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Investment letter – 3rd Quarter 2023

The benefits of an independent, long-term investment strategy

The overall market includes all companies and is thus, by definition, average in terms of quality, valuation, and performance. Comparing one's investments to the overall market appears to be a reasonable starting point because the goal should be to achieve above-average returns. However, from time to time there are exaggerations that lead to certain areas of the market being disproportionately represented at the least favorable times. At the turn of the millennium, it was technology companies. During the 2007 financial crisis, it was the financial industry, and in 2021, it was expensively valued growth stocks and long-term bonds. The opposite is also true. Neglected and undervalued areas are temporarily underrepresented in the overall market.

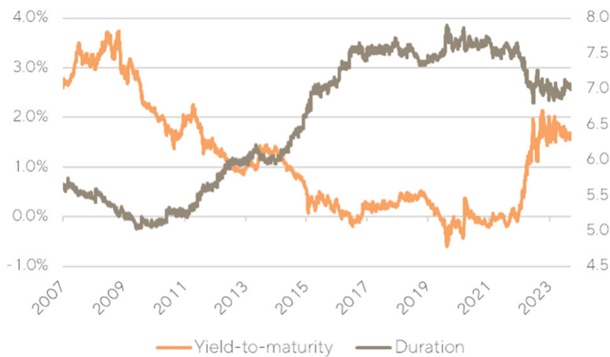
When the investment strategy simply replicates the market, or the asset manager is measured against it in the short term, the risk of being exposed to these temporary exaggerations is particularly high. The fact that these periods are often accompanied by intensive media coverage and correspondingly high interest from private investors further complicates the situation.

The past year serves as a good illustration. When interest rates reached their lowest levels, it was the general expectation that this situation would persist. Consequently, equity valuations played a negligible role due to the absence of opportunity costs. The investors' focus was on stocks with the most compelling growth stories and equities with steady earnings, which were used as substitutes for bonds. Accordingly, their valuation was very demanding. With the return of higher interest rates, the mathematical laws of gravity returned to the markets as we outlined in our investment letter in the second quarter of 2022. Current earnings and future financial prospects must once again compete with considerable fixed-income alternatives.

When it comes to bonds, particular attention should be paid to the duration risk, which is a measure of how long capital is committed. As in the stock market examples mentioned earlier, once again market positioning was at its most extreme at the least favorable time. When the Swiss bond market in 2020 showed a negative yield to maturity, the duration of the fixed income market reached its peak. Replicating the market or the benchmark indices would have tied up capital for almost eight years at negative interest rates. The

other major currencies also exhibited a similar pattern during this time period.

Yield-to-Maturity vs. Duration (SBI AAA-BBB)



The graphic above illustrates how bond market duration had steadily increased as interest rates had fallen Companies have used the low-interest-rate environment to issue long-term bonds and secure the low-debt costs for the foreseeable future. The resulting low coupon payments have meant that investors not only provided capital for an extended period but also received minimal cash flows during this time. Consequently, long-term bonds have corrected significantly to reflect the new interest rate environment.

As active and independent investors we see our role in constantly challenging the market's proposition as well as our own positioning. In order to do what is right for our clients in the long run, we must scrutinize risks and withstand short-term pressure This allows our portfolios to circumvent temporary exaggerations and stay true to the suitable strategy throughout the entire economic cycle.

Due to the significant increase in interest rates, we have experienced in a short period of time, we consider the current environment to be challenging. The delayed impact on governments, businesses, and households is multifaceted and complex besides being fundamental for asset valuations. As a first consequence, we witnessed the bankruptcy of Silicon Valley Bank and the acquisition of Credit Suisse, accompanied by government interventions. Governments are facing significantly higher interest costs, further increasing their steadily growing debt burden. Consumers are not only forced to cope with higher interest rates but are additionally grappling with increased costs of living and the gradual depletion of their excess savings accumulated during the Covid lockdown.

The current market volatility reflects these circumstances and also the major shifts in consensus expectations among market participants.

For us, the robustness of our investments, regardless of the scenario that unfolds, is of utmost importance. The companies we hold in the client portfolios have proven time and again that they can successfully overcome difficult markets. Thanks to their leading market positions, rising costs could be passed on to end consumers. Structural growth in products and services lead to scale efficiencies and low levels of indebtedness keep interest expenses in check. Both the yields on our selected stocks and bonds have increased over the past months, which is generally positive for expected returns. For now, it will be decisive when and at what level interest rates stabilize or reach their peak. This, in turn, depends on the path of inflation and the economy. Instead of making a conclusive forecast, we focus on staying agile, analyzing the constantly changing data situation and taking advantage of opportunities that arise from the challenging environment. The key is to distinguish between the assessment of the environment and what is already reflected in current prices.

Zurich, end of September 2023