FRANKFURT PERFORMANCE MANAGEMENT AG

FPM-Comment Reducing the Noise

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Prospects and value trends on the stock market and what the Wirecard case does to our confidence in the regulatory institutions of the capital market

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- Why the worst fears did not come true
- Interesting venue for stockpickers and value investors
- Opportunities in the context of the pandemic
- Our approach to Wirecard and the damage to the financial industry

Where do we stand after a turbulent first half year

The first half of 2020 will undoubtedly go down in the history books, and not just those of the stock market. After the economy had just started to improve at the beginning of the year, the corona pandemic broke out. Initially underestimated outside Asia, the spread of the virus first turned everything upside down and called everything into question. After the peak of the panic and the trough of the economic cycle, which was reached at the end of the first/beginning of the second quarter, mankind has found a way to deal with the pandemic. The procedures are similar, but the containment successes vary depending on the willingness to follow the virologists' recommendations. However, the worst fears have not materialised.

Where do we stand today? For one thing, panic is not appropriate. Headlines about the deepest recession in living memory do not hit the point: this was precisely the aim of politics, supported by the clear majority of society, to bring public life down in the first place. So it is imperative that a recession sets in, similar to every weekend when there is little business going on.

Meanwhile, knowledge about the virus has increased at an unprecedented rate. Procedures have been developed that allow a large number of activities, though not all, to resume. This should compensate to a large extent for the economic slump that lies behind us. What is lacking to regain the pre-crisis level are all activities that involve close interpersonal contact, in whatever form. This in turn means that part of the economic supply is missing, and with it part of the demand. In addition, this also puts pressure on the consumer mood, which all in all leads to a weakened economic activity.

Not the end of the world

If the economic expectations for the current year for Germany come about as expected today, i.e. a decline of 7 % (which would admittedly require a significant recovery in the second half of the year and be associated with a significant increase in government debt), the country would fall back to the income level of 2015. Truly no drama.
However, the "damage" is extremely unevenly distributed compared to 2019. For most people nothing will change at all, salaries will flow, pensions and benefits will rise, and many workers will even have de facto more paid holidays.
A large part of the damage will be borne by the companies, many self-employed and some of the employees. As well as, of course, those whose living conditions have changed considerably, such as parents, which is not reflected in GDP.
The moaning is of course louder than the silent enjoyment of those who are not affected or those who may even benefit from the situation. So, as so often, it is necessary to separate the noise and the facts.

A word about the national debt: Two-thirds of the gigantic figure that the German government has earmarked consists of loan guarantees and the like, which means nothing other than that the state is prepared to take on the credit risks, but the money would only be lent. Economically, the same is true of other parts of the programme, so that although the state measures were still of a considerable order of magnitude, they were not at all on the scale that is always passed around, even in comparison with other European states. In addition, to the triumphant clamour of the friends of state deficits, it must be said that this is not the abandonment of the black zero, but rather the reason why one should strive for one in good economic times. Waste not, want not: this statement seems too complex.

Uncertainty drives prices for safe investments

As far as the part of the economy that is relevant for us is concerned: on the stock market, the effects are also miles apart, just like in real life. Here, too, the segments that suffer most are those whose business model does not provide for avoiding physical proximity or where this is even part of the concept. These are followed by those industrial sectors where the purchase of products can be postponed and which are therefore subject to cyclical demand. At the other end of the scale, of course, are the companies that help to avoid physical proximity. And in between are a large number of companies that are coping reasonably well with the situation.

The financial markets have adapted to the current environment as they have always done over the past ten years: Safety first, and safety comes at a price. In addition to fixed interest rates (if you want to talk about interest rates, there is often nothing left), the shares of companies whose business has been little affected by the pandemic were in demand, and of course the beneficiaries of the situation. The valuations of stable companies have reached new highs in the process, which has also affected the indices, which have thus been able to make up for much of the losses of the bear market.

This naturally leads to the question of how it is that the indices are trading close to record levels in the midst of the current chaos. This viewpoint is causing renewed uncertainty and is obviously driving the demand for safe investments - but

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only if valuation is not taken into account. But even this can be justified: If the very low profit expectations for the current year for the more normal companies are taken as a basis for valuation, super-stable and high-quality companies do not seem expensive by comparison. Since the second quarter, for which reporting is about to start, was a disaster for many companies, there will be enough reasons to avoid investing outside the top tier for the time being. However, one should bear in mind that the recovery of the economy is obviously already underway, and a look at the current results is a look in the rear-view mirror. As a result, we expect the tables to turn again in the coming months.

In the meantime, average shares have also stabilized. With a perspective that extends beyond the next few months and which assumes a recovery that is even only halfway successful, many of the "normal" companies are trading at extremely low valuations. Series of more or less significant markdowns on the book value already adjusted for intangible assets, even for companies that achieved solid profitability before the crisis, represent an opportunity that arises only once in many years.. It is not even necessary to venture into the areas of companies that are suffering severely from the recession and are likely to suffer a substantial loss of substance even in the best case. In our view, it is sufficient for companies to survive the current situation without losses in order to represent a very attractive investment in the long term.

How are we positioned? Apart from special situations, the portfolios are geared towards "normal" companies, followed by companies that are suffering below average from the pandemic, but which for various reasons are not valued at the level of their quality. Special situations with companies for which the worst case scenario has been priced in, but which in our view will not be the most likely outcome, as well as companies with very strong growth, some of them as beneficiaries of the crisis, are similarly weighted. We are still not positioned in companies that are extremely crisis-resistant and have an extreme valuation based on this, which, thanks to their performance in recent years, now make up a relevant part of the market capitalization. We consider this segment to be very vulnerable from a valuation perspective if the general conditions normalize, which should happen quite simply, for example, with the likely possibility of a vaccination in the next one to two years.

Joy and sorrow are close together

In addition to the disadvantages of the pandemic, which are being discussed extensively in the media, the opportunities should also be mentioned here.

On the one hand, the shortage of personnel, from which many companies have suffered in the last two years, should have been significantly reduced. Furthermore, in the course of the economic boom it was practically impossible for many companies to improve inefficient structures. Some things ran out of control, some became obsolete but were retained, some were dragged along even though they had no prospects. It was almost impossible to communicate efficiency improvement measures to the public. That has now changed. It does not have to end in mass layoffs, it is enough for the efficiency of a company to increase by only a few percent to have a significant effect on the results (which have suffered from the high capacity utilisation in recent years).

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But the biggest advantage is likely to be the breakthrough for digitalisation. Let me make this clear by looking at the German school system: For years it has been discussed, committees have been formed, projects launched, educational platforms launched, millions sunk, and nothing has happened. And now, within a few weeks, Google Classroom or Microsoft teams have been introduced in various schools, just like that, without a national campaign, without the resistance of the permanent retarders from parts of the civil service or trade unions, who probably would have reacted with long-term strikes just a few months ago if they had had such a perspective. Even if the German education system is likely to be a dimension in its own right: It's no different in the corporate world. Here too, what would otherwise have taken years happens in a few weeks. The earnings potential from this will be seen in the coming years.

All in all, the economies have been exposed to a stress test, which, apart from a war, has probably come close to its maximum. It took a few weeks to have enough information to adjust to the new situation. The adjustment has begun, the interim measures until normalisation are expensive but they are feasible. As for the market's dichotomy: the market seems to be pricing the possibility of vaccination at a much lower level than is seen by all those involved in it, otherwise the discrepancies would not be so great in a medium-term perspective. But perhaps this has something to do essentially with the fact that this view extends beyond the usual six months into the future. As I said, depending on the investment horizon, one now has the opportunity to take advantage of special opportunities.

On this occasion, a few words about Wirecard

In the funds and mandates we manage, we were invested in Wirecard for only a short period and not in all products. After we had watched the rise of the company as bystanders and had not invested for years due to the permanent discussions about the company, the ever-growing list of first-class customers who worked with Wirecard and who must necessarily have carried out a validation of the company gave us the impression of a functioning, competitive business model as well as sufficient security of solvency. But two aspects were decisive: The certificates of the auditors Ernst & Young as well as the supervision by the BaFin. A competitive product does not mean that you have to earn money with it. Whether this is the case: this should then be evident from the income statement and balance sheet, which are checked by specialists appointed and paid for this purpose. Whether this was done in the right way: This is monitored by the supervisory authority, which can act in all possible ways. Furthermore, in the case of Wirecard, the executive bodies of the company, including the recently appointed Chairman of the Supervisory Board, had initiated a special audit by KPMG. The course of the special audit was commented on by the executive bodies to the effect that obviously nothing was discovered that would have violated the usual regulations, insofar as everything was on the right track. This was all done without any objections from the special auditor.

Wirecard has repeatedly been the target of attacks for more than ten years. In this respect, the conclusion was obvious that this was the best-audited German company, which, however, was an ideal target for external attacks due to its very virtual business model. The allegations made were always irrefutably denied, and the

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company's auditors and supervisors always took the company's side. The motives of hedge funds are not always committed to the common good, so it was not necessary to adopt their respective points of view.

In short: in line with the motto "In doubt stay out", we were on the spectator's seats for years and essentially only entered into our investment after the significant fall in share prices and, in particular, after the start of the special audit, after the alleged business was, in our view, clearly undervalued despite all the uncertainties. Finally, the fact that an audit was initiated was, in our view, a confidence-inspiring signal that the accusations were groundless. In retrospect, it was as trustworthy as Christoph Daum giving a hair sample at the time. At the stock exchange opening on April 28, the day of the publication of the KPMG report, in which KPMG announced that it did not have sufficient evidence of the existence of the reported Group liquidity, we settled our position before the opening of Xetra. Lack of evidence is actually unthinkable, since every audit should begin with the confirmation of liquidity by the banks. However, this confirmation had obviously not been demanded in recent years. This was also a signal, namely that in recent years exactly the opposite of what one might have expected has happened: that a company that has been so harshly criticised has been looked at particularly closely. Our reaction as active fund managers allowed us to even settle the Wirecard position with slight profits for our investors for all mandates. Ultimately, Wirecard also found a reason for the lack of bank documents and was able to delay the moment of ultimate truth until mid-June.

Why fundamental trust in the capital market is at stake

But this should not be about Wirecard: There has been criminal activity here, the rest will be dealt with by legislature. What is relevant for us as investors, but also for the capital market as a whole: there are institutions that were created to reduce fraud, or at best to prevent it. These are primarily the auditors and, in the case of financial service providers, BaFin. Both have failed so blatantly here that this cannot remain without consequences without the German financial market declaring itself a banana location. It is not about preventing fraud in every case. It is about taking a closer look at cases that have already been discussed in public for years and where there are indications for a closer examination. And if an examination is so simple that a bank confirmation alone, or the lack thereof, would indicate a major disaster: Then this can only be gross negligence, if nothing worse, on the part of those on whose work all capital market participants must rely. If one wants to blame analysts or fund managers, one should bear in mind that audited financial statements of supervised companies are one of the raw materials for the capital market. A taxi driver must be able to assume that the engine of his car will not explode, a pilot that the plane will work, every consumer that food bought is not spoiled, otherwise the supervision would have failed. These institutions have rights that third parties do not have, and these rights must be used to identify problems. That is what they were created for. It is rarely possible for investors to recognise audited annual reports as fiction. If auditors can then no longer be trusted, fundamental trust on and in the capital market is endangered.

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It is unacceptable that the blunders of those who are practically appointed as trustees should undermine the integrity of the capital market and leave everyone else who trusts in their work and, quite incidentally, pays for it, at best as ignorant, at worst as crooks and gamblers. We are eagerly awaiting further developments, but we are afraid that the reaction from BaFin will be the same as in the past: even more regulations, even more slips of paper and documents, and still no eye for the essential. We are eagerly awaiting the day when regulators discover a disaster before everyone else is already talking about it. And in the case of auditors, we are eager to see how they will try to muddle out of the situation. If this abysmal performance had no consequences: then you can do away with auditors right away.

Sincerely yours,

Martin Wirth

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