Flossbach von Storch

1/2023

POSITION

Thought-provoking issues for investors

USA

Tech companies coming back to reality

EUROPE

Why currency diversification is paramount

RUSSIA

Hope has been dead for a long time

Let‘s take a guess:
Like most colleagues at Flossbach von Storch, you took a look at the cover picture and saw the Mona Lisa, right? Well, your brain has played a trick on you. It has linked familiar things together – and thus led you up the wrong path. Psychologists call it pattern recognition.

What does this have to do with our profession, investing?
A great deal, in fact!

The greatest danger to one‘s own assets will not come from the next crisis – that is certain to come! More important is how investors will react to it. In other words, it‘s all in the mind.
See page 26 onwards for insights into these findings.

Flossbach von Storch
POSITION 1/2023

Flossbach von Storch Invest S.A. presents the quarterly magazine from our Fund Manager Flossbach von Storch AG, Cologne.

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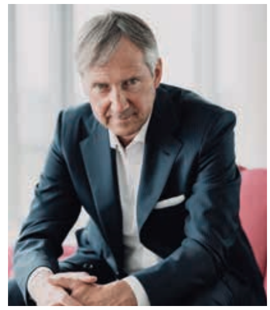

IN A WORD

The central banks will not bring their more restrictive interest-rate policies to a close until there is a lasting fall in inflation rates. That is, of course, unless their "anti-inflation policy" begins to cause problems that outweigh the benefits before we arrive at that point – and that's certainly not something we can rule out.

Globally speaking, debtors – whether governments, companies or those building their own home – have become accustomed to cheap loans in recent years. An end to cheap money is likely to hit particularly hard for those who rely on low interest rates, and that is not a small number of people. It can be dangerous to get used to something!

Whether or not the central banks will ultimately be successful in their fight against inflation is something that probably even their representatives couldn't tell you. Investors will therefore look from one central bank meeting to the next, constantly trying to work out when the rate-hike cycle will come to an end. Sometimes it will seem like that time is coming, as it did at the start of the year, and prices rise; and sometimes it will seem far in the distance as prices fall. There's a constant up-and-down, without any clearly discernible trend. And more serious setbacks are still a possibility.

Shares of good companies are nevertheless needed to preserve capital in the long term. Their valuations are currently around the same level as interest rates and yields. Higher interest rates would depress valuations once again. This makes it all the more important for long-term investors to select the right stocks and diversity their portfolios as intelligently as possible.

Furthermore, the current environment is likely to keep providing opportunities, not just for equities but also for bonds. Their risk-return profile has improved noticeably over the past 12 months. As long-term investors, we are therefore confident that the future will bring better years for investors again, even if the road ahead is initially rocky.

I wish you an enjoyable read!

Dr Bert Flossbach
Co-Founder and Owner of Flossbach von Storch AG

Flossbach von Storch

POSITION

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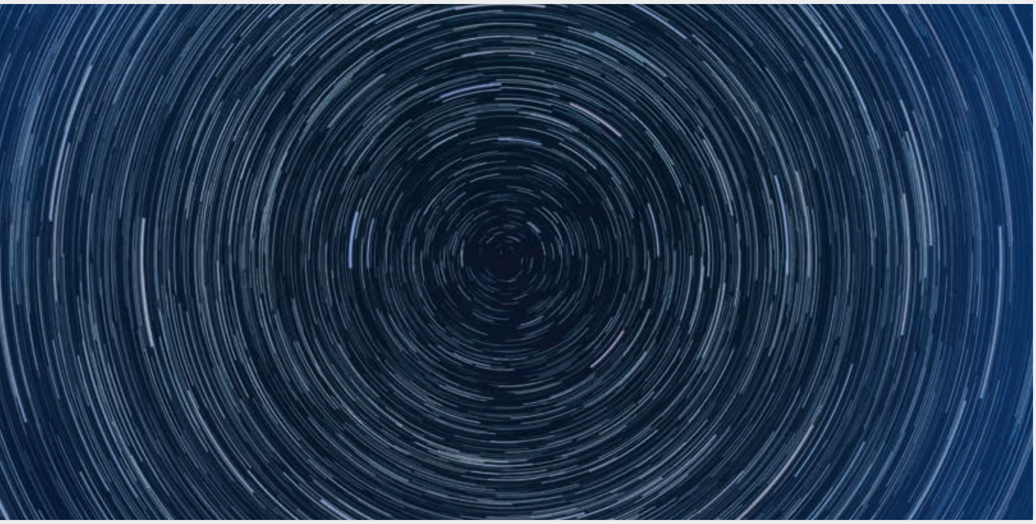
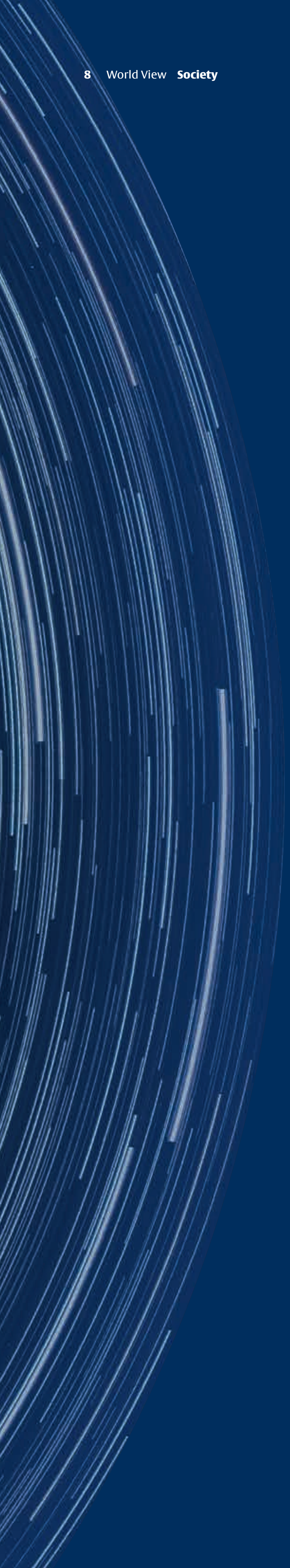


CHANGE OF

PERCEPTION

Times are changing. The pace and number of changes, however, have rarely been as great as now. What does that mean for us, our beliefs and for finances?

→



by Bert Flossbach

The world is complex. A certain amount of mental gymnastics is required if people have to change their world view because reality has changed. Buzzwords can help – certainly if they appropriately describe the changing zeitgeist in a way that means people still know what happened back then even decades later. The “Miracle on the Rhine” is one example, perhaps also the “Protests of 1968” or the “Peaceful Revolution”.

A great deal has also changed for us since last year. The Gesellschaft für deutsche Sprache (German Language Society, GfdS) has chosen *Zeitenwende* (“turning point”) as the word of the year for 2022. *Zeitenwende* means the end of one era and the start of another. The transition can be abrupt or slow. Does the word describe our current new situation?

German Chancellor Olaf Scholz used this word in his speech to the Bundestag (German Federal Parliament) about the Russian attack on Ukraine to describe the start of a new era in the European post-war order. It had, however, already been eight years since Putin annexed Crimea, which meant it had taken that long to understand that Putin was an aggressive ruler willing to wage war.

The “turning point” referred to in February 2022 was therefore perhaps more of a change of perception. Decisive measures, i.e. action not words, are needed before one can speak of a turning point.

The current period is especially rich in new understanding, not just about the relationship with Putin’s Russia, the defence of country and democracy and the supply of energy. A change of perception is also occurring with respect to the viability of the welfare state, the quality of Germany as a location for business, China’s zero-Covid policy and the sustainability of monetary policy and investments.

We have tried to identify the topics about which our, perhaps typically German, point of view has changed. Our findings make no claim to be exhaustive, but we have identified nine new viewpoints with regard to Germany.

Energy policy

The belief that Russian natural gas, together with a small amount of wind and solar power, could provide a cheap source of energy has given way to an understanding that the supply of energy from such an arrangement is far from secure. The German energy transition that was initiated in 2011 was not well thought out. Trying to replace almost all energy sources with wind and solar at practically the same time was probably very naive. It has also put at risk the German business model, which is based on cheap energy imports and a flourishing export economy. In spite of this, an understanding that prosperity is not God-given, but has to be earned, still has not been achieved.

Welfare state

Many people have reached a new understanding about the extensive social benefits that are taken for granted. The actual turning point already occurred years ago, but politicians have still not reached a change of perception. This is because the baby-boomer transition into retirement is happening slowly, i.e. without a trigger or, as Chancellor Scholz would say, without a "bang" that would usher in a new era of pension policy.

The euro

The euro fell below parity with the US dollar last year for the first time since 2002. In our opinion, the euro is not the successor of the German mark, but rather a mixture of the German mark and Italian lira. Even if a change in understanding occurred, it would not indicate that a turning point was coming. The political will and assertiveness needed for that are lacking.

Defence policy

Putin's war of aggression led to a dramatic change in understanding for defence policy. Democracy is precious and has to be defended against attackers. However, an efficient procurement system is needed to reasonably invest the hundred billion euros that Chancellor Scholz has promised to restore the defence readiness of the Bundeswehr (German armed forces). That this is clearly lacking in the Bundeswehr was an open secret for a long time, but it was not until the *Zeitenwende* was proclaimed that the public became aware of it. A change of perception now appears to have been achieved and hopefully the turning point for defence capabilities lies ahead.

Sustainability

The greenwashing scandals in 2022 made it clear to investors that not everything dressed up in ESG green is sustainable. This does not mean, however, that a new perception has been achieved, since the ESG apologists and bureaucrats still believe it is possible to use school grades to divide the world into good and evil.

Dysfunctionality of Germany as a location for business

In addition to the Bundeswehr, the railways, government authorities and infrastructure also no longer function as they should, reflecting the growing dysfunctionality of Germany, whose global reputation has also suffered from the bigoted behaviour of a number of top German politicians. The quality and importance of the business location is declining. As at the end of February, only one German company ranked among the world's 100 most valuable companies. France comes in at five, Great Britain at four and Switzerland at three. A total of 17 European companies are still among the top 100, compared to almost half 15 years ago. The USA and Asia are where the action is and where the future of the global economy will be decided. German industrial companies and French luxury companies can still benefit from this, at least indirectly. Germany's small- and medium-sized business sector, which is the envy of the world, still gives it an ace up its sleeve, but it is also no guarantee of success. Excessive regulation shows that a change of perception has not occurred here yet, to say nothing of a turning point.

Zero-Covid policy

Two changes of perception occurred in China in 2022. The first occurred in March, when it was believed that only a brutal lockdown could protect the inadequately vaccinated population and weak healthcare system. The virus, however, was not impressed. When the population revolted and the country was threatened by economic collapse, another change of perception took place. Widespread ad-hoc relaxation of the lockdowns created chaotic conditions in hospitals, but also raised hopes of a rapid return to normality in China.

Monetary policy

2022 clearly marked a change of perception for central banks. Inflation is not a temporary phenomenon, but a serious threat to the long-term value of money and prosperity. Faced with the threat of a loss of confidence, the US Federal Reserve (Fed) began to implement this new perception in March 2022 with the first of a recent total of eight interest-rate increases. The European Central Bank (ECB) followed in July with the first of five interest-rate hikes so far. The interest-rate turnaround in 2022 marked the end of the ultra-loose monetary policy that lasted for more than a decade, aside from a brief interlude in the USA. Whether this is now the start of a turning point in monetary policy like the one former Fed Chair Paul Volcker achieved in the early 1980s is by no means certain. Although current Fed Chair Jerome Powell certainly has the will to do so ("*We will keep at it until we are confident the job is done*"), the Fed's room for manoeuvre is limited by the high level of debt. This applies even more to the ECB, which also faces the Herculean challenge of reconciling the goal of price stability with the political goal of preserving the euro.

Stock-based compensation

The well-intended idea of giving employees a share in their company's success has led to one of the biggest thefts in financial history in the USA. Providing stock-based compensation components has been standard practice in US companies for a long time. Their use in the technology sector, however, has recently reached excessive levels. The 10 largest US technology companies recorded around USD 75 billion in expenses for employee stock-based compensation in the four quarters of 2022 (see p. 41 for details). Investors ignored the issue for a long time because their tech darlings were nevertheless performing well and it would have been fatal to miss the rally because of it. The end of this practice, however, is now paving the way to a new understanding. More and more investors are putting this unpleasant issue on the agenda. Of all people, the ESG protagonists still fail to recognise this form of poor corporate governance. Their models only see the tip of the iceberg, namely executive compensation.

When reality changes, we modify our behaviour. Taking stock of our change in perception.

EVERYTHING NEW?

Is the end of the year still fixed in your mind? During the annual forecasting ritual, economists, strategists, analysts and even central banks practise forecasting economic growth, interest rates, equity prices and exchange rates.

Most of them don't do this because they believe they can predict the future, but because it is expected of them. They are, after all, experts. The point forecasts they then make for the Dow, DAX, US dollar, etc. are therefore often due to the demands of third parties who are asking them to do nothing less than measure the unknown, as so fittingly described in the book by the same name ("*Die Vermessung des Unbekannten*") by our colleague Prof Thomas Mayer.

How much higher will central banks raise interest rates? When will they start reducing interest rates? When will the bear market in bonds and equities be over? How much further can prices fall? And when will the new bull market begin? These are all important questions that are addressed (in varying detail) in all types of market forecasts. The problem is that no one can answer them with a clear conscience at that moment, at least not with a definite forecast months or calendar years into the future.

But certainty does exist for some things. That bonds cannot be a good (long-term) investment if they provide a guaranteed negative return was such a certainty. As a result, we held no bonds for a long time when investment guidelines permitted. We did not predict that 2022 would be the worst year for bond investments, but the nature of negative interest rates meant that, like the year before, it could not be a good one.

This example from practice shows that instead of making precise point forecasts for an investment period that is arbitrarily defined based on the calendar, we feel it is more appropriate to make working hypotheses. Even these don't always turn out to be correct in retrospect, as shown by key statements we made in 2021 (see right).

It is important to take new understandings into account and adjust your working hypotheses accordingly. The most serious adjustment in the previous year was due to the war in Ukraine and lockdowns in China. Inflation rose even more sharply than previously expected and central banks reacted with great determination in the second half of the year by increasing interest rates dramatically. The following examples show how our convictions changed due to the new situation.

— 1 —

There is much to suggest that inflation will be considerably higher in coming years than the last decade.
Although this statement turned out to be correct, the magnitude of inflation significantly exceeded our expectations.

— 2 —

Since a true interest-rate turnaround cannot be implemented, because interest rates would have to be raised back up to or above the rate of inflation, real interest rates will remain negative for a long time to come.
This still seemed very plausible in 2021. From today's perspective, however, it is necessary to differentiate. The statement is ultimately right and wrong at the same time. In terms of nominal rates, the interest-rate turnaround has taken place. Real interest rates, however, are still negative. This could change in the USA in the next few months if the Fed, as currently indicated, raises its key interest rate to five per cent and base effects cause inflation to decline. The situation is much more difficult for the ECB. Even the prospects of further interest-rate hikes are unlikely to raise the level of interest rates above the rate of inflation to fulfil the criterion for a true interest-rate turnaround.

— 3 —

Investors who want to preserve and (or) increase the value of their assets during a long period of negative real interest rates have to invest a significant portion in real assets, such as equities and gold.
In our view, this working hypothesis still holds, even though equities suffered major losses in 2022. The weak performance over the last year increases the potential for coming years. Ultimately, of course, it will be several years before a "final" judgement can be made about whether this statement is correct.

— 4 —

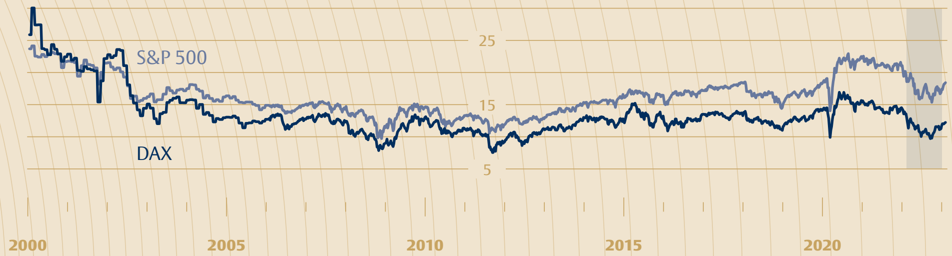
Even though equity valuations are historically high at a price-to-earnings (PE) ratio of 21 (based on expected earnings for the S&P 500 index in 2022), the very low level of interest rates also has to be taken into account.
This statement unfortunately turned out to be incorrect. Although corporate earnings have increased in spite of all the difficulties, thereby fulfilling analyst expectations, the earnings multiplier or equities valuation fell from 21 at the beginning of the year to 17.5 times due to the sharp rise in interest rates. The situation is similar for the DAX, where the valuation fell from 15 times expected earnings to a price-to-earnings ratio of 11.3 in 2022 (see figure 1).

— 5 —

Before the crisis, we also described the start of a collapse in the prices of completely overpriced, unprofitable technology stocks, such as the electric car manufacturers Rivian and Lucid, which still had not sold any cars, but had a higher market capitalisation than Mercedes and BMW due to battery-powered speculation.
This statement was correct, but fell short. Share prices for the electric car manufacturers Rivian and Lucid did actually plunge more than 80 per cent. And the boom-and-bust-scenario for unprofitable technology high flyers that we outlined in the first quarter of 2022 has continued, as shown by the example of the ARK Innovation ETF, which fell 67 per cent in 2022 (see figure 2). However, we underestimated the potential setback for the big profitable technology companies – the "Big Five": Apple, Microsoft, Alphabet, Amazon and Meta – which also suffered significant losses.

Figure 1
2022: equity valuations come down
Price-to-earnings ratio based on (expected) earnings for the next 12 months

Source: Refinitiv, Flossbach von Storch, data as at 28 February 2023
The earnings expectations are based on specific assumptions. Actual results may differ significantly.
Past performance is not a reliable indicator of future performance.



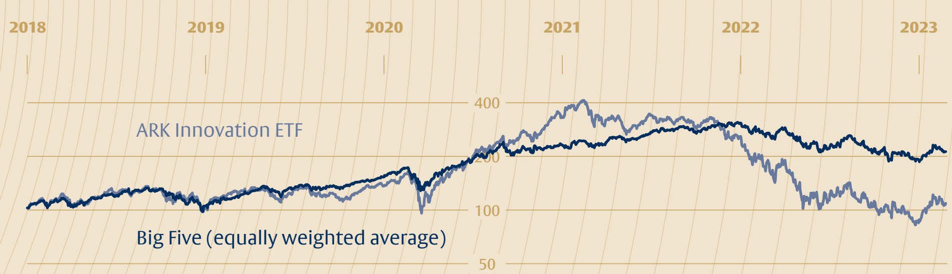


Figure 2
Boom – Bust
Correction especially large for second-tier technology companies (log. scale, both indexed to 1 January 2020 = 100)

Source: Refinitiv, Flossbach von Storch, data as at 28 February 2023
Past performance is not a reliable indicator of future performance.

Maintaining a clear focus is important, given the many crises. The most important topic in financial markets is inflation – and its consequences for monetary policy.

INFLATION

The highs for annual inflation rates will likely gradually move into the rear-view mirror. Energy prices, which could be below last year's level in the coming months, make a significant contribution to this.

So all is well? A closer look shows that while base effects, such as energy prices, decrease headline inflation, the core inflation rate (excluding food and energy), which is monitored more closely by central banks and is currently six per cent in the USA and five per cent in the eurozone, will likely be more persistent due to strong wage growth.

HERE TO STAY

At least that is what a variety of data is suggesting. Including in Germany. According to a survey by the Ifo Institute and personnel service provider Randstad, German corporate HR managers expect wages to increase an average of 5.5 per cent in 2023. Since many new collective agreements will not be concluded until 2024, wage inflation is not expected to end soon. In addition, the supply shortfall in the labour market continues to rise as the number of people leaving the market exceeds new entrants each year.

Other factors are also likely to keep prices rising. The transition to a "green economy" in coming years, for example, will involve high costs. The efforts taken by many companies to make their supply chains more resilient will also likely lead to higher costs and increased prices.

People have already been dealing with inflation for a long time, as shown by inflation expectations. German private individuals, for example, most recently expected annual inflation of five per cent for the next five years, as shown in a Bundesbank survey (see figure 3).

That is a problem. Central bankers have repeatedly stressed how important it is that high inflation expectations not become entrenched in people's minds, because this would affect their activities, especially wage demands. Even if expectations are largely based on perceived inflation and therefore come from a gut feeling, the respondents anticipated actual developments in the past better than the chronically optimistic central bankers did in their forecasts (see figure 4).

The chart shows quite clearly that the ECB has also reached a new understanding. It recently raised its inflation forecasts significantly after its inflation optimism had been repeatedly contradicted by reality and it faced the possibility of a loss of confidence, and is now following an anti-inflation policy. At the end of last year, it expected an inflation rate of 6.3 per cent in 2023, 3.4 per cent in 2024 and 2.3 per cent in 2025.

The Fed is a good deal ahead of this. They already expect a significant drop to 3.1 per cent in 2023, 2.5 per cent in 2024 and 2.1 per cent in 2025, which would mean that its inflation target had almost been reached again (at least based on the PCE price index for personal consumption expenditures, which is generally slightly lower than consumer price inflation (CPI)). The Fed is therefore confident that the interest-rate increases in 2022 will soon have a dampening effect on demand and slow inflation. Fed Chair Jerome Powell has also repeatedly signalled that he would not take his foot off the brake until inflation had reached its target level of two per cent.

ECB President Christine Lagarde is now attempting to follow Jerome Powell. Significant interest-rate hikes and a long period of higher interest rates are expected to dampen price increases. But not all central banks are following this path yet. The Bank of Japan (BoJ), for example, has not raised interest rates yet, even though inflation has reached 4.3 per cent in Japan, the highest level in a good four decades. All the same, the BoJ nevertheless took the risk of making a small tweak to its yield-curve control policy by raising the yield cap for 10-year Japanese government bonds from 0.25 to 0.5 per cent.

This example shows that key interest rates are only one part of monetary policy. Central banks worldwide purchased a huge mountain of bonds in previous years to reduce yields at the long end of the curve as well, i.e. for bonds with long maturities. The goal now is to unwind those massive holdings again.

The Fed already started in June of last year. It was recently allowing up to USD 95 billion of government bonds and mortgage-backed securities to mature per month. This sounds like a lot, but the fact that its mountain of debt was recently around USD 8,000 billion in size puts it into perspective.

The ECB did not signal the start of its balance-sheet turnaround until the end of 2022 and made the interest-rate terms for some longer-term refinancing operations less attractive. This caused the volume to decrease from EUR 2,116 billion at the end of October to EUR 1,321 billion at the end of the year (see figure 5). The ECB will also begin to unload its mountain of bonds starting in March 2023, although this will initially only take place in miniscule amounts of EUR 15 billion per month.

Figure 3
High inflation expectations
Inflation expectations of private individuals in Germany

Source: Bundesbank, Flossbach von Storch, data as at 28 February 2023

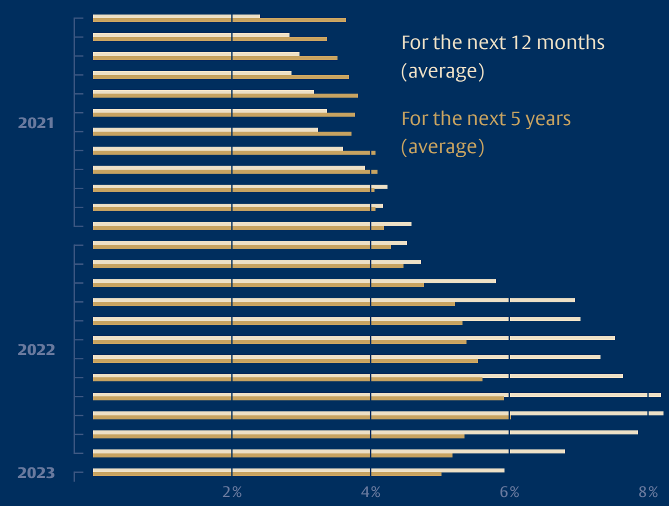


Figure 4
Change of perception
ECB inflation forecasts over time

Source: European Central Bank, Flossbach von Storch, data as at 28 February 2023

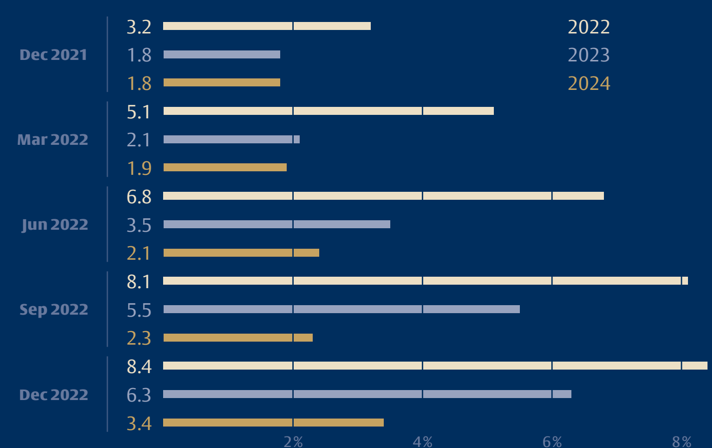
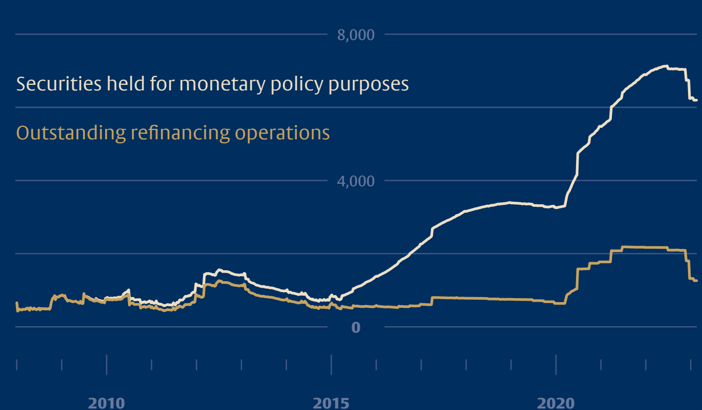


Figure 5
From interest-rate turnaround to balance-sheet turnaround
Main European Central Bank balance-sheet items, in EUR billions

Source: Refinitiv, Flossbach von Storch, data as at 28 February 2023



RISKS AND SIDE EFFECTS

In monetary policy, it is always a question of the right dose. When measures are implemented, there is always a risk of collateral damage.

When it comes to tackling the causes of inflation, it is always a question of correctly estimating the effects. As in medicine, the treatment should not cause more harm to patients than the original disease.

Although inflation has to be fought so that people do not lose confidence in the value of their money, returning to lower rates of inflation does not come without a price. The general view is that fighting inflation is less costly than allowing it to run free.

No one knows, however, including the central bankers themselves, how much further central banks can actually raise interest rates and unwind their balance sheets before the costs of fighting inflation are no longer acceptable and serious collateral damage occurs in the financial system.

POTENTIAL COLLATERAL DAMAGE

For the first time in decades, many countries are now having to prepare for significantly higher interest rates. The eurozone countries had interest costs of EUR 180.3 billion in 2021. Based on the total national debt of EUR 11.7 trillion, this was an average interest cost of only 1.5 per cent (see figure 6).

If market yields were to remain at the current level, interest expenditures would double in a few years if the debt remained unchanged. The increase would, however, occur gradually. Italy's national debt, for example, had an average remaining maturity of 7.7 years at the end of last year. Interest expenditures are expected to be slightly less than EUR 70 billion in 2022, which corresponds to an average interest rate of 2.5 per cent. The market yield for Italian bonds is currently around four per cent (average over all maturities). If yields remained this high and Italy's debt remained unchanged, its annual interest expenditures would increase by around EUR 40 billion to EUR 110 billion.

It is therefore not surprising that Italy is the harshest critic of the ECB's anti-inflation policy. The debt sustainability of (most) countries is nevertheless not in serious danger, because economic output and tax revenues automatically increase at the same time due to inflation.

Many private borrowers do not enjoy this compensating effect, or only to a limited extent. The shorter the fixed-interest period, the sooner the full effect of higher interest rates will be felt. While German private households predominantly have long-term mortgages, around one in five UK mortgages have variable interest rates. The remaining 80 per cent only have a short fixed-interest period, and for a good two million British borrowers that period will end this year. The current interest rate for a two-year and five-year mortgage is a good five per cent. It was only 1.6 per cent a year ago.

Coming quarters will show when and to what extent this leads to mortgage defaults. In any case, the Bank of England (BoE) will be keeping an eye on the effects that further interest-rate increases have on mortgage serviceability and, consequently, the solvency of the banking sector.

LESS ROOM FOR INCREASES

It is also becoming difficult for highly indebted companies that will have to refinance maturing loans or bonds in the next few years. This is especially true for so-called zombie companies that were only able to stay afloat in the past thanks to low interest rates.

Unprofitable growth companies, which are now slowly running out of money, are also suffering from the high level of interest rates and increased risk premiums. Raising equity on the stock market or from venture capital companies has become more difficult and debt is too expensive or simply no longer available.

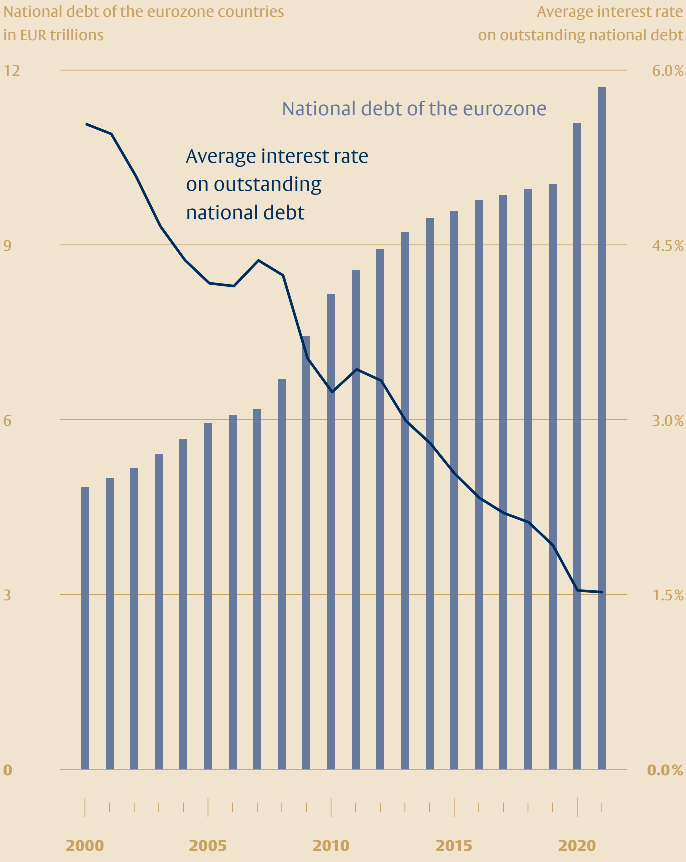
This is a healthy market shakeout, which the central banks are likely to accept in their fight against inflation. Another problem, on the other hand, is more virulent – an increasing lack of liquidity (also see p. 46).

While the central banks gradually unwind their bond holdings, i.e. sell them on the market, governments are planning to maintain a high level of net new borrowing at the same time. This also affects the demand for corporate bonds, which will likely increase their risk premiums and make corporate refinancing more expensive. Last autumn, the sharp increase in yields for British government bonds (gilts) already forced the BoE to temporarily change its monetary policy because the price of gilts plummeted.

Rising interest rates are also causing the real economy to suffer. This is clearly visible, for example, in the construction industry, where the number of incoming orders has already fallen significantly. However, whether and where a recession will occur, how deep it will be and how long it could last are ultimately moot questions. Central banks will have to accept them as consequences of a restrictive monetary policy if they want to decrease demand enough to bring price increases almost to a standstill.

Figure 6
Debts cost money again
Falling interest rates kept debt sustainable for a long time

Source: Refinitiv, Flossbach von Storch, data as at 28 February 2023



The debt sustainability of (most) countries is nevertheless not in serious danger, because economic output and tax revenues automatically increase at the same time due to inflation.

The crisis is not over yet. What will happen next? Here are five working hypotheses for investors.

LOOKING AHEAD

The changing times we are experiencing have shaken things up in the lives (and attitudes) of many people: in politics, the economy and (not least) in the capital markets.

What was special in the recent *Zeitenwende* – or whatever one wants to call the recent changes – was the large number of interdependent and mutually reinforcing crises. In addition to the effects of the pandemic and broken supply chains that are still being felt, there is the barbaric war in the middle of Europe and the inflationary storm which has arisen from the two. Many people are worried about their future, especially since the state we live in appears more dysfunctional than ever before.

We take our responsibility for the assets entrusted to us very seriously. Our principles have not changed. Our investment guidelines: focus on diversification, flexibility, quality, solvency and value also proved themselves during the recent crisis. We remain true to our strategic investment world view and our robust investment strategy.

It is still too early to draw final conclusions. When times change, we change our working hypotheses. For the current year, we would therefore like to present five issues that, at least from our point of view, will likely be important for private investments. ◆

Dr Bert Flossbach is Co-Founder and Owner of Flossbach von Storch AG.

— 1 —

Central banks take the fight against inflation seriously and only end their restrictive policy when a sustained reduction in inflation is observed or the risk of unacceptable collateral damage is no longer acceptable.

— 2 —

Inflation will remain significantly above two per cent for some time to come, in part because of demographic effects on the labour market and the resulting wage increases.

— 3 —

Financial markets will focus on inflation indicators from one central bank meeting to the next and try to determine when the cycle of interest-rate increases will end. This means a constant up-and-down movement in markets without a clear trend.

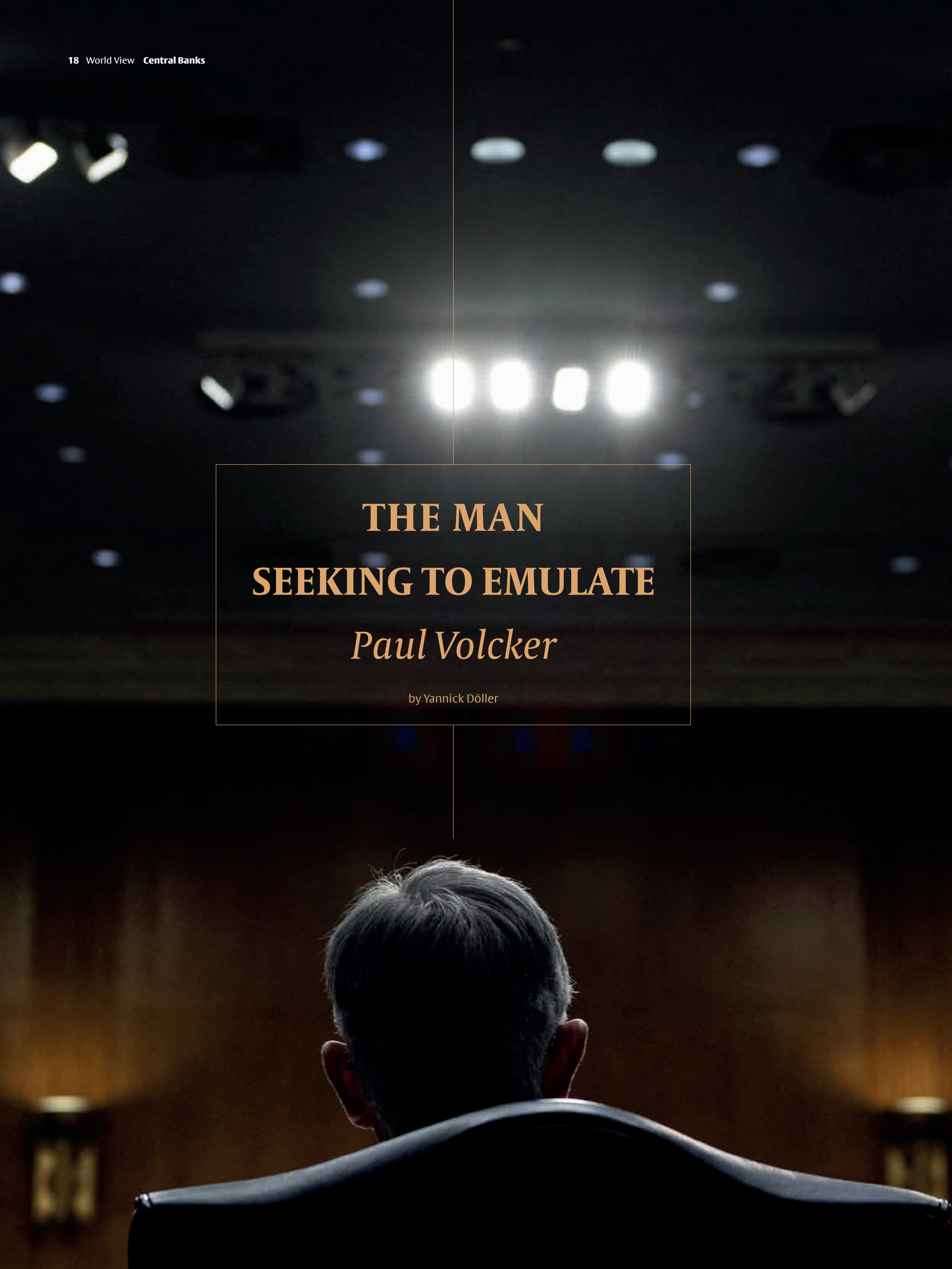
— 4 —

Equity valuations have reacted noticeably to the higher level of interest rates in the past year. Another significant and sustained increase in interest rates would lead to further pressure on valuations.

— 5 —

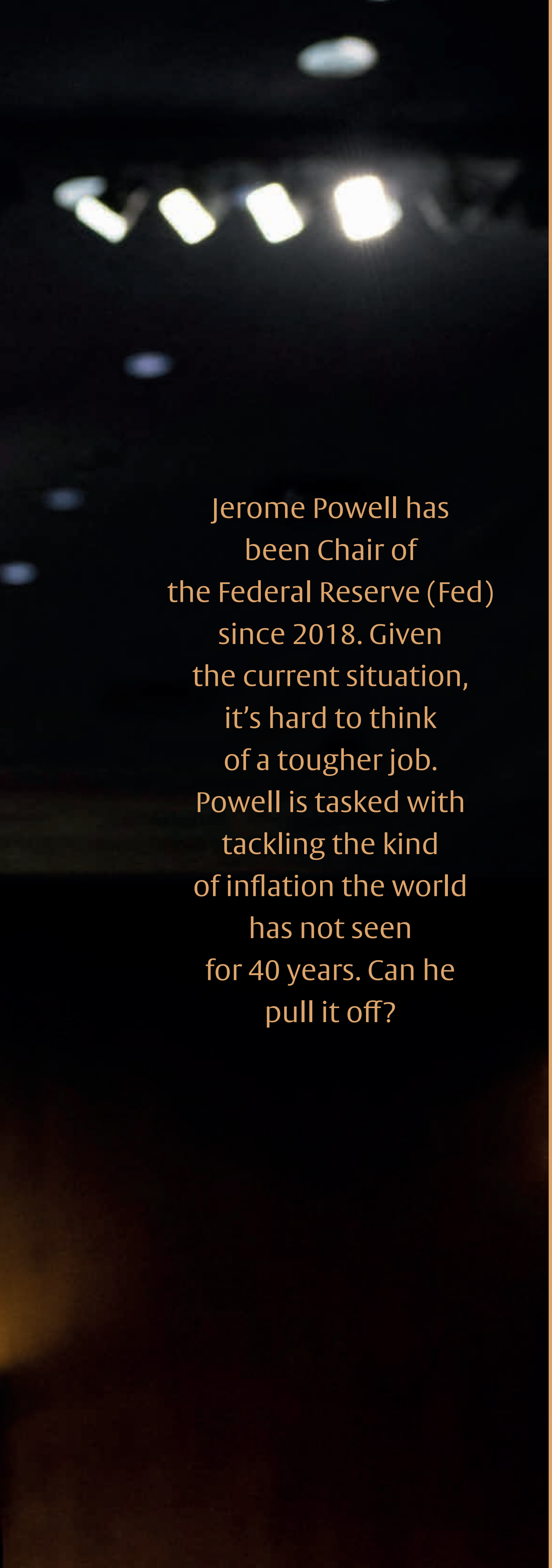
Corporate revenues benefit from inflation-related price increases, which is why nominal earnings can rise even if volume falls.

What was special in the recent *Zeitenwende* – or whatever one wants to call the recent changes – was the large number of interdependent and mutually reinforcing crises.



THE MAN SEEKING TO EMULATE *Paul Volcker*

by Yannick Döller



Jerome Powell has been Chair of the Federal Reserve (Fed) since 2018. Given the current situation, it's hard to think of a tougher job. Powell is tasked with tackling the kind of inflation the world has not seen for 40 years. Can he pull it off?

Unusually for a central banker, especially in this environment, his speech is brief: not a second over nine minutes.

When Jerome "Jay" Powell talks about inflation, he gives his audience very little to write down in their notepads and files. No lengthy and complex deductions, no forecasts or scenarios – nothing that would make those listening attentively to his words drift off. Ultimately, the only thing Powell says that he wants people to remember, and that they indeed will remember, is

"We must keep at it until we are convinced the job is done."

Once a year, central bankers from all over the world gather in the idyllic valley of Jackson Hole in Wyoming. From this location in the foothills of the Rocky Mountains, they discuss monetary policy and its consequences. The symposium has been compared to an elite university, with commentators often referring to it as an ivory tower. The address by the chair of the Fed has traditionally been far and away the most important speech at this conference – and in August 2022, this was truer than ever.

HEAD DOWN AND PRESS ON ...

Powell has been Chair of the Fed, the world's most powerful central bank, since 2018 when he was appointed by Donald Trump to succeed Janet Yellen. He is a political scientist and lawyer, and first joined the Fed's Board of Governors in 2012. In contrast to Yellen, however, Powell ticked the right boxes for the former US president in that he is a Republican. He is well connected within the party and, like his predecessor, he favours a comparatively loose monetary policy (or at least he used to). So he would seem more of a pussy cat than a tiger, or perhaps something in between. The German daily newspaper Süddeutsche Zeitung wrote on his nomination that, for Trump, Powell would be a better version of Janet Yellen.

The former US president measured his personal performance record exclusively in terms of economic growth and S&P 500 index points. That meant Trump needed cheap money – →

so he also needed the Fed. He believed that Powell would continue to deliver for him ...

But by August 2022, Trump became part of the history books, and now the world wants to know what the Fed chair intends to do to combat spiralling inflation in the USA, which is ultimately the result of the ultra-loose monetary policy pursued in the preceding years. Central bankers had previously claimed that the increase in the inflation rate would only be temporary and that the nightmare would soon be over, but nobody believes this anymore.

Nothing is over yet.

Powell admits that the central banks are behind the curve and have been too slow in fighting inflation, which is roughly nine per cent at the top end of the scale. This means that the fight will probably take longer than it could have done, but ultimately this will not hamper the success of his mission.

"We must keep at it until we are convinced the job is done."

The job will be done once the inflation rate has fallen – permanently – to about two per cent, a figure that represents monetary stability in the world of central banks. This is true for the Fed and also for the European Central Bank (ECB).

To underline the seriousness of what he is saying, Powell mentioned Paul Volcker six, maybe seven times in total, which is pretty remarkable for a nine-minute speech. Statistically speaking, he got a mention every one-and-a-half minutes.

TODAY IS NOT YESTERDAY

Paul Volcker served as Chair of the Fed several decades prior to Powell. In the early 1980s, he brought the absurdly high inflation rate – which was up to 15 per cent at the time – under control simply by raising the interest rate to even higher than the rate of inflation. This took interest to more than 20 per cent at times, which in the end caused inflation to fall.

No one present at Jackson Hole would subsequently have cause to doubt Powell's determination. His choice of words and his body language reflect a man who is taking his position seriously.

Axel Weber, former President of the Deutsche Bundesbank and now a strategic advisor to the Executive Board of Flossbach von Storch AG, was certainly impressed: Powell's speech was remarkable, he says. "The Fed is no longer an observer; it now sees itself as the key player." Weber has known Powell for many years. When he set off from Jackson Hole to go back home to Germany, there was precious little written in his file. Like many others, though, he did make a note of one sentence:

"We must keep at it until we are convinced the job is done."

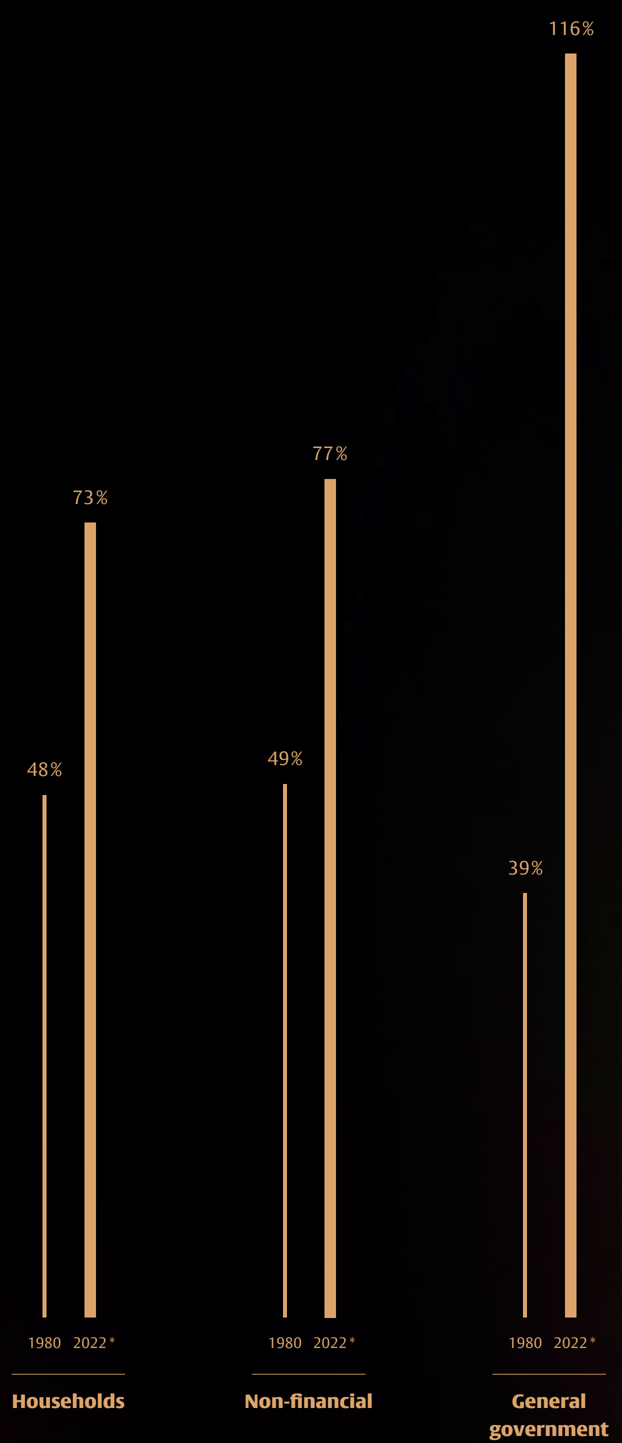
In the past 12 months, the Fed has hiked its base rate from 0.25 to 4.75 per cent. The question is how much more will it increase.

Powell's problem is that time has not stood still since Paul Volcker was in office. US debt has not only continued to grow in recent decades, but has actually grown much faster owing to the financial crisis, COVID-19 and hefty aid packages (see figure).

As interest rates rise higher and higher, the accumulated debt gets ever more expensive and the collateral damage that may be inflicted by the high interest rates becomes ever greater – a chain of events that happens firstly in the US real estate market, but then plays out in the financial system as a whole. The greater the damage, the more likely the Fed will fail.

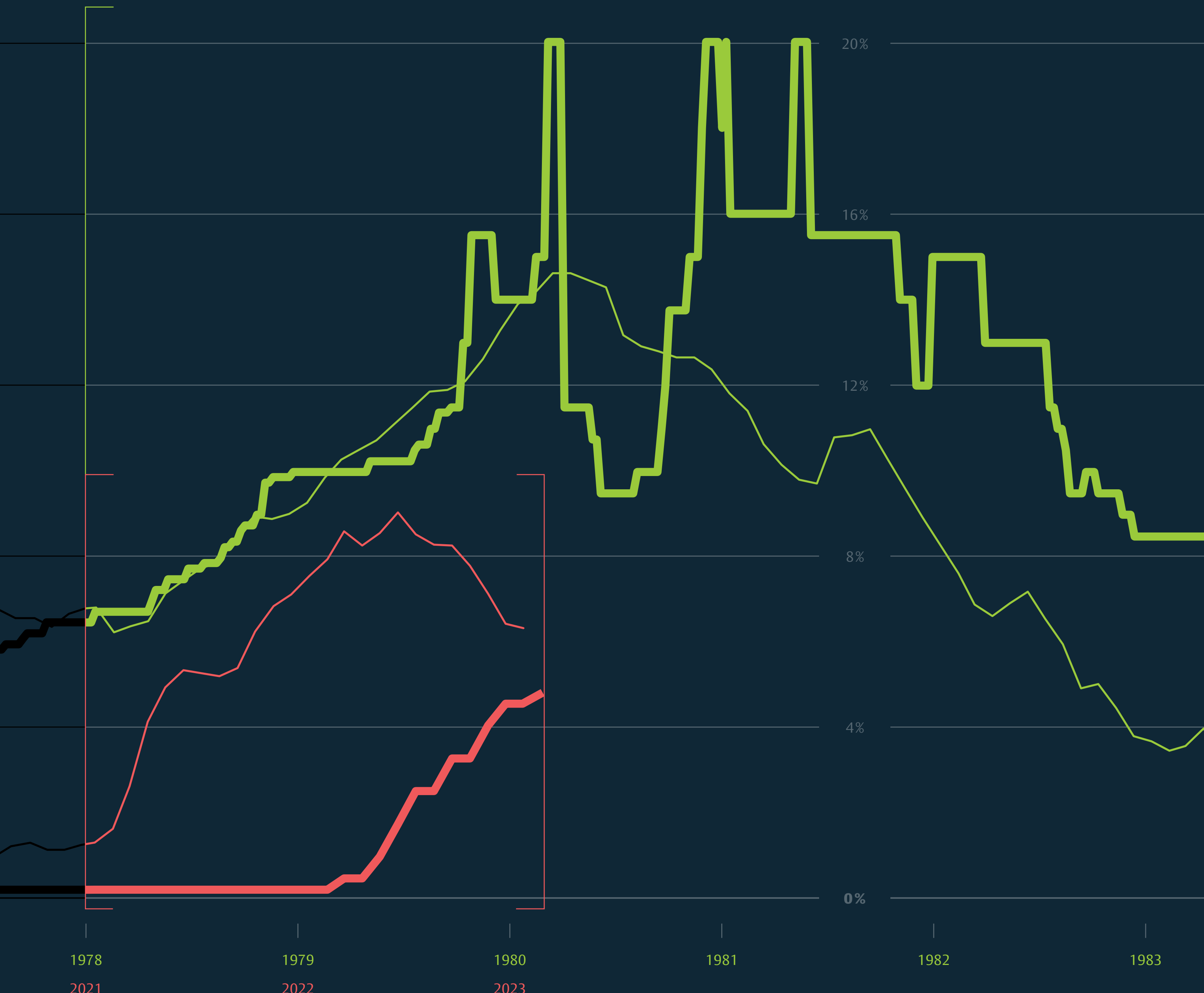
How far will the man seeking to emulate Paul Volcker really go? Will he get the job done? ◆

Yannick Döller is a freelance journalist.



Other periods
US national debt as a percentage of gross domestic product

*Data as at Q3 2022
Source: Federal Reserve, Flossbach von Storch, data as at 28 February 2023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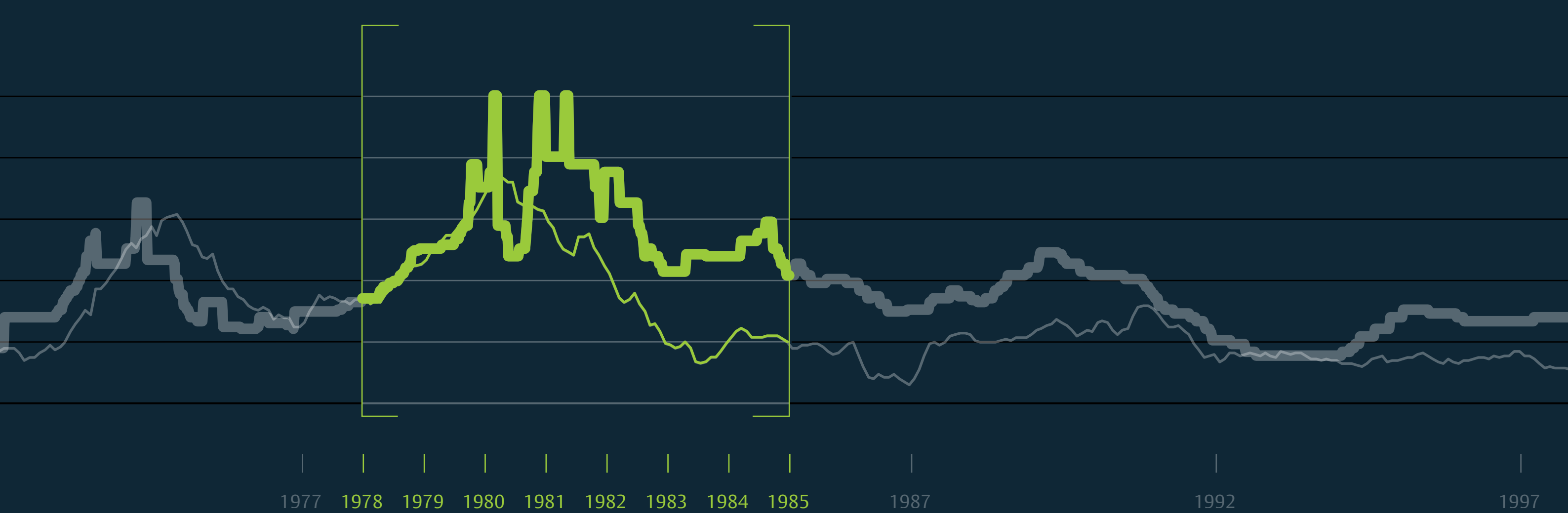
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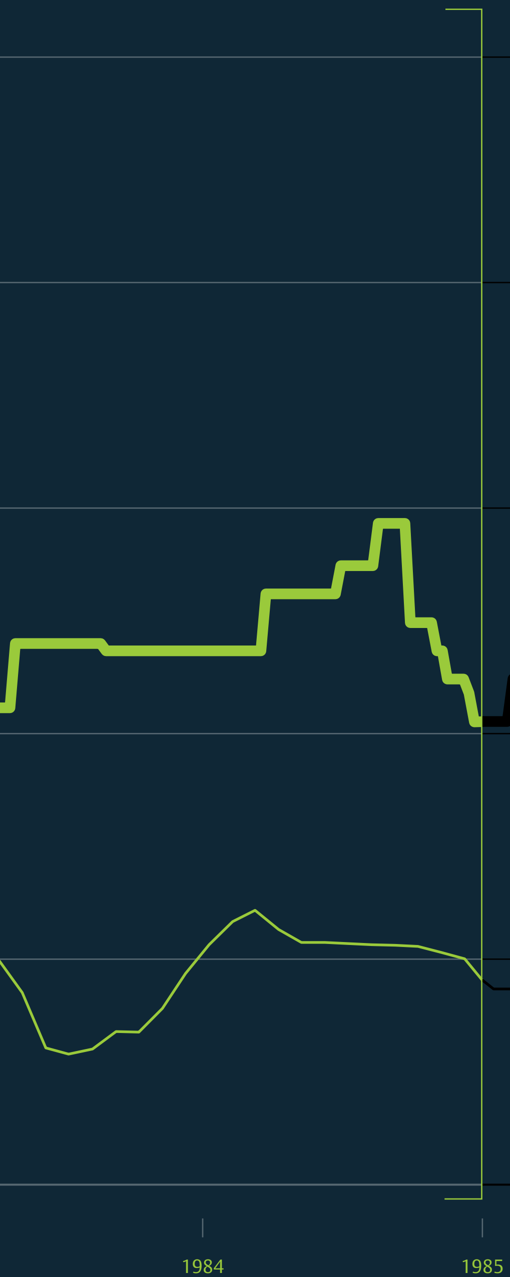


When inflation hits, interest rates rise. This has been the foundation of monetary policy for decades. Higher interest rates make loans more expensive, which in turn slows economic growth. This creates a burden on the income of swathes of citizens, on corporate profits, and on public spending. Demand for goods falls as a result, and then some time later inflationary pressures ease.

The only question is: how high do interest rates need to go? The last major inflationary period in the USA was back in the 1980s. The Federal Reserve responded with massive interest-rate hikes. The Federal Funds Target Rate jumped to 20 per cent, remaining well above consumer price inflation for many years (see green part of the figure).

In the current inflationary period we are still a long way from rates like that. Even if rates were to be hiked still further, they are currently still well below the rate of inflation. In order to bring inflation back under control in the current climate, interest rates won't have to rise by anywhere near as much as they did in the past – both in terms of absolute rate and in relation to inflation. The debt burden facing governments and non-financials rose sharply in the (interest-free) times of old. Given the existing mountain of debt, smaller rate hikes now have a greater effect. What's more, inflation expectations are more firmly entrenched today than they were in the 1980s.

Even the most experienced central banker cannot currently predict how much higher rates will have to go. The mechanisms of national economies are too complex for simple equations to be meaningful, and there is always a time lag before the effects of interest rate hikes are felt. Ultimately, monetary policy is always an experiment (especially after many years following an extremely expansionary approach). Only time will tell whether it works in practice.

Inflation and monetary policy – then and now
Inflation and key interest rates (Federal Funds Target Rate) in the USA

US key interest rates *(wide lines)*

US consumer price inflation *(thin lines)*

Source: Bloomberg, Refinitiv, Flossbach von Storch, data as at 28 February 2023

LESS IS MORE

by Shenwei Li

MAIL FROM SHANGHAI

Economic engine, superpower, party dictatorship. If you are interested in global trends, look to China. Analyst Shenwei Li provides a subjective account of her experiences from the perspective of a Chinese citizen, this time in relation to buying a home.

For most Chinese people, owning their own home is an important life goal: 61 per cent of households in Shanghai and 65 per cent of households in Beijing live in freehold flats. Many young people first need to save for many years before deciding to buy.

This is the start of a testing time for some, because new builds are generally sold via a "pre-sale" process. Buyers generally have to wait for two years after the contract is agreed before the flat is ready to live in. As soon as they sign the contract, however, they are obliged to transfer 30 per cent of the purchase price to the developer who is building the property. Mortgage payments are also due from this point onwards. So during this transitional period, property buyers must cover the rent on their old flat as well as their mortgage payments. Although Chinese buyers generally finance a smaller portion of the purchase price with a mortgage than those in Germany, current mortgage rates of 4.1 per cent for a first home are not exactly favourable.

THE SHOCK

For many years, flats in China, particularly those in good locations, were seen as quite a secure investment. But a bubble is likely to have already formed in some markets when the liquidity problems of leading property developer Evergrande first hit the headlines in September 2021. Around a year later, the company could no longer service its debt and was facing insolvency. At this point it became clear that there is no longer such a thing as "too big to fail" in China. There are no government rescue packages, not even for a market leader like Evergrande.

Hot on the heels of the Evergrande situation, property developer Sunac was also on the brink of bankruptcy. Sunac had often been associated with high quality since its construction projects are predominantly located in "high-tier" cities (large, economically powerful cities such as Beijing and Shanghai), whereas Evergrande's projects were often situated in "low-tier" (smaller, less important) cities. But even prime locations obviously do not protect investors.

The crisis in the Chinese real-estate market peaked in summer 2022, as more and more developers struggled with liquidity problems and increasing numbers of housing units were left unfinished. But thousands of buyers had already put down deposits and had been making mortgage payments on these properties. They are liable for these loans to the extent of their assets, so an unfinished housing unit is a catastrophe for the buyer. According to reports on social media, some of those affected even moved into their half-finished homes because they could not afford to make the mortgage payments and rent for longer than originally anticipated.

Desperate buyers ultimately held demonstrations against banks that were still demanding that they pay their mortgage on time even though construction on the flats had ceased. The Chinese government intervened and many state-owned developers took over the projects. However, it seems that rebuilding trust in the market will take a little longer. Sales revenues in the real-estate market in 2022 were 28 per cent lower than in the previous year.

THE DOWNSIDES OF A NEW BUILD

Despite these developments, the price per square metre increased slightly over the same period. Because people need housing. Pre-owned flats can be occupied straight away and would be an alternative. The problem is, however, that for historical reasons there is no real market for them in most low-tier cities; the market is only well-established in high-tier cities. In addition, the sale prices of pre-owned homes, unlike new builds, are not controlled by the local government. This situation means that a new build unit can be as much as 50 per cent cheaper than a pre-owned flat in a similar area.

So new builds bring the "pre-sale" risk, while pre-owned flats are comparatively expensive. As a result, the real-estate market slowed considerably in 2022 – probably due also in part to the numerous lockdowns.

In addition, many have recently begun to question whether the mortgage interest rate, currently just over four per cent, is too high. Some people apparently consider early repayment a sensible step, as shown by the decline in the average share of mortgage loan financing from 37 to 24 per cent by December 2022. By contrast, before the Evergrande bankruptcy hardly anyone raised an eyebrow at mortgage rates of five to six per cent. Most people wanted as much credit from the bank as possible for the longest possible time, partly because many invested in real estate not only for their own use but also for others.

At the time, many seemed to hold the view that one could generate returns of more than five to six per cent over time with real estate. Given the decline in purchases, this opinion is less prevalent today. And so our government has finally managed to effectively control the real-estate hype, which it had warned about for years, and made speculation in this area less appealing.

Analyst Shenwei Li reports from China.

MINDSET

by Stephan Fritz

The bad news? There's no magic formula when it comes to investing money, even if stock-market literature sometimes suggests otherwise. The good news? You don't need to be a genius either. Morgan Housel[1] writes in "The Psychology of Money" that "Doing well with money has a little to do with how smart you are and a lot to do with how you behave.".

Investing money is not an exact science – many paths lead to success, but just as many lead to failure. So what does it take to succeed as an investor? Or to put it another way, what should you not do?

Investing money is not an exact science, even if it does deal with data and numbers like maths and physics do. Investing is about "feelings". The world's stock exchanges act as a meeting place for many millions of market stakeholders who have equally as many different goals and opinions. These stakeholders include private investors such as professional investors, large pension funds and insurance companies, who bring with them a whole host of fears, desires, misjudgements, hopes and expectations.

Richard Feynman (1918–1988), physicist and Nobel Prize winner, i.e. a conventional scientist unlike most investors, once said: "Imagine how much harder physics would be if electrons had feelings.".

[1] Morgan Housel: bestselling author (The Psychology of Money), analyst and investor.

THE PLACE WHERE EVERYTHING CONVERGES

So let's take a look at how our emotions affect our decision-making – and how you might be able to control yours better when it comes to achieving success with your investments. To do this, we first need to understand how we actually go about making decisions.

So let's start from the place where all our thoughts and feelings originate: the human brain. And let's start with a short story, which doubles up as a little experiment. Try to imagine that you are the narrator of this little tale. Let's get started ...

I travel frequently on business. A few weeks ago I flew to the south of Europe, with a British airline. I had trouble stowing my cabin bag in the overhead locker — something was stuck. And this was on a day when, for one reason or another, nothing so far had quite been going to plan.

Apparently the pilot noticed my pathetic, even desperate, attempts, so he offered to lend me a hand. He was very friendly, joking about technology and its pitfalls. His voice was reassuring; it sort of reminded me of a children's storyteller I used to listen to in the 1980s, it was very deep yet comforting — the only difference being that he spoke perfect English rather than German like on my childhood audio tapes. After we landed, he shook my hand as he said goodbye and wished me a pleasant stay. Maybe we would see each other again on the return flight, who knows.

I still had a few hours before the event I'd come for was due to start, so I went to a nice café to work for a little bit. Sitting across from me was a young couple. Unfortunately, I didn't understand anything they were saying — though they were having an undoubtedly very animated, almost euphoric discussion.

Focusing on work was hopelessly out of the question — and, as Murphy's Law dictates, my headphones, which I could have put on to drown them out with some music, were of course on my desk back in the office.

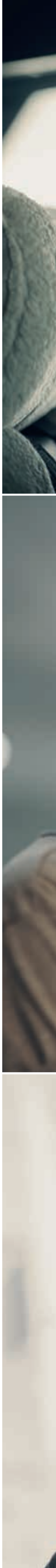
Since there wasn't a table free at the other side of the café, I practised my observation skills and tried to work out who or what was prompting such lively discussion at the next table. I had no idea until I caught a glimpse of the couple's tablet: furniture. So the handwritten notes on the pad of paper next to the tablet had to be measurements: length, width, depth. I presumed the couple were furnishing a flat, potentially their first one together.

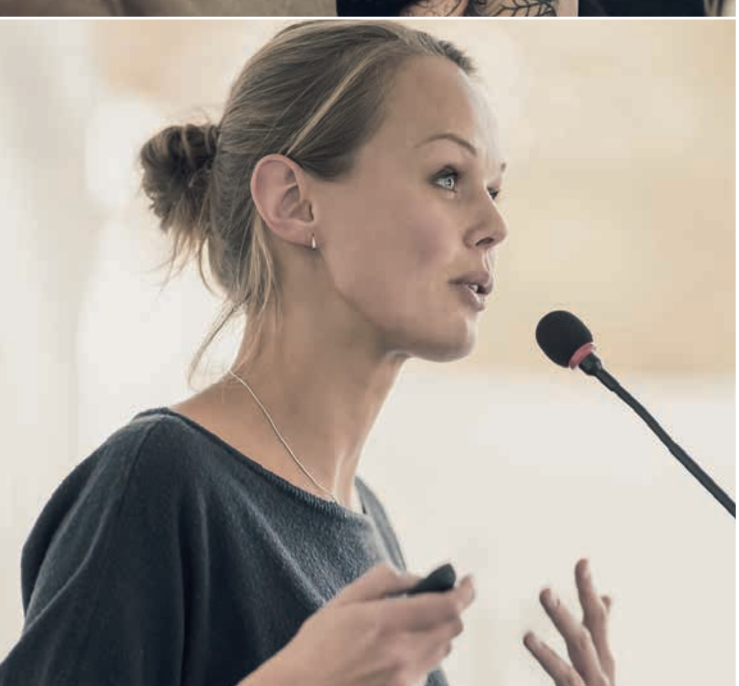
I left the café without having proved this hypothesis and set off for an event that was about the world in 2050, where Professor Schmidt gave a lecture on self-driving cars. I travel a lot by car when I'm at home, so it gave me an incredibly exciting insight into the future. The talk was very demanding in terms of content, but always understandable ...

I'd like to end this little story here and hand over to you. Think about the characters in my story: the pilot, the couple and Professor Schmidt. What do you think they look like?

THE BRAIN UTILISES PATTERNS

So, can you picture them in your mind? Now look ahead a little. You can see the four of them on the following pages. Do they look how you expected them to or not? I wouldn't be surprised if the pictures in your head were (very) different.





But what does this mean?

Our brains tend to think inside the box; experts call this "pattern recognition". The brain always seeks the shortest route – by recognising patterns, and sometimes stereotypes. It can't not do this, because our environment is not only diverse, but also incredibly complex. We are exposed to huge volumes of information – approximately 11 million bits' worth – at any given moment. This completely overwhelms us because our brain can only process about 50 bits at a time and our short-term memory can only store seven new impressions simultaneously.

Patterns help the brain to create an overall picture, but it reaches maximum capacity quickly. To give another example: one of the things that humans are best at is seeing. Our sense of sight uses about a quarter of our brain power. We see things every day for hours on end. And though we can see so well because we exercise our sight so frequently and over such long periods, this doesn't prevent us from making mistakes. Please take a look at the image on the opposite page. Look closely at the two grey circles. Which one is bigger? The one on the right? No, they are both the same size.

The brain works in patterns in this scenario too. It sees a small circle surrounded by larger ones and a large one surrounded by small ones. This makes the apparently small one look smaller by comparison and the apparently large one look larger.

What I'm getting at is that if we are so easily deceived in a discipline that, thanks to evolution, we perform as comparatively well in as sight, this means we are all the more susceptible to making mistakes in disciplines that are allocated less brain power.

RUNNING AWAY FROM THE BEAR

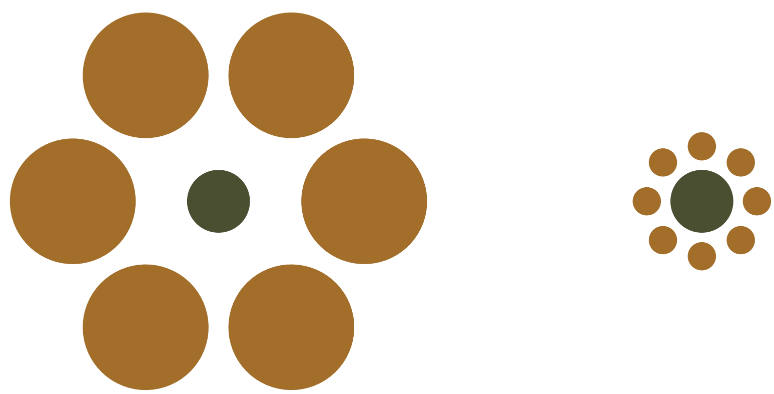
This brings us back to investing money and the question of why we decide the way we do – and why we make mistakes, time and again.

In his seminal work "Thinking, Fast and Slow", psychologist and Nobel Prize winner Daniel Kahnemann describes two systems that work together in the decision-making process.

System 1 works at high frequency, using stereotypes to process information intuitively, quickly, automatically, emotionally and subconsciously. **System 2**, by contrast, is the "lazy controller", being slow, laborious, irregular, exhausting, sluggish and forgetful, but also logical.

System 1 makes sure that we run away when a bear starts coming towards us (which might not be a good decision in this particular case!). System 2 helps us solve maths problems without having memorised the results beforehand.

The two systems work together. The result of this cooperation forms the basis for most human decisions and, unfortunately, for the wrong decisions too. Experts talk about "distortions", of which there is a relatively large number.



Since space here is limited, I would therefore like to present only a select few of them – and as briefly as possible. You might find that you are familiar with one or two of them already.

WE SEE WHAT WE WANT TO SEE

Let's start with what is referred to as **confirmation bias**. That is to say, we usually give greater weight to evidence that is consistent with or at least comes close to our existing beliefs. Similarly, we prefer to talk to people who share our views because we want to feel "confirmed". Don't we? When was the last time you changed your mind about something because the person you were talking to thought differently – and gave you such a convincing reason that you ate your words? Conversely, we neglect arguments that contradict our world view; in other words, we see what we want to see.

Availability bias refers to comparisons we make without Event A being comparable to Event B, at least not one-to-one, because the time is different and the circumstances have changed. We are nevertheless perfectly happy to make these comparisons because Event A seems all too present and important to us. For example: investors who were heavily influenced by the dot-com crash at the turn of the millennium will repeatedly project their experiences and the chronology of events back then onto new crises. History might repeat itself ... or it might not! This means we're going around with an incorrect "risk map" – if you wanted to see the Eiffel Tower in Paris, you wouldn't get far with a city map of London ...

From my perspective, the most common mistakes are caused by **overconfidence**, which is the systematic overestimation of one's own abilities. Anyone who has bought the right shares and consequently generated decent returns believes that they will succeed again next time. Conversely, we tend to underestimate the power of chance and consistently attribute success to our own actions and intellect, which is a dangerous way of thinking.

Let me give you a tangible example of what I mean: one question we are constantly asked – especially in turbulent times – is whether we would hedge our portfolios against price setbacks. This question is justified and very understandable. This is something we do, but it's not a regular occurrence – we only do it in specific, rather rare market phases, such as at the height of the Coronavirus pandemic in spring 2020.

So why don't we do it more often?

Firstly, because hedging costs money, and the higher the costs the more meagre the returns over the long term. Secondly, because of the overconfidence phenomenon: choosing the right time to hedge is one thing, but catching the right time to exit is something else entirely. It's essentially like a football match featuring your favourite club. After just 10 minutes, they take a one-nil lead – awesome! But they're still a long way off winning: there's another 80 minutes of the match left to play (not including any extra time) and the team will have to overcome numerous tricky situations and make difficult decisions in order to emerge victorious. One goal might not be enough.

WHY DON'T YOU HEDGE YOUR PORTFOLIO?

The point I'm trying to make is that getting it right once is never enough. You have to get it right every single time, again and again. If you undertake hedging, you will have to stop at some point and so on. This doesn't work in the long run in our opinion; it's not something we do, at any rate. In this respect, hedging should never be an end in itself – because the long-term costs may be greater than the benefits.

What happened in 2016 illustrates this point perfectly: if you had known that the UK would vote to leave the EU and that a man like Donald Trump would become President of the United States, you might have sold all your shares – or hedged everything! You know how the story ends: the equity indices climbed from one high to the next in the months that followed – in spite of Brexit, in spite of Trump.

In our opinion, the best way to hedge risks in the long term is not by somewhat frantically attempting to time the market, but by cultivating an intelligently diversified portfolio – and by having a strong team comprising different types of people who don't always agree but do strive for the best arguments and ideas.

Let's get back to our brain though. What's the use in knowing that while this organ is wonderful, complex and fascinating in equal measure, it nevertheless makes decisions that are irrational and occasionally harmful?

This realisation makes us humble, or at least it should do. Knowing that we don't know everything and we won't always be able to assess things correctly – that we will make mistakes and sometimes the wrong calls – forms the basis for long-term investment success.

MISTAKES ENCOURAGE HUMILITY

Anyone who acknowledges having made mistakes will question themselves again and again. They will endeavour to examine things more closely and analyse them more critically. They will look for ways to limit the impact of potential mistakes. They will try to build "firewalls".

Ours is the "Flossbach von Storch Pentagram", which is intended to protect us, and above all our clients, from any mistakes we make. The Pentagram basically reflects the sum of all the experiences we have gained and conclusions we have drawn from our mistakes.

We know that we don't know everything, which is why our investment strategy must follow clear rules and principles. There are five terms that guide all of our investment decisions.

Perhaps the most important term is **diversification**: investors who want to protect their assets over the long term have no choice but to rationally allocate them to various asset classes, individual securities and currencies. This reduces risk.

Quality is an important factor for investments too. Investors should always consider the substance of an investment, the long-term returns generated by the investment and, above all, the predictability of those returns.

Investing also requires **flexibility**. The stock market is prone to exaggeration, about the positives and the negatives. Investors should therefore maintain a certain liquidity buffer to enable them to respond to unforeseen circumstances as necessary and take advantage of investment opportunities.

It may sound trite, but excessive debt is the most frequent reason why companies and countries – not forgetting private individuals – go bankrupt. Investors should therefore always consider their own **solvency**, as well as the solvency of the issuers of the shares and bonds they buy.

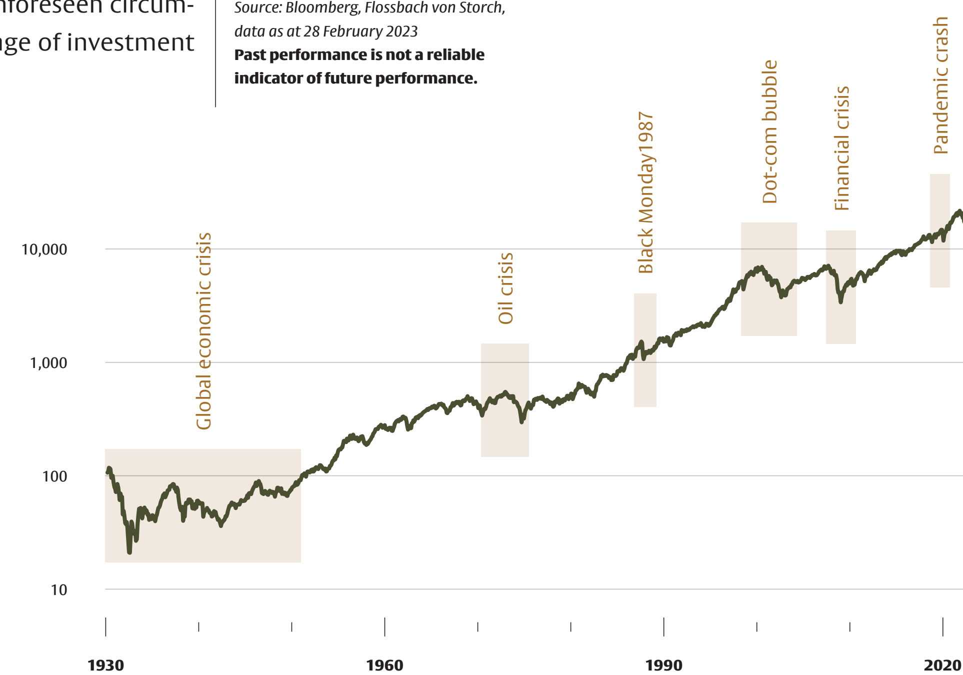
The fifth term is **value**. Warren Buffett[2] once said that price is what you pay, value is what you get. There's very little else we can add to that. So tread carefully with deals that seem too good to be true – they often cost investors dearly.

Those who adhere to these principles have no need of a magic formula. The foundations of their investment strategy will be sufficiently stable, provided they can be patient. An investor's most powerful ally is time (see figure). Time forgives mistakes because their consequences are put into perspective over the years that follow. ◆

We do not need to know everything.

Time puts things into perspective
S&P 500 index performance in US dollars (logarithmic scaling; indexed to 1 January 1930 = 100)

Source: Bloomberg, Flossbach von Storch, data as at 28 February 2023
Past performance is not a reliable indicator of future performance.



2 Warren Buffett: Chair of the Berkshire Hathaway Board of Directors and world-renowned investor.

Stephan Fritz is a Product Specialist at Flossbach von Storch AG in Cologne.

“Investing

has to be Constructive”

The investment environment remains challenging in spite of the recent rally. In this interview, Kurt von Storch discusses the risks and the possibility of a crash – and what this could mean for investors.

Mr von Storch, war, inflation, climate change, the Coronavirus pandemic – the problems just keep on coming. Have you, as an investor, ever experienced anything like this?
The number, combination and interlinking of the various crises is certainly something out of the ordinary.

Some feel that it is reminiscent of the turn of the century – although this would mean that stock-market prices still have some considerable way to fall ...
I would be cautious about making such comparisons. The history books provide parallels and potential similarities for each market phase; but the differences are equally significant and just as numerous.

So it’s better not to compare?
I wouldn’t want to prevent anyone from doing that. It’s only human to seek out points of reference in the past in the first instance – it’s just that doing so can sometimes drive you mad.

So to put it another way: you don’t think that a crash is imminent at present?
Nobody knows what will happen tomorrow or the day after that. So in that respect, a crash can never be ruled out. But how does knowing that help me as an investor?

Can you explain a little more?
If I constantly thought about the next crash, I would probably never invest a single euro in shares. And probably nothing in bonds either. But if I don’t invest, then at some point I’m going to be in big trouble. Investing should be constructive; I would actually go so far as to say it must be constructive.

What do you mean by that?
Over the next few years, the stock market will be less about getting rich and much more about protecting your assets from inflation. That won't happen without real assets; it's not possible without the shares of good companies.

You don't think that the central banks will bring inflation under control?
If by "bring under control" you mean inflation rates falling to or below the two per cent target any time soon, then no, I don't.

What are your inflation forecasts for 2023 and 2024?
We don't think much of annual forecasts or point forecasts. Forecasters can end up getting it wrong. We leave others to concern themselves with that. Instead, we try to look at the dominant trends, at structural factors that could influence inflation development in the long term – in either direction. So, for us, it is more about using a rough guideline than supposedly precise forecasts. We should not deceive ourselves, or our clients and investors, into thinking that we can do anything more.

Can you give us some examples of trends and factors?
We like to talk about the three "Ds" – demographics, deglobalisation and decarbonisation. All that costs money and is likely to mean that inflation rates will be structurally higher in the future than they have been in the past. Not 10 per cent, probably not even seven or eight per cent, but significantly more than two per cent.

Are equities actually the right instrument in this situation? Price performance over the last 12 months has at times suggested not – in spite of inflation …
That depends on the shares, on the pricing power of the company in question, and most of all on the time horizon that you as an investor have in mind. 12 months represents a snapshot in time – nothing more. Anyone who invests in shares should do so based on the premise of sticking at it long term, for at least five years.

What about the risk of major price fluctuations?
Long-term investors don't view that as a risk, but simply as something that they must accept, especially since it is in these phases that they will usually discover the most attractive investment opportunities. So the question is also: are the losses on the stock market long-term and therefore a genuine risk? Share prices for sound companies will recover sooner or later, but for some less sound companies the situation may be different. Some tech companies, for instance …

… for which investors had ludicrous growth expectations at the height of the COVID-19 pandemic …
Yes, that's true. But considering the stock market in retrospect doesn't help us.

What does help?
Looking at companies that have a robust, crisis-tested business model and sufficient pricing power. I have confidence that their prices will perform positively in the long term. But that won't happen overnight – it needs time and therefore patience. And, last but not least, the aforementioned robust tolerance of price fluctuations. You must have the emotional strength to withstand price setbacks. Unfortunately, there is no alternative.

Would you say that the choice of individual investments is more important now than it has ever been?
Let's say I wouldn't disagree with that.

What about bonds?
They are a more attractive prospect on today than they were a year ago. But again it depends which ones you choose. Anyone who looks carefully will certainly find an opportunity somewhere.

The bond market crash last year was unprecedented. Price losses of that kind, and in such a short space of

time, had never been seen before. What was your experience of that situation?
A first-hand one. Investors had nowhere to hide during that period. Even if, as a portfolio manager, you did a lot right – for example, by reducing the duration and thus the risk of bonds in good time – that would only have helped you to a limited extent.

Investors used to be able to rely on one thing: if shares crash, bonds from sound issuers will stabilise a mixed portfolio. Why didn't that work this time?
Because the return potential for bonds was limited at close to the zero-per-cent mark. And when the interest level increases significantly for the first time in years, because the central banks need to keep inflation in check, in those circumstances even moderate interest-rate adjustments are enough to significantly depress the prices of bonds already issued. We were speaking with our clients a great deal and very frequently during this period, in particular with those who invest their money more defensively, i.e. with larger sums in bonds.

How did they respond?
Very positively overall, which made us extremely happy and also grateful. We have known many of these investors for a very long time. They value the fact that we are extremely transparent in how we communicate our investment strategy and the philosophy behind it, especially in difficult times. It goes without saying that we want to live up to their faith in us ...

Thank you for the interview.

Kurt von Storch is Co-Founder and Owner of Flossbach von Storch AG.

"Over the next few years, the stock market will be less about getting rich and much more about protecting your assets from inflation."

BACK TO REALITY

During the boom, several technology companies rewarded their employees in grand style – with share options. A report on waste, concealment, and the disciplining effects of the market.

by Bert Flossbach

Times of crisis always present a challenge for investors. And this isn't just the case when portfolio values are extremely volatile; there are also opportunities – both apparent and genuine – that you can turn to your advantage.

In a crisis-ridden 2022, large price drops made shares with previously extremely high valuations look like bargains in the stock-market display window that you didn't want to miss. But just because a price has fallen significantly, that doesn't mean you're getting a bargain. There are often fundamental reasons why prices fall and in many cases the valuations were simply too high due to the low level of interest rates and exaggerated expectations.

Sometimes it is also due to the culmination of several factors, as shown by the sharp drops in the share prices of former stock-market favourites (e.g. PayPal, Tesla and Meta) in the past year, which have lost around three quarters of their value since their highs. Experience has shown that a downturn does not end at a moderate or fair level, but considerably lower. This is especially true for equities with valuations sent into the stratosphere by euphoria and then dragged down by the gravitational pull of the capital market again when business momentum slows and interest rates rise. This is also naturally where the best opportunities can be found when growth returns and the stock market starts to price in the improvement in the future prospects of the companies.

There is, however, one important caveat. If you are serious about calculating valuations, the companies should be profitable. Hoping a growth company that has consistently recorded losses will eventually post solid profits again only leads to large price gains in boom phases.

Hoping a growth company that has consistently recorded losses will eventually post solid profits again only leads to large price gains in boom phases.

REAL OR ILLUSIONARY?

This phenomenon has been particularly evident in the USA. In the especially hard-hit technology sector, which represents a good 25 per cent of US stock-market capitalisation, companies often gloss over their lack of profitability by pointing to their adjusted earnings and supposedly high level of free cash flow. Free cash flow is a kind of Holy Grail for long-term investors that indicates how much cash a company has after deducting all investments.

Unlike corporate earnings, free cash flow is considered less easily manipulated, especially over a long period of time. Some companies, however, use a (legal) method to make their company look more profitable than it actually is. They disguise an important part of their costs by ignoring some personnel expenses and/or misappropriating the company's free cash flow.

More specifically, the costs involved are stock-based compensation, which is not costless and often not neutral with respect to cash flow. Few were interested in this during the boom and many companies did not initially understand why the issue was so important to professional investors like us in the first place. This seems to be changing with the stock-market decline, although not everyone who gets caught out seems to have a problem with it.

How genuine are the earnings? For shareholders, who ultimately own the company, that is a very important question. Way back in 1998, Warren Buffett addressed the issue of employee stock options in his inimitable way in the Berkshire Hathaway annual report and called for them to be included in income statements under personnel expenses: "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses should not go into the calculation of earnings, where in the world should they go?"

How genuine are the earnings? For shareholders, who ultimately own the company, that is a very important question.

This topic is therefore anything but new. After the dot-com bubble burst in 2000 and following the resulting pressure by investors, the recommendation to include these expenses became an obligation in 2005 and was included in the US GAAP (Generally Accepted Accounting Principles) in 2009. Since then, if employees receive options on shares of the company as part of their compensation, the value of the options must be included under personnel expenses, thereby reducing earnings.

That's what the regulatory guidelines say, anyway. In practice, there is room for interpretation. Wall Street analysts, for instance, never really took to the idea. They quickly switched to calculating their own so-called adjusted earnings, which eliminate the cost of the options again and therefore increase the earnings per share.

Over time, more and more investors have accepted these adjusted earnings as an appropriate measure of return that is frequently also used as an indicator of management compensation. The difference between the different definitions of earnings is often small. Many companies in the technology sector are an exception. Stock-based compensation has always been quite widespread in this sector, but has recently taken on such excessive dimensions that it brings back memories of the excesses of the technology bubble at the turn of the century.

LOOSENING THE PURSE STRINGS

This is evident from a quick glance at the facts. The 10 largest US technology companies, which are included in the S&P 100 index, had around USD 75 billion in expenses for stock-based compensation in the last four reporting quarters. The total since 2017 was USD 276 billion. As figure 1 shows, this represents 21 per cent of their free cash flow.

Analysis reveals immense differences with these companies. The other 90 companies in the S&P 100, for instance, have compensation expenses totalling just seven per cent on average. Probably the most glaring example is the software provider Snowflake, which still has a stock-market value of around USD 42 billion even after the slump at the end of the year. With revenue of only USD 1.9 billion, the company spent USD 757 million on stock-based compensation, i.e. 41 per cent of its revenue. This corresponds to an average of around USD 190,000 for each of its almost 4000 employees.

The phenomenon of excessive stock allocations and their concealment by adjusting earnings is essentially limited to the technology sector. The companies often describe stock-based compensation as necessary for motivating employees. They hope it will improve identification with the company and create greater loyalty and view stock-based compensation as an important tool in the fight to secure and retain talented employees, who are demanding ever higher salaries.

But well-intentioned does not always mean well-executed. In reality, every employee is ostensibly talented. At Google's parent company Alphabet, there are 187,000 of them. Similar to their colleagues at Meta, they earn an average salary of USD 200,000 and also receive share options with a value of USD 100,000 at the last count.

Figure 1
Stock-based compensation (SBC*)
for the 10 largest technology companies
Q1 2017 – Q3 2022, in USD millions

Company	SBC* expenses	Free cash flow	SBC* share of free cash flow
Alphabet	73,100	231,557	31.6%
Amazon	52,477	27,152	193.3%
Apple	40,193	451,925	8.9%
Meta	37,395	130,378	28.7%
Microsoft	30,767	220,157	14.0%
Oracle	10,650	67,063	15.9%
Cisco Systems	9,935	73,870	13.4%
Broadcom	9,546	64,223	14.9%
Nvidia	7,164	25,219	28.4%
Adobe	5,270	30,553	17.2%
Total for the Top 10 technology companies	**276,497**	**1,322,096**	**20.9%**
S&P 100 ex Top 10 technology companies	**258,341**	**3,693,363**	**7.0%**

**SBC – Stock-Based Compensation*
Source: FactSet, corporate reports, Flossbach von Storch, data as at 28 February 2023

→

In practice though, employees don't see this compensation model as an expression of co-entrepreneurship, but simply as a second salary. This is clear, for example, from the common practice of selling the allotted shares as soon as the vesting period has ended. This also leads to the downside of these participation programmes. The employees are unhappy and the mood in the company sours if the share price plummets and the options become worthless. As some company managers freely admit, the situation is then remedied by either issuing even more shares or options or reducing the exercise price.

SHAREHOLDERS ARE THE LOSERS

Even free cash flow, which is supposedly almost impossible to manipulate, has long since ceased to be safe from the actions of some managers. In order to avoid the dilution effect caused by issuing new shares to employees (increasing the number of shares reduces the percentage of the company held by existing shareholders), shares of the company are often repurchased on the market and then passed on to the employees. This leaves the number of shares largely unchanged and there is no dilution of existing shareholdings.

There is, however, a problem. The money used for the repurchases comes from the free cash flow, which by definition is the cash that remains after deducting all costs and investments. The company can distribute this to its shareholders, retain it in the company (increase cash holdings or reduce liabilities), or use it for acquisitions or share buybacks. Share buybacks reduce the number of shares in circulation and increase the percentage holdings of existing shareholders. If, however, the repurchased shares are passed on to employees to satisfy share entitlements, they represent personnel expenses. That means the high level of free cash flow so proudly announced by management is not so free, since part of it is used to cover personnel expenses.

In principle, there is nothing wrong with stock-based compensation, especially if it is targeted and used to an appropriate extent. What is objectionable, however, at least in our view, is the euphemistic way it is handled. When quarterly results are published, share buybacks are enthusiastically proclaimed to be a benefit for shareholders. The third-quarter press release issued by the payment service provider PayPal, for example, states the following: "Year-to-date through Q3-22,

When quarterly results are published, share buybacks are enthusiastically proclaimed to be a benefit for shareholders.

returned $3.2B to stockholders through share repurchases." (Note: including tax payments, however, USD 1.35 billion of this amount went to employees.)

A more transparent and honest approach to this looks different. Shareholders should be informed about how much of the share repurchase was used to cover employee entitlements under stock-based compensation programmes and how much can be considered to have been "returned to our shareholders" because the number of shares was actually reduced.

The technology companies' expenses for stock-based compensation programmes have continued to rise in previous years. They reached a new record of 26 per cent of the free cash flow in the previous year, or previous four reporting quarters (see figure 2).

A BAD DEAL

Hardly anyone took offence as long as the prices of technology stocks continued to rise like clockwork, partly because it would have been fatal to miss out on the long-term rally because of this. That could change now that the bull market in technology stocks has ended, especially since it is now also becoming apparent that a great deal of money was often wasted by paying high market prices for shares that could be bought for half the amount today.

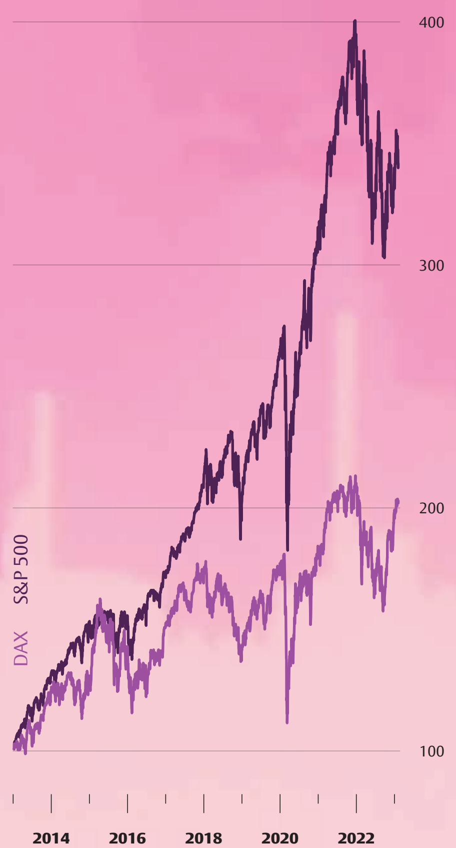
Facebook's parent company Meta provides a striking example of this. Meta has paid USD 90 billion to repurchase 371 million shares over the past five years. The number of shares outstanding, however, only decreased by 243 million, which cost the company an average of around USD 242 per share to acquire. The share price was USD 170 at the end of February, i.e. roughly 30 per cent lower. That represents a (preliminary) loss of around USD 17 billion. A further 128 million shares with a value of USD 29 billion were issued to employees and the resulting income tax of USD 18 billion was also paid. A total, therefore, of USD 47 billion.

We have expressed our displeasure at the wasteful spending and lack of transparency surrounding stock-based compensation and other excessive costs in letters and discussions with many managers. In view of stagnating revenues, companies are also now increasingly coming to the realisation that things can no longer continue like this.

Figure 2
A growing part of the expenses for technology companies
Ratio of expenses for stock-based compensation programmes to free cash flow

Source: FactSet, corporate reports, Flossbach von Storch, data as at 28 February 2023
Past performance is not a reliable indicator of future performance.

Figure 3
DAX vs. S&P 500
Stock-market performance
incl. dividends in local currency
(indexed to 1 January 2013 = 100)



Source: Bloomberg, Refinitiv, Flossbach von Storch, data as at 28 February 2023
Past performance is not a reliable indicator of future performance.

Hundreds of thousands of employees have been hired at a breathtaking pace since the beginning of the pandemic. Alphabet alone has hired around 70,000 highly paid employees who also receive restricted stock awards since the beginning of 2020. Now the tide is turning and companies are struggling with a flattening of growth and the high costs of an excessive expansion policy.

The days of pursuing growth at any price are over. Thousands of employees will be laid off again with large severance payments and office space will be reduced. In a recent CNBC interview, Satya Nadella, CEO of Microsoft, predicted that the technology world has to prepare for two more difficult years: "The next two years are probably going to be the most challenging because, after all, we did have a lot of acceleration during the pandemic and there's some amount of normalisation of that demand and, on top of it, there is a real recession in large parts of the world. The combination of pull-forward and recession means we will have to adjust …". For him, this also means that Microsoft's expenses should no longer grow more quickly than its revenues.

Other companies also appear to be realising that a more moderate pace is appropriate. In total, US technology companies have laid off around 150,000 employees up to the end of the year, which in some cases represents 10 to 15 per cent of their workforce. The resulting costs will be dealt with in the previous and coming quarters. The technology sector is therefore in a consolidation phase.

Even if the assessment of the companies' long-term growth prospects remains positive because digitalisation is reaching more and more sectors and areas of the economy, it will still be a long time before the shares of these companies reach their previous highs again. The large price losses suffered by the highly weighted technology stocks in the S&P 500 index have also put an end to the US stock market's long-standing outperformance of the DAX and EuroStoxx 50 for now (see figure 3).

Even though the worst in stock markets is likely behind us and valuations of many companies on the stock market are significantly lower than a year ago, we do not believe that we will see the start of a new, sustained bull market yet.

The tide will not turn until the Fed indicates it has inflation so well under control that it is unlikely further interest-rate hikes will be necessary and it can loosen its monetary policy again. No one knows when this will happen and how high interest rates will be at that time. Until then, stock and bond markets will likely focus on inflation measures from one central bank meeting to the next, accompanied by a rollercoaster of emotions.

QUALITY COMPANIES REMAIN ATTRACTIVE

In the case of highly interest-rate-sensitive growth stocks, one also has to take into account that business development lost momentum following the COVID-19 boom and costs have got out of control. Now belts have to be tightened and costs adjusted to lower growth expectations.

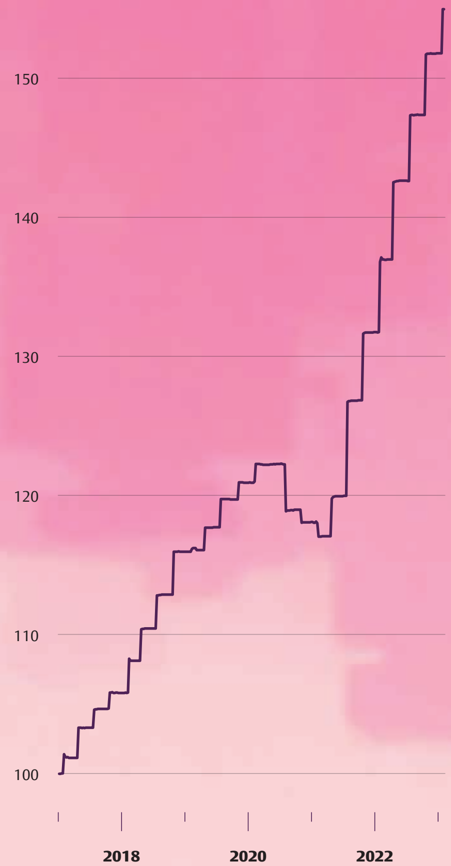
Once this has been done and the pressure of rising interest rates eases, technology stocks can resume their role as the draught horses of the stock market again. By then, the wheat will also have been separated from the chaff, and some companies that were still unprofitable will have disappeared from the market.

You don't have to worry about this for large, established companies. The main concern for those companies is to determine share-price levels that offer attractive risk-return ratios and can be used to create or expand positions. Earnings stability plays an important role in this.

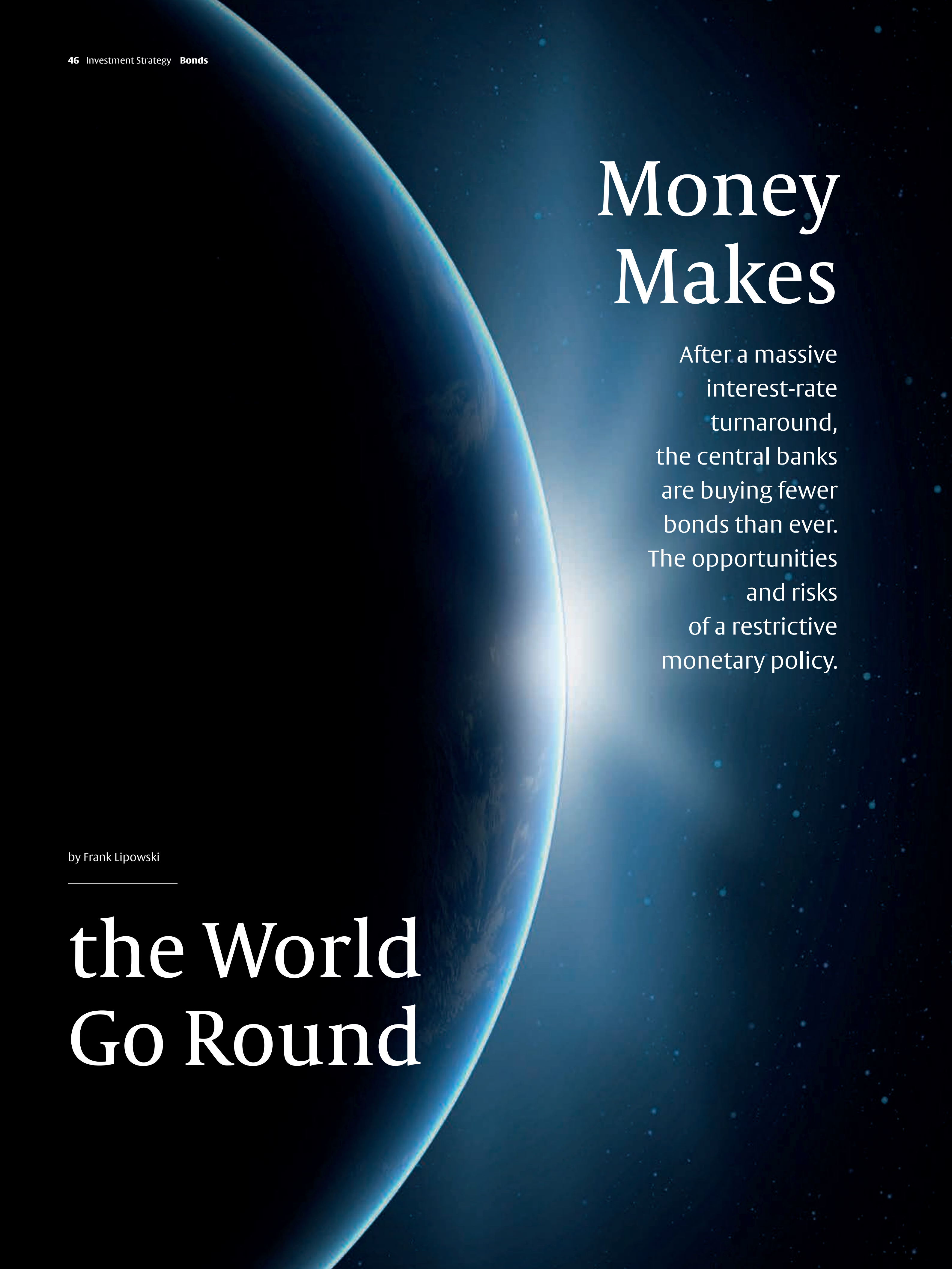
In the case of shares of companies with high pricing power and products and services that can be considered established, a relatively reliable earnings floor can be defined for setting possible buy levels. The earnings multiplier used is highly important and is mainly based on the company's growth prospects and the level of interest rates.

Ironically, inflation has two opposing effects on this. On the one hand, it gives corporate revenues and earnings a boost (see figure 4). On the other, it puts pressure on central banks to further increase interest rates and keep them high for longer, which can reduce the earnings multiplier. Given the high level of volatility with no clear trend that is expected, both individual stock selection (which shares do I buy or sell?) and timing (at what price level do I buy or sell?) will be particularly important this year. In short, technology stocks remain attractive, if the price, costs and entrepreneurial perspective are right. ◆

Figure 4
Inflation as a revenue driver
S&P 500 corporate revenues
for the past 12 months
(indexed to 1 January 2017 = 100)



Source: Bloomberg, Refinitiv, Flossbach von Storch, data as at 28 February 2023
Past performance is not a reliable indicator of future performance.



Money Makes the World Go Round

After a massive interest-rate turnaround, the central banks are buying fewer bonds than ever. The opportunities and risks of a restrictive monetary policy.

by Frank Lipowski

Interest-bearing securities still have the reputation of being something for “widows and orphans”, for “conservative” investors (whatever that means), or for those seeking limited fluctuations and consistent returns. In other words, investors who are primarily concerned with retaining their assets rather than increasing them.

But it’s not quite that simple. Depending on the market segment (and individual securities), the risks can vary considerably. There are also “macro issues”, which can have a huge influence on the entire market. Lately, bonds have been an asset class of extremes – and the future will also present a number of challenges.

FIRST THE INTEREST RATES DECLINED, THEN CAME THE CRASH

After the financial crisis in 2008 there was a significant drop in interest rates that persisted (with minor interruptions) until 2021. Falling interest rates led to increasing bond prices – anyone who reacted to the different market trends in the right way was able to earn impressive returns.

After the drought, last year brought a tsunami that could probably be described as historic. The central bank raised interest rates dramatically in an attempt to stall out-of-control inflation. Within a year, key interest rates in the USA rose by 4.5 percentage points; in the eurozone they rose by 3.0 percentage points.

There were huge shifts on the markets. In this environment, some investors felt safe with inflation-linked bonds, but the prices of these bonds respond primarily to traded real yields. And when inflationary pressure brought the expected interest-rate hike, these real yields rose dramatically, causing inflation-linked bonds to have their worst year on record.

10-year US treasury inflation-protected securities saw a turnaround in 2022, rising 2.66 per cent from deep negative territory to a positive real yield of +1.56 per cent. At no point in the last 50 years had there been such an increase in the yield on two-year and five-year US Treasuries, which rose by 3.69 and 2.75 per cent respectively within one year. The performance of the broad-based global Bloomberg Global Aggregate bond index (EUR), at -13.2 per cent, was weaker than ever before in 2022. Alongside the historic price losses on safe government securities, in some cases there was also a massive widening of credit spreads on some corporate bonds or covered bonds.

After a historically weak year for bonds in 2022, however, opportunities are now presenting themselves once more. Interest is back. The higher level of yields has made bonds more attractive. There are once again bonds available that can beat (expected) inflation in the long term from their current yield alone. In addition, current income has noticeably increased – and will also serve as a “buffer” if storm clouds appear on the horizon once again.

So all is well again on the interest-rate market? Not entirely. There are new challenges on the horizon. While 2022 was dominated by rising interest rates, 2023 could become the year of liquidity shortages given that the central banks are continuing to tighten the reins, and not only for the directly influenced key interest rate.

The European Central Bank (ECB) und the US Federal Reserve (Fed) want to significantly reduce their balance sheets and are thus withdrawing surplus liquidity from the market. In previous years, they have purchased securities to immense values. The goal now is to reduce this holding again.

The Fed has already started “quantitative tightening” – yields from maturing securities from central bank balance sheets that have reached end of their term are no longer reinvested. The ECB will follow suit in the spring. This will be accompanied by the winding down of the TLTRO programme, which has provided banks in the eurozone with highly subsidised refinancing over the past few years.

In terms of its impact on the markets – and ultimately on our financial system – withdrawal of liquidity should not be underestimated. →

As recently as autumn 2021, the Fed was still actively purchasing US dollar securities to the tune of USD 120 billion every month (and thus creating liquidity); it then began withdrawing USD 95 billion from the market every month as of June of last year. This alone creates a total liquidity differential of USD 215 billion per month – and of around USD 2.5 trillion over a 12-month period.

And that's not all – now we are also seeing reductions from the ECB, which by the end of 2021 had purchased an average of around EUR 70 billion in securities before gradually scaling things back until summer 2022. From March of this year, the central bank will withdraw EUR 15 billion from the market every month. The bottom line is that there remains a liquidity shortage in the eurozone of around EUR 85 billion per month, or around EUR 1 trillion over a 12-month period.

The ECB is also expected to reduce its balance sheet and see a liquidity shortage due to the anticipated repayment of "TLTROs". Following the first repayments of around EUR 900 billion in 2022, approximately a further EUR 800 billion will be incrementally repaid by the banks this year through pending maturities alone. Due to the now significantly less favourable terms of these TLTROs, additional early repayments are also, at least, not unlikely. The current situation can be seen as see-sawing between supply and demand, with the heavyweights not only getting off one side of the see-saw, but even sitting down on the opposite side.

Alongside the ECB's huge withdrawal of liquidity, the immense net financing requirement of the European states and the European Union (EU) also needs to be met. The consequences of the Russian invasion of Ukraine need to be financed, such as fiscal relief measures due to the energy price shocks. Not to mention the ongoing programmes from the COVID-19 pandemic. The net financing requirement of the European states (including the EU) could double in comparison to the previous year, which saw a financing requirement of around EUR 600 to 700 billion.

Naturally, such assumptions are always subject to a certain degree of uncertainty. But the trend is clear, and it points towards a shift in the ratio between supply and demand to the tune of several trillion euros.

A shortage of liquidity is generally most evident in high-risk niches of the bond market. In previous years, when there was still negative interest and sufficient liquidity, we could see a certain "naivety" in this regard. Bonds from companies that did not have the best credit rating were issued by companies under favourable conditions (and also purchased by market participants). Now risk premiums need to be revised, for example, in terms of potential default and liquidity risks.

An example of how a liquidity shortage can suddenly be painful for the market was evident in the United Kingdom last autumn. The shock temporarily impacted many asset prices around the globe and did so suddenly, without any direct warning.

It goes without saying that central bankers never want to risk a financial or currency crisis – for instance if, in a worst-case scenario, countries were no longer able to adequately refinance. Conversely, inflation seems to be more persistent than expected, meaning that higher interest rates could continue for longer than the all-too-optimistic market observers would currently like to think.

One thing is clear: in spite of rising interest rates, it still seems too early to sound the all-clear for the bond market. That said, there has been a very notable improvement.

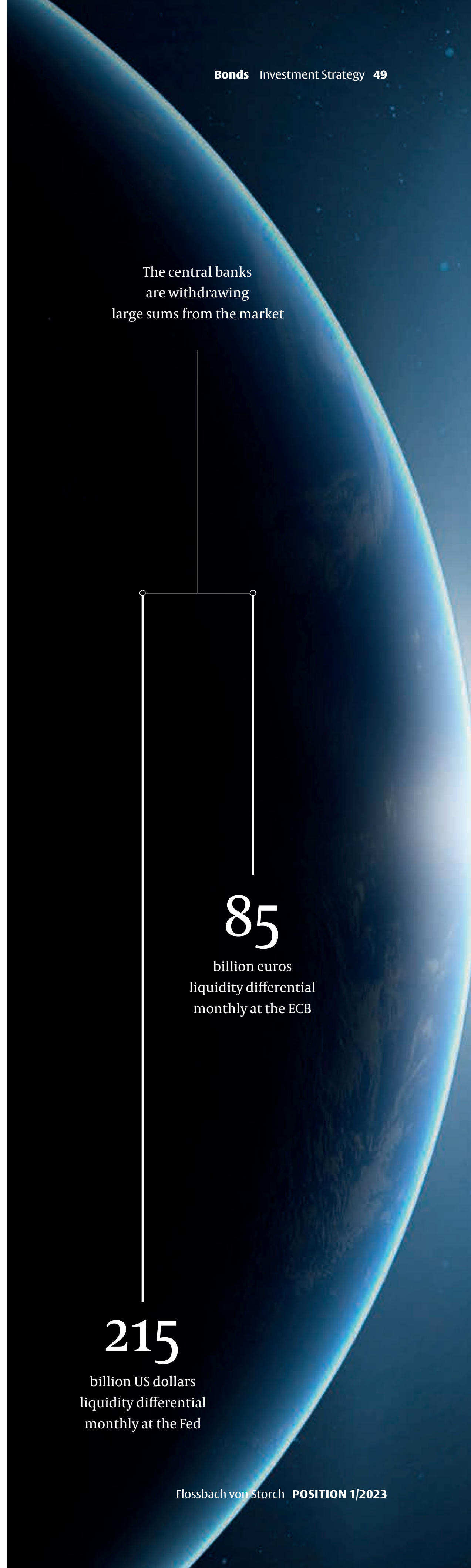
Interest rates have markedly increased – with all the associated benefits. The nominal rate of return seems more attractive than at any point since the financial crisis in 2008, as do real yields considering the inflation expected and traded by the market.

But patience is required in order to pick the right moment. You also need to be very familiar with market mechanisms. For the foreseeable future, you will probably need some tactical finesse to succeed in this asset class (after the historic crash in 2022). It may remain volatile for some time and investors should therefore continue to expect substantial fluctuations. The central banks are retreating further and further as guarantors of seemingly never-ending flowing liquidity. The inflationary pressure has improved but has not yet been lifted altogether.

There is an important difference, however: interest is back. The higher level of yields, as well as current income, can again act as a buffer to offset potential risks. At the end of the day, the most important thing is to be able to take advantage of opportunities as they arise, including in the short term. Or, to put it another way: active, anti-cyclical and flexible investors with the necessary experience have certain advantages in a market environment that remains nervous. ◆

Frank Lipowski is a Portfolio Manager at Flossbach von Storch AG in Cologne.

The central banks are retreating further and further as guarantors of seemingly never-ending flowing liquidity.



„STAYING ON THE BALL“

There are good reasons why things might remain difficult on the stock markets in the coming months. Fund manager Michael Illig explains why it is nevertheless important for long-term investors to keep investing.

Mr Illig, war, inflation, fears of recession: 2022 was a bad year on the stock markets, and crisis points continue to simmer as we move further into 2023. This is making many investors nervous, to the extent that some are considering exiting the markets. What would you say to them?

Given the worrying headlines and fluctuating stock markets, it's natural that investors are worried about further setbacks. The problem is, however, that those who sell their shares and put their money aside for a long period of time risk having it chipped away by inflation. And, in the long term, there is much to suggest that stock markets offer growth that significantly exceeds inflation.

So some are considering exiting the markets if they can, and returning later when the turbulence has died down …

… and, if possible, at more favourable entry prices. That sounds logical, but generally speaking it doesn't work. Those wishing to leave the markets must not only find a favourable time to exit, but also to re-enter. And, historically, the markets have usually recovered very quickly following periods of turbulence. So the chances of missing the recovery if you exit are pretty high. In order to choose the optimal re-entry point, you have to be able to correctly predict the mood of market participants – an extremely complex and questionable undertaking. I wouldn't try it myself, at any rate.

But isn't that part of your job as a fund manager? What do you base your investment decisions on?

No, the psychology of market participants and the events that influence them are so complex and random that we do not trust ourselves to make a reliable judgement in this regard. But there is something else, something that is far from easy to estimate but in some cases much more tangible: long-term company profits.

And we can draw conclusions and anticipate market movements from these?

Not in the short term, no. But in the long term, the fundamental development of a company determines its share price. Our primary focus is assessing and evaluating this development – it acts as our compass.

And how does that work?

One of the most successful investors of all time, Warren Buffett, once said when asked about the secret of his success: "Life is like a snowball. The important thing is finding wet snow and a really long hill.".

Although some of us might enjoy building a snowman, this statement is still a bit of a mystery. Could you explain it to us?

Buffett's snowball is an excellent illustration of the most important ingredient for success in long-term investment – compounding or, more correctly, compound interest. A snowball rolled over damp, sticky snow can collect more snow with each rotation because its surface area continuously increases. Mathematically, this means exponential growth – which is also what's behind the compound interest effect.

So the compound interest effect is nothing new, then, and ultimately easy to calculate

… but is often mind-boggling, especially when it evolves over many years. It's no coincidence that Albert Einstein is said to have described the compound interest effect as the eighth wonder of the world. Because the human brain is primarily geared towards linear thinking.

Could you give us an example?

Yes. Let's imagine that an investor invests EUR 10,000 and receives a five per cent annual return on this investment for 30 years. If they were to stash the interest under the mattress each year, they would have EUR 500 per year over 30 years,

"The fundamental development of a company determines its share price. Assessing and evaluating this development acts as our compass."

→

meaning that at the end of this period they would have EUR 15,000 in interest and EUR 25,000 in assets. If, however, they were to immediately reinvest the interest at the same five per cent each year – i.e. generate compound interest – the picture would look completely different. In that case, the investment would have increased in value by EUR 33,000 and the total value would be a triumphant EUR 43,000. The investor in the example would not have increased their capital by two-and-a-half times, but more than quadrupled it – precisely because, as in Buffett's metaphor, the surface area of the snowball became larger and larger, and thus more and more snow remained attached to it.

The example shows that it is important to stay "on the ball" with your investment strategy and be patient. But unlike the situation with a fixed-interest bank product, annual returns on equity investments fluctuate. To continue the analogy: sometimes lots of snow is added to the snowball, and sometimes none at all.

That is true, and there will always be periods of negative performance on the stock markets. History tells us that. But now we come to the point I made earlier about our "compass": the profitability of most companies fluctuates far less than their share prices. The snowball we are looking at is therefore the company profits. And these increase over time – for good companies and, historically, on aggregate, for companies in a broad-based equity index like the US S&P 500 – not without setbacks, but with exponential growth rates.

How does this come about?

Companies have productive resources. Think of physical assets such as factories and real estate, intellectual property such as trademarks and patents; and most importantly of course, the energy and creativity of their employees. If companies now invest their profits in expanding these resources, they will increase their capacity and thus be able to generate higher profits in future. This results in more money for investment, a correspondingly larger profit increase – and so the snowball rolls on.

"The profitability of most companies fluctuates far less than their share prices."

But this growth must have limits?

Absolutely. Even if an economy grows over time, individual companies will always disappear and new ones will emerge. We are looking specifically for companies that we believe will be successful for a very long time, i.e. in the long term. But even these companies can generally only reinvest a fraction of their profits. This brings an important point into play: our share of a company's profits is the decisive factor. If these excess profits are paid out as dividends, we can use that money to buy more shares. If a company buys back its own shares, this also increases our portion of its profits, because these are now distributed among fewer shares.

Other than sustained success, what are the key criteria that holdings must meet in order to have the potential for compounding?

Sustainable success means that a company grows profitably over a long period of time – meaning that it rolls its snowball up a long hill with lots of wet snow. It is also important that management is disciplined and prudent in its use of shareholders' capital. If parts of the snowball break off as it rolls along – for example, because management makes overpriced acquisitions or invests in unsuccessful initiatives – this significantly reduces the compounding effect. Lastly, it is particularly important that we pay an appropriate price for our stake in the company's profits, that is, for the shares.

You have been managing equity funds for several years. How did you handle the past year, which was particularly challenging for the stock markets?

As a fund manager you always have to keep a cool head, even if incidents seem to be coming thick and fast. Personally, our quality-focused investment philosophy helps me enormously here. It was developed in a time of crisis, after the technology bubble burst at the start of the millennium. We firmly believe that you cannot predict the future, but you can certainly be prepared for it.

And what would that mean?
Firstly, our portfolio must always be intelligently diversified. This is because, in addition to unforeseen developments, we also have to stay humble regarding the potential fallibility of individual assessments, which is why we avoid cluster risks and excessively large individual positions. For this reason, we exercise strict valuation discipline – we do not want to buy or hold overly expensive shares. And, last but not least, the quality of the companies in the portfolio plays a crucial role.

There is often talk about quality. How would you define it?
For us, the quality of a company is based on the expected growth potential of its profits and its predictability.

That sounds pretty technical. To what extent does this help investors?
You can share in the value that outstanding companies generate. As high-quality real assets, these holdings also offer good protection against the effects of inflation, which erode purchasing power. Our companies also have a capacity for resistance and adaptability that is far above average.

Could you be more specific, especially with regard to concerns about persistently high inflation rates or a possible recession?
Of course. The strength of our competitive position is always at the heart of our analysis. Does a company stand out from its competitors in a way that is difficult to replicate, and is also appreciated and needed by clients on a lasting basis? These companies are usually highly profitable, even in times of weaker demand. In the event of persistently high inflation rates, they are well positioned to pass on cost increases to their customers. Of course, there could always be developments that cause their profits to drop more sharply, at least temporarily. However, it is crucial that companies are not thrown off track by this and can adapt. For this reason, a healthy balance sheet is a prerequisite for any holding, and strong management is also important to us.

Let's leave it there in terms of crisis resilience. Over the past year, prices of some of the companies in your funds have also fallen significantly. Does this contradict what you just said?
No. Stock markets fluctuate depending on the mood of market participants. In the long term, however, as already mentioned, the fundamental development of a company determines its share price. History shows us that outstanding companies have generated a lot of value for their shareholders over time thanks to sustainable, profitable growth.

So it's all just a storm in a teacup?
I wouldn't say that. A lot has happened over the past year. You should never be careless, and must always question the sustainability of your holdings in the light of new information. For this reason, we always follow the development of our holdings very closely. And if our quality assessment changes, we accept the consequences and act.

Are you confident that your portfolio has you well prepared for the future?
Yes. We firmly believe that our focus on quality combined with valuation discipline gives us a sound portfolio of companies that can increase their earnings power thanks to above-average resilience to crises and, ultimately, with attractive growth rates. And, despite interim price setbacks, stock-market prices should follow this profit trend over time. In our view, therefore, patient investors have a good chance of generating attractive long-term returns.

Thank you for the interview.

Michael Illig is a Fund Manager at Flossbach von Storch AG in Cologne.

DON'T PANIC

Staying afloat and where possible even improving their position in difficult times – we expect nothing less from the companies we invest in.

by Kubilay Yalcin

Loss of control is a basic human fear. Being exposed to potential danger and unable to do anything about it. The idea makes many people uneasy. Everyone knows that queasy feeling you get when flying through heavy turbulence. When all you can do is place your trust in the pilots ...

It's no different when stock markets are volatile. That also often triggers a reflexive need to take "action", cut losses and regroup investments as much as possible. As a result, there is a danger of portfolio turnover being used as a benchmark for good risk management during difficult market phases. But be careful. It's not that simple.

Reacting quickly to changing circumstances may, of course, be appropriate in some cases. Such as when your own analysis includes mistakes or a structural break occurs in a long-term trend that is a critical factor in the performance of an investment. Failing to act might even be negligent in such cases.

But it's not advisable to simply give in to this reflex. And, tragically, some people always reorganise their portfolio in difficult times, mainly out of caution. You shouldn't, however, take action for action's sake, especially in times of crisis. You should do the right things, not just anything at all. And you shouldn't act too quickly, without thinking through the possible consequences.

The impulse to act gets stronger when there is an endless stream of nerve-wracking news. If, however, the investment horizon becomes increasingly shorter, such as the next quarterly figures, the next interest-rate decision or the next chart signal, investors generally only chase after trends they can rarely catch up with. In most cases, they lose sight of their long-term investment objectives.

RISK MANAGEMENT THROUGH STOCK SELECTION

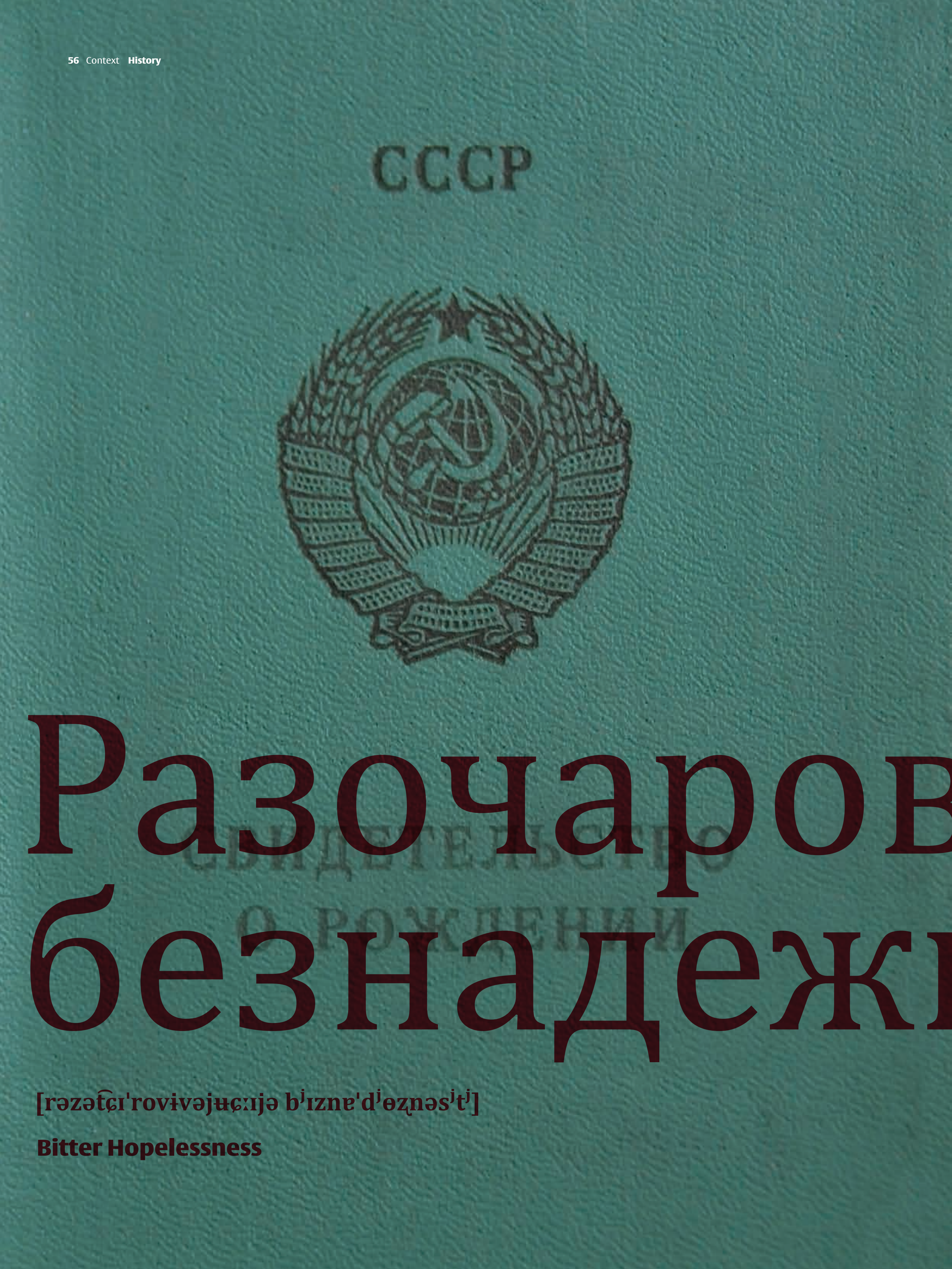
We want to participate in the long-term performance of first-class companies instead, and therefore put a great deal of effort into selecting them. In our company, it can take several weeks to complete an analysis. Complex scenario analyses are performed for all the companies that end up on our buy list. We do, of course, repeatedly adjust individual positions, monitor developments and question our own assumptions. But we generally have trust in our companies – even in times of crisis.

In the end, the managers of all these carefully selected companies have to be able to handle crises well. In other words, it is the companies we invest in that should position themselves optimally (even) in difficult times, not us, the investors. We believe that the more convincing their business model, competitive position and management, the more likely it is they will be to continue generating attractive future returns in spite of difficulties and take advantage of crises to position themselves even better for the future.

The recipe for success may vary. In the past, many of the companies in our portfolios were able to quickly restore their earnings to pre-crisis levels and further increase them both in the financial crisis of 2008/09 and the COVID-19 crisis starting in March 2020. Some of these companies show a very long history of steadily increasing earnings, and have proven themselves time and again during difficult market phases in past decades.

Trust eases the mind, and that includes the minds of investors. In our view, knowing you are invested in high-quality companies makes it easier to endure a period of price turbulence. And, in addition to sensible portfolio diversification, we feel the best risk management is to select shares in high-quality companies. ◆

Kubilay Yalcin is a Portfolio Director at Flossbach von Storch AG in Cologne.



Разочаров
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Bitter Hopelessness

The Soviet Union was founded around 100 years ago. The Russian president has repeatedly lamented its dissolution. But a journey through time shows that for the civilian population of Russia, these were above all painful times marked by great hardship.

by Julian Marx

Even though the celebrations in Moscow to mark the 100th anniversary of the founding of the Soviet Union were subdued, Russian President Vladimir Putin has repeatedly described the dissolution of the Soviet Union in 1992 as "the greatest tragedy of the 20th century".

Many Russians likely see things differently (even though they probably keep their opinions to themselves). A journey through time from the perspective of an ordinary citizen shows that widespread poverty and inequality are by no means just a post-Soviet phenomenon. And over long periods of time, economic hardship was probably not even the worst thing for broad sections of the population.

BLOODY BEGINNINGS

On 30 December 1922, around 2,200 delegates from the four Soviet republics of Russia, Ukraine, Belarus and Transcaucasia founded the Union of Soviet Socialist Republics – the USSR or Soviet Union for short – in the Bolshoi Theatre in Moscow. A bloody civil war lay behind them. Now they had committed to following the path together through socialism to communism. Russia had already started on this path.

The winter of famine in 1916/17 triggered the February Revolution and Tsar Nicholas II was forced to abdicate. Then, in November 1917, Vladimir Ilyich Lenin, the leader of the Bolsheviks, seized power from bourgeois forces. He declared that Russia's participation in World War I was over, all land was the property of the state and he was the head of state.

A civil war began and millions of people died on the battlefields in subsequent years, but also as a result of terror and epidemics. The "Reds", or Bolsheviks, fought for power against the "Whites", a coalition of all the other political forces. But the civil war was much more than just a war between two political camps.

Above all, it was also a war against the "Greens", the peasants. At that time, around 80 per cent of the population and, therefore, average Russians, were peasants. Most of them had only been freed from serfdom in 1861, and 49 years later in addition to having paid their taxes had also paid off a small piece of farmland. Many of them also had to work as servants. During the civil war, they were subject to forced recruitment and horrendous demands for grain by the Red Army.

As a result, many peasants fled into the forests to join forces and defend their vision of a just state. Almost 1.2 million deserters were tracked down and thousands of them were shot. A famine in 1920/21, resulting from a poor harvest and the confiscation of all grain by the Bolsheviks, finally broke their resistance. Five million people are said to have starved to death.

Vladimir Ilyich Lenin (left, Chairman of the Council of People's Commissars) and Josef Stalin (General Secretary of the Central Committee of the CPR) during a meeting in Gorky in August 1922.

Members of the first Soviet government and the Presidium of the Central Executive Committee on 1 June 1923.

The situation only eased with the advent of the New Economic Policy (NEP), which ended "war communism". It was introduced in 1921 and allowed private enterprise and private trade to resume. In addition, workers' faculties were founded, women's education was promoted and electrification was started.

Lenin died in 1924 and Joseph Stalin gained power in a struggle that lasted several years. The terror was to reach new dimensions under his leadership.

DECADES OF TERROR

What took place in January 1937 in the October Hall of the House of the Unions read like a great celebration, according to the report in the Soviet government newspaper Izvestia: "The best representatives of Soviet society fill the courtroom. Medals glisten on the chests of workers, pilots and scientists".

But no one was in the mood to celebrate. The "trial of the anti-Soviet Trotskyist Centre" was the prelude to a veritable bloodbath in 1937, with Stalin setting the pace. He used the Moscow trials in 1936, 1937 and 1938 to "legitimise" a broad-based purge. Between autumn 1936 and winter 1938, the NKVD (the Soviet secret police) is said to have arrested more than one-and-a-half million people and shot around 700,000.

Stalin had begun "purges" against supposed opponents as early as the end of the 1920s. Those affected were often sentenced to death or camp imprisonment with forced labour under false charges during show trials and secret trials.

By 1929, hardly anyone was immune to terror. Certainly not the peasants and, therefore, the average citizens of the Soviet Union. Stalin replaced the NEP with the Command Economy in 1928. In a matter of 10 years, the Soviet Union, which at that time was still barely industrialised, was supposed to reach the same level of development as the Western nations. This was to be financed by the peasants.

Farms were expropriated during the forced collectivisation of agriculture. Many peasant families who were considered wealthy (kulaks) and those who could live off their property (middle peasants) were arrested. Most of them ended up in penal camps (gulags) or were forcibly resettled in inhospitable areas. These gulags were a bloody but important industry in the Stalin era. Power stations, waterways and railway sections were built by millions of forced labourers. Forced labourers also did an important share of the work in mining and the timber industry until the 1950s.

The Second World War brought further suffering. Stalin sided with Adolf Hitler initially and the Red Army occupied eastern Poland and parts of Romania starting in 1939 and began a winter war with Finland. Millions of lives were then lost during the German invasion of the Soviet Union starting in 1941. Estimates put the number of Soviet war dead at 25 to 30 million.

Josef Stalin (left) and Nikita Khrushchev (right) greet May Day demonstrators at the Lenin Mausoleum in 1951.

The First Secretary of the Central Committee of the CPSU, Nikita Khrushchev, visits the Moskovsky state enterprise in 1964.

But the misery in the Soviet Union was not over even after the end of the Second World War. Although 1946 had been a drought year, Stalin allowed considerable quantities of grain to be exported. Millions more tonnes remained in the storehouses, even as the need continued to grow, and around two million people starved to death.

By the time of his death on 5 March 1953, Stalin had created such a climate of fear and terror that the doctors who treated him following his stroke, which paralysed him on one side, are said to have hardly dared to touch him.

According to statistics, however, the economic situation had improved during the Stalin era. In the 1940s, 24 per cent of the labour force belonged to the working class, compared to just three per cent in 1917. Many power stations, important waterways and railways had been built. The expansion of heavy industry and the armaments industry was also essential for the Allies' victory in the Second World War.

With the exception of the elites, however, most Russian citizens lived in poor, cramped conditions in the early 1950s. Urban families at that time often shared one room, for instance, with three generations usually living together. Wooden huts with no electricity or sewage systems were the norm for the rural population. The peasantry was considered especially poor after forced collectivisation. Employees on the collective farms did not even receive a de-facto wage for their work. Their piece of farmland secured their existence instead.

REFORMS, REFORMS, REFORMS

There was reason to rejoice in October 1957. The Soviet Union successfully launched the world's first satellite, "Sputnik 1", into space. It sent signals to the "shocked" West, which had not believed the USSR had such technical capabilities. The space race was on and was to become a miracle weapon in the Cold War media for Nikita Khrushchev, who became the most powerful man in the Kremlin following Stalin's death.

Khrushchev ensured that the many repressive measures suffered by the Soviet people under Stalin quickly came to an end after Stalin's death. Summary courts and torture were abolished. The labour camps, which reputedly numbered more than 200 in the end, were also largely dismantled. Around four million people were released in the first five years after Stalin's death.

He began the "Khrushchev Thaw" under a policy of peaceful coexistence with the West. For example, he signed the Austrian State Treaty in 1955, which guaranteed the country's sovereignty. He was nevertheless remembered in the West primarily as a hardliner responsible for bloody suppression of uprisings in the GDR, Hungary and Poland in the 1950s and construction of the Berlin Wall in 1961.

In the Soviet Union he was a reformer. Providing food for the people was one of the most urgent problems there. Merging a large number of agricultural operations had resulted in the number of collective farms being reduced from 91,200 (1953) →

Iconic image of contemporary history: Leonid Ilyich Brezhnev and Erich Honecker greet each other with a brotherly kiss at the celebration of the GDR's 30th birthday in East Berlin.

General Secretary of the Communist Party of the Soviet Union and President of the USSR Mikhail Gorbachev (left) together with Fidel Castro at Havana airport.

to 67,700 (1958), and the grain harvest had been increased by 75 per cent. Khrushchev now wanted to overtake US production, both in volume and technology.

He developed agricultural land in Kazakhstan and Siberia on a large scale and grew grain, and production actually rose significantly in the first few years. But yields soon began to fall. The soil was not suitable for farming, the harvests were disappointing and in the early 1960s grain had to be imported from the USA.

In the industrial sector, Khrushchev focused on the expansion of producer goods and armaments. Considerable progress was made there, as shown by the launch of Sputnik. The production of consumer goods, on the other hand, fell short of expectations. In addition, Khrushchev announced mass housing construction in 1956. Factories for producing prefabricated components were set up to increase the housing stock. A few decades later, standardised prefabricated housing would mean an enormous increase in comfort for most families.

He also implemented wage and pension reforms:

- In 1955, for example, the minimum wage for workers was raised from 10 to 30 roubles per month. Shortly after, a minimum pension of 30 roubles per month was introduced for workers.
- The collective farmers still found themselves at the bottom of the food chain. They were awarded a minimum pension of 12 roubles per month for the first time in July 1964.

Nevertheless, his reform policy was hardly a success. And because he alienated many followers with his reform efforts, the majority of the Central Committee voted for a change of power in October 1964.

BREZHNEV'S GOLDEN STAGNATION

Khrushchev was succeeded by Leonid Brezhnev, who was General Secretary of the Communist Party from 1964 to 1982. This era is considered the Era of Stagnation – and of the arms race.

Brezhnev emphasised the importance of the military in the very first May Day Parade after he took power. On 9 May 1965, the 20th anniversary of the victory over the German Reich, a large parade was held in Red Square for the first time since 1945. Even Stalin was partially rehabilitated in the victory cult. In 1968, Brezhnev bloodily suppressed the Prague Spring, which questioned Czechoslovakia's friendship with the Soviet Union. After that, the Brezhnev Doctrine, which allowed military intervention if socialism was considered "in danger", applied in the Soviet empire.

Production grew much more slowly under Brezhnev's leadership than it did in the initial post-war years and fell further and further short of the goals Brezhnev set for himself. US industrial productivity was around two to two-and-a-half times higher. Agricultural productivity was even around four times higher. Brezhnev did increase investments in rural regions and granted more autonomy to businesses.

Figure 1 **Waiting for the good times** – Population mobility as a reflection of prosperity

Source: U.S. Bureau of Economic Analysis, Central Intelligence Agency, World Bank – World Development Indicators, Flossbach von Storch, data as at 28 February 2023

Agreements were also made with Western companies. In 1966, for example, the automotive ministry agreed to co-operate with the Italian company Fiat to build a car factory on the Volga. But the measures had little effect. A large part of the Soviet population nevertheless experienced the Brezhnev era as the "golden years" in which their prosperity increased.

Some 80 per cent of the urban population had their own homes in 1980, mostly in prefabricated buildings. They usually had one-and-a-half or two rooms, central heating and a bathroom. People gradually bought record players, televisions, refrigerators. In rural areas, conversely, a bathroom and running water still only featured in 10 per cent of all houses.

The waiting times for cars remained legendary, though. And for good reason. The Soviet Union produced around five cars per 1,000 people in 1975, as was also the case 10 years later (see figure 1). Sales were around 10 times as high in the USA, at around 50 and 65, respectively.

In spite of slow economic growth, the USSR entered an arms race with the USA during Brezhnev's time. But competing with the USA was costly. To increase its influence, the USSR also provided goods to many countries. North Vietnam, for example, received 75 to 80 per cent of its material aid from the Soviet Union during the Vietnam War. The domestic economy was increasingly overextended by these burdens. Soon, the available resources were no longer able to keep pace with the growing demands of the "controlled" territories.

GLASNOST AND PERESTROIKA

The party leadership consciously accepted the wide-ranging economic stagnation under Brezhnev because the Politburo was afraid of an end to stability. "Stability of the cadres", however, led to a gerontocracy, rule by the elderly. There were three state funerals in fewer than three years between Brezhnev's death in November 1982 and March 1985: Brezhnev, his successor Yuri Andropov and the latter's successor Konstantin Chernenko.

Mikhail Gorbachev, then 54, took over as General Secretary in the spring of 1985 and announced his programme of *perestroika*, or restructuring, together with a policy of *glasnost*, or transparency.

In economic terms, he wanted to use the forces of supply and demand to reform socialism, similar to the NEP under Lenin. To achieve the renewal of industrial machinery that had been demanded since the 1960s, the state promoted joint ventures with Western companies starting on 1 January 1987. As was the case under Brezhnev, Gorbachev also granted businesses more autonomy. But this led to excessive wage increases again, causing the gap between purchasing power and the supply of goods to keep growing. The economic situation continued to worsen as a result. A strike by 500,000 miners during the 1989 economic crisis symbolically showed that the workers were not complaining about their wages, but about the lack of supply of consumer goods. Their demand for soap, for physical cleanliness, was symbolic.

Figure 2 **A fresh start with obstacles** – Real gross domestic product of former Soviet republics (indexed to 1992 = 100)
Source: Refinitiv, Flossbach von Storch, data as at 28 February 2023

To make matters worse, the increased freedom of speech under *glasnost* caused criticism to grow louder and louder. Even the one-party system was questioned. In addition, the Communist Party had always propagandised that the peoples of the Soviet Union lived together peacefully and voluntarily. But this myth was exposed under *glasnost* and *perestroika*. In February 1988, for example, the Nagorno-Karabakh conflict broke out between Armenia and Azerbaijan. Since the summer of 1988, the Baltic states have denounced their forcible incorporation into the Soviet Union in 1940 and demanded an end to the influx of Russians. The growing efforts towards autonomy in several Soviet republics therefore intensified the centrifugal forces within the Soviet Union.

Its end was sealed by an attempted coup against Gorbachev in August 1991. After negotiating a new union treaty with nine Soviet republics starting in April, he had gone on holiday at the start of August 1991. The members of the Security Council were appalled, however, by the freedoms that Gorbachev wanted to grant the Soviet republics and therefore decided to declare a state of emergency and tried to force Gorbachev to resign.

The coup attempt failed due to the resistance of the first Russian President, Boris Yeltsin, who had been elected in June 1991. The Soviet Union and its power structure were no longer sustainable. On 21 December 1991, 11 Soviet republics signed the founding document of the Commonwealth of Independent States (CIS), thereby consigning the Soviet Union to the history books. On 25 December 1991, Gorbachev resigned, and six days later the Soviet Union was officially dissolved.

ECONOMIC DECLINE OF THE 1990S

Some 15 new states emerged from the dissolution of the Soviet Union in 1992, including the Russian Federation. The severing of economic ties between the former Soviet states plunged Russia into a deep crisis. It was not until 11 years later that the level of economic output seen in 1992 was achieved again (see figure 2).

This was the official start of the transition from a planned economy to a market economy, and on 2 January 1992 Yeltsin lifted controls overnight on 80 per cent of the previously state-regulated prices for production goods and 90 per cent of consumer goods. Consumer prices rose 1,526 per cent in a year and Russians' savings vanished into thin air. Pensions and state wages were no longer enough to cover the cost of living. The black market flourished.

In 1992, Yeltsin also ordered that state enterprises were to be divided among the population. Everyone was eligible to receive vouchers (privatisation cheques for share rights in a company) for a small fee in this mass privatisation. Privatisation did not have the desired success in Russia, however, due to the unstable macroeconomic environment and high level of legal uncertainty. Total economic production

Boris Yeltsin delivers a speech at the Second Congress of People's Deputies of the USSR in December 1989.

Vladimir Putin, 1994, as the first Deputy Chairman of the St. Petersburg government and Chairman of the Foreign Relations Committee.

decreased by around a half between 1989 and 1998. The country became insolvent in 1998. The consequences were catastrophic. State social benefits, including pensions, fell below the subsistence level. According to Russian information, 30 per cent of the population of Russia lived below the poverty line in 1999. The World Bank estimate suggested this was actually true of over more than 40 per cent of the population. Average life expectancy fell.

The sizeable cuts that the Russian population also experienced after the end of the Soviet Union were the breeding ground for later Soviet nostalgia. In particular, it was the large sections of the population that lived in poverty that longed for the social security of days gone by. It was in this environment that Russia's current President, Vladimir Putin, was able to make his mark. In 2000, Putin was elected President and rose to become Russia's most powerful man.

BACK TO THE GLOOM

After Putin took office, Russia's economy initially experienced a significant upswing. Real per capita gross domestic product almost doubled between 1999 and 2008. The average monthly wage rose from around EUR 62 to EUR 475 during those years and the unemployment rate fell by half to around six per cent. Putin's popularity rose along with the positive economic growth to reach a temporary high in 2008. According to surveys by the Levada Center, Putin's leadership had an approval rating of 83 per cent among the Russian population.

But Russian growth has slowed since the 2008 financial crisis. Without economic success, support for Putin crumbled. His approval ratings reached a low point in 2013. The Russian economy has not come close to matching the growth rates seen at the beginning of the century since then. Between 2013 and 2021, Russia's real gross domestic product grew by an average of one per cent per year. This means that Russia's population remains poor across the board. The average pension was fewer than EUR 200 per month in 2021.

The poor economic growth of previous years did not, however, have much of a negative effect on Putin's popularity. On the contrary, his popularity soared again after the annexation of Crimea in March 2014 because many Russians supported the "protection" of Russian minorities abroad. The invasion of Ukraine followed eight years later. It was preceded by military attacks in Chechnya and Georgia.

And this brings us full circle to the darkest times of the Soviet Union. The well-being of the population also played a subordinate role in Stalin's time. The individual is defenceless against the arbitrary exercise of power. For many, this is a deeply depressing development from which they can scarcely see a way out. Exiled Russians call it "Russian depression". ◆

Julian Marx is an Analyst at Flossbach von Storch AG in Cologne.

“How Much do you Have Invested in Foreign Currencies?”

The restrictive monetary policy of the central banks has certainly brought the different currencies into focus – and thus the question of which are “stable” and which are not. Thomas Lehr and Philipp Vorndran discuss the global currency – the US dollar – and the former pretender – the euro.

Over the course of the past year, the US dollar has appreciated notably against the euro, whereas in recent times the opposite has been true – which of the two currencies is now more “robust”?
VORNDRAN: My advice would be to disregard short-term shifts; they cannot be predicted in any case.

Let’s rephrase the question then: which of the two is more future-proof?
VORNDRAN: The US dollar.
LEHR: The euro is and will remain fragile; in order to keep the monetary union together, the European Central Bank (ECB) always has to focus on the weakest members – it doesn’t work otherwise. It also has to take this into account when fighting inflation.
VORNDRAN: Or to put it another way: the US Federal Reserve (Fed) has more room to manoeuvre because the USA, unlike the eurozone, is a homogenous monetary union.

What does this mean for European investors?
LEHR: They should be aware of the structural weakness of our currency – and not just invest all their assets in euros.

But what specific steps should they take?
VORNDRAN: To start with, you should always take stock and ask yourself the question: how much do I actually have invested in foreign currencies? That’s actually not an easy question to answer.

Can you give us a little help then please? ...
LEHR: Let’s start with your own assets. Your salary is paid in euros, real estate is in euros. Savings accounts, call money and endowment life insurance likewise. Funds are more complicated. Let’s suppose that you have invested some of your assets in an equity fund of a German investment company and check the current value on your securities account statement ...
VORNDRAN: ... You will also most likely find a number followed by the suffix “euro”. So does that mean it’s all in euros?
LEHR: Maybe, but not necessarily. It depends less on the currency in which the fund is listed and more on the currencies in which it invests. If it is a global equity fund, then the euro may make up only a small part of the currency mix.

Could you perhaps give us a specific example?
VORNDRAN: I would like to invest EUR 10,000 (this is not an investment recommendation!) in an equity fund with which we are familiar. The fund price is listed in euros, but the fund invests globally. So let’s look at the factsheet. That can normally be found on the investment company’s website and contains the most important information.
LEHR: At the end of the month, 69 per cent of the equity holdings in our example fund was listed in US dollars, and only 13 per cent in euros. There is also

around five per cent in Canadian dollars, four per cent in Swiss francs and three per cent in Hong Kong dollars. Smaller proportions are listed in Indian rupees, British pounds and Danish kroner.

But that only works if the fund manager does not hedge the currency risk …

LEHR: That information is definitely important. If a manager hedges against currency fluctuations as standard, which some do, then of course there's no currency diversification.

VORNDRAN: But this information is also available from the factsheet – it states whether hedging has taken place or not. In our example fund, figures are given "after accounting for hedging".

Many investors always associate the words foreign currency with the word risk …

VORNDRAN: That mostly applies to Germans, who continue to consider the euro to be as strong as the German mark. But it isn't.

LEHR: I would rather talk about "currency opportunities".

Strategist & Strategist
Philipp Vorndran (right) and Thomas Lehr (left) are Capital Market Strategists at Flossbach von Storch.

Glossary

Economic terms in brief

Asset class – Financial products with similar characteristics can be allocated to different groups. Traditional asset classes include, for example, equities, bonds, real estate and precious metals.

Bloomberg Barclays Global-Aggregate Index – Index that reflects the performance of investment-grade bonds. It is composed of government and corporate bonds from 24 countries (developed and emerging markets) and includes over 20,000 bonds.

Bond – Securities that an issuer can use to borrow in the capital market. Bonds can be issued in different currencies and can have different maturities and coupon rates.

Corporate Governance – A legal and factual regulatory framework for the management and monitoring of a company. This area deals with the question of how a company can be managed as well and responsibly as possible. The aim is to harmonise the incentive structures of different interest groups in a company as effectively as possible.

DAX 40 Index – Equity index that tracks the performance of the 40 largest and strongest (with the highest turnover) German stocks in terms of market capitalisation. The criteria for the weighting of the shares in the DAX are the stock-exchange turnover and the market capitalisation of the free float. The DAX is calculated as a price and performance index.

Diversification – The allocation of assets across various investment classes, individual securities, regions, sectors and currency zones – with the aim of reducing potential risks in investments by distributing investments widely.

Dividend – The earnings that a company distributes to its shareholders.

Duration – The duration reflects the average period during which the capital of an investment is invested in a fixed-rate security and is consequently the weighted average of the dates at which the investor receives payments from a security.

Equity index – An equity index is an indicator of the average price development of the share basket of a country, a region or even individual sectors. It tracks the price level of the selected shares.

Euro Stoxx 50 Index – Equity index that tracks the performance of the European equity market and comprises 50 of the largest listed companies from nine countries in the eurozone.

Exchange Traded Fund (ETF) – ETFs allow investors to invest in a broadly diversified portfolio of equities and other asset classes. They generally track the performance of an existing index, such as the DAX.

Federal Funds Rate – Interest rate set by the Federal Reserve at which US financial institutions lend their excess reserves to each other “overnight”.

Federal Funds Target Rate – The interest rate set by the Federal Open Market Committee (FOMC) as the US Federal Funds Rate and enforced through open market operations.

Gross domestic product (GDP) – The value of all goods and services produced in an economy during a year.

Inflation – A general increase in the price of goods that is accompanied by a loss in the purchasing power of money.

Key interest rate – The interest rate that central banks charge commercial banks for secured lending.

Liquidity – Liquidity means the “money proximity” of assets, i.e. their potential to generate immediate or short-term cash inflows. The liquidity of a market must be distinguished from the liquidity of assets. This is the case when the difference between the bid and ask price is low and larger volumes can be traded without substantially influencing the market price.

MSCI World Index – The MSCI World equity index shows the performance of stock markets in the industrialised countries. It is based on more than 1,600 equities in 23 countries.

Portfolio – A collection of investment securities.

Rally/stock-market rally – A sharp increase in capital market prices in a short period of time.

Real interest rate – The real rate of interest that remains after deducting the rate of inflation.

S&P 500 Index – An equity index that shows the performance of the broad stock market in the USA and includes the 500 largest listed companies in the USA.

Share – A share is a security that makes its holder a co-owner of a public limited company. When a share is purchased, the shareholder acquires a portion of the company's share capital. There are common shares and preferred shares. Common shares give their holders voting rights in general meetings. Holders of preferred shares do not have voting rights, but instead receive a preferred dividend that is generally larger.

Stock Based Compensation – Companies use stock options as part of the compensation of certain employees (especially executives).

TLTRO (Targeted Long Term Refinancing Operations) – Long-term refinancing operations offered to banks by the European Central Bank (ECB) to facilitate lending and make it more favourable.

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Publisher:
Flossbach von Storch Invest S.A.
2, rue Jean Monnet, 2180 Luxembourg, Luxembourg
Telephone +352. 275. 607-0, Fax +352. 275. 607-39
info@fvsinvest.lu, www.fvsinvest.lu

Executive Board:
Christoph Adamy, Markus Müller, Christian Schlosser

VAT Number: LU 25691460
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Editors:
Yannick Döller, Dr Bert Flossbach, Stephan Fritz,
Jens Hagen, Dörte Jochims, Thomas Lehr, Kai Lehmann,
Shenwei Li, Frank Lipowski, Julian Marx,
Laura Oberbörsch, Christian Panster, Helen Ponsford,
Kurt von Storch, Philipp Vorndran, Kubilay Yalcin

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Flossbach von Storch Invest S.A.
2, rue Jean Monnet, 2180 Luxembourg, Luxembourg
www.flossbachvonstorch.lu

Flossbach von Storch