours,

Martin Wirth

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