Why didn't I ...

... buy shares in 2003, 2009 or 2020?

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Dear investors, dear friends of FPM AG,

This is the question many investors later asked themselves. It was easy to double one's money with shares in the years that followed. But the market situation was always too confusing, the challenges too high, the end of the world close at hand.

Like now. Russia's war of aggression on Ukraine is shaking the order of security in Europe dreamed up by German politicians. The same political circles now prefer to talk about the danger of nuclear war in order to distract from their failure and to justify their hesitation. High inflation rates and the ensuing crash on the bond market, which are being favored by external circumstances, but which were already apparent beforehand, combined with concerns about growth, are leading to fears of stagflation. In addition, the Chinese are pursuing a completely senseless pandemic policy, which is further burdening production and supply chains due to lockdowns. (By the way, this is the zero-covid policy that many scientists, left-wing public circles and journalists in Germany were praising to the skies just a year ago. Perhaps a free society is superior to other forms of society in more areas, even if this is often doubted by right-wing public circles: Everything was discussed intensely, and in the end an acceptable path was taken). And hovering over everything is a potential gas embargo, which is supposed to be the final death blow to the German and European economy. Lots of good reasons not to buy stocks right now. Really?

Opportunities arise when you take a closer look

Against this backdrop, I think it is completely overlooked what great chances the stock markets are currently offering again. Opportunities that have probably not been available since 2014/15 - in other words, during almost my entire time at FPM AG. If you only look at the DAX or the S&P 500, with corrections of 17% and 21% respectively, the current negative factors do not really seem to be priced in. But if you take a closer look at the markets, the picture is completely different. It is almost only stocks from the commodities/quality growth/defensives sector that are not already making the indices look far worse. Many (more speculative) growth stocks have already lost high double-digit percentages, price declines of 75% and more are not uncommon. Cyclical stocks (e.g. automotive suppliers or industrials) do not look much better; here, too, many shares have dropped by more than half.

It is true that here and there raw material costs are a temporary burden on profits, as they cannot always be passed on immediately. Not every growth expectation could be met; in addition, rising interest rates are weighing on growth stocks in particular via the discount factor. Higher logistics costs, a lack of or significantly more expensive upstream products are putting pressure on margins in many places. The shortage of semiconductors has cost volumes not only for automotive suppliers. Assuming a slight normalization, but far from perfect conditions again, many stocks are trading at mid-single digit P/E ratios and EV/EBIT multiples, e-commerce stocks sometimes only marginally higher than net cash. So not only is there a large number of extremely cheap stocks, but there are also cheap stocks in both "value" and "growth". Cheap growth stocks in particular have been hard to find for many years. We have tended to avoid these areas for more than half a decade because many stocks were too expensive in our view, or at least did not have a sufficient safety buffer in the event that things did not go smoothly. The falling interest rates led to a boom in these stocks, as valuations were no longer seen as relevant at interest rates of 0%. At the same time, stocks that did not promise great growth rates, or at least very stable earnings, were sold off to fund investments in the stock market darlings. This led to a fluctuating performance in our funds, which demanded a lot from our investors, especially in 2018 and 2019. However, our consistency in sticking to our valuation-oriented investment philosophy in spite of fund outflows, true to style, paid off in the end. Even in an environment where stocks that met our criteria were rarely in vogue, our style largely kept pace with market performance on balance, despite the emerging, widening valuation discrepancies. Since 2020, this trend has begun to reverse. This, in turn, was compelling in the long run.

We love growth, too!

Why do we put "value" and "growth" in quotation marks? Let's take a brief look at what value investing means to us, as this is often misunderstood in our eyes. For most investors, value means investing exclusively in companies with low P/E ratios or low price/book ratios. Thus, value investing is often associated with slow-growing or stagnating companies from the old economy (banking, automotive, industrial...). Index providers also adhere to this allocation, further fueling this misconception of value investing. But: A stock is never always just "value" or "growth": Banks also traded at several times book value in the 1990s. Back then, they were also a growth industry. The debacle that followed is well known. At the same time, Microsoft was trading at a P/E ratio of 10 ten years ago. Recently, it was more like 35 times pre-tax earnings. That's how value became growth. This, by the way, is the sweet spot par excellence: the period in which a company's valuation moves from the value to the growth camp. In the opposite direction, it's a disaster. In this respect, our funds will always tend to overrepresent companies that are considered "boring" value stocks. Our most significant performance drivers in the past have been the companies where investors' views have gradually changed thanks to better corporate earnings, but also to ever-improving share performance. Thus, the distinction between "value" and "growth" is at best somewhat incomplete, but actually misleading. Of course, growth plays an important role. We, too, prefer companies that are growing, as long as the growth is not bought with absurdly high capital expenditures or risky business changes. However, unlike growth/momentum investors, we are not willing to pay just any price for growth. This is exactly what happened in the equity markets until twelve months ago: Only stories counted, and many unprofitable start-ups became so-called unicorns. Why don't we want to overpay for growth? Because growth is not as self-evident as is often assumed in phases of euphoria. If growth expectations are not met, there are headwinds from two directions. On the one hand, a lower multiple is then paid for lower growth, and at the same time, previous estimates have to be revised downward. Lower multiples on lower estimates then quickly lead to high double-digit percentage share price losses. This is the path described above from a growth stock to a value stock: disaster. Sometimes, however, rising interest rates and thus higher discount factors are enough if a large part of the valuation lies very far in the future. And then 50%, 60% or 90% of the investment is lost, without the company having to be in an existential crisis. Today we realize that unicorns are extinct or mythical creatures. And they are not real.

That is why we have a seemingly "boring" portfolio

Due to the (overly) high valuations in the growth/quality growth sector, which we were not willing to pay, our portfolios in the last years mostly consisted of a high share of classic industries, known as the "old economy". However, this was the result of our valuation-oriented investment approach, not the result of a general aversion to growth stocks. In recent years, as I said, attractively valued companies tended to be found in the traditional industries. Things have changed: The sharp correction in normal stocks of companies with high expected growth rates (not necessarily in the much slower growing high quality growth stocks) is now offering opportunities again for the first time in many years to diversify our portfolios in terms of sectors.

Perspectives

In detail: Many stocks are extremely cheap in the context of what is currently foreseeable and likely. The war in Ukraine continues without any significant escalation (for example weapons of mass destruction). The supply chain problems will be solved in the medium term (one to two years, for semiconductors, for example, the easing is already visible), and increases in input costs can be passed on with a time lag. By raising prices, companies are living up to their reputation as inflation protectors. Inflation rates will reach their high in the next few months and then decline, as is already visible in the case of steel and semiconductors. Having always been the prophets of doom who warned about underestimating long-term inflation rates: The current price drivers, which in the EU are primarily commodity prices, would have to continue to rise at the same rate as in recent quarters. We shall see, but this is unlikely for several reasons. The futures markets are showing quite different expectations, which of course is also no guarantee. Without the fluctuating components, i.e. in the core rate, price increases are between 3% and 4%: High, but not absurdly high. So now everything is likely to depend on wage negotiations.

Q1 reporting was not that bad, some companies even managed to raise their outlook or resumed it after suspending it in early March following the start of the Ukraine war. This shows that despite the many negative factors, the situation is much better than the share prices of many companies currently indicate. We are also getting this as feedback from company talks. If China were to significantly tighten its zero-covid policy and shut down the entire country by the end of the year (little joke: but if you look at the senseless policy there, you wouldn't want to completely rule out something like that), there would of course be further drag marks. The same applies to a supply stop of natural gas from Russia. But probably even such scenarios are already partly priced in: There would be no other way to justify the current valuations. There is definitely a slight recession anticipated in the valuations of cyclical companies, and as I said, that is the worst-case scenario at the moment. Above all, one thing should not be forgotten: Every day without a gas supply freeze reduces the risk for drastic dislocations. Simply because everyone is currently working to reduce dependence on Russian natural gas. Companies are exploring contingency solutions with oil, numerous coal-fired power plants in companies that have been designated for shutdown with the goal of reducing CO2 may be operated longer, gas storage facilities are slowly filling up, the time until mobile LNG terminals are operational is getting shorter, higher prices are leading to savings effects for consumers, other countries are supplying higher volumes, and so on. If the going got tough, considerable savings would certainly be demanded or morally accepted from private consumers as well, higher prices will lead to reduced consumption anyway. And lastly: Russia also has a very strong interest in continuing to sell gas, at least for now. What I'm trying to say is that the situation is nowhere near as bad as the current mood. Seeing how quickly the economy has adjusted to the coronavirus pandemic, at least I'm not worried that companies will eventually find answers to a gas supply freeze as well. One should not underestimate the price signals of a market economy. Nevertheless, tail risk remains: unlikely, but if it occurs very relevant in the short term, compensable in the medium term, although not for all companies. This should be taken into account when selecting stocks.

As always, there remains the question of timing

While many stocks are already pricing in a relatively negative scenario after price declines of 50% to 80% or more, and at the same time we are looking at current market dynamics, a final sell-off of Quality Growth and Bitcoin & Co. is probably still pending in the short term. The segments in which many investors are still overinvested. Incidentally, these segments are also what keep market P/E ratios from looking cheap. For example, Linde, as the largest stock in the DAX (over 10% weighting), is more or less at the peak and thus for almost three points in the DAX P/E. However, we do not buy the market, but individual stocks, some of which are trading at very low valuations.

However, looking at the current market dynamics, one should not take too much time. Waiting until after the summer break could end up being too late. With the current interest rate momentum and given the speed at which markets are pricing in even higher policy rates, a stabilization or decline in inflation rates with declining growth expectations could start to reverse the trend. The probability of both is relatively high. Excluding new significant distortions in food and energy in the inflation component, this should actually be the case in the next few months. Time therefore as an investor to move out of the comfort zone. Assuming a certain return to normal over the next two to three years, many individual stocks are set to post gains of 50 to 100%. If worse comes to worst, the potential losses over the same period should also be relatively manageable - apart from an initial negative market reaction.

What am I doing in the portfolio right now?

For the first time in a long while, I have started to increase the number of companies in the FPM Funds Stockpicker Germany Small/Mid Cap. Some smaller initial positions, but these can be increased quickly. There are two main reasons for this. Firstly, we are currently finding more cheap stocks than we have in a long time, and secondly, we are minimizing the risk in case one or the other company is affected more strongly in the event of a negative scenario (e.g. gas supply freeze).

But one thing is important: The old saying "buy when the guns are thundering" works quite well. While normally you only have a short window of opportunity to do so (as in the case of the pandemic), this time we can pick and buy stocks with plenty of time to spare.

Now it's your turn

Go through your portfolios. The crowd-pleasers of the past few years should be critically examined. ETFs are certainly better than "active" funds that only track an index (index huggers). But in many ETFs the winners of the last years are represented with high weightings. The losers of the last years are not included or only with small weightings. There will probably be little, if any, potential at the index level. Moreover, if there are outflows from ETFs, and they are always above average at the extreme points in the bear market as are the inflows in the bull market, then active investors will have to buy the stocks. The question is, at what point do the stocks that have been hyped in recent years become interesting for value investors? After all, value investors are ultimately the only ones who remain as buyers when the friends of momentum, stories and marketing turn to new themes or lick their wounds. Moreover, are value investors really value investors anymore? Or has classic valuation-driven investing been replaced by "Modern Value," "Value 2.0," etc., justifying a switch into blue-chip but expensive companies benefiting from falling interest rates? And lastly: Nominal assets are still very likely to lose money.

After 40 years of declining interest rates, we are most likely facing a real turning point. While politicians talk about it but do not always act in this sense, markets are consistent. Structurally higher inflation rates and thus structurally higher interest rates, combined with political changes, have ushered in a turning point in the markets. Especially coming from negative interest rates: what had been considered unreasonable for decades was suddenly a fixed factor in the calculations of many investors. 2% higher interest rates and the first real estate companies are swimming belly up? Real estate projects that no longer pay off? Start-ups that can no longer get follow-up financing? Such a transformation process does not end after twelve months. Even if the desire or reflex is only too understandable. But the central banks have not even really started to withdraw liquidity from the markets. **It' s time for more real value in the portfolio.**

Yours Raik Hoffmann