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FPM-Comment Reducing the Noise

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German small and mid caps: things can only get better

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- Large caps are great, small caps not so much
- Parts of the financial markets in speculation fever ...
- ... financed by the sale of European assets, among other things
- Thanks to poor economic policy Europe is seeing outflows across the board
- German economic policy has destroyed a lot of trust in Germany
- Result: significant undervaluation of large parts of the German stock market
- Financial investors and others take advantage of the low valuation when equity investors do not

At first glance, 2024 was a very pleasing year for shareholders. At second glance, however, this was primarily limited to large stocks. Smaller stocks, often regardless of the development of their business, were unable to benefit much from the positive sentiment and in some cases recorded significant losses even if their business expectations were missed by even just a small margin. The performance of the German share indices diverged accordingly: while the DAX recorded significant price gains of 18.8 %, the MDAX, TecDAX and SDAX achieved a performance of -6.7 %, +2.4 % and -1.8 % respectively, whereby the TecDAX owes its unique position with a plus in the “ small cap segment” to the fact that the largest stocks SAP, Deutsche Telekom, Siemens Healthineers, Infineon, Qiagen and Sartorius are also represented in the DAX and account for 70 % of the index. And arithmetically, seven stocks accounted for almost the entire performance of the DAX and therefore also for the overall performance of the German stock market.

Large caps are great, small caps not so much

In addition to company size, the drivers of share price performance were, as always, the fundamental development of the companies, but also the stability of profits, the obviously sustainable higher level of interest rates for banks and insurance companies and the importance of the US business for the companies: The higher, the better. In addition, the big winners had reasonable, in some cases low valuations at the beginning of the year. However, unlike in previous years, the quality of a company was no guarantee for performance, regardless of its valuation: some former favourites, even if they are highly capitalized, suffered considerable losses. In this respect, despite all the downbeats, it can be said that valuation does play an important role and that value investing is the basis for sustainable investment success.

Due to the disproportionate weighting of small caps, the FPM Funds were unable to escape the weak performance of small caps with +2.4 % in the

Stockpicker Small/Mid Cap and +3.3 % including dividends in the Stockpicker All Cap, and although they performed significantly better than the small cap indices, they were also far off the performance of the DAX. Roughly speaking, the following can be stated: The winning positions benefited from higher interest rates, rising defense spending and individual company-related performance data; they suffered above all from the aversion to anything cyclical as well as consumer-related stocks.

Parts of the financial markets in speculation fever ...

The general situation can be described as follows: If Donald Trump can increase his wealth by 60 billion US dollars in 24 hours with the launch of the Trump Coin, this leaves questions: firstly, whether crypto assets are really as valuable as their fans claim, and secondly, how you can master these so-called chain letters (or even want to try) if you are not a crypto fan. In any case, the value of Trump Coin is now higher than the value of VW, BASF or Infineon. Accomplished in one day. Congratulations.

... financed by the sale of European assets, among other things

In our humble view, however, this does not mean that Mr. Trump is able to create gigantic values in the shortest time possible, but rather that gigantic speculative bubbles have risen that have largely moved away from real values. And the money that drives these bubbles (or at least overvaluations) has to come from somewhere. Just as it is obvious who the profiteers are (crypto assets, US tech stocks, US equities in general, the US dollar, even gold), you can see the losers or the sources of funding: Global equities ex USA, especially small and mid caps, also and especially in Europe. In addition, there are the payment flows from all over the world that finance the US budget deficit, from Germany alone an amount in the three-digit billion range, which could also finance investments in Germany if there was confidence in the local framework conditions. The fact that this does not exist is due to the bureaucracy, the de facto red-green government and the bureaucracy expansion scheme called European Union, although it should be noted that things are not much better in other European countries. At any rate, the fact that the USA has to pay 100 basis points more for its national debt than Greece, has to spend around 5 % of its GDP on interest and is fueling this with a national deficit of 6 % of GDP in the middle of a boom could give food for thought, or it could be dismissed along with the terrific growth prospects.

Thanks to poor economic policy Europe is seeing outflows across the board

In our view, the situation at the start of 2025 looks like this: Interest rates on the bond markets are at a solid level, measured against inflation and expectations, and further cuts can be expected at the short end, at least in Europe. The euro is around 20 % undervalued against the US dollar in terms of purchasing power parity, which overall makes life easier for European companies. Europe is experiencing capital outflows, the USA inflows. This is unlikely to change until politicians agree on more growth and less bureaucracy and the European states are also prepared to build up military strength proportionate to their size. The fact that Europe today always looks to the USA with anxiety and hopes not to be forgotten does not build confidence in internal and external security. Because at least that can be said: Given the modest defence capabilities in Europe, it should come as no surprise that investors are also demanding a risk premium for this compared to the USA. The very modest successes in supporting Ukraine are a deep concern, after two years ago the French president was still seeking to avoid humiliating Russia. In view of the economic size and technical superiority of Western weapons, this is all the more an embarrassment for the political leadership in Germany and Europe, and Europe is already paying a high price for the associated mistrust of international investors.

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German economic policy has destroyed a lot of trust in Germany

This is reinforced in Germany by an (economic) policy that is more like that of activists than a well thought-out strategy that would be appropriate for a complex economy. There are certainly structural problems in Germany, perhaps to a greater extent than in other European countries, but this hardly explains the years of weak growth and, in particular, the zero growth rates since the last government took office. The only relevant positive thing that can be stated from an economic perspective is the fact that Germany has a solid State budget, which practically all other major economies would also like to have. Including the USA, which has gone from one debt orgy to the next in recent years, kindly financed by the rest of the world. In addition, excessive bureaucracy and an investment-avoidance mentality are not laws of nature but can be reduced to an appropriate level by the government. And the idea that every investment should be subsidized by the state instead of creating attractive framework conditions for everyone has primarily ensured that many investments, including in climate protection projects, have been held back on the assumption that sooner or later there will certainly be a government grant if you just wait long enough. However, the mere fact that all this is harmful is unfortunately no guarantee that things will be done differently in the future. But at least further deterioration of these framework conditions should have become less likely.

Result: significant undervaluation of large parts of the German stock market

Up to this point, this was the view from a height of ten kilometers. As equity investors, however, we are cruising just above the turf. And here the picture is somewhat different. On the one hand, the valuation of the German stock market as a whole is at a sustainable level. If you take the highly valued heavyweights out of the equation, the valuation falls significantly. The fact that margins are at a rather low level, especially in cyclical sectors, shows the potential for earnings improvements when the general conditions normalize. The surplus that arose in the manufacturing industry and the subsectors downstream after the pandemic is likely to have been largely reduced, and this reduction explains part of the recession. Interest rates have fallen, meaning that the capital goods and construction industries should also gradually see an improvement. A more investment-friendly climate is likely to develop after the general election, following the previous government's frequent ideological missteps.

It makes little sense to look at the valuation of the market as a whole to understand the differences in the valuation of German (and European) companies compared to the USA. This always leads to the argument that the Magnificent 7 plus many other technology companies are of a completely different caliber compared to the large European companies. So, you should compare them on an equal footing. And here, too, you will find valuation premiums of 50 to 100 % for US companies compared to their European competitors, even if they also operate a substantial business in the USA and are not only active in low-growth European countries.

Financial investors and others take advantage of the low valuation when equity investors do not

And this brings us to the topic of “financial engineering” as an opportunity for the German and European stock markets if these valuation differences do not level out on their own: This calculation of the valuation discrepancy is so obvious that companies themselves are coming up with the idea of splitting up and separating their US business (the automotive supplier Norma, HolCim, possibly HeidelbergMaterials) or starting share buybacks. It would exceed the scope of this article to list the number of companies that have started to do this. Or the companies themselves are taken over in their entirety by (mostly) financial investors, which is now happening about once a month in Germany. In addition, insider transactions are regularly far higher than sales, which also indicates an

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inappropriately low valuation. If you then see that European holdings which almost exclusively hold listed American assets are trading at record high discounts to net asset value, then you can see how the capital flows are going, regardless of any fundamental valuation considerations. Whether all this is enough to make Europe and Germany an outperformer again in times of social media, index investing and constantly reduced research activity remains to be seen. At least the downside risks - despite an all-time high in the DAX - are manageable and significantly lower than in other regions of the world. And at the current valuation, solid performance opportunities are certainly available to an above-average extent.

Sincerely yours,

M. Wirth

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