

POSITION

Thought-provoking issues for investors



AXEL WEBER

Mistakes of the central banks


BERT FLOSSBACH

Expected investment returns

CHARLES T. MUNGER

The plumbers of Bemidji





When the European Central Bank (ECB) was founded 25 years ago, few people knew what to make of it. It was practically absent from the media, just a side note. Today things are different. Today most Europeans know, or at least they suspect, that not only the purchasing power of their savings, but also the weal and woe of the eurozone depend on the ECB, on its President Christine Lagarde.

Will she get inflation under control?
And how stable is the monetary community anyway?
We have been asking ourselves these and other questions
and have tried to answer them as best we could.

Flossbach von Storch POSITION 2/2023

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

You can subscribe to our magazine free of charge.



IN A WORD

We are back to normality – interest rates have returned. However, the way there, the adjustment process, was very difficult and sometimes painful. Consider the past year. The major asset classes – bonds and equities – have lost ground in lockstep, significantly so. We are still feeling the consequences of this adjustment process, even though the 2023 stock-market year has so far fared much better than its predecessor.

Most market observers and commentators had not seen such a development coming, quite the opposite. The vast majority had gone on record at the beginning of the year saying that the probability of a significant setback in the first half of the year was very high. And therefore they once again proved that annual, or half-yearly forecasts, even more so over such short periods of time, are very unforgiving and not worth the paper they are written on.

Nobody knows what tomorrow will bring! There are simply too many imponderables, potential risks and disasters, but also good news. Therefore, it is better not to listen when someone wants to tell you exactly where the DAX (or whatever index) will stand at the end of the year.

One thing is certain, however: the environment for investors has improved insofar as the higher interest rate again provides alternatives on the bond market. In other words, assets can be structured and diversified much better today than they were a year ago.

How much further will interest rates rise? That, too, cannot be said with certainty.

Nevertheless, in this issue of the Position magazine we focus on the central banks' options for fighting inflation. How far will they be able to go? We also take a special look at the "birthday child", the ECB.

I wish you an enjoyable read!

A handwritten signature in black ink, appearing to read "Kurt v. Storch".

Kurt von Storch
 Founder and Owner of Flossbach von Storch AG



Flossbach von Storch
POSITION
2/2023

WORLD VIEW

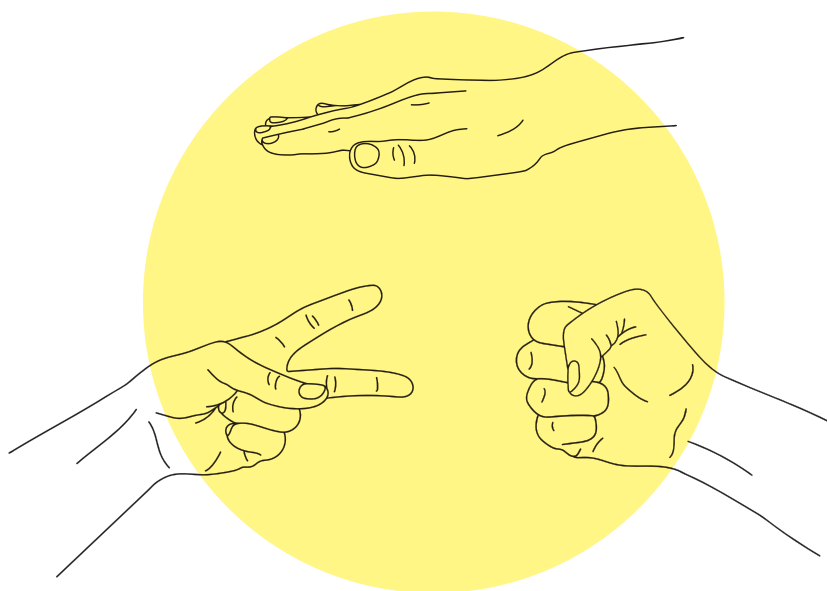
- Monetary Policy
6 **Showdown of the Central Banks**
European Central Bank
11 **One for All**
Guest Commentary
16 **A Balancing Act**
History
20 **The Bank**
The World in Charts
32 **Hard Currency?**
34 **Trial & Error**
Round Table
35 **“There’s a Bumpy Road Ahead”**
Column
40 **Mail From Shanghai**
-

INVESTMENT STRATEGY

- Interest Rates
42 **A Portfolio Composition is the Result of Selection**
Stock Market
50 **About Rollercoasters**
Interview
56 **“The Dividend Follows the Quality of a Company ... and Not the Other Way Around”**
Guest Commentary
61 **The Plumbers of Bemidji**
Bonds
64 **Beware of the Pitfalls**
-

CONTEXT

- Guest Commentary
68 **Entry not Exit**
Strategist & Strategist
72 **“Outside the Box”**
74 Glossary



Monetary Policy

Showdown of the Central Banks

What is more important: the fight against inflation or the stability of the financial system?

6



Stock Market

About Rollercoasters

The fairground and the stock markets have more in common than you might think. We take a quick look.

50

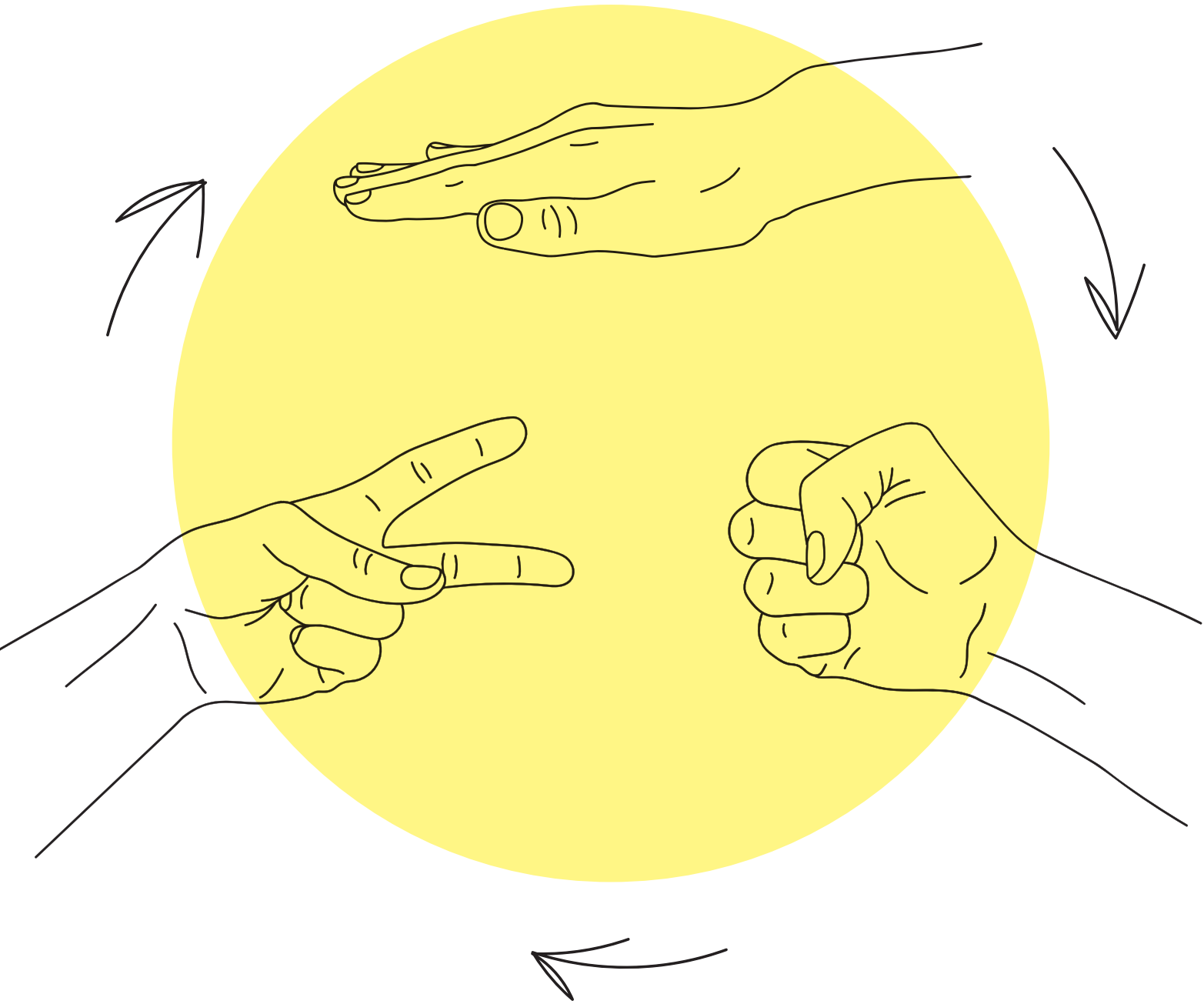


Guest Commentary

Entry not Exit

Oliver Zipse, Chair of the Board of Management of car manufacturer BMW, on sustainable business.

68



S H O W

D

O

W

N

O F T H E C E N T R A L B A N K S →

Inflation is more persistent than initially expected.
Monetary policy is fighting against it – at least for as long as it can.

by Bert Flossbach

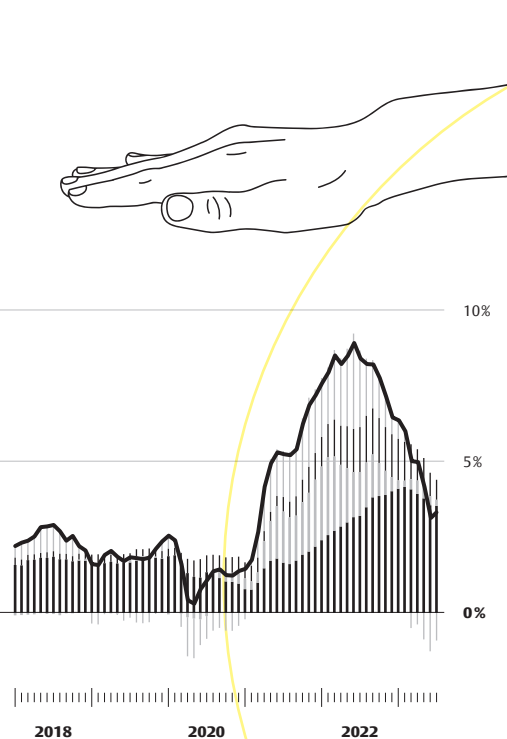


Figure 1
From commodity price inflation to services inflation
 Contributions of different components to US inflation

- US inflation
- Services
- Goods (excluding food and energy)
- Food
- Energy

Source: Bloomberg, Flossbach von Storch, data as at 11 August 2023

If prices go up, they won't come down that quickly. This is what the central banks are currently experiencing because inflation is proving to be more persistent than many had initially thought.

Currently, the biggest challenge for monetary policy is the unusual nature of inflation. After being mainly fuelled by rising commodity prices in 2021 and 2022, inflation is now primarily due to the increasing price of services (see Figure 1).

The US core inflation rate (excluding food and energy) of 4.7 per cent in July is therefore higher than the overall inflation rate of 3.2 per cent and its persistence has made it the focus of central banks.

The main drivers are large wage increases caused by a structural shortage of labour. There are 1.7 job openings for every job seeker in the USA.

This phenomenon makes the work of central banks much more difficult because high wage inflation carries the risk of a wage-price spiral. To cool the excess supply in the labour market and slow wage increases, central banks would have to raise interest rates so high they would create an "adjustment recession" that would significantly reduce the demand for labour.

(IN)CONSISTENT CENTRAL BANKERS

At a European Central Bank (ECB) conference in Sintra, Portugal, US Federal Reserve (Fed) Chair Jerome Powell warned that further interest-rate hikes might be needed to achieve a sustainable reduction in inflation. At the same time, he expressed his confidence that this might be achieved even without a recession, or that the recession could be mild. This hope casts doubt on whether, in an emergency situation, the central banks are really prepared to implement their anti-inflation policy without limits, thereby risking a severe recession.

One thing that is certain, however, is that there are no economic models that can determine the exact level of interest rates that would be needed to cool the labour market so much that wage pressure would also no longer affect core inflation.

Long-standing critics of central bank policy argue that the models the central banks use to guide their monetary policy are unsuitable. They point to a decade of failed efforts to create inflation. When it arrived with a vengeance, it was initially considered a temporary phenomenon. Then the realisation grew that the

inflation was more stubborn than had been thought. Monetary policy doves became hawks, who are now trying to get the inflation genie they had been conjuring for such a long time back into the bottle.

The associated risk of recession would be bearable provided financial market stability is not endangered. The near-collapse of a number of British pension funds last autumn and the failed US regional banks in March have made it clear that massive interest-rate increases following a long period of zero interest rates almost inevitably lead to collateral damage.

The dust has recently settled again after the weakest institutions were taken over by other banks. However, the fact that the share prices of regional banks have scarcely recovered shows that in addition to the risk of larger outflows of funds, the institutions would also be negatively impacted by falling real-estate values and an increase in corporate insolvencies if the Fed were to increase interest rates further (see Figure 2).

This may also have been the reason the Fed announced a pause in interest-rate hikes in June for the first time after 10 interest-rate hikes in a row. It justified this by stating it wanted to wait first so that it could better assess the effects of the massive key interest-rate increases that were implemented in the past 15 months. Further interest-rate hikes are planned, however, if the data from the inflation front fail to give the all-clear. This was promptly followed by another interest-rate hike in July.

The ECB, conversely, still had not announced a pause until recently, raising both the deposit rate and the main refinancing rate in July by 0.25 percentage points each to 3.75 and 4.25 per cent, respectively. In doing so, it has also somewhat reduced the gap with the USA (see Figure 3).

The Bank of Canada and Bank of England also recently enacted further interest-rate increases. The key interest rate is now 5.25 per cent in the United Kingdom. Mortgage rates have increased to around six per cent there in the meantime, making mortgage refinancing enormously more expensive and putting pressure on real-estate prices on the island.

The central banks, on the other hand, are having difficulties reducing the massive holdings of bonds they accumulated in the years following the financial crisis. The Fed already began the process a year ago. The ECB has also accelerated the reduction of its balance sheet. Since July, it is no longer purchasing new bonds to →



Figure 2
Collateral damage in the US banking system
SPDR S&P Regional Banking ETF

Source: Bloomberg, Flossbach von Storch, data as at 11 August 2023
Past performance is not a reliable indicator of future performance.

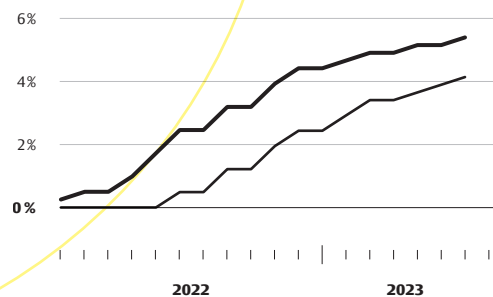
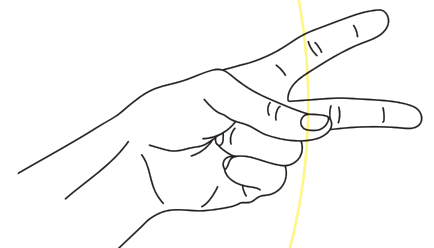


Figure 3
Pause in interest-rate changes in the USA, but not in the eurozone?
Key interest-rate changes since the start of the current cycle of interest-rate hikes

— USA (Federal funds target rate – upper bound)
— Eurozone (main refinancing rate)

Source: Refinitiv, Flossbach von Storch, data as at 11 August 2023

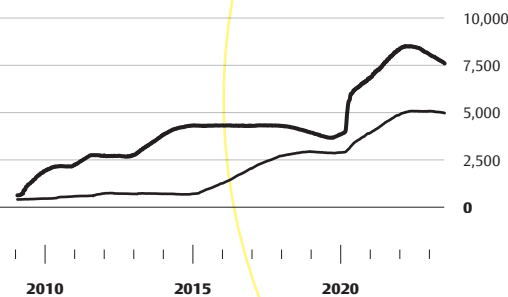
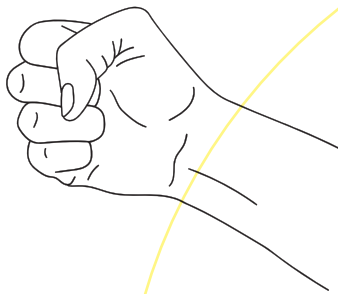


Figure 4

Moderate pace of reduction ...
... in the context of high inflation rates
and gigantic securities holdings

- Securities holdings of the US Federal Reserve (Fed) in USD billions
- Securities holdings of the European Central Bank (ECB) in EUR billions

Source: Refinitiv, Flossbach von Storch,
data as at 11 August 2023

replace maturing bonds that were acquired under the Asset Purchase Programme (APP). This should reduce its securities holdings by around EUR 333 billion by June next year, which is, however, only a small step given the total volume of around EUR five trillion (see Figure 4).

The central banks are left with the hope that the global economy will cool even if they do nothing more. So far, there have only been signs that rising interest rates are having a negative effect on business development in some economic sectors, such as the real-estate sector.

China, where the hoped-for boom following the end of the rigorous lockdowns still has not occurred, could help cool the global economy. Weak growth in the world's second largest economy would also make itself felt in other regions and ease global inflationary pressures somewhat. A significant reduction in the stubbornly high rate of core inflation in the USA or Europe should, however, not be expected.

We are approaching a possible showdown. Which objective takes precedence: the fight against inflation or financial market stability?

In other words, how far can central banks go in their fight against inflation before the financial system shows signs of stress? And how bad does the stress have to become before central banks feel compelled to back-pedal, even though inflation is not yet under control?

There is no precise answer to this question. However, if the financial system shows turbulence that cannot be limited to individual regional institutions, as was the case in March, it can be assumed that central banks will have to give up their fight against inflation in favour of financial market stability.

This would also be the case if they only achieve partial success because rising interest rates lead to a severe recession, but inflation nevertheless remains significantly above the two per cent target. Central banks would then have to make a U-turn in their monetary policy, even though the actual goal had not been achieved. ♦

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



ONE FOR ALL





The European Central Bank (ECB)
is more than “just” a central bank –
something that has never been clearer
than it is today, some 25 years
after the ECB was established.
But is this a blessing or a curse?

by Philipp Vorndran

Christine Lagarde is an experienced politician. Among the roles she has held in her home country of France are Minister for Agriculture and Fisheries and Minister for Economy and Finance. She has also headed up the International Monetary Fund (IMF). Since November 2019, she has been President of the ECB, an institution that must be completely independent and never political – at least in theory. Her primary task is to keep the monetary value of the single currency stable over the long term.

The picture is a little different in practice though. Contrary to the assertions from various politicians and central bankers, the ECB is indeed a political institution, a very political one at that – because it simply cannot be otherwise.

THEORY AND PRACTICE

This situation arises because the euro is above all a political project – one that is very well-intentioned but not particularly well designed. We have often written in this publication about the design flaws affecting the single currency: that a single currency needed a common economic and financial policy; that Europe should therefore have ensured greater consolidation before a single currency was brought in.

Don't get me wrong: we are certainly not strong opponents of the euro; quite the contrary in fact – we are committed Europeans! If we want to have a single currency that remains stable in the long term, we will need considerably more "Europe" than we have today. As we look ahead, we will need to do much more for Europe than is currently happening.

THE ECB FILLS THE VACUUM

The ECB is forced to fill the vacuum that politics leaves behind. This has never become clearer than during the financial and debt crisis of 2011/12 and the years that followed. It was Mario Draghi, former President of the ECB, and predecessor

of Christine Lagarde, who calmed the stormy waters of the financial world with his now legendary "Whatever it takes" speech in the summer of 2012. We will save the euro, Draghi said at the height of the crisis during a speech in London: "Whatever it takes ...".

With just a few apparently throwaway sentences, ECB President Draghi achieved what no head of government had previously managed despite countless nightly crisis meetings: he offered something to counter the euro crisis! A promise that was subsequently backed up by enormous central bank support packages, for example in the form of bond purchases alongside massive expansion of the central bank balance sheet (see [Figure 1 on the following page](#)). The credit spreads for bonds from highly indebted eurozone countries fell, and confidence in the euro gradually returned.

Although Draghi was the target of all kinds of criticism during his term of office, he saved the currency union back then by doing what was necessary at the time.

The problem though, was that Draghi's promise to come to the rescue was subsequently only too readily misunderstood as a fully comprehensive insurance policy. By investors and consumers and not least by politicians. If the central bank stands ready to intervene in any crisis (like the COVID-19 pandemic, for instance) and provide the safety net of cheap money, the burden of individual responsibility is removed. More serious still, these interventions have potential to change how we respond in any given situation. True to the motto "It's only money", we get comfortable, we get used to nice things – very quickly (and we find giving them up much more difficult!). The rapid increase in national debt within the eurozone is proof of this.

Draghi's appeals to eurozone leaders to understand the ECB's initial aid as temporary and to use the time it bought them to pass reforms that would shore up the eurozone failed – again and again. You don't win elections with reforms ... →

THE PANDEMIC AS A TURNING POINT

Thus, the ECB became an insurance company, and Mario Draghi, the central banker, a politician. During his tenure he was referred to by various media outlets as shadow chancellor of the eurozone. Very fitting, I believe. In keeping with this moniker, Draghi moved into top-level politics a short time after he stepped down from the ECB. On 11 February 2021, he was sworn in as Prime Minister of Italy. His most important project in that role was to be the COVID-19 recovery fund.

When she took over office in 2019, Christine Lagarde had probably hoped that she would be able to simply continue with Draghi's rescue policy. Keeping debts affordable and thus keeping the eurozone together. To be allowed to continue acting as a politician, despite the fact the ECB and its representatives are not actually supposed to be political at all. At the start of the pandemic, it looked like everything would pan out that way.

Today, though, we know that COVID-19 and Russia's terrible war on Ukraine, along with all their effects such as the interruption of global supply chains and combined with years of ultra-relaxed ECB monetary policy, have fuelled inflation. Prices have risen faster and more sharply than we have seen for decades!

Since then, the ECB has been once again in demand as a guardian of monetary stability, and less as a generous lender. And Lagarde, the politician, must once again step more firmly into the role of central banker.

For a long time, she and her economists at the ECB insisted that inflation was simply transitory, i.e. temporary. Because what was not allowed to be could not be, and significantly higher inflation rates (and higher interest rates) could become a real problem for the eurozone and the euro over the long term. So, they hoped that the nightmare would soon be over. But it wasn't.

HOW MUCH DAMAGE MIGHT THERE BE?

Lagarde and the ECB had to hold firm and raise interest rates to get inflation under control – which they did, albeit hesitantly at first. The ECB has now raised the base rate to 4.25 per cent – a level not seen since before the financial crisis took hold in 2008. Lagarde has also announced further increases. Will that be enough? We will see. Inflation has fallen slightly but is still well above the ECB's target of two per cent.

One question that many people are therefore asking themselves is: how far will Lagarde be able to go to combat inflation? What if it won't be enough? Because the damage caused by the rigid interest-rate policy is becoming too great – some countries are having problems refinancing their accumulated piles of debt (see Figure 2). And what about businesses? Or the millions of "home builders" in the eurozone?

The problem facing the ECB is that unlike the USA, for instance, the eurozone is not a homogeneous monetary zone. In other words, the ECB must pursue a monetary policy that takes account of the needs of various, highly diverse, national economies. Both the strong and the less strong. At the ECB, the rule is: for one and all. The central bank must focus not only on monetary stability, but also on the stability of the entire euro system.

At some point, possibly in the not-too-distant future, Lagarde will have to decide which is more important: combating inflation or the survival of the euro. My feeling is that we have long had an answer to this question. Whatever it takes ... ♦

Figure 1 **The saviour of last resort** – European Central Bank balance sheet total (in EUR billions)

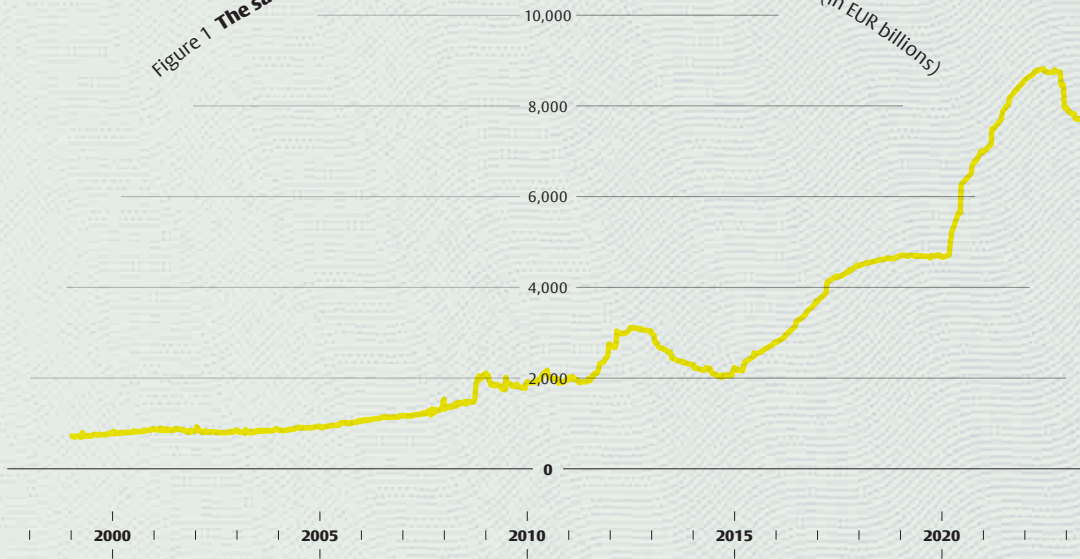
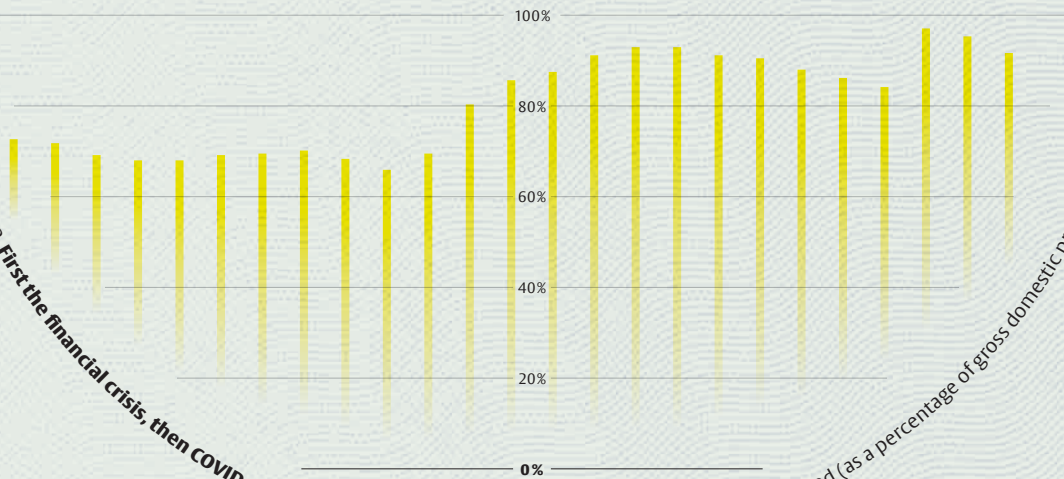


Figure 2 **First the financial crisis, then COVID-19** – The national debt ratio of the eurozone countries has increased (as a percentage of gross domestic product)



Source: Refinitiv, Flossbach von Storch, data as at 11 August 2023

A BALANCING ACT

Why both the European Central Bank (ECB) and the US Federal Reserve (Fed) reacted too late to the rise in inflation – and why interest rates are not likely to fall for a long time.



by Axel Weber

The leading central banks have made mistakes in recent years: they have long neglected their mandate to ensure price stability. And they have relied on complex models that do not work in practice for their inflation forecasts. They will have to deal with the consequences – a significant, particularly persistent rise in inflation – for a long time to come. A painful process for all involved.

The fundamental problem, in my opinion, starts with the definition of “monetary stability” itself – from the perspective of central banks, we are talking about around two per cent inflation. Is the value of money really stable if prices rise by two per cent per year? Or to put it another way: what does it mean if prices do not rise?

WHAT DOES “STABLE” MEAN?

Around 2016, when the price level within the eurozone did not move, Mario Draghi, then President of the ECB, warned of the growing risks of deflation. I’ve never seen it this way. To me, constant prices are an expression of particular stability. Therefore, there is no risk of deflation until prices fall overall. They did not do that at the time.

So central banks saw risks in those years when there were none at all – and, unfortunately, acted accordingly. Essentially: their monetary policy has always been more offensive than it could have been – than it should have been.

This also applies to the years that followed, especially the outbreak of the Coronavirus pandemic. The Fed’s strategy change in 2020 was certainly a big mistake. The use of what is known as “average inflation targeting” artificially gave inflation more room to continue rising. Price stability was suddenly defined in terms of an average. If inflation remains below the two per cent inflation target for several years, then it can rise significantly above the target in subsequent years ...

This is a completely incorrect design for monetary policy! It is simply “late by design”. It is always “too late” because it was incorrectly designed in the first place.

Once again, it shows that central bankers rarely talk with “normal people”. No one I know is happy if inflation overshoots just because it was below the inflation target in previous years and the overshoot causes the overall average rate of inflation to reach the target. It is an unsuitable policy instrument and we are now paying a very high price for its use.

“The central banks’ monetary policy has always been more offensive than it could have been – than it should have been.”

→

“The central banks have been trying to correct past mistakes – to banish the spirits they called up.”

MONEY FOR EVERY CRISIS ...

A look at the price level in autumn 2020 would have already shown that a structural change had occurred. Up to that point, prices had risen one to two per cent a year on average. The increases have been much larger since then.

But why have prices risen so strongly? Aggressive fiscal policy is one reason. In the USA and worldwide, 20 to 25 per cent of gross domestic product (GDP) has been spent on crisis intervention in recent years. Another reason is the ultra-expansive monetary policy pursued by the USA and worldwide that also expanded central bank balance sheets significantly to ensure that this generous fiscal policy would be possible and funded in the first place.

Transfer payments were used to shift income growth from the future to the present, thereby massively stimulating demand. However, the production normally associated with income, and thus the expansion of the supply of goods, did not happen due to lockdowns. In addition, supply-chain problems due to the pandemic also led to shortages in the supply of goods.

Since then, central banks have been trying to correct past mistakes – to banish the spirits they called up. However, their actions so far have not (yet) been sufficient to push inflation back towards the target value. More is needed, although the side effects of the adjustments are becoming increasingly apparent, with problems in the banking and financial systems.

INFLATION IS FAR FROM OVER

The big question is: will the central banks' balancing act be successful – will they manage to suppress inflation without risking too much damage?

All those who are already celebrating that inflation is falling are getting ahead of themselves. Yes, after sitting at around 10 per cent for the past year, inflation rates have now fallen back noticeably in the eurozone and the USA. However, they are still well above the central banks' two per cent target. Bearing that in mind, it will be a very bumpy road back – and probably longer than many are hoping for today.

But what does that mean for the capital markets?

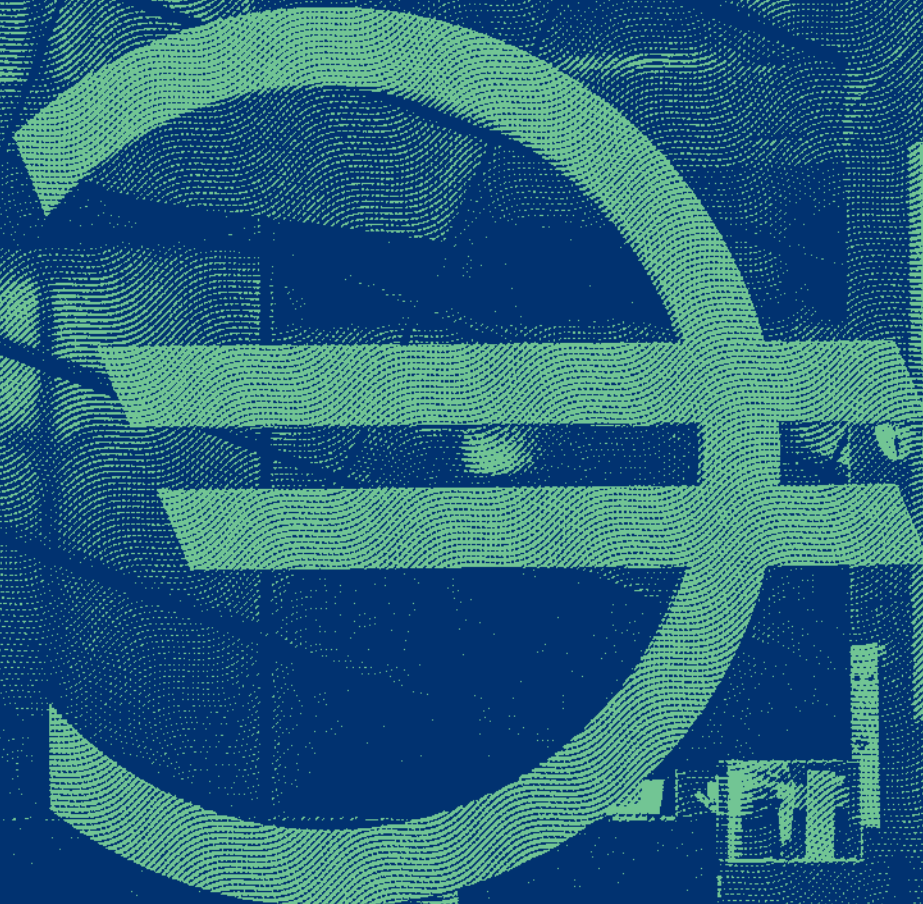
Anyone who has managed crises knows that they have something of a tsunami effect. After the first big wave has rolled in, the sea retreats right back, and everything initially seems calm. The second wave is then usually much more destructive than the first. So we should remain vigilant. ◆



ABOUT THE AUTHOR

Prof Axel A. Weber

was President of the Deutsche Bundesbank for many years and made a name for himself with his public admonishments on monetary stability during the euro crisis. He then moved to UBS where he became Chair of the Board of Directors and played a key role in the successful realignment of the major Swiss bank. Since last year, he has been advising the Executive Board of Flossbach von Storch AG on strategic matters.



THE BANK



Central banks in Europe have long been shaped by national interests. With the launch of the European Central Bank 25 years ago, a supranational monetary institute was created. Here is an (intermediate) report.

by Julian Marx

On 1 June 1998, the time had finally come. The European Central Bank (ECB) was founded. It is not just any central bank, but part of a large-scale political project. When it was launched 25 years ago, 11 countries shifted their monetary policy from national to community level – an important milestone on the way to European economic and monetary union.

Although the new central bank was based in Frankfurt, it was initially rather overlooked by the German public. During the founding week, the German magazine “Der Spiegel” dealt with the historical topic of the Inquisition in its cover story. And the nightly TV news show “Tagesschau” reported primarily about an earthquake in Afghanistan and then about the election in Montenegro. For most ordinary citizens, the planned euro was still very abstract at that time.

When newly elected ECB President, Willem Frederik (“Wim”) Duisenberg, and his five high-ranking board members entered the 35th floor of the 40-storey Eurotower, their aim was to change all that. Together with around 500 experts from 15 nations, they took on the task of making the new money tangible. At the beginning of the year, the exchange relations between the national currencies and the euro had to be finalised. In January 2002, the entry of the single currency into the wallets of European citizens was to be followed physically in the form of notes and coins.

POLITICAL CROSSROADS ...

The Germans found it difficult to break away from the Deutsche Mark. However, the euro promised to bring tangible benefits, with greater price transparency for consumers and investors, a wider market for businesses, the elimination of exchange-rate risks within the internal market, and a reduction in transaction costs. Unfortunately, from the outset, some important decisions focused less on economic issues than on political considerations.

ECB President Duisenberg had become conscious of this before the start of his term in office. In 1997, following his predecessor the Belgian Alexandre Lamfalussy, he became President of the European Monetary Institute (EMI), which was something of an intermediate step on the way to the ECB. Alongside Duisenberg and his deputy, the EMI Council was attended by the central bank presidents of 15 EU countries, who were already working to coordinate their monetary policy.

There is said to have been agreement in this body that Duisenberg should become the first ECB president. But French President Jacques Chirac felt he was overlooked and demanded a French solution, especially since France had lost out in the competition for the ECB’s headquarters. Nevertheless, Dutchman Duisenberg pipped him to the post. →

However, there was a compromise. And so, even before taking office, Duisenberg announced that he did not want to complete the full term of eight years as President of the ECB.

From the perspective of monetary policy, too, political sensitivities dominated the introduction of the euro from the outset. For example, the fulfilment of the four convergence criteria of price stability, exchange-rate stability, budgetary discipline of the States, and the level of long-term interest rates for Member States as a prerequisite for accession to monetary union had already been agreed in the Maastricht Treaty in 1992. Similar levels across Member State economies aimed to minimise the burden on a common monetary policy.

... EXPLAIN THE STRUCTURAL ERRORS OF THE EURO

The EMI's final convergence report of March 1998 confirmed some dangerous differences: with regard to the criterion of price stability, it was possible to give the green light to a large extent, as the inflation rates of the member candidates had converged. Exchange-rate fluctuations were also relatively calm. However, public finances had been a cause for concern in the creation of the single currency from the outset. For example, the annual government deficit for all euro members was not less than three per cent of the respective gross domestic product (GDP), as required, and government debt was in some cases very far from the benchmark figure of 60 per cent of GDP.

At the end of 1997, Italy's public debt amounted to 117 per cent of GDP instead of only 60 per cent. Belgium was the leader among the 11 founding countries, with a figure of 124 per cent. With a clear gap and a government debt ratio of 66 per cent, the Netherlands followed in third place. In total, only four of the 11 countries met the target at that time. In the mid-1990s, the budgetary situation of the first two countries, which were at the time particularly heavily indebted, showed a positive trend. For example, Italy had been able to reduce its budget deficit from 10.1 per cent in 1992 to just under 3.0 per cent in 1997 and Belgium from 8.4 to 2.2 per cent. Nevertheless, the progress made was not sufficient to meet both criteria.

Surprisingly, this seemed to be of little interest to anyone on the capital markets. The fourth convergence criterion, alignment of long-term interest rates, was easily met despite diverging debt ratios. The yields on 10-year government bonds of the euro countries were already at an almost identical level at the end of 1997 (see Figure 1), as many investors seemed to be speculating on the convergence of the future eurozone countries.

In any case, the sometimes overly high debt ratios no longer had any influence on the decision to start the 'euro' project with these 11 countries. It was decided that the third stage for monetary union had been reached and that the ECB could be established. However, this also cemented the eurozone's structural weakness and laid the foundation for an (unofficial) joint liability agreement.

In time for 1 January 1999, the exchange rates for the 11 currencies of the member countries were set with respect to the euro, making currency fluctuations within the internal market a thing of the past. Now the Stability and Growth Pact and a common monetary policy were in place.

SOLID AS WHIPPED CREAM

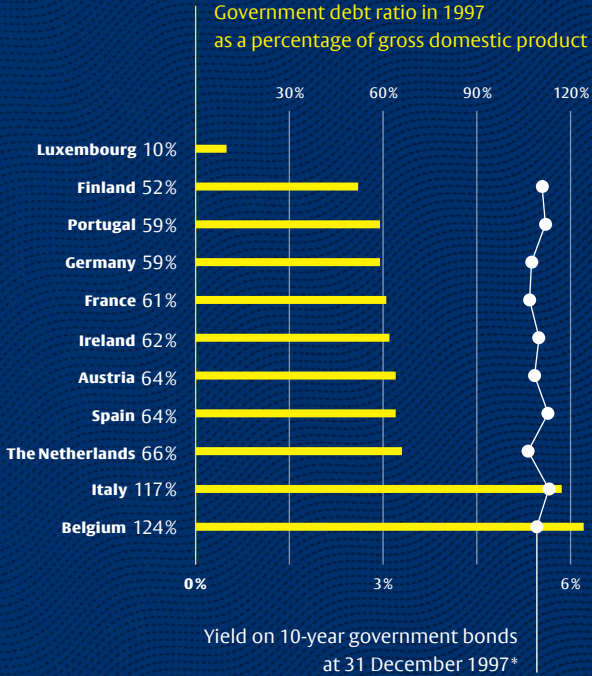
The eurozone monetary guardians were originally supposed to base their policies primarily on the Deutsche Bundesbank, which was considered particularly stability oriented. EU President Jacques Delors demonstrated its importance in 1992 by saying: "Not all Germans believe in God, but they all believe in the Bundesbank." And Duisenberg had also remarked in July 1996, in his typical tongue-in-cheek way: "The Bundesbank is like whipped cream – the more you beat it, the more solid it becomes."

And hence the ECB was given a clear mandate, geared toward price stability and independence. The independence of the ECB is based on five pillars: financial, institutional, operational, personal, and legal independence. Institutional independence guarantees that the governments of Member States cannot exert any influence on the ECB's decision-making bodies. Legal independence ensures that the ECB can refer to the European Court of Justice to enforce its independence, if necessary. The institutional framework →



Willem Frederik ("Wim") Duisenberg
ECB President from June 1998 to October 2003

Figure 1
The convergence effect of the euro
As early as 1997, the capital market had already factored in joint liability



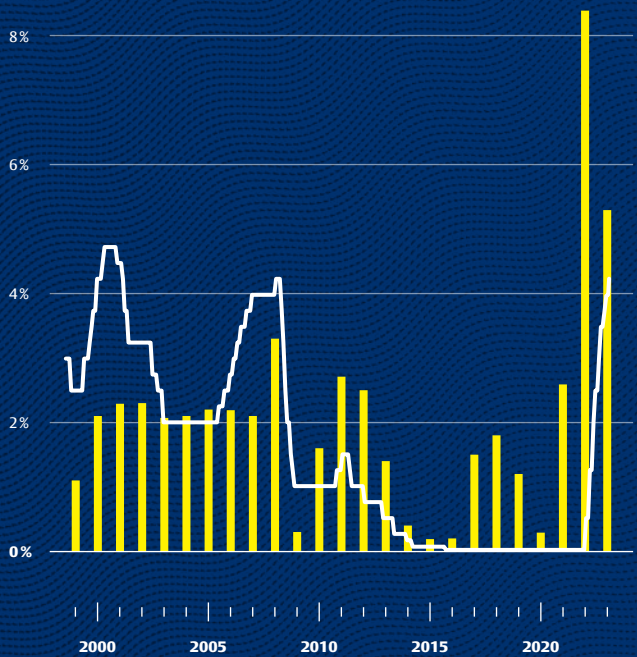
* At that time, Luxembourg did not have a 10-year government bond in circulation.

Past performance is not a reliable indicator of future performance.
Source: Refinitiv, Flossbach von Storch, data as at 11 August 2023



Jean-Claude Trichet
ECB President from November 2003 to October 2011

Figure 2
What does price stability mean?
Eurozone inflation as an annual average* (bars) and ECB key interest rate** (line)



* ECB estimate for 2023
** Interest rate for the main refinancing operations

Source: Eurostat, Refinitiv, Flossbach von Storch, data as at 11 August 2023

for single monetary policy thus protects the ECB against any kind of political influence – to this day.

And the Treaty on the Functioning of the European Union established the primacy of price stability: “The primary objective [...] shall be to maintain price stability.” However, the impression that this is a clear mandate is deceptive. It is not clear what “price stability” means at all. The Governing Council therefore initially defined price stability in October 1998 as a “year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below two per cent”. This objective is to be maintained over the medium term. And, in fact, inflation expectations were initially in line with this objective in many countries.

In May 2003, the ECB Governing Council confirmed this definition in principle, but made it clear that it wanted to keep inflation rates below, but close to, two per cent in the medium term. In doing so, the monetary guardians set a clear ceiling on the inflation target, which was compatible with the objective of price stability in the medium term. By raising the lower limit to “below, but close to, two per cent”, the Governing Council also intended to introduce a safety margin to avoid deflation risks. The aim was also to take into account possible measurement errors in the HICP and structural inflation differences in the euro area.

Duisenberg remained ECB President for five years. The accession of Greece to the monetary union thus fell under his aegis, as did the introduction of the euro as cash in January 2002. The issued euro notes came under close scrutiny at the time – and bore his signature. From 2003, the signature changed to that of French economist Jean-Claude Trichet, who became the new president of the ECB for a full eight years.

INITIAL SUCCESSES

Trichet had risen from being an officer at the French Ministry of Economy and Finance to Head of the Treasury and President of the Paris Club. He had been an adviser to French presidents Mitterand and Chirac before moving to the top of the French Central Bank in 1993. He had co-negotiated the Maastricht Treaty and, as Governor of the Central Bank, earned the nickname “Ayatollah of the strong franc”, as he

was always prepared to fight for the independence of a central bank. But this conviction was put to the test in his term as ECB President.

At first, the euro seemed to establish itself as a stable common currency. Although the external value of the euro initially fell against the US dollar for about two years after its introduction as book money under Duisenberg, it mainly increased after the introduction of cash until the summer of 2008.

And that didn’t come about by chance: when inflation rose just above the two per cent mark from 2005, the monetary guardians reacted decisively. They raised the interest rate on main refinancing operations from two per cent in 2005 to four per cent in 2007. By comparison, it eventually took an inflation rate of 8.4 per cent most recently before interest rates were increased to the same high level (see Figure 2). So, under the current President Christine Lagarde, is the ECB only serving wobbly jelly rather than the firm whipped cream that Duisenberg had been aiming for?

The test began for Trichet with the start of the financial crisis in the summer of 2008, when the ECB cut interest rates to one per cent. But that was not enough.

BREAKING TABOOS DURING THE EURO CRISIS

In 2009 the euro crisis started, and it turned out that the (price) stability culture of a Bundesbank could not simply be transferred to the ECB. In the eurozone, more and more states had to admit to having lived beyond their means for years. The European Financial Stability Facility (EFSF), established in 2010, and the European Stability Mechanism (ESM), adopted in 2011 as its successor, created a rescue package, albeit a politically controversial one. Ireland was the first country to use it in 2010, followed by Portugal, Greece, Spain, and Cyprus.

Under Trichet’s aegis, the ECB then broke a taboo, bringing in bonds from cash-strapped eurozone states like Greece to help these countries. Not everyone in the Governing Council had voted in favour of this, and Trichet quickly came under →

fire: “I know that not everyone necessarily approved of some of these decisions,” Trichet said later. “But I am convinced that they were necessary – especially in Europe.”

In Greece, for example, there was a threat of state bankruptcy. But Spain’s government debt ratio had also risen from 36 per cent of GDP at the end of 2007 to 101 per cent by 2013. Ireland’s public debt had even increased fivefold from 24 to 120 per cent of GDP. The eurozone was threatened by a government debt crisis. Six of the 12 eurozone countries that jointly introduced euro cash in 2002 reached a debt ratio of more than 100 per cent of GDP after the financial crisis. And only the 543,000 or so Luxembourgers were able to look at a government debt ratio that was below the Maastricht limit of 60 per cent of GDP. The initial suspicion of a (too) heterogeneous monetary union seemed to be confirmed. The apparent convergence in government bond yields had been deceptive (see Figure 3).

Trichet showed in May 2010 that ECB central bankers were willing to cross the boundaries of their mandate in an emergency: he had initiated the Securities Markets Programme (SMP), removing the taboo on government bond purchases as a monetary policy tool. By 2012, the ECB had acquired government bonds from Greece, Ireland, Italy, Portugal, and Spain for more than EUR 200 billion.

At the time, the central bank argued that there was a disruption in the capital markets and that the monetary policy transmission mechanism had to be restored. Even then, this assessment was not altogether convincing. For example, interest rates on housing and corporate loans were relatively low at the time the programme was launched compared to previous years when no SMP was in place. The supply of credit to the real economy therefore did not seem too restrictive, and the monetary policy transmission mechanism seemed to be intact. So, was it primarily a matter of granting monetary security to highly indebted Member States back then? (see Figure 4 on page 28)

In November 2011 – and thus in the middle of the euro crisis – Trichet then handed over the helm to the new ECB President Mario Draghi. After a career as an academic economist in Italy, he initially worked for the World Bank in Washington.

In 1991, he became Director General of the Italian Ministry of Finance, and after a decade he moved to the investment bank Goldman Sachs, before being appointed Governor of Banca d’Italia in 2006.

“SUPER MARIO” AND THE CENTRAL BANK’S OMNIPOTENCE

As President of the ECB, Mario Draghi quickly earned the nickname “Super Mario” in the tabloid media because he managed as early as July 2012 to do something that aid programmes and agreements had not previously been able to achieve. He reassured the financial markets with the magic words: “The ECB will do whatever it takes to support the euro – and you can be sure that it will be enough.”

But the Italian finally broke with the legacy of the Bundesbank. He did not see himself committed to a strict stability policy, but repeatedly warned against deflation risks. Under his aegis, interest rates remained at the lowest level, even in years of growth. And breaking the taboo became a new normality. Draghi did not shy away from using unorthodox instruments on a large scale and flooding the financial markets with more and more money.

And thus, the room for manoeuvre in the ECB’s monetary policy would continue to grow long after the euro crisis. In this context, the redefinition of the price stability target, initiated by Mario Draghi in June 2016, was central. He argued in favour of a symmetrical inflation target, which would henceforth feed into the Governing Council’s decision-making process and was officially completed as a symmetrical two per cent inflation target in July 2021, under his successor Christine Lagarde. In this context, “symmetrical” means that two per cent inflation was no longer a cap but required upwards and downwards deviations to act; even if they were allowed to be tolerated for a while, provided inflation expectations did not shift. But too little inflation or very high monetary stability was then declared a problem.

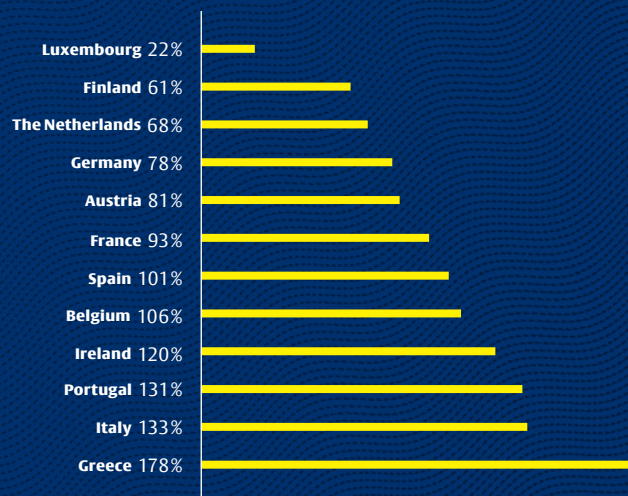
On this basis, the euro monetary guardians then justified new, large-scale securities purchases at the end of 2017, as eurozone inflation was 1.5 per cent in 2017 and ECB projections →




Mario Draghi

Mario Draghi
ECB President from November 2011 to October 2019

Figure 3
**The “misunderstood”
convergence**
2013 government debt ratios
as a percentage of gross
domestic product

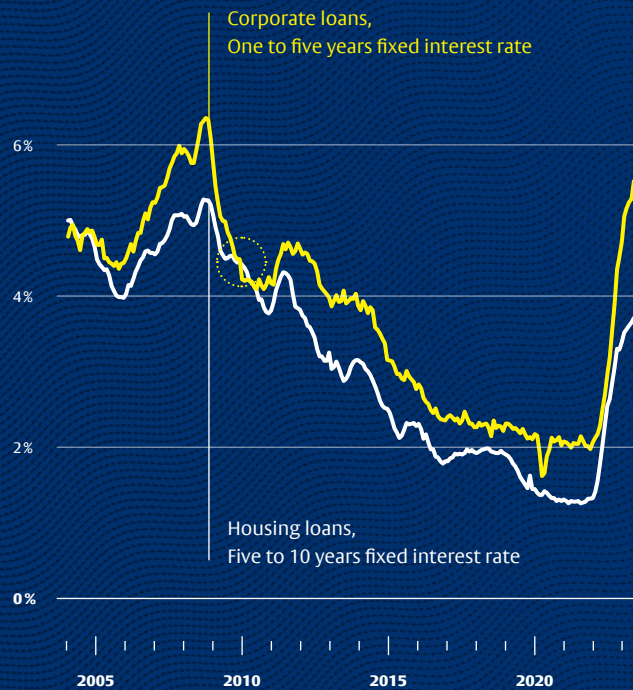


Source: Eurostat, Flossbach von Storch,
data as at 11 August 2023



Christine Lagarde
ECB President since November 2019

Figure 4
“Disruption” of the monetary policy transmission mechanism
Average lending rates in the eurozone for selected new lending business



Past performance is not a reliable indicator of future performance.
Source: Refinitiv, Flossbach von Storch, data as at 11 August 2023

for 2018 and 2019 also only expected inflation of 1.4 and 1.5 per cent, respectively. Securities purchases continued at a rate of EUR 30 billion per month, even though the sum of securities purchases initiated in 2015 already amounted to more than EUR two trillion.

Areas of responsibility also swelled under his aegis. In 2013 and 2014, the ECB gradually took over banking supervision in the eurozone. There were good reasons for centralising supervision. For example, the fact that many European banks are highly interlinked through mutual business relations. However, why the central supervisory body was established at the ECB still raises questions today.

Internal conflicts of interest with monetary policy are pre-programmed. Rate hikes, such as those we have seen recently, lead to price reductions on bonds. As a result, banks may be forced to write off their securities holdings. However, if the ECB takes account of the hardships of the banks in its monetary policy decisions, this can lead to a loss of confidence. After all, the primary objective should be price stability. In addition, external monetary independence may be jeopardised if, for example, politicians try to influence far-reaching decisions by banking supervisors in crisis situations.

In the middle of Draghi's tenure, in November 2014, the ECB moved from the Eurotower to its new building in Frankfurt's Ostend, designed by the Viennese architectural firm Coop Himmelblau. The construction had been planned for many years and the old offices were bursting at the seams. The original 500 employees had become more than 2,500 – growth that was set to continue.

A LAWYER AT THE TOP

In November 2019, to the surprise of many, Draghi was succeeded by Christine Lagarde. Lagarde is not only the first woman to head the central bank, she is also the only person to hold the role who is not a central banker, but a trained lawyer. She worked as a lawyer for many years before becoming French Minister of Commerce in 2005 and then Minister of Economy and Finance in 2007. After that, she headed the International Monetary Fund (IMF) for a number of years.

Lagarde was confronted with the consequences of the Coronavirus pandemic as early as March 2020. She not only continued Draghi's zero interest-rate policy, but also used the instrument of securities purchases intensively: after already holding almost EUR 2.7 trillion in securities for monetary policy purposes as of February 2020, this amount rose to almost EUR five trillion by the end of 2022. A good EUR four trillion went into government bonds or government-related bonds.

As a result, the euro-system held 26.1 per cent of Italian and 28.3 per cent of Spanish government debt at the end of last year. And because that may still not be enough, ECB President Lagarde intervened last July, announcing that the bank would buy unlimited government bonds as required under the newly created Transmission Protection Instrument if the ECB's Governing Council found that the yields of euro government bonds would diverge too widely.

The ECB cannot force the originally envisaged economic convergence of its now 20 Member States. However, with such measures, it can ensure the sustainability of debt even in highly indebted Member States. (In)direct state financing for rescuing the euro has now become "officially" established.

The new head of the ECB also put the climate on her agenda. When the IMF invited her to its annual spring meeting in April 2023, Lagarde said that monitoring climate-related and environmental risks should be one of the top priorities of the ECB from 2023 to 2025. But what this means in concrete terms remains unclear for the time being. Should the ECB be looking to employ meteorologists or seismologists in order to be able to better assess the balance sheet-specific flooding and earthquake risks of individual banking institutions? Or perhaps the plan is to shift the central bank's securities holdings into "green" investments? Either way, it should not be possible to make a significant contribution to the latter if Bundesbank President Joachim Nagel is to be believed. After all, since July, reinvestment payments under the roughly three trillion "APP" securities purchase programme are no longer being reinvested.

Monetary policy, fiscal policy, financial stability policy and now climate policy. The ECB wants to become a "Jack of all trades". But that raises questions: →

- Is the conscious acceptance of potential conflicts of interest a violation of the primary mandate of price stability?
- To what extent can a central bank intervene in the market?
- Is it within the competence and responsibility of the monetary guardians to manage umpteen trillions of euros in securities investments over many years or to assess climate risks?
- How far can the ECB go before violating the ban on monetary state financing?

Many of these issues are currently being ignored or accepted. Perhaps because without the central bank and its “printing press” everything would stop running?

Record-high inflation rates in the ECB’s euro area are haunting the 25-year anniversary, which has so far been celebrated only in a very cautious manner. And there is good reason for this. For a long time Lagarde and the Governing Council of the ECB ignored the increase in the price level that had already occurred in the fourth quarter of 2021 or classified it as a temporary phenomenon. It was only last summer that a tightening of monetary policy began at an unprecedented pace. Causes for celebration are currently therefore rather few and far between.

ONE FOR ALL AND ALL FOR ONE

Black-and-white thinking has no place in a central bank that also has political considerations to account for. In recent crises, the ECB has found itself in the grey area several times. The desired economic convergence of the now 20 Member

States has never really been achieved. The eurozone has remained extremely heterogeneous from an economic point of view. Many are also blaming the ECB’s years of zero and negative interest-rate policies for the extraordinary inflation rates, which are now burdening many, especially poorer, households. All of these are reasons for a certain scepticism with respect to the ECB.

No one can tell today how far history will carry this institution. But perhaps further than some critics would suspect. Perhaps the ECB’s strengths lie in its well-known weaknesses? Can it not also be a source of confidence if citizens do not have to worry about state bankruptcies and the state can act as a safety net in times of crisis? When pushed to the limits, in order to protect a (monetary) community, which is now also to be understood as a union to uphold our basic principles of democracy and freedom?

Answering these questions is not easy. There are good reasons for the (historical) actions of the ECB. But there are also numerous arguments that shed a less favourable light on its actions. What is right and what is wrong? The world of currencies is complex. There are not always clear answers, and above all these answers often do not apply universally.

Monetary policy always involves politics. The almost 350 million citizens of the euro area alone will ultimately decide whether they will continue to place their trust in our financial and monetary system. If that is the case, the 25-year anniversary is only the beginning of this institution, and there will be many years and decades together to come. Therefore, it is also up to us whether the euro has a future. ♦

ELEVEN FOR ONE

40.3399 BELGIAN FRANCS

1.95583 GERMAN MARKS

5.94573 FINNMARK

6.55957 FRENCH FRANCS

0.787564 IRISH POUNDS

1,936.27 ITALIAN LIRE

40.3399 LUXEMBOURG FRANCS

2.20371 DUTCH GUILDERS

13.7603 AUSTRIAN SHILLINGS

200.482 PORTUGUESE ESCUDOS

166.386 SPANISH PESETAS



From 1 January 1999, currency fluctuations within the euro area became a thing of the past. The exchange rates against the euro were irrevocably fixed for the first 11 member states.

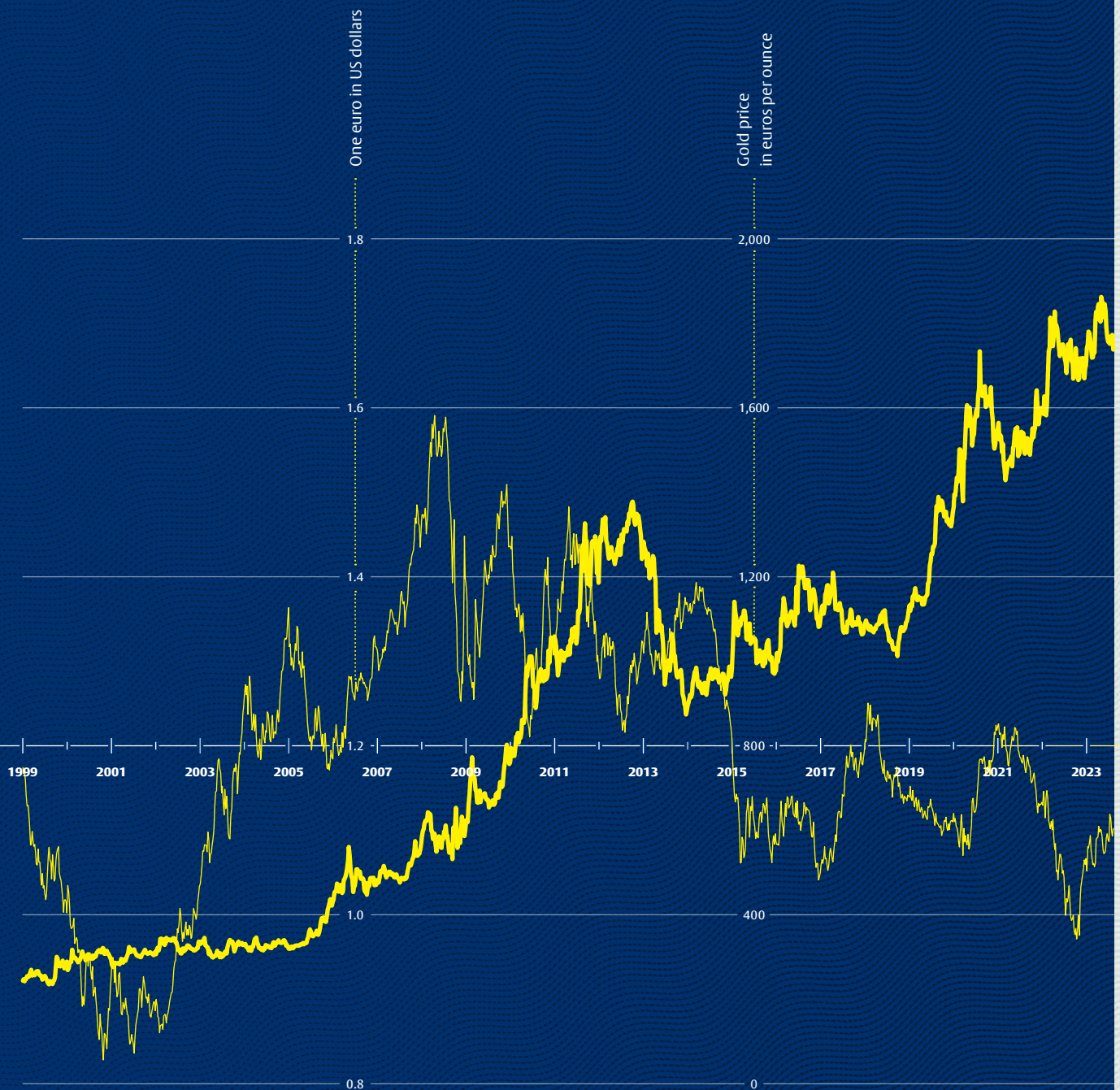
HARD CURRENCY?

**Stable against the US dollar,
lost ground against gold**
Development of the euro
since its introduction on 1 January 1999



**Past performance is not a reliable indicator
of future performance.**

Source: Refinitiv, Flossbach von Storch,
data as at 11 August 2023



The euro has an impressive balance sheet. At least at first glance. Compared to the US dollar, which is considered the “world’s leading currency”, the common currency has almost held its value since its inception (see chart). Of course, there have been some fluctuations over the past 25 years – but that is quite common on international currency markets. The balance sheet at the end of July 2023: since its inception, the euro rate has fallen by six per cent against the dollar – within a corridor of minus 29 per cent to plus 35 per cent.

This look back at the currency’s history also exposes a fundamental weakness of “paper currencies”. Since the introduction of the euro, the price of gold (in euros) has risen by 600 per cent. In US dollars, the increase has been 565 per cent. Rapidly rising national debt, extremely expansionary monetary policy over many years and high inflation all speak in favour of the precious metal.

Perhaps even more importantly: gold is considered the currency of last resort. For thousands of years, the precious metal has served as a store of value in times of crisis. As insurance in case nothing else works, in the financial, monetary or economic system. So the euro balance sheet also shows: gold is (the better) money. A stable currency, even if you won’t get far at the supermarket checkout with coins and bars.

Forecasts are complicated things. In principle, of course, they are always welcome if we want to have a basis for decisions whose consequences will not be felt until further down the line.

The problem is: complex models are intended to make future developments predictable, but the causes of these developments often stem from a far more complex reality. There are also “black swans” – unexpected phenomena that cannot be reproduced with models. You might be familiar with this from long-term weather forecasts. Often the forecasts are correct. But there is no guarantee – and certainly not in the case of thunderstorms.

This is something that the central bankers at the European Central Bank (ECB) have also experienced: they were rather off the mark with their inflation forecasts for 2022 (see graph). At the end of 2021, they predicted inflation of 3.2 per cent for the following year. Then came Putin’s attack on Ukraine, the energy crisis. In the months that followed, expectations then rose to more than eight per cent.

&

Now you could explain away the incorrect forecast with the “black swan” phenomenon described above. After all, Putin’s war (and some other developments) came as quite a surprise. But even after accounting for that, the ECB’s forecasts were still too optimistic.

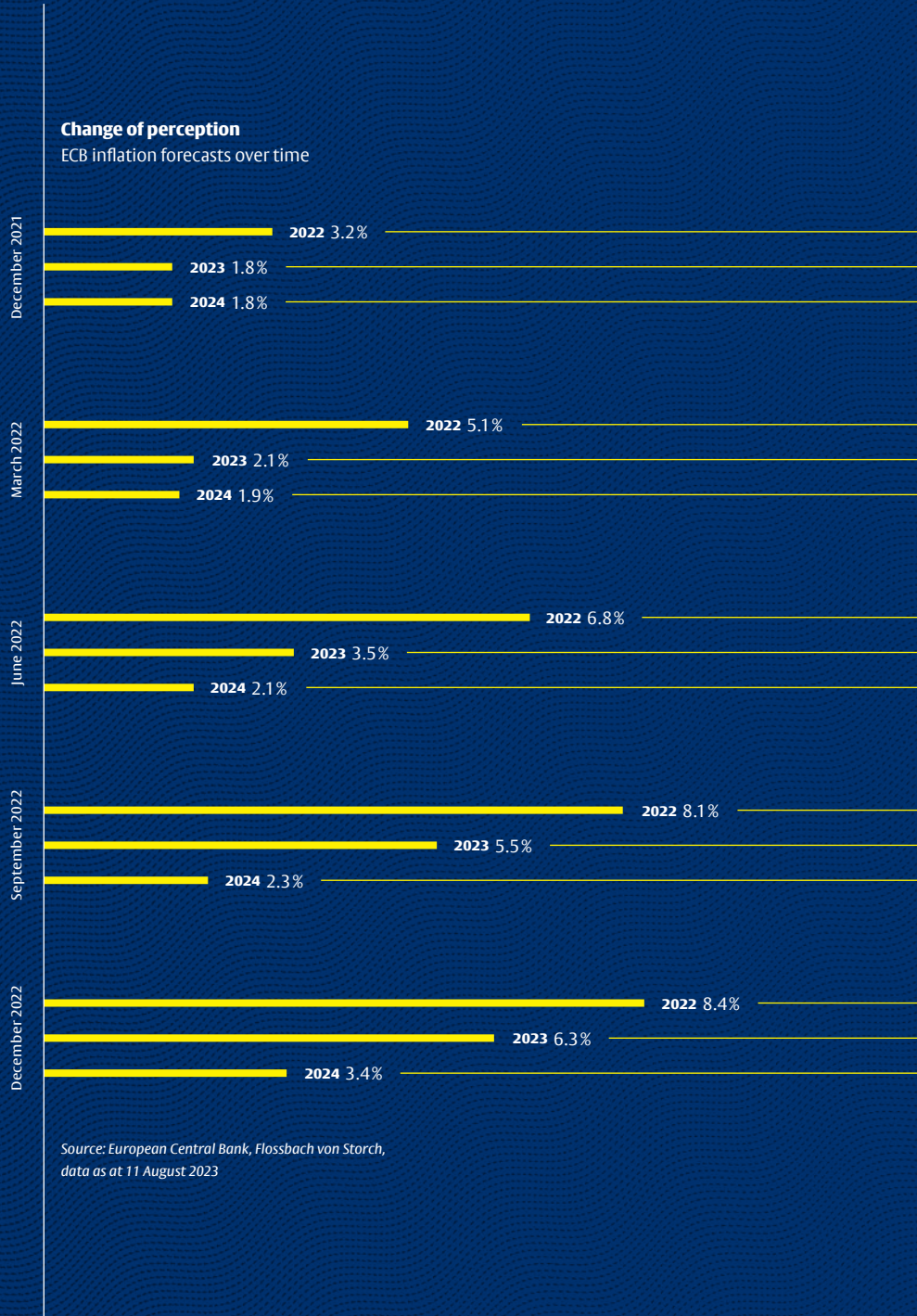
In June 2022, the ECB predicted that inflation for 2023 should be only 3.5 per cent. The current ECB forecast (as of June 2023) for the current year is 5.4 per cent.

Central bankers will not tire of claiming that they make their decisions “based on data”. Of course, an inflation forecast is not enough here. The ECB also collects data on the economic situation, labour markets, production, payment transactions, financial markets, exchange rates, to name just a few examples.

But the fact is: the central bank has been quite late with its rate hikes over the past year. Despite rapid price rises, it kept the key interest rate at zero per cent until the end of July 2022. Only then was it increased significantly.

In times of high inflation, central banks must act quickly and consistently. Otherwise, things can get out of hand. But to do this, they need to be able to realistically assess the situation. Let’s hope they succeed in this as we head into an unpredictable future.

TRIAL



Source: European Central Bank, Flossbach von Storch, data as at 11 August 2023

€ R R O R

Inflation is here to stay. This means that monetary policy needs to remain restrictive, at least as far as this is possible without causing any major turbulence.

“There’s a Bumpy Road Ahead”

Prof Axel Weber, Kurt von Storch and Marcus Stollenwerk talk about the consequences of the fight against inflation – for the financial system, for the capital markets and for the portfolio.





Prof Weber, inflation reached double-digit figures in the USA and the eurozone last year. As a result, central banks raised interest rates significantly. Inflation rates have come back down a little since then. Do you think that interest rates will stay at their current levels, continue to rise, or come back down soon?

AXEL WEBER: I expect central banks will tighten their monetary policy further to get prices under control. The inflation target of two per cent per annum has still not been reached. In the USA and the eurozone, core inflation in particular is proving stubborn. Above all, we must also be prepared for the fact that interest rates are not likely to come down again so quickly.

The US Federal Reserve (Fed) has now taken a break after all the turbulence in the banking sector. Did you think this was right?

AXEL WEBER: I can easily understand the reasoning behind the interest break. Both the Fed and the European Central Bank (ECB) reacted very late to the rise in inflation. As a result, we saw an extremely fast pace of rate normalisation with the largest rate hikes seen in post-war history. No one should be surprised if the banks, which were unable to prepare for this development, are no longer able to keep up. This creates risks for the financial system which should not be underestimated.

Do you still expect to see further action from central banks?

AXEL WEBER: Yes. Worldwide, 20 to 25 per cent of gross domestic product (GDP) has been spent on crisis intervention in recent years. At the same time, central bank balance sheets have expanded massively. These need to be reduced. And this is what the ECB in particular has just started to do. So we still have a long road ahead of us.

Mr von Storch, what does this type of environment mean for investors?

KURT VON STORCH: In English, there is an excellent phrase to describe this: "bumpy road". It will remain choppy on the stock markets, with constant ups and downs. The tailwind that brought the ultra-low interest rates of recent years is gone. And now, we have to get used to headwinds.

“The question is: when is before and when is after the crisis?”

Kurt von Storch

That sounds moderately optimistic, put cautiously ...

KURT VON STORCH: I've been in business for a long time, but a year like the one we've just had, where both equity and bond prices have slipped, has been a new experience for me as well. Investors were used to the fact that significant price setbacks in equities could be compensated at least in part by current income or price gains on bonds. That has not worked with a negative yield level. In the meantime, the risk-return profile of the bond asset class has improved significantly. And in the first half of the year, some stock markets even recorded new record values.

How have your clients reacted to the ups and downs in the markets, Mr Stollenwerk?

MARCUS STOLLENWERK: One particular issue that has caused clients concern over the past year is the lack of diversification provided by equities and bonds. Some even questioned the point of their investments. But now, many of them are glad that they did not let themselves be discouraged and have remained invested. The main thing that a lot of clients want to know now is how to proceed with inflation and interest rates as they are.

Even if it would have been a mistake last year, what is so wrong with the idea of getting out in a crisis if you were to get straight back in again?

KURT VON STORCH: The question is: when is before and when is after the crisis? I can tell you from many years of experience that in most cases such “timing” considerations or attempts to find the best time to get out and in are more harmful than they are useful. Because people often sell when prices have already gone most of the way down – and then the optimal time to return to the market is usually missed because as prices rise, most investors are still convinced that the lowest low point is yet to come.

MARCUS STOLLENWERK: It's like gambling. An internal evaluation of 107 market forecasts issued by various asset managers at the beginning of the year shows just how little difference such timing efforts would have made in the first half of the year. The vast majority of authors assumed at the time that the first half of the year would not be a very good one, in fact a very bad one for shareholders. But, as is so often the case, things changed.



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





And what do you think is the biggest risk to investors today?

KURT VON STORCH: If the financial system shows serious turbulence that cannot be limited – as it could in March – to individual regional banks, in our opinion, central banks are likely to give up their goal of forcing inflation down again. They will probably even make a U-turn if they only achieve partial success in the fight against inflation because rising interest rates lead to a recession but inflation nevertheless remains significantly above their two per cent target.

Is there not another danger? Whether you look at Europe or the USA, a lot of countries have a very high level of debt.

AXEL WEBER: Worldwide, debt has risen massively over the past three or four years. Several major economies now have a debt ratio of more than 100 per cent, which academics such as Kenneth Rogoff and Carmen Reinhard describe as no longer sustainable. With a mountain of debt at this level, debt servicing can become difficult, at least if there are significant interest payments. And we are now in a phase where, on the one hand, interest rates have risen significantly and, on the other hand, central banks are reducing their balance sheets, meaning that (in some cases) they are no longer replacing expiring securities in their holdings.



Prof Axel A. Weber advises the Executive Board of Flossbach von Storch. He was President of the Deutsche Bundesbank between 2004 and 2011, and then Chair of the Board of Directors of UBS for around 10 years.

This means that taking on new debt is likely to be significantly more expensive than before. What can countries do to get down from their high debt levels?

AXEL WEBER: At the university, I've always told my students that there are five ways to get rid of debt. First: a country grows out of its debt – that is the best option. Second: debts are inflated away. Third: they are restructured. Fourth: default, with all its consequences. And fifth: mixed forms – repressive measures by the state, for example.

And what solution do you think is realistic, especially in the eurozone?

AXEL WEBER: As someone who has been in business and politics for a long time, I can say: corner solutions never work! In the end, it takes a little bit of everything.

Debt ratios are very high, particularly in Greece and Italy. Is a new euro crisis to be expected if there are further interest-rate hikes?

AXEL WEBER: The probability of this is rather low. The ECB will intervene early to prevent credit spreads on government bonds from diverging too much. This does not mean that the fight against inflation in the eurozone remains without harm.

“Above all, we must also be prepared for the fact that interest rates are not likely to come down again so quickly.”

Axel Weber

“Inflation means, first of all, that prices are rising. And it’s companies that are raising prices.”

Marcus Stollenwerk

Do you not expect a default in Europe?

AXEL WEBER: I don’t expect a “default” in industrialised countries. In the world’s weakest countries, however, it can be a danger. Even now, some are struggling with debt servicing; that is why, over the past two years, the G20 has already been discussing whether debt servicing should be waived for the countries concerned to prevent them from being crushed by their debts. Even in the high-yield sector, it can become critical if interest rates do not come down again in a year or two.

And how quickly do you think we will get back on track when it comes to inflation?

AXEL WEBER: According to the ECB’s forecast, we will “overshoot” for at least two years. I think this estimate is too optimistic. Even if inflation does come back down a little soon, it is expected to remain at a high level for years to come.

What does this mean for the financial markets?

MARCUS STOLLENWERK: Inflation means, first of all, that prices are rising. And it’s companies that are raising prices. So when it comes to investing in equities, investors should ask themselves whether a company is able to pass on price increases to customers. Because in difficult times, the rising tide often no longer lifts all boats. This makes the selection of equities all the more important. That’s why there is a lot to be said for active portfolio management at the moment. When selecting equities, one of the things we look for is a leading market position and the pricing power that comes with this.

KURT VON STORCH: Especially in difficult times, it is important to have confidence in the companies that you are invested in, so that you don’t get out at the wrong time. When inflation is high, you need to achieve a nominal yield that at least compensates for the loss of purchasing power – if you want to preserve the value of your assets. And this is difficult to do with bonds alone even after the rate hikes, so having a certain amount of equities in the portfolio is advantageous.

One more question to finish: how do we get out of this multi-crisis situation?

KURT VON STORCH: As has so often been the case in the past, through innovation. Innovation has a deflationary effect, especially in relation to structural inflationary drivers, which we refer to as the three “Ds”: demography, deglobalisation and decarbonisation. Although it may be difficult for investors to “time” innovation spurts, the key to a solution is human innovation.



Marcus Stollenwerk
is Head of Asset
Management and Partner
at Flossbach von Storch AG.



by Shenwei Li



MAIL FROM S H A N G H A I

Economic engine, superpower, party dictatorship. Anyone interested in global trends looks to China. Analyst Shenwei Li provides a subjective report on her experiences from the perspective of a Chinese citizen. This time we take a look at demographic change.

Like the Italians and the Germans, on average we Chinese are also getting older. At the end of 2022, almost one in five of us were older than 60. At the same time, the proportion of young people is decreasing. Thus, who will take care of all these senior citizens and how can this be financed? The government has initiated several reforms to tackle the situation.

By 2025, each province will need to set up a “care-for-the-elderly system”, which senior citizens must be able to access within 15 minutes. Primarily these systems will need to provide food and medication. Room for facilities for the elderly must be included when planning new housing developments. But above all, the number of places in retirement homes must rise to nine million by the end of 2025, of which 55 per cent need to be hospital/nursing beds.

90 PER CENT OF SENIOR CITIZENS LIVE AT HOME

Do these plans go far enough? Even nine million places in retirement homes will only cover around three per cent of the total of 265 million people aged 60 and over. The central government advocates the “9073” principle. This means that 90 per cent of senior citizens would live at home with their families, seven per cent would receive supportive care from the municipality, and just three per cent would be cared for in retirement homes.

But there are also around 45 million elderly people with a physical disability, and only five million hospital/nursing beds are planned. Hence, 90 per cent of this cohort would also have to be cared for at home. And the costs can really mount up – even if each case is considered on an individual basis. Something that will help here is that the regulatory authority for the insurance industry has announced a pilot programme that will allow insurers to exchange claims arising from existing life insurance policies that can currently only be accessed in the event of death for ongoing long-term care insurance.

LOCAL GOVERNMENTS LEND A HAND

The role that can be played by a financially robust local government should not be underestimated. Shanghai, for example, provides canteens throughout the city that offer inexpensive food for the elderly. Other municipalities offer free health checks. There are also taxi stations in many residential areas, where you can press a button and wait for a taxi if you need it, so you don't have to order it by smartphone. Pensioners living alone can also log entries to a smart water meter: if no water is used for two days, an employee comes by and checks that everything is OK.

However, I believe that the greatest impact on the daily life of senior citizens has been made by the project to install lifts in old residential complexes in Shanghai; work on this project has been accelerated since 2020. More than half of the city's housing stock are six-storey buildings without a lift, built 30 to 40 years ago. Around half of the inhabitants are over 60 years old. Back when Shanghai launched the project in 2011, 30 to 50 per cent of the costs were covered by local government. However, things did not really get going until 2020, when a ruling was implemented that meant agreement from just two-thirds of the building residents was required, rather than consent from all residents. Previously, residents on the ground floor often refused consent.

PRIVATE SUPPLEMENTARY HEALTH INSURANCE FOR THE ELDERLY TOO

Most pensioners only have statutory health insurance, which is often not sufficient to cover all costs; especially for senior citizens who have paid in very little or nothing at all in the past. This includes farmers, for example, who usually still have to pay the equivalent of around EUR 50 a month into the health insurance fund even at retirement age. In the case of pensioners, the state assumes responsibility for transferring a fixed but very small contribution to their health insurance account every month. Again, this is often nowhere near enough to pay for medication and outpatient services. The remaining amount to be paid by each insured person can be covered by taking out private health insurance. But these policies are not available, or they are unaffordable, for older people with pre-existing medical conditions.

As a result, local governments have called on insurers to offer a new product. Residents who have statutory health insurance in Shanghai, for example, can now also take out private insurance – regardless of age or health status. They pay the equivalent of around EUR 18 for the calendar year to cover costs of up to EUR 43,000. More than 7.4 million people have taken out a policy. There are more than 200 similar government-driven products throughout the country, with a total of more than 101 million insured individuals. Given the attractive pricing strategy and the unattractive profile of the insured persons, this business model can hardly be sustainable for insurers. But this is “common prosperity” done the Chinese way – the insurers involved make very little profit but are committed to fulfilling their social responsibility.

COMMON PROSPERITY FOR GENERATIONS

Common prosperity also applies to intergenerational aid. Some banks, for instance, have relaxed the maximum age limit for people taking out mortgages from 60 to 70 years when parents apply for a mortgage together with their children. In addition, young people who are currently unemployed usually live off the pensions of their parents or grandparents. In turn, the young people assist their elders with health insurance, since they are healthier on average and often do not use up the credit in their accounts. This is why the elderly are now allowed to use the credit of younger immediate family members – at least in Beijing and Shanghai.

Of course, the government is also attempting to alter the contribution structure. For example, the required contribution period before being able to take advantage of statutory health insurance during retirement is currently being increased incrementally. There is also scope for improvement to increase the retirement age. But there is still a lot to do because one thing is certain: there is no halting demographic change. Even if it is entirely possible that more babies will be born again in the future due to better support measures, slowing down the rate at which the population is ageing remains a “mission impossible”. ◆

Analyst Shenwei Li reports from China.

A PORTFOLIO COMPOSITION

IS THE RESULT OF SELECTION

Interest rates are back.
Are bonds now more attractive than equities?
We provide an analysis.



by Bert Flossbach

Smart savers can rejoice. After many years of zero and negative interest rates, bonds are once again (or so it appears, at least) providing appealing yields. Of course, the question arises as to whether bonds are still a lucrative investment in the long term.

Answering this requires us to delve a little deeper. Whether the nominal yields of long-maturity bonds are already high enough to be seriously considered as long-term investments depends on the inflation expectations for that period. In the current situation, inflation would have to quickly approach the two per cent target for this to happen. If this does not occur, 10-year German government bonds (Bunds) yielding only 2.6 per cent would lead to a real loss of capital.

And even if central banks get inflation under control (which is in doubt, as you will read on page 8), long-maturity bond yields are still too low to make significant price gains possible. In our opinion, the potential risk-return ratio is therefore still not good enough to make top-rated long-maturity euro bonds attractive.

As we know, yields increase when you move down the credit rating ladder. For example, a long-dated corporate bond from a German conglomerate (rating: A+) yielded 3.5 per cent in July, which is quite a bit higher than a German Bund.

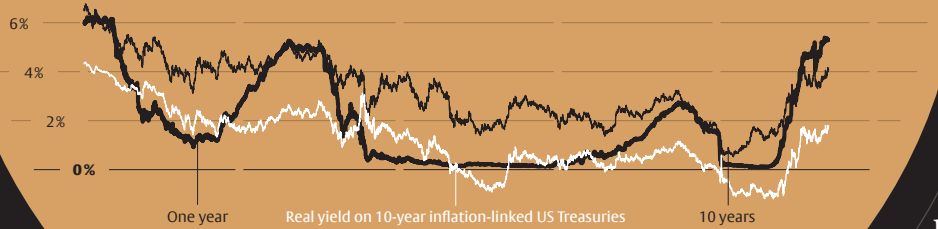
At one notch lower (rating: BBB), a bond of a German semiconductor manufacturer yielded 4.0 per cent. If this is still too low, investments can be made in highly liquid Italian government bonds, which provide a yield of 4.4 per cent with a term of 15 years. That should be enough to exceed even a stubbornly high rate of inflation. The large yield spread over German Bunds reflects the – albeit low – risk of an Italian state bankruptcy, which is, however, likely more theoretical →

Source: Bloomberg, Flossbach von Storch, data as at 11 August 2023

Figure 1
German Bunds: (Nominal) Interest rates are back
Yield on German government securities
Real yield on 10-year inflation-linked German Bunds



Figure 2
US Treasuries: (Real) interest rates are back
Yield on US government securities.



Past performance is not a reliable indicator of future performance.

However, the general emerging enthusiasm for bonds seems premature to us. The yields on top quality long-maturity bonds still do not offer sufficient protection against inflation risk, at least in the eurozone.

in nature, as it would mean the end of the euro and a meltdown of the financial system. Neither the European Central Bank (ECB) nor eurozone countries can allow this to happen, as it would implicitly turn Italy's debt into eurozone debt.

However, the general emerging enthusiasm for bonds seems premature to us. The yields on top quality long-maturity bonds still do not offer sufficient protection against inflation risk, at least in the eurozone. Short-maturity euro bonds with yields of 3.6 per cent are, however, already suitable as a (nominally) risk-free parking position for liquidity. The 5.4 per cent yield (in USD) offered by one-year US Treasuries is greater than the expected rate of US inflation for the next 12 months.

EQUITIES REMAIN THE FIRST CHOICE

In the past, however, equities were expected to provide the highest returns together with inflation protection (at least for long-term investors) (see Figure 3 on the next page). The significantly higher return on equities is rightly also referred to as the risk premium and can be considered a form of compensation for enduring the price fluctuations on the stock market.

It can, however, only be measured "ex post" based on the returns achieved in a certain period. If we look at the 20-year periods since 1960 for the US market (in each case from the beginning of the calendar year), the risk premium, i.e. the return premium of shares compared to bonds with the highest credit rating, was four per cent on average.

The worst period for equities was 1989 to 2008 (ending with the financial crisis), with a modest risk premium of 0.7 per cent. The best period was from 1980 to 1999, with 8.1 per cent. However, there are phases of several years in

which shares not only performed much worse than bonds, but also suffered high price losses that tore at investors' nerves. For example, those who invested in equities at the turn of the Millennium lost almost half of their investment in the following three years. In the same period, government bonds achieved a plus of 30 per cent (interest and price gains). Of the hoped-for risk premium, there was initially only the risk.

What seems like compelling logic with a glance at the charts in retrospect is anything but certain in the darkness of the stock-market night. But even the darkest nights come to an end, only no one knows when. Since the turn of the Millennium, the S&P 500 has lost half its value twice and lost a good third another time. Anyone who has gone through such periods as an investor knows the pain and psychological pitfalls that result. Not infrequently, all good intentions were thrown overboard at the wrong time and the risk premium ready for harvesting was given away before it became a return premium.

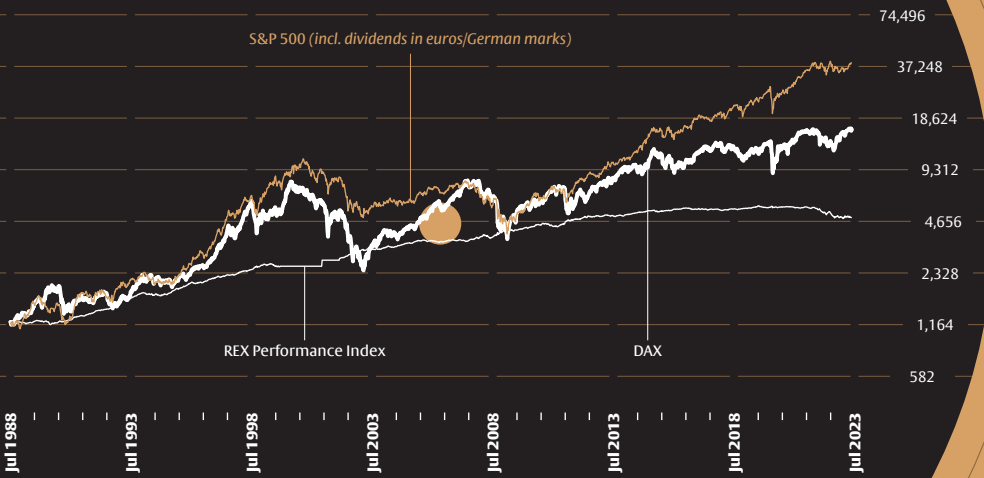
An investment strategy that fits the investor's risk tolerance provides the best protection against psychological pitfalls. But this is not easy to determine, however, and it is therefore not uncommon for an early period of losses to induce investors to abandon their long-term strategy. Jeremy Grantham, a well-known British fund manager, expressed this in a nutshell: *"Most people don't make it for the long term if they lose too much in the short term."*

The size of the equity allocation is the most important parameter for adjusting the level of risk. Risk can, however, also be reduced within the equity portfolio. One way to accomplish this is balanced diversification that limits the effects of individual assessment errors. As we know, this is because it is sufficient to be right about the majority of investments. Another way is to focus on quality, even though this also has a subjective component, such as the assessment of a company's earnings prospects and management. →

Source: Bloomberg, Flossbach von Storch, data as at 11 August 2023

Figure 3
35 years of the DAX

Performance of different indices since 1 July 1988
(all indexed to 1 July 1988 = 1,164, log. scaling)



Past performance is not a reliable indicator of future performance.

We use a combination of high earnings reliability, good growth prospects and high financial strength to define the quality of a company. Although this does not provide protection against temporary price fluctuations, it does substantially reduce the actual risk, namely the probability of sustained losses.

It is not sufficient, however, to focus solely on quality, thereby disregarding the value or valuation of such investments. This applies to all forms of investing, whether real estate, bonds, or equities. Quality has its price, but there are limits.

The low level of interest rates in previous years caused valuations to rise. Real estate and equities investors have felt this effect over the years. The tide began to turn around a year ago and interest rates have increased considerably since that time.

Share prices naturally react more quickly to such changes than real-estate prices and have already partially processed the increase in interest rates to date. The shares of quality companies, on the other hand, still have quite generous valuations. As long as prices are still pricing in too much of a good thing, they could fall even if the companies are as prosperous as possible, but still fail to satisfy excessive expectations. The overvaluation will be resolved over time, however, if the company can further increase its earnings due to its high quality, but the share price remains the same. In the long term, the risk of suffering sustained losses due to paying too much for quality is lower than if the supposedly cheaper shares of bad companies are bought.

Now, determining the “fair” value of a share ex ante is unfortunately not as easy as it appears to be ex post when looking at the charts. The point at which a share is considered too expensive is a matter of opinion and depends on the earnings prospects you attribute to the company, the risk premium you require and the level of interest rates.

In addition, a supposedly “expensive” share can also become significantly more expensive. At the end of 1997, for example, Microsoft’s valuation was 38 times its last net earnings. That appeared exorbitantly high at the time. Its valuation nevertheless doubled in the next 24 months and its price more than tripled.

- Even if you pay a high price for a quality company, the investment can pay off in the long term. But it requires a great deal of patience.
- If the valuation is absurdly high, on the other hand, even the greatest patience is not enough to lead to a happy ending.
- A company’s quality can change over time, especially in the technology sector. Many a company that is very successful today was once considered a “lame duck”.

Quality has its price, also on the stock market. Experience teaches us that in the long run it is still worthwhile investing in such shares. If you accept too high a valuation, however, it requires a great deal of patience before the investment can pay off. However, high valuations also mean a small margin of safety, or a large drop if the company does not perform as well as expected.

The recent euphoria about artificial intelligence (AI) has led to large price gains for some equities. How much additional business potential AI will actually provide and who will benefit the most still remains to be seen.

We are long-term investors, not speculators. Focusing on quality reduces the risk of sustained losses. Quality, however, is not an end in itself and must be purchased at an appropriate price in order to contribute to capital appreciation in the form of price gains and dividend distributions.



A look at the valuation level for the global equities market shows that the current valuation at a PE ratio of 17 (based on the MSCI World Index; see Figure 4) roughly corresponds to the long-term average.

However, one also has to take into account that some heavyweights with high valuations in the index (e.g. Apple, Microsoft, Nvidia) are pulling up the average. Although this is not a new phenomenon, the large price gains achieved by some heavyweights are particularly large today.

In any case, whether the market as a whole is expensive or cheap only plays a role if you are holding or want to buy the market as a whole. If you purchase individual stocks, on the other hand, looking at the market as a whole only provides a general indication. What matters is the relationship between a company's quality and its valuation.

We learnt this lesson during the start-up phase of our company, which took place in the middle of the technology bubble at the turn of the Millennium. The fear of missing out on something really big and the imperative to be among those participating tempted us (or more precisely, the author of this article) to define the path of virtue somewhat more flexibly and give the new world of unlimited possibilities its due place in the portfolio.

Or, in a nutshell: we bought high-valued technology stocks. After achieving very pleasing price gains in the first 18 months, disillusionment set in. In just a few months, the amazing gains were gone, and a slow, painful period of losses began.

This period had a very lasting effect on us. It was also the time our asset pentagram (The Flossbach von Storch - Pentagram) was born, which presents the guidelines of our investment philosophy.

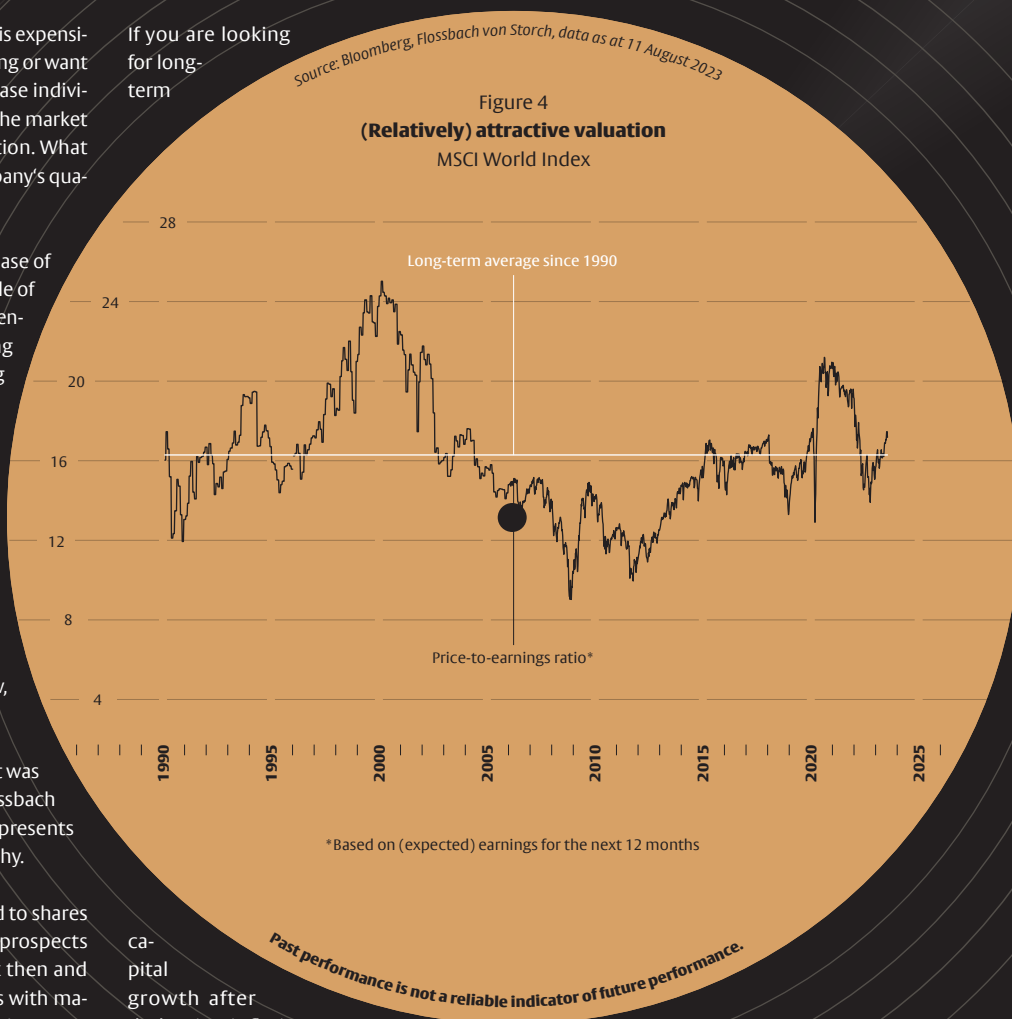
In the years that followed, the focus turned to shares of robust companies with good earnings prospects and reasonable valuations. The goal back then and still today is to generate attractive returns with manageable risk, thereby making it easier for investors who are sceptical about equities to also get started and persevere.

The first test came during the financial crisis. Our focus on companies with resilient earnings and avoidance of bank shares limited the extent of the price losses and increased investor confidence, thereby also improving confidence that better times were coming again.

Share-price setbacks were also considerably smaller than the market as a whole during the weak stock-market phases that followed. It should be noted that this period includes three of the four deepest market plunges during the post-war period.

The investment environment looks better again today for investors holding mixed portfolios who last year suffered price losses of a similar magnitude as pure equity investors due to the crash in bonds. After all, their cash holdings are generating good interest again, and there is even a four in front of the decimal point for solid corporate bonds with short residual terms. Although this is not enough to protect a portfolio, i.e. compensate for a sharp share-price correction on the stock market, it can at least limit the effects on its asset value.

If you are looking for long-term

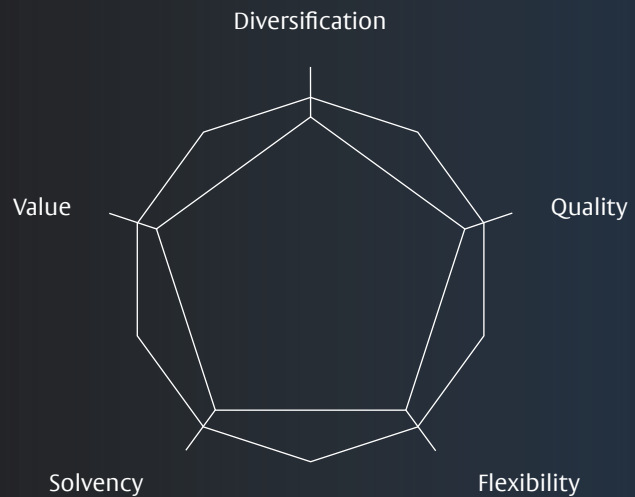


capital growth after deducting inflation, you will not be able to avoid equities. In our opinion, holding a combination of risk-free German government treasury notes, short-maturity corporate bonds with good credit ratings, shares of companies with strong earnings and gold is currently the best strategy for investors who cannot or do not want to bear the fluctuations of a pure equity portfolio.

It is important that the size of the equity allocation does not exceed the investor's risk tolerance. However, company quality and an appropriate valuation are also important for confidence in the long-term strategy and to provide the best protection against pro-cyclical behaviour.

A QUESTION OF PRICE

FLOSSBACH VON STORCH - PENTAGRAM



Diversification – Investors who wish to preserve and grow their wealth over the long term have no choice but to diversify their portfolio across asset classes, securities, and currencies. In this way, investment risk is reduced.

Quality – The intrinsic value of an investment depends on its quality. Consequently, the attractiveness of the future potential of each investment must be thoroughly examined.

Flexibility – Flexibility provides the necessary room for manoeuvre to adapt the portfolio to different market movements and to take advantage of investment opportunities that may arise.

Solvency – The creditworthiness of the issuer of the investment instrument is another fundamental factor and, as such, must be part of the prior analysis of each investment. For this reason, in addition to obtaining credit ratings from external agencies, it is important to develop an in-house credit analysis of each company.

Value – Value is also crucial. Warren Buffett once said: “Price is what you pay, value is what you get.”. Shares of quality companies justify a higher valuation than those of average companies.

by Stephan Fritz

ABOUT

ROLLER



The fairground and the stock market
have more in common than you might think.
Let's explore why.



COASTERS



People long for certainties,
even if they do not
actually exist. This is perfectly
understandable, or in short:
it is human.

If, like me, you have children, at some point during the year you will find yourself at a fairground. Or in a theme park. With all the attractions that they offer: a swing carousel, a rollercoaster, a fortune-teller's stand or perhaps a ghost train.

One thing that you absolutely cannot do without on a day out like this is to have a plan. This is especially true for larger parks and fairgrounds. Where can I find the best rides? Which way should I go to fit in as much as possible while the park is open (depending on the mood and state of the children!)? Where can I take a break – and get a hotdog with chips? Where is the ice cream?

It's even better if you have a knowledgeable companion with you; someone who can advise you because they have been there plenty of times before and know the rides, but also what you all like. They can give you valuable tips about which rollercoasters are suitable for the children, and which might be too much for their stomachs.

FINDING THE RIGHT SOLUTION

They might be able to tell you whether the fortune teller is any good and what the odds are of winning at the lucky raffle stand (bad or really bad?!). In short, they can help you figure out what is right for you.

It is no different when it comes to investing money. Many people are inexperienced and therefore unsure about it, for lots of very different, sometimes very personal reasons. Some people simply feel overwhelmed. They need someone to support them and help them find the right solution for their personal investment goals and – not least – their own well-being.

And that's where the "park companions" come in. The many advisers available in banks and savings banks, as well as independent intermediaries and asset managers. They help their clients define investment objectives and choose the right

instruments to achieve them. To stick with the fairground analogy, they help people find the right rides because they know their characteristics and the opportunities and risks extremely well.

Let's take a walk (in our imagination) through the fairground and make two stops, first at the colourful fortune-teller's stand. It is usually near the entrance or somewhere between two larger rides. It's not a big attraction, but it is very popular – who doesn't want to know what the future holds? Step up and see!

Fortune-telling is widespread in the financial sector. Only there it's called a forecast. Let's take the annual forecasts as an example. It doesn't take long for predictions to start appearing about what the future will bring – how 2024 will pan out on the stock markets ...

In the financial sections of the newspapers, the pages are cleared to make way for large tables with numerous forecasts from a wide variety of forecasters, neatly shown, column by column, each with their different predictions on various investments: DAX, Dow, euro/US dollar, interest rates, the price of oil. If nothing spectacular is happening at the time, the preview is even good enough for a lead story in a newspaper or magazine. It sells well at the newspaper stand.

NO ONE CAN KNOW

There is great confidence in the financial industry's forecasts, unfortunately. Because those who make the forecasts, at least in the view of the interested reader, spend their entire day on nothing other than the factors which determine the forecast. That's true, of course, but nobody can say today what tomorrow will bring.

Innumerable factors have an impact on the various markets, including uncertainties and catastrophes. A forecast over

such a short period of time, which is precisely what six or 12 months is, is simply impossible.

Let me give you a brief example: at the end of 2022, my colleague Thomas Lehr, one of our two capital market strategists, read the annual forecasts of 107 asset managers, a total of 1,507 pages, in order to provide an overview for himself and us – what are the expectations and the associated opportunities and risks on the capital markets?

At the time, the vast majority of the forecast authors assumed that the first half of the year would not be a very good one for shareholders, but rather a very bad one. And, given the risk factors that still existed (inflation, the fight against inflation, recession, war), that sounded all too plausible to the interested reader; we too have been cautious. A recovery was to be expected only in the second half of the year, with "buying prices", according to the (vast majority of the) reports. Things turned out differently, as we all know ...

RECOGNISING THE STOCK-MARKET NOISE

Incidentally, the forecasters also know that their predictions have limited significance (I'm honestly not so sure about fortune tellers though ...). They try their best anyway because they are paid to do so, just like the fortune teller.

Ultimately, the forecasters assume that the public expects exactly that from them – forecasts. Bring light into the darkness of the uncertainties, even if it is still faint. This helps to overcome fears. People long for certainties, even if they do not actually exist. This is perfectly understandable, or in short: it is human.

However, a good companion will not tire of reminding you of the limited significance of the forecast circus. They will tell you that all the predictions are essentially just the crooked sounds of the daily stock-market noise. →

Forecasts can sometimes be amusing but should never be binding or influence your investment decisions. Just like the visions of the future that appear to the fortune teller in their cards.

A good companion will tell you not to be afraid when one of the notorious prophets of doom sees the next big crash on the horizon; in the same way, no one needs to rush to prepare their will when the fortune-teller's cards evoke death and illness. It's the same principle. So don't let yourself be driven mad!

Let's continue to the big rollercoaster. It's right next to the fortune-teller's stand in our imaginary fairground.

It climbs steeply up – and rushes back down again just as steeply. Not for the faint-hearted. Sometimes it is no different on the stock market. Prices fluctuate, sometimes significantly. Not just equities, but also bonds – the last 18 months have clearly demonstrated this. The question is: how much of this, how many of these fluctuations, the ups and downs, can you personally tolerate? What kind of person are you? Please be honest with yourself.

DON'T PLAY THE HERO

Don't try to play the hero. This is just as true at the fairground as it is in investing. It's about finding a way that works for you – an investment strategy and associated products that will help you sleep soundly at night.

Ultimately, price fluctuations are not a risk per se and are completely normal. That is the good news. The less good news is: not everyone can tolerate these fluctuations, at least not the big ones.

I've been working in the financial sector for some 25 years now and have experienced several stock-market crises, both

small and large. One thing I can tell you with some certainty is that if the major equity indices slide by 30, 40 or even 50 per cent, very few people keep their cool. I've seen seasoned investors, entrepreneurs, with decades of experience – “stock-market veterans” – panic and sell their shares near the lowest point of a crisis, in other words at the worst possible time, simply because they could not tolerate it anymore. Because, in the truest sense of the word, it caused them pain. They were no longer able to sleep at night.

The further equity prices fall, the more investors fear that they will fall further still. And further. And further. At some point, panic sets in – and most of them give up.

I'm often asked about the best way to invest: directly into equities or bonds? Via actively managed funds? Or better via an exchange-traded fund, an ETF.

My answer is always the same: it depends. If you enjoy analysing companies and their business models, are extremely familiar with them and, most importantly, have the time to do this, then individual securities are the right approach for you – kudos! But I suspect that very few can do this properly. I would not trust myself to do this at any rate.

SLEEP PEACEFULLY

With ETFs, however, the effort required is minimal. Investors invest in many different companies via an index. They don't have to worry about which ones to select. ETFs are a very good tool, and a cheap one at that, for investing money relatively “broadly”. Now comes the “but”: they are not suitable for everyone because they require investors to have a high tolerance for volatility.

An index tracks specific markets, both in good and bad times. That means even if the stock market – as described above – threatens to slide to the bottom and panic sets in.

If the stock market crashes by 30 per cent, then the ETF that tracks it also crashes by 30 per cent. And the probability that investors will pull the ripcord – nowadays, just one or two clicks of the mouse at the online broker – grows with every further point that the index loses. That is something we must be able to endure. If you are able stay cool, really cool, and have a long-term investment horizon, ETFs are the right instrument for you.

The less “cool” ones, myself included, had better look at actively managed funds, the good actively managed ones. Although they are more expensive than ETFs, and do not necessarily perform better in the long term, they spare the nerves at times when good nerves are required because – unlike ETFs – they don’t just throw all the companies into a basket, but rather try to choose the good business models and avoid the less good ones, the more vulnerable ones. And if there is a crash, it usually isn’t so bad. I’ve had very good experiences with these funds. I sleep well at night. For me personally, a good multi-asset fund is like a good fairground companion: they choose the rides that suit me.

One thing is clear, however. Share-price fluctuations are just as much a part of the stock market as the ups and downs are part of the roller coaster. In the long run, they are the price you pay for the return you (want to) achieve. You just need to figure out how much of it you can take. A good adviser will help you with this. Above all, they will try to prevent you from doing things that aren’t right for you.

You don’t have to get on every rollercoaster. ◆

Stephan Fritz is Multi Asset Portfolio Director at Flossbach von Storch AG.

How much of this, how many of these fluctuations, the ups and downs, can you personally tolerate? What kind of person are you? Please be honest with yourself.

*“The Dividend
Follows the Quality
of a Company*

*the Other Way Around”
... and Not*



In this interview, Ludwig Palm explains how investors generate decent returns over the long term with high-quality equities and their dividends – and why he discussed student accommodation with Charles T. Munger.

The dividend was considered to be the new interest rate not so long ago. Since then, interest rates have risen significantly. Is the dividend euphoria over already?

I have to admit I've never liked this comparison. The dividend is not interest – it never has been and never will be. So in that respect, this question is irrelevant.

Many financial service providers have advertised with this slogan in recent years ...

I can only speak for Flossbach von Storch – and we have not done that. Because, unlike interest rates, dividends are not fixed. They can be reduced or even cancelled, depending on how successful a company is. Just because the phrase sounds pithy, doesn't make it any good!

Nevertheless, the question remains whether the rise in interest rates is causing dividend strategies to become less popular.

No, why should it? Investors will still need good equities in the future in order to maintain the purchasing power of their assets in the long term. The dividend is an important component of income, though not the only one.

What do you mean by that?

When you buy an equity, you should never look first and certainly not only at the amount of the dividend, the dividend yield.

What do you look at instead?

At the quality of the company in question. We are looking for first-class companies worldwide. For robust business models that can survive even major crises relatively unscathed. Our investors should be able to sleep well with the companies that we invest in for them. They should generate decent long-term returns – with reasonable risk.

How do you determine the quality of the company – from the balance sheet figures?

Yes, but not just that. Of course, the company should have a clean balance sheet. However, it is just as important, if not more so, to look at how robust and sustainable the business model is. Is there a – what's the word – an economic moat that protects the business model from competitors? And on a related note: how predictable are future earnings? It is also very important for us to look at the people in charge: how reliable is the management team? The better we understand the companies, the better we can avoid potential risks, even if there are no guarantees, of course.



Define risk.

The biggest risk for an investor is to permanently lose money with their investment. Or to put it another way: volatility, i.e. price fluctuations, is not a risk per se. Even the prices of very good companies can fluctuate significantly sometimes. Investors who invest in equities or equity funds therefore need a decent tolerance for volatility. However, the likelihood that these high-quality equities will quickly make up any price losses is much greater than for less good companies.

How are company quality and dividends connected?

A company will only be able to consistently pay out dividends when the quality is right, ideally increasing them over time. The dividend follows the quality of a company and not the other way around.

You manage a dividend fund and yet you don't care about the dividend yield?

I didn't say that. For us, the dividend yield is one of many criteria, no more and no less. This may distinguish our investment approach from others. The appeal for investors, at least we hope, lies in the combination: the quality of the companies on the one hand – this hopefully enables investors to sleep soundly. And regular distributions on the other hand – this hopefully enables them to eat well and stay in the picture.

What are the other criteria in relation to the dividend?

Firstly, dividend security, i.e. the ability of a company to pay dividends at all. Or better: the company's ability to pay consistently. That sounds so trivial, but it is not.

Can you please explain this?

The cash flow must be substantial enough to invest in research and development, develop the business model and distribute dividends. To put it another way: there's no point in keeping shareholders happy with high distributions if it means eating up the future of the company because there is no money left for investments.

And what else is important to you?

The potential for increasing the dividend. Both aspects – dividend security and potential for growth – depend in particular on the quality of a company, the stability of the business model.

This means that there are also equities in the portfolio with a dividend yield of – let's say – two per cent or less?

Yes. And, in exceptional cases, we even invest in companies that do not yet pay dividends, but we believe they will do so in the future – because they are capable of it.

“The likelihood that these high-quality equities will quickly make up any price losses is much greater than for less good companies.”

“There’s no point in keeping shareholders happy with high distributions if it means eating up the future of the company.”

Some investors may say: for a dividend fund, that is an insufficient dividend for me ...

What use is a one-off dividend yield of eight per cent to a long-term investor if the dividend is then not paid in the following year – or the years after that? We much prefer companies that grow into reliable dividend payers or have become reliable dividend payers since we added them to the portfolio. In this respect, I can assure you: there are also equities in the fund whose dividend yield is greater than two per cent.

Besides the quality of the companies, what characterises a dividend strategy in general?

You have to give it time, think long term. Be patient. That sounds much easier than it actually is.

Are you patient?

I practise it every day. And I would say: it helps! If you are confident about the quality of your investments, then you should stick with them and not jump ship every time there is a wobble. At Flossbach von Storch, this is easier for us as an asset manager because we don’t have to slavishly follow or be measured by a reference index.

Many years ago, Warren Buffett’s advice was to buy cheap and never sell.

And as is so often the case, there was a lot of truth and wisdom in that advice. It reduces complexity. I like it a lot!

Last year, for the last time, there was the opportunity to bid for a dinner with him – the winner paid a record-breaking USD 19 million for the privilege. Did you bid?

No, that opportunity is definitely reserved for others. But it is wonderful that so much money was raised for a good cause*.

Not a little jealous?

Perhaps a little, but I can handle it because a few years ago I had the great pleasure of meeting his friend and business partner, Charlie Munger, in person. What’s more, this was at his home, for dinner, in Los Angeles ...

How did that come about?

I regularly attend the Berkshire Hathaway annual general meeting. On this occasion, I met Charlie’s daughter-in-law at some point. She made the contact. I first communicated with Charlie himself by email. At some point, the invitation came. I could hardly believe it at first. Go to Charlie Munger’s home?!



How did it go?

It was very straightforward. When I got there, Charlie was just working on designs for student halls of residence. He wondered whether, for space reasons, it would not be better to do without windows in the bedrooms in order to have more space for larger common rooms instead. For example, Charlie planned to have an LED lamp with a ventilation system instead of a window in the student rooms. This then led to a lively discussion about how important windows are for our well-being.

Did he also give you investment advice?

No, and I didn't ask for it either. We talked about investing in general, the attitude that makes a good investor. About good books, outstanding individuals – their lives. About the world and its challenges.

Was there even time for dinner?

That was secondary. We spent many hours in Charlie's library. That's probably where he spends most of his time by far. The thirst for knowledge seems to be his elixir of life. There was also a glass of Maotai (Editor's note: Chinese Schnapps) for good measure!

How would you describe him as a person?

He's very humble, incredibly clever, friendly, humorous and above all thirsty for knowledge.

What impressed you the most about him?

His curiosity. "The school of life", he says, is not limited by semesters. And it is not restricted to individual disciplines.

Thank you for the interview.

* The proceeds of the auction will benefit homeless people in San Francisco

Ludwig Palm is a Fund Manager at Flossbach von Storch AG.

The Plumbers of Bemidji

To be a successful investor, you need not just knowledge, but above all discipline. →
Some thoughts by Charles T. Munger.



by Charles T. Munger

If you want to be the best tennis player in the world, you might try it for a while – and find that it is hopeless. That others are better because they have more talent.

But if you want to be the best plumber in Bemidji*, that is probably feasible for two-thirds of you. You will need ambition and intelligence, but above all discipline. After a while, you will have learnt and mastered everything you need to know about the plumbing trade.

The point I'm trying to make is that even if you will never win a major tennis tournament, you can achieve a lot by acquiring skills, expanding your knowledge and in this way gaining a competitive advantage.

The school of life is about becoming a good plumber in Bemidji, while very few people have what it takes to win a Grand Slam tournament.

ABOVE ALL, YOU NEED DISCIPLINE

It's very similar in the world of investing. I don't want to deal with emerging market investments or complicated arbitrage transactions. What interests me is choosing shares in ordinary companies. And believe me, that's difficult enough.

What is the nature of the stock market? Many years after I graduated from university, the theory of the efficient market really took hold. According to this theory, nobody can be better than the market. The textbooks have been full of it ever since.

What is much more interesting, however, is that one of the world's most renowned economists is a significant shareholder in Berkshire Hathaway. While he taught students that the stock market was completely efficient, his own money flowed to Berkshire – and he became rich.

Is the stock market really so efficient that no one can beat it? Yes and no. The market is partly efficient and partly inefficient. It takes intelligence and, above all, discipline to be able to beat it over a long period of time. By definition, not everyone can. The iron rule of life is that only 20 per cent of people can be among the top five. That's how it is.

I consider those who have pushed the theory of the efficient market to the extreme to be "spinners". The theory is for people with great mathematical talent – because you can do beautiful maths with it. The problem, however, is that the basic assumptions don't entirely match reality. But for a man with a hammer, every problem looks like a nail ...

* Bemidji is a city and the county seat of Beltrami County in the north of the US state of Minnesota. It has around 15,000 residents.

BET LESS OFTEN

When I was young, I played poker with a man who made his living exclusively by betting on harness races. The harness racing track is a relatively inefficient market. There is not as much “intelligence” gathered there as in normal racing.

For my poker buddy, the bets were his main income. He did not bet very often, but after deducting any ancillary costs, he earned a considerable fortune for his efforts. Admittedly, his example is the exception rather than the rule. But if the market is not fully efficient, then there will always be people who, with acumen and dedication, achieve far better results than others.

It is the same in the stock market. Those who limit their costs because they wait for the right opportunities and therefore are not too active increase their chances of performing above average. That takes discipline!

In short, what connects successful “horse bettors” and equity investors is that they “bet” very rarely. ♦

ABOUT THE AUTHOR



Charles Thomas Munger

(born 1 January 1924) is an American investor, businessman and philanthropist. He is Vice Chair of Berkshire Hathaway and a close friend of Warren Buffett.

Like Buffett, Munger was born in Omaha, Nebraska. After studying at the University of Michigan, he became a meteorologist with the US Army during World War II. He graduated from Harvard Law School in 1948. Eleven years later, he met Warren Buffett at a dinner party. As successful value investors, they are seen as role models by many investors around the world. This article is a small excerpt from a speech given by “Charlie” at USC Business School, which he has authorised us to use.



B E W A R E

O F T H E P I T F A L L S

Bonds are currently celebrating a comeback.
But a return to former investment habits
would be a big mistake.

by Sven Langenhan

Sometimes you could be forgiven for thinking that we Germans actually love a problem. How else could you explain why we are all constantly talking about them? The same applies to many areas of life, and especially to comments on the interest-rate markets.

There actually was a whole host of problems lurking in this area though: firstly, interest rates had been virtually non-existent in the eurozone for several years dating back to 2015. Although market experts were of the opinion that a situation of this kind could not have endured over the long term, at some point even interest rates for our beloved bank deposits fell into the negative range.

To varying degrees, we began to reconcile ourselves to this situation. During the Coronavirus pandemic, this narrative even extended as far as the belief that “Interest rates will never again rise to significant levels”, but then came an abrupt turnaround: inflation initially crept back up quietly and unnoticed, but then it hit the economy with full force. This resulted in interest rates being driven back up to levels that we never expected to see again.

WHAT'S GOOD FOR SAVERS IS BAD FOR BORROWERS

The complete turnaround of a previously problematic situation (for savers) is exactly what is now causing another problem: loans are now more expensive, and for many people this fact is crushing the dream of owning their own home. In some sectors of the economy the situation is even starting to become what could be termed difficult at best. Several banks are really beginning to feel the strain, as we saw back in the spring of this year, first in the USA and then in Zurich's Paradeplatz (the financial centre of Switzerland). Some equity valuations, such as those for highly financed high-growth companies, are now feeling the squeeze due to the return of higher interest rates.

So, we have problem layered upon problem – and we could, of course, continue to wallow in the issues here. But we are pragmatists, and pragmatists do not simply dwell on detailed descriptions of problems; first and foremost, they look for solutions. That said, in our view a certain amount

of scepticism is called for when it comes to solutions that appear too good to be true and offer quick results.

Back in the days of the initial interest-rate problem, when returns were non-existent or even in the negative range, the simplest solution would probably have been to just stop buying bonds. Put everything into equities! But hand on heart, how many private investors have done this in earnest? Bonds somehow remained part of portfolios, preferably more so in the form of the beloved coupon and the familiar buy-and-hold approach. Force of habit does not always generate the best solutions though, especially in extraordinary times.

For many traditional “coupon cutters” who wanted to remain loyal to their bonds (come what may) until the end of their term, the simplest solution at the time appeared to be either to make more and more compromises in terms of the quality of the borrower or to choose ever-longer terms. That led to some extremes. Almost immediately before the interest-rate turnaround when global interest rates were at their absolute lowest, ultra-long terms were in demand. Austria issued a 100-year bond during this period. Although this would perhaps have pleased the finance minister, who was able to secure EUR 4.6 billion for the Alpine republic at favourable terms, it made some investors significantly poorer (see graph). A look at price development also shows that even at the time of issue the risk already far exceeded the potential benefits (if we can even call it a benefit with a coupon of 0.85 per cent). And with a maturity date of 30 June 2120, “waiting out losses” is unlikely to be a viable strategy, at least in terms of average life expectancy.

Granted, the 100-year Austrian government bond is a dramatic example. However, it shows how quickly supposedly simple solutions can create another problem. Or as the Spanish economist Ignacio Ellacuria put it: “It's better to have problems than to have a bad solution.”.

MAKE THE BEST OF UNSOLVABLE PROBLEMS

Perhaps it sometimes makes sense to just accept problems for what they are. And the solution is to try to make the best of the impact created by the problems. Over the years we →



Significant price declines for long-dated bonds

Price development of a 100-year Austrian government bond since 1 July 2020

Past performance is not a reliable indicator of future performance.

Source: Bloomberg, Flossbach von Storch, data as at 11 August 2023

have repeatedly shared our opinion that investors in the bond market should consistently adopt a buy-and-hold strategy.

We have renamed the asset class known as “Fixed Income” and it is now known as “Active Income”. This reflects the fact that only by adopting a global, flexible and highly active investment strategy that made use of all the available yield components was it possible even during the zero-interest period to continue reaping the benefits of bond investments. Back when it still was all about getting everything possible out of a market that appeared to have nothing to offer. We’re not talking about committing hara-kiri here, but rather about carrying out a clean risk-benefit analysis with a business head on.

HAS THE INTEREST-RATE TURNAROUND SOLVED ALL THE PROBLEMS?

As interesting and educational as retrospectives may be, investment decisions must always be made with an eye on the future. If we look ahead, we can see that the huge rise in interest rates last year has brought something positive alongside all the pain. “Penalty interest” on bank deposits is a thing of the past; to varying degrees, institutions are beginning once again to offer adequate interest on instant access and fixed-term deposits. Thanks to their yield levels, bonds once again appeal to many as a sensible investment alternative to highly mixed portfolios. Especially given that the diversification effect of bonds can be restored by the return to high interest rates. But many investors may be attracted by the prospect that with selected bonds (and depending on their own expectations of inflation) a slightly positive return would once again be possible in real terms even using the buy-and-hold approach.

We urge caution here, though. As already mentioned, solutions that seem too good to be true could turn out not to be a solution at all. Truly adequate returns, which with this approach have the potential to outsmart expected inflation in the long term, currently only exist against correspondingly high credit risks and not in the long term.

The yield curves are currently clearly inverse. In other words: the longer the term (and thus the possibility of securing the

interest level over the long term), the lower the achievable yield, despite the simultaneously higher duration risks and thus price risks. And will all investors ultimately be able to tolerate the resulting price fluctuations? This is doubtful, especially in view of the continuing considerable political and macroeconomic risks and the fact that central banks continue to operate a data-driven approach.

Forecasting specific market trends (at best using specific price information for specific reference dates) has always been difficult and will remain so. This is the reason why at Flossbach von Storch we exercise caution in this area. However, in the current environment we do not think it overly foolhardy to forecast that we should expect or be prepared for considerable market fluctuations.

Capital investment should always be about staying in the game at all times. This means being as prepared as possible for everything and for every scenario. Even though there is currently much to suggest that central banks are slowly getting inflation under control once more and steering things towards an end to the current cycle of increases (at least temporarily), inflation could still outsmart us again. Reference need only be made here to persistent core inflation and the oft-cited base effects, which do not just have a downwards effect – as we saw in the first half of the year. The central banks may in such a scenario be forced to increase the base rate, which could push up yield levels a little more.

A buy-and-hold strategy would then put investors at the mercy of the negative market environment; on the one hand through corresponding price losses on the acquired securities and on the other hand probably also through the subsequent manifestation of negative real returns.

Looking at the current economic data, there are more and more signs of a slowdown. Nevertheless, the economy as a whole still seems relatively robust, and the oft-cited (or perhaps just longed for) soft landing could actually succeed for the first time in a crisis situation of this nature. At least in view of the currently low credit spreads for corporate bonds, this scenario is likely to reflect the market consensus in any case. But what if things were to turn out differently? No matter what way you look at it, current assessments do

not leave much room for misjudgements about the future economic outlook. In our opinion, the apparently unwavering confidence in the central banks taking any risk out of the market in the event of uncertainty as in previous years appears somewhat too optimistic. There could be a risk of a rude awakening if simple solutions are sought, and people make too strong a grab for what in our view are at best currently modest risk-reward ratios with a significant corporate bond portion (especially in the high-yield area of less solvent issuers).

“ACTIVE INCOME” REMAINS THE ORDER OF THE DAY

To be clear, for many clients there has always been a place for bonds in mixed portfolios, even in a climate of low and negative interest rates. They have now become much more attractive. In addition to the current interest yield, which once again provides a solid basis and thus a buffer for any interest-rate increases or changes in the credit spread, the bond markets are currently also offering significantly better opportunities to achieve added value as an active manager.

One thing that appears to us to be a huge plus on the assets side is the mere fact that in market phases that are, let's say, “unclear” with few convincing opportunities in return for the risks involved, we are more likely to hover on the sidelines, able to benefit from the resurgence of adequate interest rates on our cash holdings and decent returns on short-term, secure government bonds.

Moreover, the important diversification effect of bonds in mixed portfolios is back. But in our opinion, this only holds true if we consistently keep a close eye on this and find the right mix – e.g. in terms of duration positioning and managing credit risks. In other words, if we consistently pursue the commercial approach of “Active Income” in order to make the best of the remaining problems with capital investment and to take advantage of the opportunities that arise. ◆

Sven Langenhan is Portfolio Director Fixed Income at Flossbach von Storch AG.

Times are changing – and for the long term. Bans alone are not enough. In order to shape the future for the better, companies need a variety of options for action. A guest commentary by Oliver Zipse, Chair of the Board of Management of the BMW Group.

E N T R Y

An aerial view of a white car, possibly a BMW, is shown on the right side of the page. The car is partially visible, showing the roof, windows, and rear section. The background is a light-colored surface with large, overlapping circular lines in yellow and black. The word 'ENTRY' is written in large, bold, yellow capital letters across the center of the image, with the 'Y' partially cut off on the right edge.



NOT EXIT

The events of the past three years have fundamentally changed our world and how we cooperate economically on an international level. This change is not temporary. There will be no return to the status quo. The automotive industry, with its closely interwoven international supply chains, faces particular challenges in this new situation.

How do we respond and where are the opportunities for the future?

In Europe in particular, we need a mental paradigm shift. Instead of just putting bans in place and designing “exit strategies”, we should devote just as much attention to “entry strategies”. Because ending something does not mean that something new will automatically take its place. I would like to explain this in more detail using two examples.

FIRST: THE CO₂ TARGETS FOR THE AUTOMOTIVE INDUSTRY.

There is industry-wide consensus that CO₂ emissions generated by individual mobility must be significantly reduced. Billions have been (and are being) invested in this issue. In order to further ramp up the pressure and accelerate change, the European Union (EU) decided last year that, from 2035, only emission-free vehicles can be registered – a classic exit strategy. →

However, this outright ban does not take into account the many facets that would be needed for a successful mobility transition. To achieve this change sooner, what is actually needed is a holistic, cross-industry approach – that is, a diverse range of entry strategies for the era of carbon-neutral mobility.

The range of fully electric vehicles on the market is growing rapidly. But that alone is not enough. It is the customer who will decide with their purchasing behaviour whether future mobility technologies are successful. That's why, at the same time as expanding the range of products on offer, we also need to build an adequate charging network.

This would dispel many customers' reservations and reluctance to buy. But this crucial step is not currently being considered.

Issues relating to the raw materials required for the green transformation of mobility were also not taken into account in the legislative process. Alternative scenarios and solutions for potential supply bottlenecks or new dependencies are only now being discussed in light of the new geopolitical considerations.

There is also no strategy to support the transition: the establishment of the necessary value chains in Europe for emission-free drive units. Here we need a much more competitive framework in terms of energy prices, subsidies and educational measures. This would secure long-term investment in the EU. Other regions of the world are acting much more aggressively here.

Unless and until we have a defined holistic solution that takes all aspects into account, only a technologically diverse and flexible approach to mobility technologies will be economically successful in global competition. That is what we are counting on at the BMW Group and that is what politicians in Europe should be counting on too.

Entry strategies should also be given much more attention in the second example, a geopolitical issue: dealing with China and developing international partnerships.

We are currently experiencing a risk-focused view of China in Germany. Exit strategies are being discussed again with little to no attention being paid to opportunities for new collaborations. But we need China to be economically successful. And at the same time, China also needs Europe, as the largest single market in the world.

If we do continue to think exclusively in terms of exit strategies, this should always be done with a view to where the prosperity in Europe and Germany comes from. Global free trade is of the utmost importance to many companies in Europe.

The development of cooperations with many different international partners in different regions therefore offers enormous opportunities and makes us more resilient. With this in mind, appropriate international cooperation models must now be defined and implemented. One thing is clear, however: attempting to exclude China is neither expedient nor realistic. China must be part of the overall solution.

Building resilience requires diversity. To come back to the automotive industry: we are seeing how e-mobility is developing in many markets, sometimes at completely different speeds. As a global company, we need to operate successfully in this environment. That is why we offer highly attractive all-electric vehicles while continuing to develop existing technological solutions at pace, making sure that we accommodate all needs during this period of transformation. The customer can decide which technology is right for them, safe in the knowledge that, with us, they will always have the latest and therefore most environmentally friendly form of drive technology available.


Our new BMW 7 Series is the best example of this open-minded approach to technology. All drive types on one platform. No compromises with the electric drive. And, of course, all our drive types – be they fully electric, plug-in hybrid, hydrogen or combustion – make a positive contribution to reducing CO₂ emissions. Our “local-for-local” strategy ensures cross-regional resilience. The locally produced vehicles meet the demand in the regions and the localisation of the supply chain improves our flexibility. In addition, balanced regional demand enables us to react promptly to developments in each of the regions.

A dynamic and volatile environment remains “the new normal”. Unfortunately, all too often – as is the case in legislation – a great deal of time and effort is spent on finding the perfect solution when rapid and pragmatic solutions would be better. New strategies must be developed with a focus on opportunities, and resilience must be built through diversity and flexibility. This also gives industry the scope to act pragmatically and to support future economic success and social prosperity. ◆

ABOUT THE AUTHOR

Oliver Zipse

has been Chair of the Board of Management of BMW AG since August 2019. The native of Heidelberg is an engineer with a focus on mechanical engineering and has been with the company since 1991.

A close-up portrait of Oliver Zipse, a middle-aged man with short, light brown hair, wearing a dark blue suit jacket over a dark blue turtleneck. He is looking slightly to the right of the camera with a slight smile.

“It is the customer who will decide whether future drive technologies are successful with their purchasing behaviour.”

“Outside the Box”

Europe, the USA or even Asia – where do investors find the most attractive investment opportunities today?

Thomas Lehr and Philipp Vorndran have a clear opinion on this.

One of the most frequently asked questions from our readers in recent weeks has been: which markets do you see marching ahead in the coming months? Since the DAX has been doing so well lately ...

VORNDRAN: I think the focus on countries, regions or industries can be extremely dangerous! This has nothing to do with the idea of investing meaningfully and in the long term.

Elsewhere, this is seen differently ...

VORNDRAN: I know. “Marketing glasses” are often put on this topic because there are some wonderful stories to be told about different countries and their peculiarities and economic advantages ...

LEHR: Especially since there is always something to say, because there is always something going on somewhere, whether it’s stories of heroism or tales of catastrophe. Our perspective, on the other hand, is a little different: for us, good investments and a good invest-

ment strategy are characterised above all by the fact that they do not have to be constantly talked about. That it is, above all, the quality of the individual companies that matters, regardless of where they are based and which sector they belong to, and whether they are attractively valued on the stock exchange, or not.

VORNDRAN: The regional or industrial narratives create pressure for investors to act – to have to constantly adjust their portfolio. Out of Europe, over to Asia, then back into German stocks, a little later into the USA, because of the US dollar, and instead of tech assets, banks or, perhaps even better, utilities, because of the dividends ...

Nevertheless, with all due respect to your objections, many investors do follow these stories. Why is that?

VORNDRAN: There are probably a thousand and one reasons. Many people know no different; after all, it’s what the pros tell them to do. And that’s why they don’t question it. It’s that classic,

inside-the-box thinking, learnt and solidified over decades. Every day we hear about the German equity index, the DAX, the Japanese Nikkei or the US Dow Jones, and more rarely about the S&P 500. If one follows the other, then those that have fallen back automatically have the potential to catch up at some point – what total nonsense!

LEHR: The same applies to industrial sectors. People are regularly advised to switch from one to the other, to follow trends.

VORNDRAN: Perhaps one or two examples may help illustrate this: there is a large food producer in Switzerland whose name we don’t want to mention here for regulatory reasons, but which you’ll no doubt know very well. This company makes 1.5 per cent of its sales in Switzerland – or conversely: 98.5 per cent outside Switzerland. What does this company have to do with Switzerland or the Swiss economy? Almost nothing! Or a Hong Kong-listed fashion company. The company generates 90 per cent of its sales in Europe!

“For us, good investments and a good investment strategy are characterised above all by the fact that they do not have to be constantly talked about.”

But aren't these exceptions, individual examples that you have specifically selected?

LEHR: Of course, these are extreme examples! But they reaffirm my statement: investors should be focusing on the quality of companies, and not on their origin or which sector they operate in. In a globalised, highly networked world, companies are at home everywhere – not just in Zurich, Frankfurt, Detroit, Shanghai or Moscow. Everywhere. Just ask the boards of directors of the DAX companies – car manufacturers, chemical and pharmaceutical companies. They are all massively dependent on exports and thus on the global economy. All world stocks!

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.

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.

Buy-and-hold approach – “Buy and hold” is an investment strategy. Securities are purchased once and then held in the portfolio for the long term.

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.

Debt ratio – The ratio of a country's debt to economic performance as represented by its gross domestic product (GDP).

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.

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.

High Yield bonds (non-investment-grade bonds) – Risky bonds with high interest rates, mostly from debtors with low credit ratings.

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.

Risk premium – The risk premium represents a valuation for the risk assumed with a financial instrument. It is priced into the agreed payments so that the risk of loss is offset by the opportunity for a higher profit if the risk does not materialise. Comparing the expected profit from a risky financial instrument with a risk-free exposure (holding a government bond with the highest credit rating) can provide a good estimate of the risk premium.

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.

SPDR S&P Regional Banking ETF – Exchange-traded index fund designed to reflect the performance of regional US banks.

US Treasury – Government bond of the United States of America.

Yield curve – Refers to the graphical representation of interest rates for bonds of an issuer with different maturities.

PHOTO CREDITS

Image rights: © Paul Fiedler, unsplash / Markus Taubeneck, Illustration (Cover); © travelview, iStockphoto (p. 2); © Marc Comes, CHB-P (p. 3); © Vasilisa Gagarina, iStockphoto (p. 5 top); © Frederick Wallace, unsplash (p. 5 middle); © BMW Group (p. 5 bottom); © Vasilisa Gagarina, iStockphoto (p. 6–10); © Paul Fiedler, unsplash / Markus Taubeneck, Illustration (p. 11); © Marc Comes, CHB-P (p. 14); © Marcus Becker, sichtplan (p. 14); © travelview, iStockphoto / Markus Taubeneck, Illustration (p. 20); © Sven Simon, Picture Alliance (p. 23); © Thomas Imo, photothek, Picture Alliance (p. 24); © Thomas Trutschel, photothek, Picture Alliance (p. 27); © Zhang Cheng, Xinhua News Agency, Picture Alliance (p. 28); © Marcus Becker, sichtplan (p. 37–39); © Jinhe Li (p. 40); © cac_tus, generato con l'AI, Adobe Stock (p. 42); © Frederick Wallace, unsplash (p. 50–55); © Marc Comes, CHB-P (p. 56); © Mika Baumeister, unsplash (p. 61); © Poor Charlie's Almanack / Markus Taubeneck, Illustration (p. 63); © Wes Hicks, unsplash (p. 64); © Audri van Gores, unsplash (p. 66–68); © BMW Group (p. 68–71); © Marc Comes, CHB-P (p. 72–73, back cover)

LEGAL NOTICE

This document is intended amongst other things as advertising material.

The information and opinions contained in this document represent the views of Flossbach von Storch at the time it was published, and are subject to change at any time without notice. The information in forward-looking statements reflects the views and future expectations of Flossbach von Storch. Nonetheless, actual performance and results may differ materially from such expectations. All information has been compiled with care. However, no guarantee is given as to the accuracy and completeness of the information. The value of any investment can fall as well as rise, and you may not get back the amount you invested.

This document does not constitute an offer to sell, purchase or subscribe to securities or other ownership rights. The information and assessments contained in this document do not constitute investment advice or other recommendations.

In particular, this information is no substitute for appropriate investor-specific and product-related advice. Statements concerning tax or legal issues are no substitute for professional advice provided by a tax or legal adviser.

This document is not intended for individuals who are prohibited by applicable law, based on their nationality, place of residence or other circumstances, from accessing the information it contains.

All copyrights and other rights, title and claims (including copyrights, trademarks, patents, other intellectual property rights, and other rights) to, for and arising from all information in this document are subject without restriction to the applicable conditions and ownership rights of the current registered owner. You have no rights to the contents of this document. Flossbach von Storch retains the sole copyright to published content prepared by Flossbach von Storch itself. The reproduction or use of such content, in full or in part, is not permitted without the written consent of Flossbach von Storch.

Past performance is not a reliable indicator of future performance.

© 2023 Flossbach von Storch. All rights reserved.

PUBLICATION DETAILS

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

Commercial register: Luxembourg No B 171513

Competent supervisory authority: Commission de Surveillance du Secteur Financier (CSSF)

283, route d'Arlon, 2991 Luxembourg, Luxembourg

Editorial deadline: 17 August 2023

EU 112 0823 XXXX EN

Reprinting or making the document's content publicly available, in particular by including it in third-party websites, and reproduction on data media of any kind require the prior written consent of Flossbach von Storch.

Editors:

Dr. Bert Flossbach, Stephan Fritz, Jens Hagen,
Dörte Jochims, Carina Kontio, Sven Langenhan,
Thomas Lehr, Shenwei Li, Julian Marx, Laura Oberbörsch,
Christian Panster, Helen Ponsford, Kurt von Storch,
Philipp Vorndran

Design: Markus Taubeneck, Carolin Euskirchen
and Heller & C

Printing: TheissenKopp GmbH

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



Flossbach von Storch