FPM-Comment Reducing the Noise

Martin Wirth – 3/2022 dated July 15th 2022

Be greedy when others are fearful

Warren Buffett

Martin Wirth – Fund Manager, founder and Member of the Board FPM AG
•Experience in German equities since 1990
•Funds: mutual funds FPM Funds Stockpicker Germany All Cap

- A recession is hardly avoidable, but has always been a good time for investments
- Energy supply is a more serious concern than inflation and recession
- The "era change" will allow many weaknesses to be overcome
- At the current valuation level, opportunities clearly outweigh risks in the medium term

First half of the year turned out to be very unpleasant on the financial markets

The first half of the year was extremely unpleasant on the international financial markets, downright disastrous for many market participants. June saw a selloff that pushed most markets into bear market territory. The combination of negative influencing factors then proved too much.

- The distribution of helicopter money, which was generously submerged almost everywhere during the Covid crisis, has largely ended.

- The disruptions caused by the Covid crisis, on the other hand, have not yet come to an end. China, in particular, excelled with senseless measures that caused shortages all over the world.

- Increased commodity prices, combined with underinvestment in recent years, drove up general prices worldwide, so that central banks were finally forced to face reality and, unfortunately, began raising interest rates into an economic slowdown.

- The pinnacle of stresses, however, in every respect, was Russia's invasion of Ukraine, which as we know is not only a human tragedy, but has and will continue to have multiple political, military, and economic implications.

In July, it immediately continued this way: Now, there is a threat of a supply shortfall of Russian gas to Europe, which, thanks to the naive policies of the last decades, would affect Germany more than most other countries.

A recession is hardly avoidable, but has always been a good time for investments

The ECB continues to expect the EU economy to grow, both this year and next. We like to be optimistic once in a while, but here we lack the imagination of how this will be achieved in view of the multiple distortions so far and in the coming months.

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

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

FRANKFURT PERFORMANCE MANAGEMENT AG

That's the bad news. The good news might be that recessions have always been a good time to buy stocks. The second piece of good news for investors in the real economy is that this recession will not be a nominal recession, thanks to substantially rising prices. This can already be seen in the performance of many companies, which are generating rising sales and in some cases very solid profits thanks to sharply rising prices, even outside the basic industries. It's almost funny again when it is then said that the recession is not yet visible.

The market has more or less priced in the recession. Despite lower valuations, the European markets have dropped just as much as the U.S. markets. The cause, of course, is perceived weakness in the political, military and energy sectors, which has also further depressed the euro. Fears about gas supply, especially in Germany, have become visible in recent weeks with a massive selloff in cyclical stocks. Some strategists believe that valuations are not in line with what is usual in recessions: this is primarily true at the index level, where quality stocks, which have been extremely popular in recent years, continue to have a high weighting at a high valuation. For "normal" stocks, the world looks quite different.

Energy supply is a more serious concern than inflation and recession

Where do we stand? If history is relevant, way down in many areas. As we all know, uncertainty is something that is not valued at all in the stock market, and after Covid, we are once again in "unchartered territories" here. It is not economic weakness and inflation, but energy supply that is driving investors into a state of capitulation. Whereby the first two aspects are unpleasant enough.

As for inflation, it can be noted that it is primarily driven by supply-side shortages, still pandemic-related, but now also by the Ukraine war. If these effects are factored out, core inflation excluding energy and food would still be a high, but not so absurd – 3 to 4 % instead of the overall figure of about 8 %. Here, too, effects from the Covid pandemic upheavals are probably still visible: logistics costs, confusion at airports, for example, missing personnel who are now employed elsewhere, etc. For a few weeks now, however, longer-term inflation expectations have been on a clearly declining path again, so that even the interest rate hikes by the central banks should presumably not lead to the recently feared heights. Falling share prices, uncertainties due to the geopolitical situation and collapsing consumer confidence are also having a restrictive impact on the economy and the price level, and in this respect the central banks are being relieved of some of their work.

Many stocks are trading at record low valuations...

Where do we stand at the individual share price level? A few examples, without these being buy recommendations. BASF is valued below book value. This has not happened in any crisis in the last 20 years. Normally, the valuation is between 1.5 and 3 times equity. Covestro's valuation is also below book value, in terms of corporate value including debt at a record low. Since going public, the company has halved its debt, doubled its equity, achieved returns on equity of between 10 % and 30 %, and is regularly growing in the region of 5 % p.a. Both companies have a global production network, e.g. only 25 % of Covestro's plants are located in Germany. The remaining 75 % are located in countries that do not have a gas supply problem. In the case of BASF, investors have agreed that Wintershall has a value of zero,

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

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

although a relevant part of production takes place outside Russia, business continues in Russia, and a theoretically conceivable expropriation of assets there will presumably be compensated in some way. And yes, BASF would suffer greatly from supply shortfalls of gas, but that is not a permanent problem and only affects the smaller part of the group. As I said, the uncertainty, which is hard to bear on the stock markets, means that investors prefer to assume the worst-case scenario and then put a tick on the issue.

... and increasingly use this to buy back shares

Another example is the increase in companies engaging in share buybacks, including some companies that for years adhered to the credo that share buybacks fell into the category of corporate failure. A view we do not share in any way, of course, and one that is completely illogical. However, it does show the aversion of companies to providing capital to the owners in a way other than dividends: Dividends are more likely to build a reputation. In addition, it does not carry any (rather formally relevant) price risks if the shares fall to a lower level after a buyback. For example, BMW or HeidelbergCement are worth mentioning here. There are obviously valuation levels at which things are looked at anew. Now we could write about 30 to 100 other companies with a similar tenor. The essential thing is: many shares are now valued at a discount to fair value of between 30 % and 60 %. If I want that discount, I have to buy at those prices. Whether they will get any cheaper: No one can say. But what we can say is this: Most people just don't buy when stocks are cheap, but when they feel good about it. The stupid thing about this strategy is that it can inevitably lead to no more than average results, if at all.

The justifications for the low prices are partly contradictory or often enough detached from the facts

There are many absurd comments that are due to the uncertainty in the markets. As for inflation: it is expected to remain high for years to come. Supply-induced price increases are now to be followed by a wage-price spiral to compensate for the increased cost of living. At the same time, due to the expectation of falling prices for companies, which are profiting particularly from the increased prices, profits are expected to fall significantly in the next few years. So the instantaneous profits are seen as unsustainable. That can happen. But if wages rise but prices don't, purchasing power would increase significantly. Which would mean something quite different for the economy than the lean years now supposedly ahead, in which consumption suffers from high rates of price increases because consumers cannot compensate for inflation rates. In the end, this says more about sentiment (everything is bad, and once it isn't, it gets bad, even if the assumptions were to be self-contradictory) than about reality. For once, we're not committing to much there, except to take advantage of the opportunities that arise from these contradictions. Because in the end, the contradictions are simply taken as given or blamed without reflection if one does not dare to take advantage of low valuations for shares.

I would also like to comment on a fairy tale that is making the rounds: Germany owes its prosperity only to external factors, and the preconditions for this have now disappeared. Prosperity is in great danger. Cheap energy from Russia, exports to China and security from the USA: Everybody is repeating after everybody else. Gas from Russia cost a few billion € less than gas from other countries, this difference was not the decisive factor for the German economic system, even if it

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

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

was of some additional benefit. For a country that can spend €1 billion per month on allegedly medically questionable Covid tests, not quite a big deal. Either way, the price of gas will be a very different burden in the coming quarters. But that has to do with the Ukraine war and not with the German economic model, which is then no longer supposed to work. And will not remain this expensive in the long term. The price disadvantage of gas from other countries compared to Russia is well below 1 % of GNP – once you have the infrastructure to deliver it. China is indeed a huge sales market, and that for the entire world. But that German companies would have been naive and better off staying at home from today's perspective is nonsense of the first degree. Companies are now so big in China that they can finance even massive investments in the Chinese market internally, either from their own profits or with financing from Chinese investors. The alleged deglobalization is also due to the fact that companies are now becoming more local: For example, German automakers are setting up more and more production facilities in China, including a local supply industry (again, often the usual German companies), which lowers costs, the risk of trade wars, of tariffs, or rising logistics costs. Is this de-globalization? Moreover, if a growing part of value creation takes place in other countries, the consequence is that foreign markets become more and more important for companies, but the opposite is true for the German domestic economy. In this respect, it is becoming less and less possible to draw conclusions about German companies from the German economy. See Covestro: one quarter of capacity in Germany, largest site Shanghai. Since this causes additional work for the top-down strategist, this view is also gladly avoided once in a while, otherwise the statements would perhaps also no longer be so snappy. But perhaps closer to reality. And to the last argument, that security was outsourced to the US: While this is true, it was not due to the German defense budget, which is one of the highest in the world, but due to a completely neglected political leadership (and this does not even concern the Ministry of Defense in the first place) as well as administrative structures that obviously far exceed the usual shortcomings in Germany. If the Bundeswehr is to be strengthened, political leadership and the willingness to do so are ultimately more decisive for success than transferring more money. In this respect, one should not be fooled by commentators with strong attitudes and little interest in facts, who often come from the political camp that considers government action to be more promising than what companies deliver. All in all, the defeatism of such statements is completely unproductive, especially if these statements should be the basic assumption when investing.

The "turn of the times" will allow many weaknesses to be overcome

None of this is intended to trivialize the current situation. It is not only a recession that is imminent, it is also the frequently mentioned turning point in time. How things will develop in the next few years is an open question. With the exception of an expanding war, from which Russia would certainly not expect anything positive and which is therefore very unlikely, there are also substantial opportunities. Many things that have been dragging on for years, obstructed by laws and authorities, blocked with masses of court cases, can be handled quite differently under the current pressure. Thus, many measures required for the energy turnaround can now be implemented. The weaknesses of the German authorities were already evident during the Covid pandemic. With the hopefully corresponding pressure for change. In addition, as mentioned, the Bundeswehr,

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

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

structures in the EU and a more active foreign policy that does not just leave the stage to autocrats.

The question of gas supply is serious, but not hopeless

How the question of gas supply will be solved is open. Many paths can be taken. What is clear is that there would be a gap in the next few quarters if Russia stops supplying gas. However, depending on countermeasures, this gap is likely to be somewhere in the range of 5 to 20% of gas demand. One should not be misled by Russia's 50% share of total German gas purchases, even though the presumably much lower figure would still be unpleasant. From the point of view of a company's shareholder, the decisive question would first be how companies would be affected by this mixed situation. And here, as things stand today, the answer is clear: Under normal circumstances, production losses resulting from the gas shortage would be far from a loss, but would reduce profits to a varying extent. And to the extent of perhaps 20 to 40% in the case of the chemical industry, roughly speaking, although individual companies might be more severely affected. And without the assumption of passing on the higher prices to customers, which might not be entirely realistic either. It could be, of course, that gas will continue to be supplied as normal: Russia used to receive about €10 billion p.a. from Germany for gas deliveries; today, at current forward prices, it's more like €30 billion to €40 billion. So for trying to pressure the Europeans, Russia would be giving up €100 billion in the case of Germany over the next few years, plus another €100 to €200 billion from other EU states: That could be the price Russia stakes in the hope of getting rid of Western sanctions. War-decisive, on the other hand, rather not. In addition, Russia would then have less money to compensate, for example, the victims of Western sanctions. Plus possible damage payments, plus the technical difficulties to resume gas production in the future: This does not suggest that it is imperative for Russia to stop deliveries. One will see.

Stability and security have built up enormous premiums again

Current events on the capital market show a reversal of the price movements since the beginning of the year. In recent weeks, commodity prices, cyclical stocks and interest rates have fallen, while the old favorites, especially quality stocks, have risen. Safety is paramount. We believe that, as far as equities are concerned, this is a move against the trend. Valuation discrepancies have widened again. These discrepancies are simply too large in the long run. Contributing to this movement has probably been the realization that a recession in the next few quarters is more likely than no recession. However, the unwinding of some aggressive speculative positions also appears to be playing a role. For example, the fact that wheat prices have now fallen back below pre-Ukraine war levels in the face of expected food shortages in the next few quarters is otherwise hard to explain. The same applies to other commodities. Here, too, we will see which interpretation was the correct one. In the first place, we see the closing of the "inflation-scarcity positions" and the switch to the familiar "quality-stability positions" in the face of the looming recession, regardless of any valuation benchmarks.

At current valuation levels, the opportunities clearly outweigh the downside in the medium term ...

On the other hand, due to the massive valuation discrepancies, we continue to stick to the strategy of investing in low-valued companies with a clearly

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

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

FRANKFURT
PERFORMANCE
MANAGEMENT AG

identifiable risk profile, most of whose valuations are at a lower level than they have been for many years. And not just measured in terms of possibly fluctuating earnings, but in terms of sustainable substance. There are some new opportunities here. In this situation, one can always remain flexible and, when they arise, take advantage of even greater opportunities that may arise over time. We don't think the full impact of interest rate hikes on the darlings of recent years will be visible; valuations simply don't allow for that.

... which can be most easily exploited by remaining invested even at the low point

We believe that it is clearly too late to focus on risk reduction per se in one's risk management now: That would have been something for the time when there was no alternative to equities. Today, we are obviously closer to the bottom than to the top. And trying to hit the bottom exactly by increasing an investment level from 0 to 100 %: We checked off that naive notion a long time ago. And the effect of lowering the cash ratio from 5 % to 4 % near the low, wherever that may be: you'll have to look for that with a magnifying glass. For more, however, the desperate search for the low is usually not enough. So we'll just leave it at that and be happy about the cheap stocks in our portfolios.

Sincerely yours,

Martin Wirth

Disclaimer: All opinions given in this quarterly report reflect the current assessment of FPM Frankfurt Performance Management AG which may change without notice. In cases where information contained in this document derives from third parties, FPM AG accepts no liability for the accuracy, completeness or appropriateness of such information, although FPM AG only uses data that it deems to be reliable. The statements and information contained in this document do not constitute a personal recommendation to buy or sell financial instruments within the meaning of the German Securities Trading Act (WpHG).

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

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de