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FPM-Comment Reducing the Noise

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How to achieve above-average results with "average" shares

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- Experience in German equities since 1990
- Funds: mutual funds FPM Funds Stockpicker Germany All Cap

- "Stocks are expensive"? A look at the individual segments shows what the market development hides at the index level
- Turnaround cases as biggest winners
- Relevant inflation drivers have picked up the pace
- The rule for 2022: keep your eyes open - not only with regard to the preferred market category

2021 encouraging for the markets and especially for FPM Funds

2021 was pleasing on the international as well as on the German stock market. Moreover, the FPM Funds were able to achieve significantly higher growth than the market as a whole. The funds benefited from their focus on low-valued and underestimated companies, which progressed well even in the face of the pandemic.

Of course, market performance at the index level always hides what is going on below the obvious. General statements such as "stocks are expensive," which may be true at the overall market level, are often not justified when looking at individual stocks. In our view, it helps to simplistically divide the market into three categories:

- Cyclical/Value/Standard stocks
- Growth stocks with high growth expectations
- Quality and safety

There were very different developments here over the course of the year, which can easily be underestimated if one simply looks at the index.

Performance varied greatly in the different segments

The first of these categories is by far the largest category according to almost all criteria such as sales, absolute profits, economic relevance, etc. With one exception: market valuation.

The situation is the other way round with the second group: here, the market valuations are in some cases extremely high compared with the actual data. Due to the moderate growth in recent years, valuations have risen to new heights for companies, some of which were able to achieve high growth rates even in a difficult environment. This is then justified by the fact that the future is traded on the stock exchange. This is often said, but it is wrong. What is traded are future expectations, and these can change quickly.

Together with the third group, where expectations naturally change only slowly (quality is often considered to be synonymous with predictability, stability and reliability), growth stocks have the disproportionate importance of interest rates as a driver for stock prices. Here, there were only comparatively minor movements last year, despite rising inflation rates. Again, economic relevance and market value are inversely related compared to standard stocks. Otherwise, a large part of the French population would have to work in the luxury industry. Which we know nothing about.

Our funds invest in all categories, provided that the valuations indicate a reasonable risk-adjusted return. This means that companies can also be of high quality or achieve extreme growth rates. This distinguishes us from the usual approach to value investing, which, at least in the trivial view, looks primarily at apparently favorable key figures.

In recent years, however, opportunities in these two areas have been scarce in our view. This was partly due to low and still falling interest rates, which favored quality stocks. If you can get as little as 0% on a bond, a de facto inflation-hedged stock with a stable business and a valuation of 30 times earnings is quite attractive. If these stocks rise, many investors have to chase this trend from a benchmark perspective, which drives prices further and then puts pressure on the prices of more "normal" stocks. Similarly, with growth stocks, their story is almost never in doubt until something goes wrong. Until that happens, many investors have the notion that they have discovered the new Amazon or Google. Standard stocks, on the other hand, have suffered in recent years from the unstable economy following the financial crisis, trade wars, technology disruptions, some of which have called business models into question. As far as share prices are concerned, crowding out by growth and quality stocks was the cause of extremely low valuations in some cases.

Last year was a different story. Quality stocks largely experienced a period of relative weakness in the first half of the year, during which they were unable to keep pace with the cyclically supported momentum of standard stocks and initially also of growth stocks. However, as the dynamic of the economic recovery slowed, they again achieved significant gains in the second half of the year and were the most successful category. The performance of standard stocks was more or less a mirror image of that of growth stocks. Growth stocks were a different story: Here, valuations went from high and extremely high to in some cases significant price losses. Companies that failed to meet expectations recorded massive price losses in some cases. Only when estimates were exceeded were upward trends maintained.

FPM invests in all segments. Precondition: The valuation is right.

Where we consider it justified, we are also invested in companies for which extremely high growth rates are expected. However, this requires that these companies have a technology, a competitive position or a disruptive business model that is difficult to challenge. Simply being present in a growth industry is far from enough: If the barriers to market entry are manageable, they will be overcome, and then the growth perspective is more of a curse than a blessing: Capital is then invested in the industry, often far beyond what is

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necessary, because "everyone" wants to be there, again building overcapacity and destroying price discipline.

When we invest in growth companies, the valuation must at the same time be comprehensible, taking into account the costs of growth and also in the event that the best case does not always necessarily materialize. In these cases, we are also willing to ride out price fluctuations, which will always come, and not abandon the position for short-term opportunistic reasons, just because price gains have just occurred. This strategy applies to a larger part of the positions in FPM Funds Ladon, which is focused on investments to avoid and reduce CO2 emissions. Here, many companies are still in their infancy, even if they already have promising technologies. The same applies, for example, to HelloFresh, which has redefined an entire value chain in food production and distribution, is highly profitable, and is still expanding its market share despite being the clear market leader in a rapidly growing market.

The biggest winners in our portfolios were turnaround cases

However, the big price winners in the FPM Funds last year came from the other camp. First and foremost among them is Heidelberger Druckmaschinen. In recent years, the company has been restructured step by step in a not easy environment, after a long period of more or less drifting along. At a time when the measures had already all been defined or were already being implemented, the company was, to put it bluntly, valued more or less like the real estate at its headquarters, if you neglect the low-interest inflated pension provisions. The capital market hardly followed this world market leader at all, and often the analysis ended with a horrified look at the pension provisions, without even questioning the nature of this position. There was discussion of bankruptcy at a time when financial liabilities had largely been repaid. In addition to Heidelberg, companies such as K+S stood out after the change in the trend of potash prices and (like Heidelberg) the balance sheet restructuring completed by the sale of the salt activities in America, which no one on the stock market wanted to take note of for a long time, or the gemstone trader Elumeo, also after the restructuring was completed. Otherwise, the winners were broadly spread across standard and also growth stocks, and major loss-making positions were largely avoided. We continued to hold virtually no stocks that benefited from low interest rates, as we simply do not share the assumption of a continuation of this situation for various reasons. Exceptions are companies such as Merck, which without question also belong to the quality league, but whose valuation was significantly depressed a few years ago by the worsening prospects for liquid crystals and which thus offered an opportunity for entry.

Outlook 2022: Great uncertainty regarding inflation and interest rates

That was the look back, now for the outlook 2022:

And as always, looking backward is quite easy and everything is logical, almost compelling, in retrospect, while future prospects are as unclear as they rarely are. However, we are indeed finding it particularly difficult this time, especially because some predictions for the past year were miles off the mark, without anyone seeming to mind. This primarily concerns realized and expected inflation.

It is natural to expect inflation rates to fall in 2022, especially as the problems in the value chains are slowly being resolved, the handling of the pandemic is becoming more routine, demographic developments are taking their toll and, above all:

because that's just the way it has always been over the past 30 to 40 years.

Relevant inflation drivers have gained dynamics

On the other hand, however, the following aspects should not be neglected: in 2021, inflation clearly exceeded all expectations. In a situation that is admittedly not normal, the trend toward stretching and optimizing value chains has led to considerable distortions in a wide range of industries. Savings, which are also becoming smaller, are therefore harder to justify, at least in individual industries. At the same time, companies are finding that customers will accept price increases, unlike in recent decades, if it means they receive security of supply. Thus, there is a willingness in the real economy not to continue the trends of recent years, but rather to initiate a turnaround. But: In order to continue the inflation rates of recent years, as the majority of the financial markets continue to do, it must be assumed that the path of "optimization" of the value chains will continue, i.e. that there will have to be a further relocation of production sites, a further division of value creation and a further willingness to increase risks. The only question is where, and who is still willing to do this after the experience of the last few quarters. The other day I read the insight that no one knows how to make a ballpoint pen. If you think about it, you come to some amazing realizations. And this is by no means the most complex product available on earth.

Back to inflation expectations: If you look at the price development of non-tradable goods and services, there is nothing to be seen of deflation fears there, at least in our environment, and there hasn't been for years. Perhaps this is explained by the fact that we are located in the Westend, but the ECB is in the Eastend and we don't have the perfect oversight. Or maybe the ECB canteen refrains from raising prices. Our local supply landscape does not. Neither do the insurance companies, the utility companies, the transport companies, not to mention the energy prices. In total, inflation in Germany over the last 25 years has been 1.5%, with a price-inhibiting effect due to the optimization of value chains. One can imagine that this level could be exceeded if this process of optimization can no longer be continued.

Apart from this structural effect, cyclical aspects are obvious: Historically, central banks are still extremely expansionary, with interest rates far below inflation rates. With the pandemic and climate protection concerns, the governments have the perfect excuse for rapidly rising public deficits, and in the U.S.A., helicopter money has become a reality with the transfer of money to citizens, which has not yet become effective in terms of demand: It is increasingly difficult to imagine a world as it was before the pandemic, also in terms of monetary stability.

Interest rate level has significant unintended redistributive effects

Getting a bit more fundamental, the interest rate environment can only be seen as harmful when viewed as a whole. Central bank policy is supposed to make life easier for debtors and to stimulate new investment. However, an investment that no longer pays off at interest rates of 1%, but does at 0%, is better left undone in economic terms. And since most investors in the real economy outside the financial markets obviously continue to handle things that way, little additional activity can be observed. On the contrary, the low interest rates tend to cause distrust in the sustainability of the financial environment. Obviously, this is different for real estate, but here, once interest rates are locked in, cash flows are largely secure.

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The main motive that remains is to relieve the burden on the indebted countries, i.e. practically all countries, after the inflation rates were already more of a fig leaf in the past and are now obviously being whitewashed and no longer taken seriously. The fact that private debtors are also deleveraged and private savers are burdened to a much greater extent is accepted, even though private debt is significantly greater overall than government debt. At the end of the day, this means nothing other than a massive redistribution from creditors to debtors, or aggregated: From the center of society to the wealthier class of fellow citizens. After all, this is where the market participants are primarily to be found who can take on debt because they have a sufficient credit rating. This redistribution is conservatively estimated to be in the mid double-digit billions in Germany alone. It is simply absurd. And thus probably not sustainable.

Interest rate and inflation risks asymmetric in the different stock market segments

Returning to the stock market, we see opportunities and risks asymmetrically distributed overall. We do not see it as our core competence to make economic forecasts. However, we also see that interest rate developments once again have the potential to become a market-determining factor. On this basis, we analyze companies, their valuations and what is priced into these valuations. And here we can continue to state: Despite the strong price movements at the beginning of 2022, quality companies continue to have high valuation premiums, not only in relative terms, but also in absolute terms, compared to companies that are considered more average. This in turn means that the majority of investors are betting that the underlying conditions will move back in the direction of the pre-pandemic times. For the reasons outlined, we believe this is anything but a given, but we do not rule it out either. However, if this does not happen, there are considerable price risks associated with quality and overvalued growth stocks. Here, there is a double risk: that the growth rates will not be achieved, and that the discount factor will increase. From a valuation point of view, "more normal" companies do not have these risks, but "only" the usual ones that result from the respective industry, the individual business model and the economic situation, and which are currently compensated with a risk premium that is rather above average.

Consequently, the choice of the preferred market segment is not that difficult: no companies that benefit from low interest rates, no companies whose high growth rates are not covered by an outstanding business model or an equally outstanding technological positioning, instead, as in the past year, rather average stocks with a low valuation. And keep an eye out, because the first fallen former growth stars are starting to look cheap.

Sincerely yours,

M. Wirth

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