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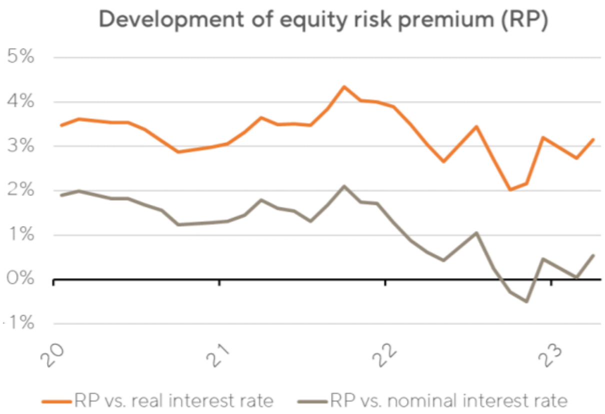
Investment letter – 2nd Quarter 2023

Beware of the money illusion

An important parameter for assessing the market valuation is the risk premium, which represents the difference between the yield of corporate earnings and risk-free government bonds. As interest rates remain elevated, equity markets approach previous highs and have risen disproportionally to corporate earnings. As a result, the risk premium is low despite the difficult market environment.

At present, inflation poses a significant source of uncertainty. However, the growth in corporate earnings demonstrates that companies have successfully tackled this challenge and have managed to partially offset the impact of inflation. On the other hand, fixed rate government bonds lack this characteristic, which justifies a lower risk premium for equities. To truly understand the risk-premium of stocks, it is important to consider the corporate earnings yield in relation to the inflation-adjusted real yield of government bonds. This perspective provides a more balanced view of the real risk premium and offers a more concise assessment of the current valuation of the stock market.

However, there are significant variations in the risk premiums among different sectors and individual stocks, reflecting investors' expectations regarding their ability to thrive in the current environment. Companies are continuously striving to enhance efficiency and achieve economies of scale through increased sales volumes.



This serves as a partial offset to the impact of low inflation rates. During periods of elevated short-term inflation, as we have recently experienced, companies are compelled to pass on higher costs (such as materials, labor, and energy) directly to end customers in order to protect their profitability. Companies that are well-positioned and have high-demand products are more successful in this endeavor compared to those offering easily substitutable products. However, even some companies with weaker positioning have managed to achieve growth in sales and profits, as price increases have more than compensated for declining sales volumes.

The latter impressively illustrates the distorted perception that can arise from high nominal growth rates. Short-term wage increases, although initially positive for consumer sentiment, also contribute to this phenomenon. The concept of money illusion highlights the tendency for people to concentrate on nominal figures while paying insufficient attention to inflation. As a result, the effective loss of purchasing power is often neglected or recognized with a delay. Consequently, nominal economic growth of 5% with 7% inflation feels better than 0% growth with 2% inflation.

Higher interest rates have undeniably made the current environment more challenging. Expensive valuations must be consistently justified with profit growth, as any disappointments are swiftly penalized by the market. This was evident in parts of the health sector, which had benefited greatly from the effects of the Covid-19 pandemic but has since struggled to sustain the previous growth and has underperformed the market as a consequence. Nonetheless, the first half of the year demonstrated that economic prospects were overly pessimistic, and the anticipated slowdown was premature.

It takes time for the effects of higher interest rates to fully unfold. It is important to note that higher interest rates do not necessarily indicate rates that are too high for sustainable economic growth. Currently, the various economic indicators present an inconsistent picture. Central banks are likely to maintain higher interest rates until inflation appears to be firmly under control. The trajectory of inflation plays a vital role in determining real interest rates. As interest rates stabilize, the risk premium benefits from reduced uncertainty, enabling a stronger emphasis on profit growth.

The economic and investment landscape remains challenging, demanding thorough and nimble analysis of assets to be well-prepared for various scenarios. By exclusively investing in direct investments, we closely monitor the progress of all companies held in our portfolio and can promptly respond when needed. Additionally, we prioritize a balanced distribution of company characteristics to ensure the resilience of our portfolio. The past year highlighted the importance of not solely relying on growth but also considering valuations for sustainable long-term performance. A relative valuation discount to the market and comparable companies provides a margin of safety to better withstand unpredictability. In the current environment, we do not compromise on quality and valuation.

Despite the presence of various risks, adhering to our long-term strategy, maintaining disciplined ownership of the best companies in our portfolio, and trusting in their ongoing pursuit of growth and efficiency, regardless of the market conditions, has once again proven successful. We capitalized on the divergent performance of individual positions by realizing profits from volatile cyclical stocks and reinvesting them in attractively valued, more defensive opportunities.

Zurich, end of June 2023.