## QUARTERLY COMMENT – 2013

Leading central banks and the economic will of a few leading politicians have distorted traditional economic and financial cycles. In our current macroeconomic setting, it looks most likely that some form of financial repression will take hold for many years to come. In such a scenario, cash and bond savers will be further squeezed for the benefit of reducing the over-indebtedness of western sovereigns. And in this context, real interest rates would have to remain very low.

Hans-Werner Sinn of the IFO Institute commented at a German Investment Conference in January that if real interest rates were negative the comparable theoretical value of stocks was infinite. So, are we experiencing the start of the great rotation from overinvested bonds to asset classes largely perceived to be riskier such as stocks? As a matter of fact, a multiple expansion in European stock prices has materialized over the last year while fundamental business conditions have not really improved. The largest part of fresh liquidity went to larger cap stocks by means of ETFs and the usual suspect fund brand names. Niche segments such as micro cap stocks could not yet uniformly benefit from these inflows. Notably, so called quality companies elevated most in value, amplified by multiple expansions. These developments and surrounding media noise warrant the question if we are going to see the next bubble occurring in too highly bid up valuations of perceived quality companies?

Given this macroeconomic overlay, I would like to take the opportunity to decompose key drivers of individual stock price returns and distinguish on which constituents Barius' investment strategy rests. In general, company valuations revolve around earnings levels and the long-term earnings trend (expectations). Subsequently, the four main building blocks of returns are a) (no growth) earnings yield, b) earnings margin arbitrage, c) earnings growth and d) multiple arbitrage. There may be further minor sources of return like micro-cap takeover premiums but the prior four certainly have most influence on stock returns.

Earnings or rather cash flow yield and margin expansion receive the highest attention in Barius' investment analysis. We look for companies with earnings and cash flow power based on strong business models with sustainable competitive advantages. Once these businesses have attractive valuations, positions will be entered and reflect some kind of base yield in form of long-term sustainable cash generation in relation to the purchase price (i.e. cash flow yield). In addition, companies might recently have undergone a temporarily difficult period and are set to show improving profit margins at a higher normalized level.

In contrast, revenue growth that translates into disproportional earnings growth has been treated very conservatively in Barius' investment strategy. Nevertheless, we almost exclusively do invest in growth companies in attractive niche markets. However, it is impossible to correctly predict exact growth rates and to derive valuations on, say, the growth rates for each of the next five years on an accuracy level of one decimal place. Generally, human beings seem to be too optimistic and too overconfident in their ability of hitting the numbers right. Therefore, Barius applies substantial growth haircuts depending on the particular investment case and the solidness of the underlying growth drivers. Particularly in today's low economic growth environment, this approach just seems prudent. Above average growth will only be attainable in small market segments and/or by taking market shares. The latter in turn requires superior competitive advantages and might already be identified in an earnings power analysis. Usually, businesses with a track record of high growth rates have expensive valuations and thus high expectations in growth. It then turns out to be a question of growth rate arbitrage.

The term arbitrage leads me to the last of the four main return drivers. Multiple arbitrage describes shifting levels of a multiplier for a particular earnings figure. The most well-known Price-Earnings-Ratio (PER) has a derivation in the form of the Cyclically-Adjusted-Price-Earnings (CAPE) Ratio showing a level of roughly 13.1x for the European market (according to Morgan Stanley). This contrasts versus a long-term average of around 17-18x, depending on the source and cut off dates. Each individual company has its own historic average PER and needs to be evaluated against this number. One school of thought, to which I strongly subscribe, propagates the concept of reversion to the mean. In this case it will be only a matter of time for the European market until the PER moves towards 17-18x. Unfortunately, this movement cannot be controlled and, in my view, therefore should be treated neutrally in any investment case. If it runs above average, then some compression should be adjusted for in the return expectations. Management could tweak some factors that influence the multiple of an individual company but then a majority stake would be needed by an investor to take the required actions.

To sum up, I personally prefer to focus on areas such as earnings power and margin analysis than on areas which are notoriously difficult to determine. By concentrating on current and past information as well as competitive structures, input data quality improves and even risks can be better mitigated or at least be better understood.

In general, markets appear to be addicted to growth and pay up premiums for above average growth rates. In the last quarters the market was seen to bet largely on a positive multiple arbitrage, something that is individually out of control, particularly in the short run. There is widespread acknowledgement that global profit margins are on average at historically high levels and might be hard to maintain (remember mean reversion). Of course, there are certain European sectors and countries whose profit margins are structurally affected by the most recent crisis. Substantial growth in the European economy is also not reasonably foreseeable for many years to come. But given the current momentum in multiple expansion there will be a good likelihood in the short-term of a further strengthening of quality and/or growth company valuations.

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