QUARTERLY COMMENT

Where are all the true value investors these days? After global equity markets hit one record high after the next, are those investors still invested in stocks or piling up huge cash positions because genuinely "undervalued" companies cannot be found anymore?

Unfortunately, the name "value investor" has emerged as more of a marketing tag than an absolute characteristic in an investment strategy. Nowadays, more often than not, "value" is supposedly found by discounting higher (than market consensus) expectations of growth in both company revenues and earnings. This procedure resembles a form of growth arbitrage by the camp of growth investment strategies.

Furthermore, "value" in terms of low valuation multiples might currently be found in companies facing operating headwinds or even restructurings and where the earnings component of the valuation metric has yet to adjust accordingly. The higher inherent risk component in these cases has to be thoroughly understood and adequately priced. Showcasing these effects in a basic price earnings ratio, the market keeps the price numerator constant while the earnings denominator is still based on stale earnings. When the earnings denominator gets marked down to the new situation, the price earnings ratio snaps back to higher levels.

After prior quantitative easing by the Fed and later by the BoJ, the ECB followed suit in January. The equity markets again reacted commensurately with multiple expansion in the valuation of companies (as they did in the US and then in Japan). Overseas investors sought especially German companies because the lower EUR vs. USD exchange rate is supposed to benefit particularly export-oriented companies (outside the Eurozone – a strong domain of Germany). Fund flows from global asset allocation decisions made their mark.

In addition, the extremely low interest rates render the discount factor lower in cash flow based valuation metrics, resulting in higher absolute valuations. Thus, companies just don't need to raise revenues or earnings to attain higher valuations. Yet, exactly here is where the double-edged, ever-increasing risk factor, artificially created by central banks kicks in. Once real interest rates or inflation climb again, the discount factor will rise and automatically drive down valuations. This phenomenon will apply to all assets at the same time, be it real estate, companies or fixed income. The taper tantrum period in 2013 temporarily showcased this scenario.

In the meantime, the macroeconomic overlay will be the most important determinant in the direction of various asset values. Both high sovereign debt levels and adverse demographic trends in developed countries will continue to depress economic growth. Central banks are politically influenced to keep interest rates artificially low to alleviate these growth headwinds. In addition, central banks have little room to maneuver in raising interest rates and not stifling economic growth as can be witnessed in the US at the moment. As an unintended – or by governments and central banks willfully accepted – consequence we are experiencing a gigantic wealth transfer from savers to borrowers. Over-indebted sovereigns benefit most and, to a lesser extent, corporate and real estate borrowers. Unfortunately, pensioners directly bear a large part of this wealth transfer. Solid governments and companies have started to receive money for borrowing funds, contradicting fundamental financial and economic law. German government bonds pay negative interest rates up to a maturity of 7 years. Corporate bonds of Nestle have gone negative too. Another unintended side effect has been the formation of asset bubbles across stocks, real estate and bonds, for which there will be a period of reckoning. As per the macro economic environment outlined above and unless some very serious event occurs (Greece and Ukraine were not), this period could be very far out.

As a result we might see multiple expansion remaining the key driver for equities for the foreseeable future. Based on the current extreme low interest rates, the implicit technical valuation of companies looks not expensive and could theoretically soar higher (with the risks of eventual mean reversion attached). Compared to bond yields, dividend yields are still higher on average and suggest stocks as a more attractive asset class. When dividing equity strategies in this macroeconomic setting, companies with superior business models and above average growth rates are supposed to continue to outperform the overall equity market – as the new "nifty fifty" quality companies with staggering multiples – yet not necessarily in sync with their respective fundamental development.

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