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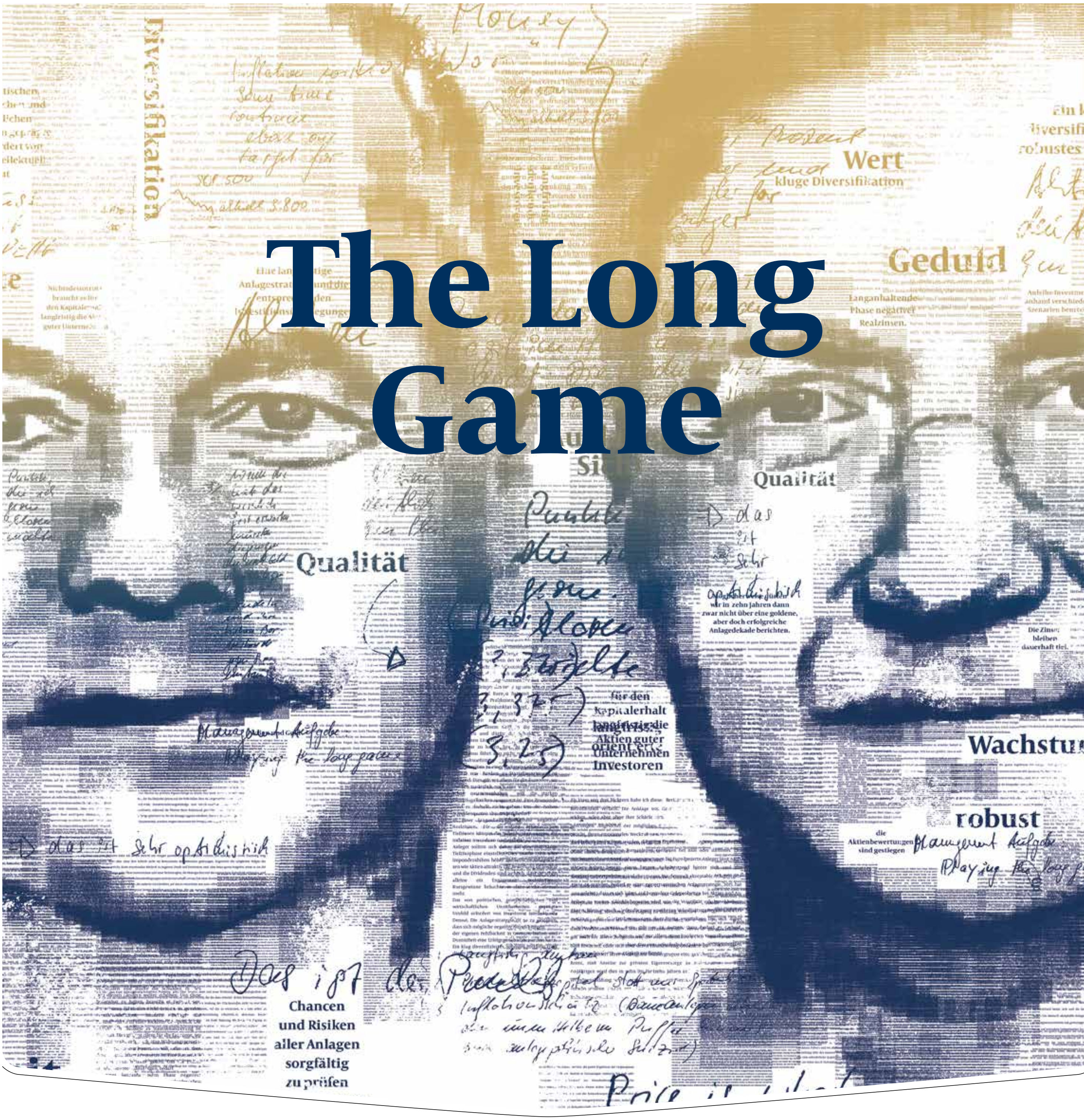
1/2024

POSITION

Thought-provoking issues for investors

The Long Game



For all Situations

The future is uncertain. There is no disputing that. And the past is rarely suitable as a blueprint for what may come. It helps us to categorise certain things, but no more than that.

This makes an investor's attitude even more important – how do they approach things? And how do they react to structural upheavals that are as certain to come as hearing "Amen" in church? What is important to them when assessing the capital markets and individual investments? In short: what characterises successful investing?

Ultimately, different paths lead to the goal, especially since the goals vary. Various factors are needed to invest money successfully. This edition of the Position magazine will focus on some of these issues. One is particularly important to us – because it is so often underestimated: the time factor.

Flossbach von Storch
POSITION 1/2024

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

"Time is money" as the old adage goes. I'm not a big fan of this saying because the context in which it is used is usually wrong. I think "time is invaluable" would be a better way to look at things.

Time is not least the most powerful ally when it comes to investing. If you invest in carefully selected bonds or stocks over many years, you have nothing to fear from price fluctuations. Even the biggest crises seem less terrifying as the years go by and memories fade. What often remains is this question: *"Do you remember when …?"*. Or the observation: *"Oh, if only I had …"*.

Flossbach von Storch has been around for 25 years now. That's not a lot of time in the context of everything the world has already seen. Those of us who consider ourselves to be long-term investors are only too aware of this fact.

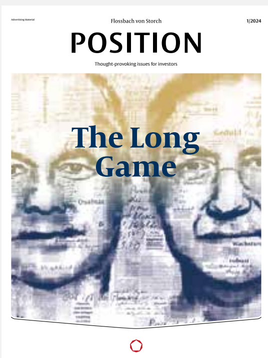
That said, 25 years is more than enough time for us to realise we owe our thanks to you – our valued investors, business partners and readers! Without your faith in us, Flossbach von Storch would not be what it is today. We are very grateful for your support.

Your encouragement inspires our commitment and motivation to continue delivering our best over the next 25 years. We have every confidence we will succeed. Even though our world seems particularly precarious right now, many domestic economies appear weaker than ever, and fear of the future is apparent everywhere, we urge you to remain optimistic!

If time has taught us anything, it's that opportunities always arise from crises. That is not about to change.

We wish you an enjoyable read!

Kurt von Storch
Founder and Owner of Flossbach von Storch AG



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by Frank Lipowski

MONEY IS GETTING TIGHT

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The United States is regarded as a model country for market economy and consumption. However, with costs exploding, many US citizens are having to limit themselves.

It's not possible to talk about the global economy without talking about the USA. Being the largest economy in the world, it is not only home to the world's leading currency, but also to the world's largest financial system. In recent years, the economy has been growing steadily despite the Coronavirus pandemic, energy crisis, inflation and the historical interest-rate turnaround.

Private consumption has traditionally been a stable pillar of the US economy. Whether online, in huge shopping malls or exclusive shopping streets, nowhere in the world does the range of services seem to be as big as in the United States. Shopping is part of American culture, at least for those who can afford it (or have a credit card in their wallet).

At least, that has always been the cliché. However, if you take a closer look, you will notice some fine but increasingly visible cracks appearing in the image of this land of consumerism. Or, to put it another way, average US consumers are at risk of running out of cash.

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The financial situation was better than it had been for decades. During the pandemic, US consumers were "forced" to save while receiving state checks on an unprecedented scale. The USA has seen a record increase in savings reserves since 2020, as shown in Figure 1 (on the following page). In the first 12 months or so of the pandemic, US consumers saved (or were forced to save) around USD two trillion or received money through aid programmes.

When the shops, restaurants and holiday resorts reopened, things moved in the other direction. After the (provisional) end of the Coronavirus pandemic, people had some catching up to do – and went shopping again. At this stage, consumers with money to burn were more likely to be price-takers than price-setters, with the corresponding consequences for inflation. However, US citizens only have finite savings, as can be seen in Figure 1.

The progressive spending of savings by US households is not only due to rising prices for oil, food and many other everyday items. Interest rates – both nominal and real – are also increasingly becoming a burden for US consumers. This is not just about mortgages. Unlike 10 or 20 years ago, the rate-fixing period for mortgage debtors in the USA has been very long (usually 30 years). This is also one reason why – unlike in other economies – there has been relatively little movement in the US housing market to date. Another issue is that, with a mortgage rate of around eight per cent, properties for sale are barely affordable for the majority of Americans.

But many Americans not only have mortgages to pay, but also credit cards, leases, or personal loans. However, according to the Federal Reserve, interest rates on credit card debt have risen to more than

→

Figure 1
In the red
US consumer aggregate savings since the Coronavirus pandemic compared to the trend (in USD billions)

Source: Bureau of Economic Analysis, Hamza Abdelrahman & Luiz E. Oliveira (both Federal Reserve Bank of San Francisco), data as at 31 December 2023

Past performance is not a reliable indicator of future performance.

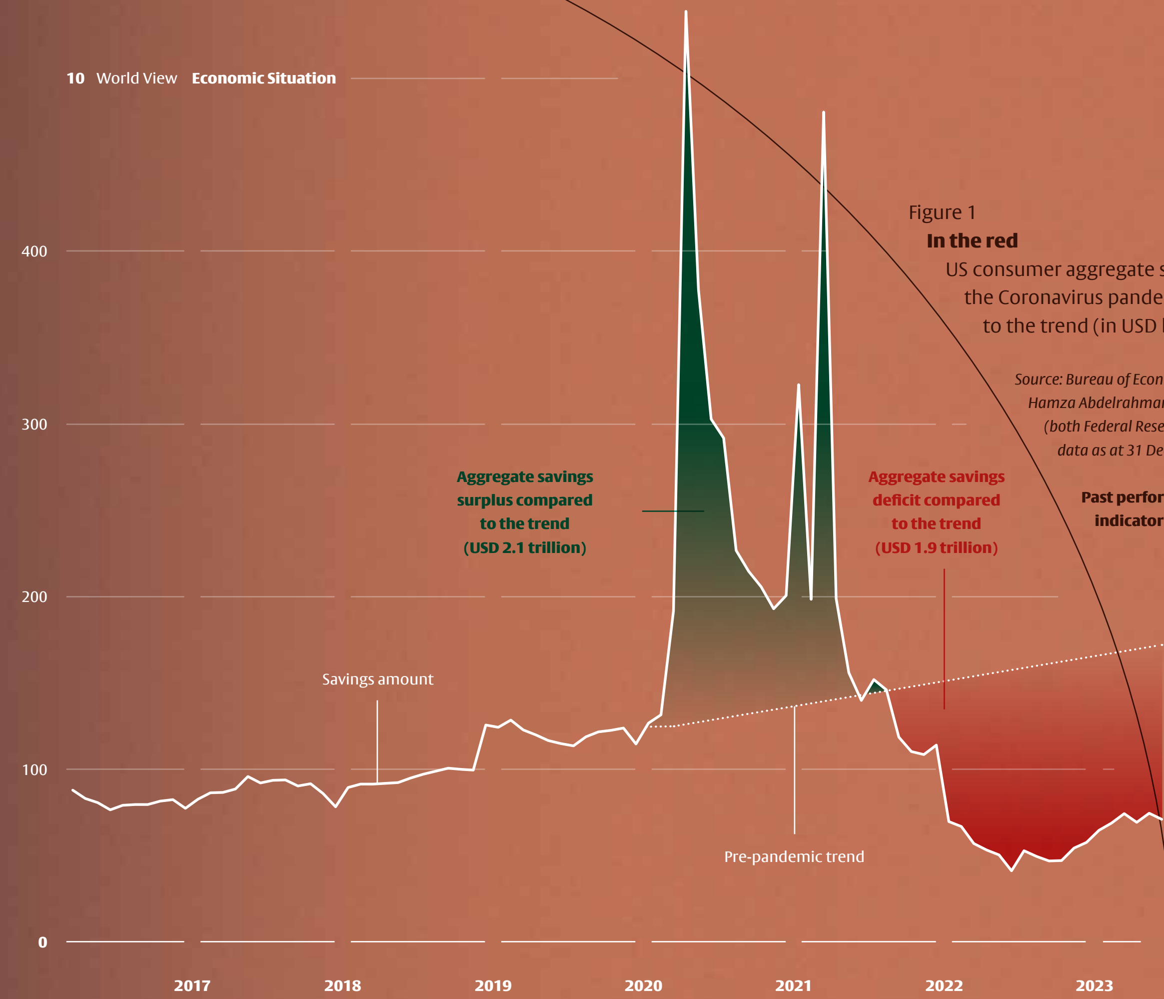


Figure 2
Loans are becoming more expensive
Annualised personal interest burden (without property financing) of US consumers in relation to GDP

Source: Federal Reserve Economic Data (FRED), Federal Reserve Bank of St. Louis, Flossbach von Storch, data as at 31 December 2023

Past performance is not a reliable indicator of future performance.

20 per cent – the highest rate of interest seen for over 50 years. Consumers' personal interest-rate burden is growing rapidly, including in relation to gross domestic product (see Figure 2).

Despite the still young interest-rate cycle, the interest-rate burden relative to economic performance is already as high as it usually is before a sharp recession. If interest rates remain at this level for longer, more and more financing with higher interest rates will be prolonged – and consumers will have less and less leeway.

The fact that servicing debts is increasingly dominating the private finances of US consumers is also reflected in the fall in savings rates compared to disposable income. At the moment, this figure is dropping to levels that we have rarely seen in the past 50 years. Most US consumers have run out of savings. Only savers in the top 20 per cent of the income distribution hold savings and money market funds that are higher in real terms than before the pandemic, after adjusting for inflation.

And that's not all – the latest data from the Federal Reserve also shows that, in addition to high interest rates, banks' increasingly stringent lending criteria are also weighing on consumers (including small and large companies).

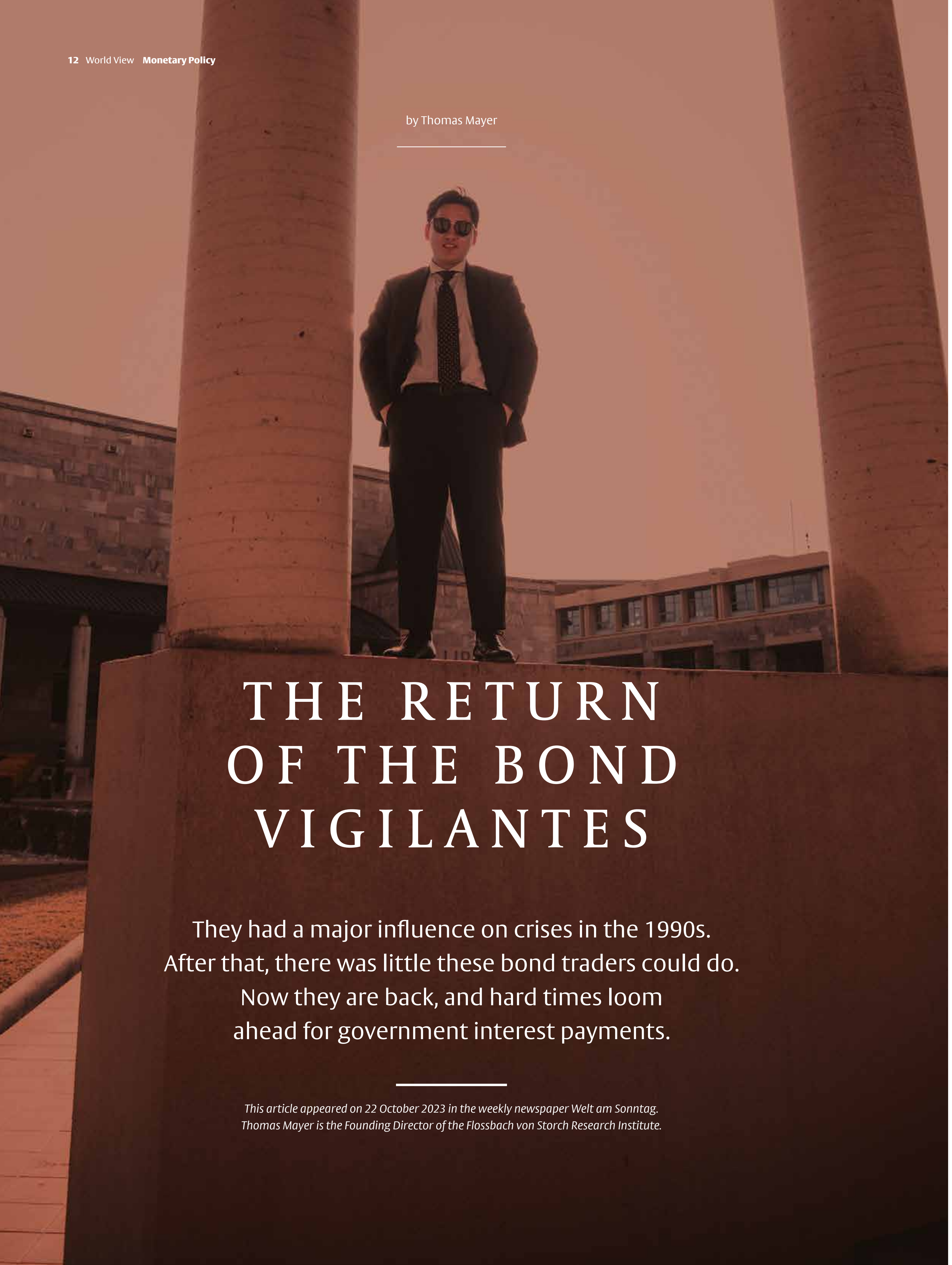
As savings diminish, loans become more expensive and restrictive, citizens must respond to the new situation. Financial pressure is leading to an increasing number of Americans taking up a new (or additional) job. The financial necessity thus creates an additional supply on the labour market. This is also one of the reasons why the unemployment rate in the USA has not recently fallen any further, even though many new jobs are being created.

Monetary policy always has risks and side effects. Only the future will show how successful the fight against inflation is – from which, of course, all American citizens and businesses will ultimately benefit.

Likewise, a greater supply of labour can reduce the pressure on wage increases. A positive development – at least from the point of view of central bankers. Steady rising wages are the ideal fuel for inflation increases.

The poorer economic situation of many Americans therefore also has something good to offer – at least from a long-term economic point of view. Ultimately, all this is what central bankers want – to cool down the labour market through a restrictive monetary policy, to dampen wage pressure, and to get inflation under control. However, this process cannot be controlled meticulously. Monetary policy always has risks and side effects. Only the future will show how successful the fight against inflation is – from which, of course, all American citizens and businesses will ultimately benefit. ◆

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



by Thomas Mayer

THE RETURN OF THE BOND VIGILANTES

They had a major influence on crises in the 1990s. After that, there was little these bond traders could do. Now they are back, and hard times loom ahead for government interest payments.

This article appeared on 22 October 2023 in the weekly newspaper Welt am Sonntag. Thomas Mayer is the Founding Director of the Flossbach von Storch Research Institute.

Many older market observers still remember the great bond market crisis of 1994. Following a modest rate hike by the US Federal Reserve by a quarter of a percentage point in February of that year, there was a global sell-off of bonds.

Ten-year government bond yields increased by two percentage points in the USA and Germany from the end of 1993 to the end of 1994, and by as much as 3.8 percentage points in Italy. However, the percentage increase in bond rates is decisive for government interest expenditure: this was between 35 and 43 per cent in the three countries.

Alarmed, the then US government under President Bill Clinton took fiscal austerity measures. Clinton's political advisor James Carville said:

"I used to think that if I could be reincarnated, I wanted to come back as president or the pope or as a baseball player with a score of 400. But now I would like to come back as a bond market. You can intimidate everyone."

The name "Bond Vigilantes" was coined for these menacing bond investors who sold bonds and thus increased yields.

With central banks' low interest-rate policies in the early 2000s and subsequent large-volume bond purchases, particularly during the pandemic years, the bond vigilantes disappeared. They could not do anything against the central banks. But they came back with the interest-rate turnaround in early 2022.

From their lows in 2019 and 2020, 10-year yields rose by 3.6 percentage points in Germany, by 3.8 percentage points in the United States and by 4.2 percentage points in Italy by the end of September. In absolute terms alone, these increases are significantly greater than in 1993 and 1994. In percentage terms, they go through the roof: with 600 to 800 per cent in the USA and Italy and – due to the negative initial yield – beyond mathematical predictability in Germany. Episode II of the Great Bond Crisis already far exceeds Episode I.

BOND VIGILANTES MARKED THE END OF LIZ TRUSS

The bond vigilantes have already demanded a political sacrifice. When British Prime Minister Liz Truss announced tax cuts without counterfinancing in September 2022, yields on British government bonds soared in anticipation of rising public debt.

Truss had to resign and went down in history as the shortest-lived British prime minister in history. Since then, the vigilantes have intervened repeatedly, for example in the six weeks before 6 October. During this period, the yield on 10-year US Treasuries rose by 0.7 percentage points.

Further reactions from the bond vigilantes are likely to follow. The consequences will be painful. If, for example, interest rates on 10-year government bonds were to remain at the current level until interest had to be paid on the entire government debt at these rates, public sector interest payments in Germany would triple. In Italy, they would increase by 74 per cent and in the USA by 57 per cent.

It would be a disaster if bond yields returned to the average level of the first half of the 1990s. Interest payments would then represent an unprecedented 27 per cent of current Italian and 29 per cent of current US government spending.

Since the heavily indebted public and private debtors cannot survive at the past interest rates, central banks will sooner or later have to declare war on the bond vigilantes again. The much-vaunted fight against inflation will then probably be over. ◆

THE WORLD OF CURRENCIES

by Julian Marx

Trillions of US dollars in foreign currency are traded every day. And yet the world of currencies remains as opaque as ever. We provide a review.

Figure 1
The greenback leads the pack by some margin
Worldwide foreign exchange trading on the spot market in April 2022

Since trading a currency pair always involves two currencies, the cumulative share of all currencies in the total transactions is 200 per cent.

Source: Bank for International Settlements, Flossbach von Storch, data as at 31 December 2023

Money determines our daily lives. In an increasingly complex world, it is an indispensable means of transacting. For a long time, cash was the dominant form of payment. At the end of 2022, the Euro system had issued banknotes to the amount of EUR 1,572 billion. A large part of this banknote circulation can be attributed to the high affinity for cash that prevails in Germany. The Deutsche Bundesbank is responsible for the majority of banknotes in circulation in the eurozone, accounting for EUR 900 billion of the banknotes issued. But cash is on the decline and has been for some time: a total of 126.6 billion cashless transactions were carried out in the eurozone in 2022, amounting to some EUR 234.3 trillion.

But it is not just the cash flows within a currency area that are enormous – foreign exchange trading is also taking place on an unimaginable scale. According to data from the Bank for International Settlements (BIS), foreign exchange transactions worth some USD 2,100 billion were traded daily on the spot market in April 2022. The US dollar, also called the "greenback", shapes foreign exchange trading like no other currency. In nearly 86 per cent of all spot market foreign exchange transactions, the US dollar was part of the traded currency pair. Some distance behind that is the euro, which was exchanged in 29 per cent of all transactions (see Figure 1).

The spot market is only one part of foreign exchange trading – albeit a significant one. For example, more than USD 1,000 billion are also transferred daily as part of forward exchange transactions. But what is behind this activity? What drives the performance of individual currencies? Let's take a look at the opaque world of currencies.

TWO CHANNELS DETERMINE CURRENCY PERFORMANCE

Whether a currency goes up or down is determined by supply and demand on the foreign exchange market. The current account balance is a major driver of foreign exchange demand – and a particularly important aspect of this is cross-border trade in goods and services. As a general rule, the more goods a country exports, the higher the demand for the domestic currencies. After all, the goods purchased need to be paid for. If all other conditions remain unchanged, the domestic currency therefore appreciates in the event of export surpluses. Conversely, currencies from net-importing currency areas tend to depreciate.

But, of course, it is not quite as simple as this in practice, because foreign trade is just one (essential) factor in the performance of a currency. This is illustrated by the example of the USA and the US dollar. Since 1990, the USA has managed to achieve a current account surplus in just one year: 1991. A modest surplus of just under USD three billion or 0.05 per cent of gross domestic product (GDP) was recorded at the time. Since then, only current account deficits have been recorded, averaging three per cent of GDP. The current account deficit accumulated since 1992 totals some USD 13,000 billion.

However, this is not reflected in the exchange rate of the US dollar. Unlike the Japanese yen, the dollar is now at the same level recorded in 1990. Compared to the Chinese renminbi, it has appreciated around 50 per cent in this time. The British pound has also depreciated against the US dollar since the 1990s, and the euro is roughly where it was when the euro banknotes were introduced in 1999 compared to the greenback. So the US dollar is certainly not a weak currency – despite the chronic and immense deficits in foreign trade.

The capital account – the second major driver of foreign exchange demand – has helped. The US capital market is highly regarded abroad. As well as being the world's largest capital market, it is also considered to be particularly open. Foreign investors have good access to the US market. As a result, there has been substantial demand over the years from foreign investors for US dollars so that they can invest in the USA – trillions of dollars, in fact.

By the end of 2022, foreign investors had invested some USD 45 trillion in the United States, while US citizens had invested just USD 29 trillion outside the USA. Much of the negative balance of USD 16 trillion is due to a large foreign investor base that puts its money into US bonds. At the end of 2022, foreign investors held US bonds worth USD 12.7 trillion – 60 per cent of which they invested in US Treasuries. US citizens, conversely, had invested just under USD 3.8 trillion in bonds outside the USA. Consequently, the attractiveness of the US capital market has so far been able to (over)compensate for the considerable deficits in foreign trade as far as the US dollar is concerned.

WHAT MATTERS IN THE SHORT-TERM

Current account developments tend to be relatively sluggish. First of all, the current account represents the trade in goods and services. Adjustments to multi-billion dollar trade flows do not happen overnight. Countries like India and the eurozone countries, for example, are among the planet's major net energy importers. In Europe, we know only too well how long it takes to significantly reduce the economy's dependence on oil or gas imports. Production facilities and existing supply chains are also not easy to replace. As a result, large changes in the current account usually occur over longer periods of time.

Significant short-term fluctuations in a currency are therefore often due to changes in the capital account – when investors shift hundreds of billions of US dollars, euros or yen between currency areas. Shifts like this may be driven by a change in interest-rate levels or the expectation of such a change.

The US capital market is a good example of this situation too. Although 10-year US Treasuries promised around 1.5 per cent of annual returns at the end of 2021 and US key interest rates remained at zero per cent, the "interest-rate picture" in the USA has changed drastically since then. By the autumn of 2023, 10-year US Treasury bonds were yielding five per cent per annum, and the key interest-rate level in the USA was a little over five per cent at the time. This increased yield level attracted lots of foreign investors. Between December 2021 and October 2023, they acquired US government securities with a net value of around USD 1,181 billion (see Figure 2).

Whether the money needed for the purchases was already parked in US dollars, whether it was withdrawn from US shares, or whether US dollars were actually purchased is not clear here. However, what is clear is that movements on the capital market in the trillions can have a significant impact on the performance of currencies in the short-term. →

Figure 2
Where to put the money?
Investments in securities are a major driver of currency performance

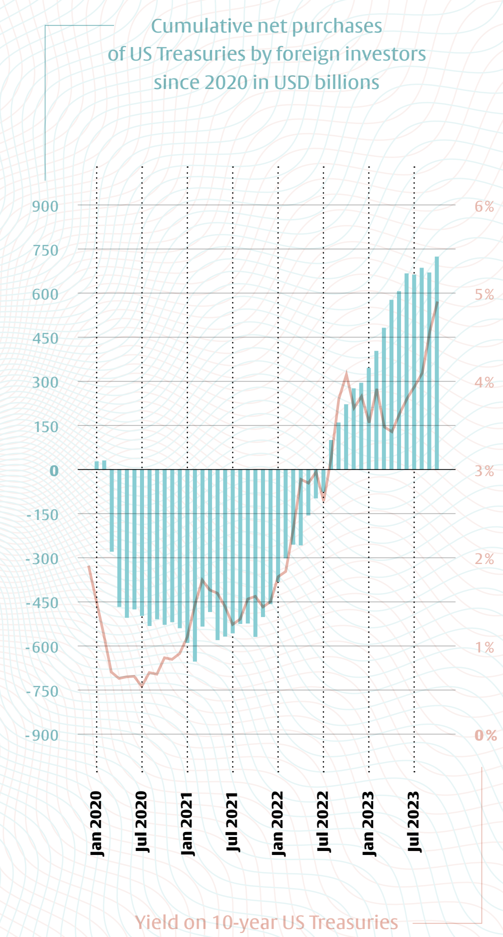
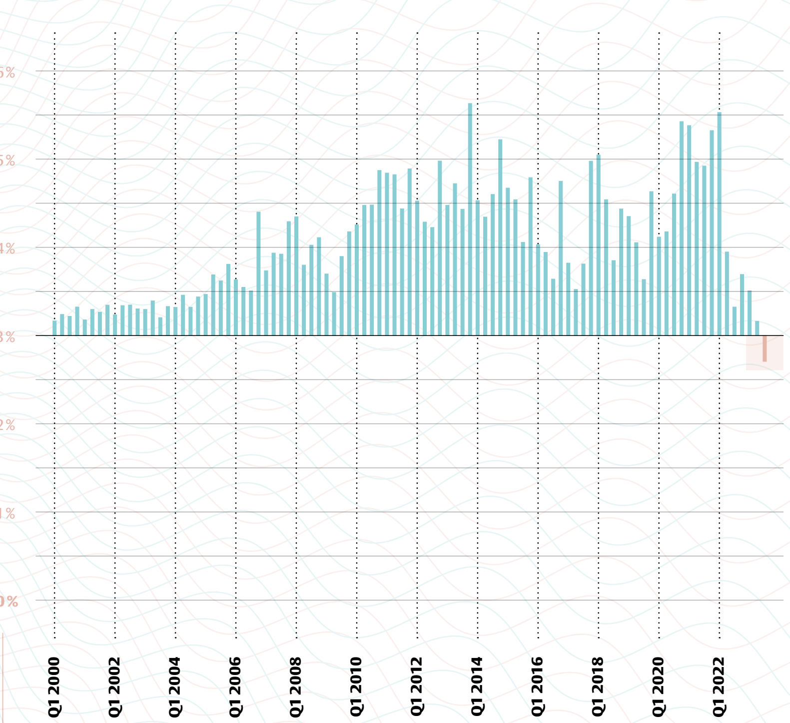


Figure 3
Not a one-way street
Quarterly direct investment in China in USD billions



Sources: Refinitiv, Flossbach von Storch, data as at 31 December 2023
Past performance is not a reliable indicator of future performance.

LOOKING FORWARD

Trade in goods and services, cross-border direct investments and securities trading are all key factors that influence currency demand. If one dares look very far into the future, however, noticeable shifts in the world order may lie ahead. The Asia-Pacific region has gained enormous economic weight in recent decades. While the region's share of global economic output was just 27.4 per cent in 2010, by 2020 this had risen to 33.5 per cent. According to forecasts by the Asian Development Bank, this share could even climb to as high as 50 per cent by 2050. The question remains: would such a shift in economic power also bring about a significant change in the use of currencies?

The US dollar is currently the undisputed number one among currencies. At the end of 2022, 58 per cent of foreign currency reserves held by central banks worldwide were still invested in US dollars. However, this figure has been on the decline in recent years, probably in part due to growing concern that US dollar reserves could be sanctioned in the wake of the Ukraine war. Some central banks may therefore have an incentive to rearrange their dollar holdings in the future. The euro follows some distance behind, accounting for a good 20 per cent of official foreign currency reserves at the end of 2022. The dollar continues to enjoy an excellent reputation for foreign currency bonds and loans, with more than half of the associated debt in US dollars.

ARE WE HEADING TOWARDS A DUEL BETWEEN THE CURRENCY GIANTS?

A shift in global economic activity to the Asian region suggests that the international relevance of Asian currencies is likely to increase. The Chinese renminbi is regarded as the natural challenger to the US dollar. After all, China is already the second-largest economy in the world. The pattern of how the renminbi may benefit in the future is clear: a higher Chinese share of global trade – measured by the imports invoiced in renminbi – initially increases the use of the renminbi in international payments. Countries that trade more with China are likely to hold more renminbi reserves as a result. This could increase the renminbi's share of total reserves in the future.

However, just how significantly and how quickly a currency like the renminbi could shake the status of the US dollar remains more than unclear. A variety of factors could play a role here that go beyond the mere economic power of a nation. For example, (geo)political interests: territorial disputes have been simmering around China for years. In the East China Sea, for example, China and Japan both regard some islands as their territory. Moreover, China does not recognise the 2016 ruling of the Permanent Court of Arbitration in The Hague: The Philippine government lodged its case after China claimed possession in the South China Sea. Even more prominent are the clashes over the island state of Taiwan, whose population has been concerned about the possibility of a Chinese invasion for years.

India, a large neighbouring country, is also locked in a clash with China, with the border conflict between the two great Asian powers still unresolved today. Since the border war of 1962, there have been repeated conflicts over where the Indian-Chinese border lies. Twenty Indian soldiers are said to have died in clashes in the Galwan valley in June 2020 as part of this dispute.

All this shows how difficult it could be for China to implement the renminbi as a kind of central currency in the face of numerous political disputes in Asia. This is likely to be much more difficult still when dealing with Western industrialised countries. Take the trade conflict with the USA, for example, which has been smouldering for years and is viewed as a product of the race for global technological and military supremacy.

Furthermore, the willingness to accumulate reserves denominated in renminbi may be limited if the ability to use this currency is also limited and the reserves are not sufficiently liquid when needed. In this context, a complete liberalisation of the Chinese capital market would probably be necessary. Nevertheless, the question remains of how likely such a scenario is. The increasing opening up of capital markets always entails risks for a country's currency. After all, open capital markets do not just attract foreign investors' capital – they also allow domestic investors to invest their money abroad.

The People's Republic first experienced that capital flows are not a one-way street in the third quarter of 2023, when foreign investors reduced their direct investment in China (see Figure 3 on page 17). While the opening up of capital markets does increase the trading activity in a country's currency, it also increases the risk of substantial exchange-rate fluctuations, meaning that it will not necessarily result in a stronger renminbi.

WORKING THESES RATHER THAN POINT FORECASTS

There remains a high degree of uncertainty as to how big a role the US dollar and renminbi will play in a few decades. There is also the possibility of a bipolar "currency equilibrium" with a US dollar and a renminbi that both enjoy a high level of international use and serve as primary foreign exchange reserves for many central banks. We have had a similar situation once before back in the 1920s: in 1929, around 97 per cent of all public foreign currency debt was denominated in US dollars or British pounds. Some 40 per cent was denominated in the US dollar and just under 60 per cent in the pound. The French franc, the German mark and the Swiss franc were largely irrelevant on an international level at this time, even though the German and French economies were considerable.

Whatever happens, currency forecasts remain fraught with uncertainty, both in the short-term and long-term. A variety of often opposing influencing factors makes it a tricky exercise. And yet investors need some form of guidance to help inform their strategy.

For example, with regard to the Swiss franc, it could be argued that this can be viewed as a genuine hard currency: thanks to consistently high current account surpluses combined with the reputation of a safe haven, the Swiss franc has appreciated significantly against many major currencies this millennium (see "Under the Magnifying Glass – Swiss franc"). However, the Swiss franc must usually be "bought" at a relatively low interest rate by international comparison. The advantages and disadvantages of individual currencies must therefore be continually weighed up in the context of the portfolio. Having a good mix has not done any harm so far. ◆

The US dollar is currently the undisputed number one among currencies. At the end of 2022, 58 per cent of foreign currency reserves held by central banks worldwide were still invested in US dollars. **However, this figure has been on the decline in recent years**

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

UNDER THE MAGNIFYING GLASS

JAPANESE YEN

Japan, whose population has shrunk by more than three million people since 2010, is ageing more and more quickly. The proportion of people over 65 years of age has risen from 23 to 29 per cent since then. But it is not only the demographic challenges that are obvious.

The Bank of Japan's (BoJ) monetary policy, which has been ultra-expansive for decades, is also becoming obsolete in view of high global inflation rates. Japan's central bankers are still capping the yield of 10-year Japanese government bonds – even though inflation in Japan has consistently been three per cent or more since August 2022. A yield level of 1.0 per cent on 10-year Japanese government bonds is regarded as a reference point; above this, Japan's central bankers intervene with large-scale government bond purchases where necessary.

According to recent figures, Japan's central bankers hold around 40 per cent of the country's national debt. This seems desperately necessary, too, as Japan's finance ministers have been fully exploiting this policy for decades. For example, Japan's annual primary deficit (government deficit before interest costs) has averaged 4.9 per cent of GDP this millennium. The debt sustainability of the state, which has a national debt level of over 250 per cent of GDP, is therefore very closely linked to the friendly assistance of the BoJ. As a result, the Japanese yen has long since ceased to be an oasis of well-being for hard currency lovers.

CHINESE RENMINBI

The economic performance of China and the attractiveness of the Chinese sales market are undisputed. China is not just the world's second-largest economy. In 2018, China's gross domestic product (measured in USD) even exceeded that of the entire eurozone for the first time. By comparison: in 2000, China's economic output was just under one fifth of that of the eurozone. Looking forward, the Chinese economy is also forecast to become increasingly relevant. As the Chinese economy's trade links grow, the importance of the Chinese renminbi could also increase further if more and more imports are invoiced in renminbi worldwide.

However, the truth is that investment in China is currently subject to the will of an autocratic government. This means that even if the Chinese capital market were to become more open, there would be no guarantee that the renminbi would benefit, because opening up in this way is always associated with risks to a country's own currency. After all, open capital markets do not just attract foreign investors' capital – they also allow domestic investors to invest their money abroad. China experienced that capital flows are not a one-way street for the first time in the third quarter of 2023, when foreign investors reduced their direct investment in China.

In addition to the above considerations, there are also many (geo)political interests involved, and so there remains a big question mark as to whether the renminbi – despite China's economic strength – will one day be able to establish itself as an alternative to the US dollar.

US DOLLAR

The US economy is the largest and most powerful economy in the world. It currently accounts for around a quarter of global economic output. The international use of the US dollar is also unparalleled. Nearly 60 per cent of all foreign currency reserves held by central banks worldwide are denominated in US dollars. In international foreign exchange trading, no currency is traded more frequently than the US dollar. In more than 80 per cent of spot market currency transactions, the US dollar is part of the traded currency pair. In addition, US foreign investors enjoy good access to the US capital market. As of the end of 2022, they had invested around USD 45 trillion in the USA – primarily through direct investments or securities investments. In this respect, the attractiveness of the US capital market is undisputed.

However, there is also a significant shortcoming. The US current account is in chronic deficit, which on its own would prevent a structural appreciation of the US dollar. The USA's cumulative current account deficit since 1992 totals some USD 13,000 billion. Last year, the current account deficit was around three per cent of GDP. The main reason for this is that the United States imports significantly more goods than it exports. The US trade deficit in goods last year was almost USD 90 billion a month.

NORWEGIAN KRONE

Norway's current account is second to none. Between 2000 and 2022, the average current account surplus was just over 12 per cent of GDP. In 2022, it was an incredible 30 per cent of GDP. The strength of foreign trade is due to Norway's enormous oil and gas exports. By far the most important customer is the European Union. The oil and gas exports mean a substantial long-term gain in prosperity for the approximately 5.5 million residents of the Scandinavian country.

However, anyone who might have speculated that the Norwegian krone would appreciate considerably as a result of the immense export surpluses in the past would be mistaken: a positive current account alone does not bring currency gains. The Norwegian krone has depreciated by some 30 per cent against the euro this millennium.

One major reason for this is likely to lie in the trillion-krone sovereign wealth fund, whose assets are fed by oil and gas revenues and are mainly invested abroad. The assets under management recently exceeded NOK 15 trillion. That is equivalent to more than EUR 200,000 in fund assets per capita, which are attributable to every single Norwegian. A lot of money. Especially considering that Norway is a rather small and illiquid currency area.

These considerable portfolio investments abroad not only alleviate the appreciation pressure on the Norwegian krone from the current account, but may even overcompensate for it. In this respect, the long-term currency development of the Norwegian krone depends primarily on how and where the sovereign wealth fund invests its money.

EURO

The eurozone is an attempt to unite many different economic areas, each with different needs, under one "monetary policy umbrella". This creates the potential for conflict. A relative lightweight (from an economic perspective) like Greece was already putting the eurozone to the test a few years ago. At the same time, a euro heavyweight like Italy has been struggling for decades with meagre economic growth and high national debt. For example, Italy's real per capita GDP in 2023 is likely to be at the same level as 20 years ago. Productivity growth: nil. Moreover, Italy's national debt is the second highest in the eurozone, accounting for around 144 per cent of GDP.

The European Central Bank (ECB) therefore has to tread a narrow path. Its primary mandate is price stability. However, this objective is subject to essential secondary conditions. The mandate for price stability can only be achieved if the euro is sustainable. In this respect, the fight against divergent government bond yields or increasing fragmentation in the eurozone can be considered a top priority. Consequently, the ECB has given itself room for manoeuvre that has marked traces of government funding. As if it were not enough for the euro system to hold a quarter of the Italian and Spanish national debt, the ECB also launched a new instrument in July 2022: the "Transmission Protection Instrument", which allows the ECB to make unlimited purchases of Member State government bonds where necessary.

Despite all the criticism, however, it is also important to recall the strengths of the euro. The eurozone is still one of the most powerful economic areas in the world. Nearly 350 million citizens, or less than five per cent of the world's population, generated around 15 per cent of the world's economic output last year. In addition, the eurozone generated almost exclusively current account surpluses between 2012 and 2023. It was only in 2022 that extraordinary gas and oil price rises put a strain on the eurozone's current account. In addition, the euro has a high level of international use. It is not for nothing that some 20 per cent of all foreign currency reserves held by central banks are denominated in EUR.

Although the euro and the eurozone have their homegrown issues, the eurozone still has decent economic substance. Combined with substantial use of the euro in international payments, the search for completely convincing alternatives remains a challenge.

SWISS FRANC

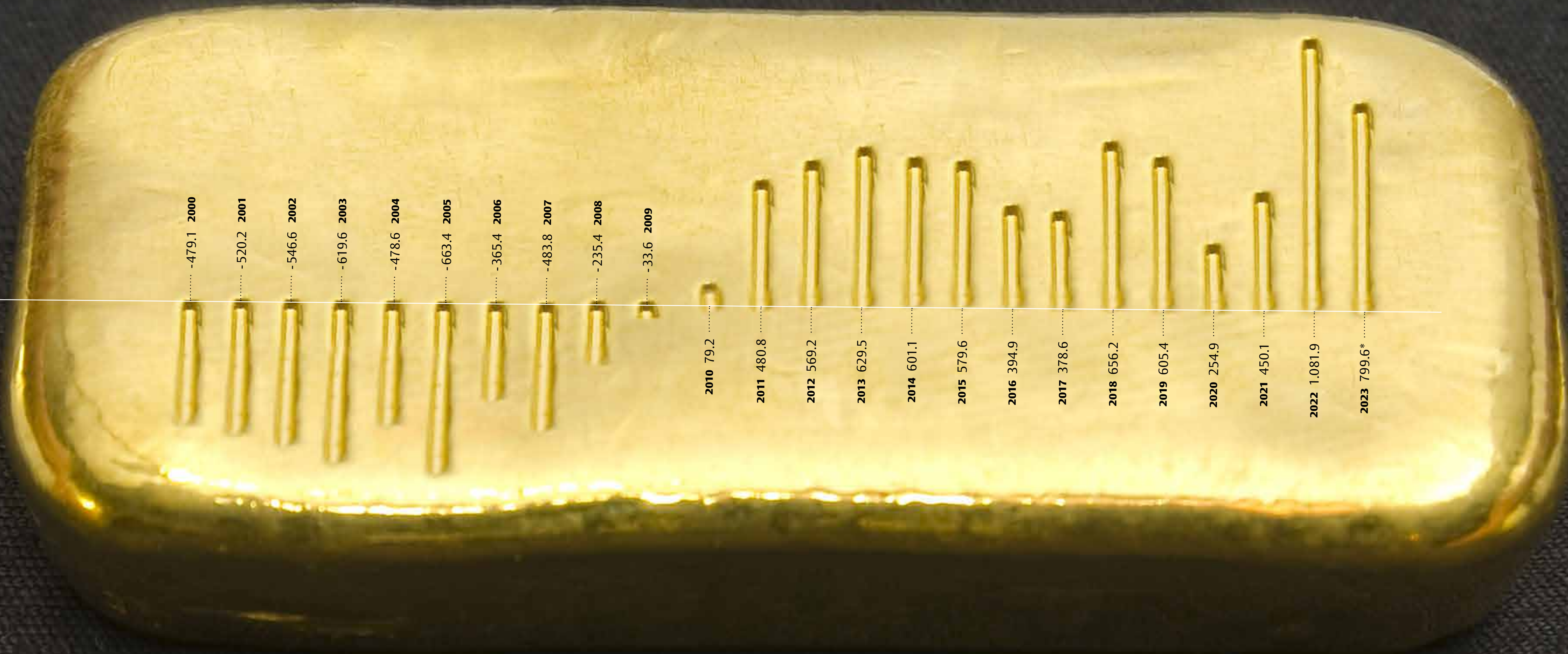
All major currencies have lost considerable value against the Swiss franc this millennium: the euro and the US dollar have lost around 40 per cent, and the British pound and the yen over 50 per cent.

There are many reasons why the Swiss franc is so strong. Firstly, the country has an exceptionally strong economy with substantial current account surpluses recorded almost every year, which boosts demand for the Swiss franc. Between 2000 and 2022, for example, Switzerland's current account surplus in 20 of the 23 years was at least five per cent of GDP.

In addition, the Swiss franc enjoys the status of a "safe haven". Since the 1920s, the Swiss franc has been characterised by monetary and political stability, while in many other currency areas the de facto abandonment of a metallic monetary system has been regularly exploited for government financing. This reputation, acquired over decades, persists today.

Investors' desire for (currency) stability has been reflected not least in the Swiss National Bank's (SNB) foreign exchange investments. By the fourth quarter of 2021, the SNB had acquired foreign currencies worth more than CHF 966 billion in order to alleviate the upward pressure on the domestic currency. Since then, interest rates abroad have risen more significantly than in Switzerland, and the SNB has again been able to reduce its foreign exchange holdings by more than CHF 200 billion. All in all, the Swiss franc probably is a genuine hard currency.

Central banks are buying more gold than ever before
Net gold purchases and sales in tonnes per year*



* For 2023, only central bank purchases from the first to third quarter were taken into account.

Source: Refinitiv, World Gold Council, Flossbach von Storch, data as at 31 December 2023

THE CURRENCY OF LAST RESORT

The rise in interest rates is likely to weigh negatively on the price of gold. It increases the opportunity costs of holding gold. However, this is not reflected in the price of gold.

Gold is often referred to as a "crisis metal". But this should not be the primary function of gold in a portfolio. After all, the price of gold often does not budge during political crises. In fact, the price almost always goes up when the security of the financial system is at stake. In the event of insolvency of large banks or insurers – or when the stability of cash flows or currencies is threatened. From our point of view, this function is very important. Gold provides insurance against the known (and unknown) risks of a fragile financial system.

Gold for us is rather the currency of last resort, which does not yield interest, but appreciates against paper money in the long-term. The rise in interest rates is likely to weigh on the price of gold, as this increases the opportunity costs of holding gold. Compared to 10-year US Treasuries, gold has recently had to compete with annual interest income of up to five per cent. Even after deducting inflation, US investors were able to secure roughly two per cent real yield for a period of 10 years with so-called "TIPS", i.e. inflation-protected US government bonds, in recent months. A development that has not been without consequences. Many investors have removed the precious metal from their portfolios. Worldwide ETC gold holdings have shrunk by more than 600 tonnes since their peak in spring 2022 to October 2023.

And the price of gold? It shook off the headwind from the interest-rate side, marking a new all-time high of more than USD 2100 per ounce in December 2023. One factor was likely to have had a decisive impact on the development of gold prices: the demand for gold from global central banks. The war in Ukraine has made many monetary policymakers aware that their US dollar reserves are exposed to sanctions risks. At a time when geopolitical crises are becoming increasingly apparent, this is probably one reason why a Turkish or Chinese central bank, for example, has once again increased its holdings in the precious metal in recent years. As in 2022, central banks may have again demanded more than 1000 tonnes of gold in 2023 (see Figure). Thus, gold remains the currency of last resort, not only for crisis-tested private investors – but obviously also for the guardians of paper currencies.

Bert Flossbach talks about the central banks' fight against inflation and its impact on the capital markets.

Don't Start Celebrating Too Soon

Mr Flossbach, how would you describe the past year from an investor standpoint?
A good year for investing – which back in the first quarter seemed far from certain following the failure of several US regional banks.

What were the particular success stories for 2023?
The synchronisation of the various asset classes has once more underscored the significance of interest-rate trends for the capital markets. As has so often been the case in the recent past, the focus was on central bank policy, and more specifically on how far any easing of the restrictive monetary policy would go.

The stock exchanges appear to have moved on from the inflation issue, viewing the two per cent target of the central banks as almost achieved – do you share this optimism?
The central banks have recently made significant progress in the fight against inflation. Take the European Central Bank (ECB), for instance: consumer prices in the eurozone rose by just 2.9 per cent on the previous year in December. This kept inflation below the three per cent mark for the third consecutive month at least. However, the decline can also be attributed to base effects such as falling energy prices. Core inflation, i.e. the rate excluding food and energy prices, was even more elevated against the ECB's inflation target in December, at 3.4 per cent.

How does this situation shape your personal expectations when it comes to central bank policy?
Despite the progress seen to date, we should not make the mistake of acting as though inflation has already been conquered. In other words, it would be advisable not to start celebrating too soon!

The central banks have urged caution, reminding the markets that the last mile is the hardest …
I wouldn't refute that. What they are trying to do is quash any overly optimistic expectations when it comes to interest-rate policy. If they take their foot off the brake too soon and begin to accelerate instead, this could trigger a new jump in inflation – with potentially serious consequences.

In what way?
The logical conclusion that would be drawn from a swing like that is that the central banks are no longer in control of the situation!

You're talking about the ECB here?
Not just the ECB; the US Federal Reserve (Fed) too.

Based on the U.S. Consumer Price Index, the US inflation rate fell from around six per cent at the start of the year to 3.1 per cent in November. Core inflation fell from 5.5 per cent to 4.0 per cent over the same period. This suggests that the Fed still has a way to go then?
That's right. Especially given that the US economy grew by 5.2 per cent in real terms (annualised) in the third quarter! The robust labour market and strong wage pressure are indicators that it is better to be very cautious with any rate cuts.

Which is more likely to ease off the brakes – the ECB or the Fed?
The key interest rate in the USA is 5.5 per cent, which is 2.5 percentage points above inflation; and the real rate of return on 10-year inflation-linked US Treasuries is significantly higher than in the eurozone at just under two per cent. What this means is that the Fed at least has greater scope available to it for some initial small-scale interest-rate cuts if the domestic labour market cools significantly.

When might we expect to see inflation rates drop back to, or perhaps even below, the two per cent target?
There's no blanket answer here. Certain factors are currently having an anti-inflationary effect. Supply-chain problems, for instance, are no longer an issue. There are also increasing signs of a significant economic slowdown in China, which in turn suppresses global economic growth and inflation expectations. Inflationary pressures could continue to decrease in the short term, giving the central banks a window to cut interest rates. The picture may be somewhat different in the long term though.

What do you mean by that?
There are structural inflation drivers that are likely to increase the "inflation base" in the coming years.

What are they?
Some time back we dubbed them the three "Ds": demographics, decarbonisation and deglobalisation. They will drive prices over the coming years. So, in this sense, a drop in inflation in the short term could turn out to be a Pyrrhic victory – i.e. a victory that is ultimately a defeat. If the central banks put their foot back on the pedal much too soon, inflation could come back even stronger than ever.

So, from an investor standpoint, inflation and interest rates are likely to remain the most important considerations on the capital markets this year?
Yes, that's true.

What role is played by the increasing number of conflicts around the world – in the Middle East and Ukraine, between China and Taiwan, and North Korea's

"Inflationary pressures could continue to decrease in the short term, giving the central banks a window to cut interest rates. The picture may be somewhat different in the long term though."

→

"The sharp increase in bond price volatility is providing opportunities time and again both for entry to the market and for withdrawing profits."

sabre-rattling? Not to mention the upcoming US presidential election …

The problem for investors is that it is difficult to predict events like this, and their outcomes and impacts. Anyone who watches the news on a daily basis will know that the reports seem not only disturbing, but extremely threatening – and sometimes they are just that. The suffering of the people in Ukraine and the Middle East is unbearable. So, what should investors do in this situation? Buy shares in companies that are likely to benefit from the various crises? It's unfortunately not that simple. Ultimately, any investment must be constructive. There is little point in preparing for the worst-case scenario – the end of the world, to put it in basic terms. Things have not yet come to this point, and if they ever were to, we would have other problems to tackle.

So, what should we do instead?

Investors should think in scenarios that keep risk in focus. To do anything else would be irresponsible. That said, we are well aware that there are many factors we cannot know or influence. Instead, what we can try to do is create portfolios that are as resilient as possible. High-quality investments, acquired at reasonable prices, and broadly diversified.

What should the composition of a mixed portfolio look like?

Each portfolio is different but given the inflationary environment we tend to hold a significant proportion of top-rated liquid assets, in particular shares of extremely well-performing companies; physical and non-physical gold holdings also form part of the portfolio. In recent months we have increased our bond holdings. Bonds are now a reliable yield source again, albeit with limitations; this wasn't the case just a year or two ago.

What are the limitations?

Following the recent price rally, long-dated bonds are now priced for perfection – the margin for error has recently been reduced again, and losses are greater. Even if inflation declines as expected the potential for a further decline in yields is low given that the roughly two per cent achieved by 10-year German Bunds at the start of the year is unlikely to be sufficient to deliver an adequate real-terms yield.

What is the situation in other European countries?

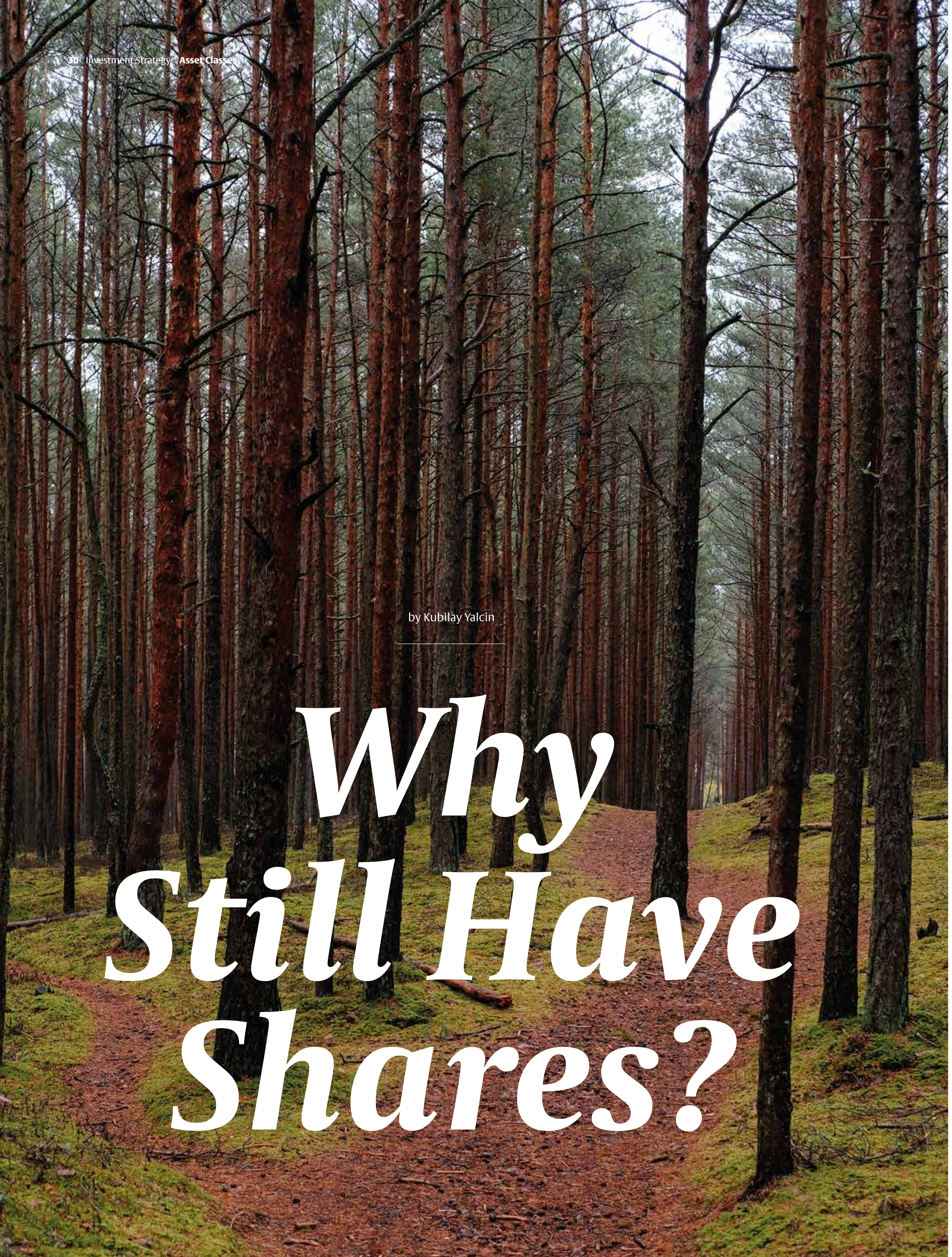
Returns elsewhere in Europe are also almost non-existent, apart from Spain with a solid three per cent and Italy with almost four per cent. If inflation does not decline as expected, inflation-linked bonds are the better choice, but even then, there will be a limit to the growth. After all, Italian securities offer a real yield of two per cent, while the real interest on inflation-linked German Bunds is zero per cent. Significantly, the German Federal Ministry of Finance has decided not to issue inflation-linked bonds in future because it would be too expensive for the state in the event of high inflation rates.

So has the window for bond investments already closed again?

No, the sharp increase in bond price volatility is providing opportunities time and again both for entry to the market and for withdrawing profits. In addition, there are market segments offering higher returns that can be utilised as part of an actively managed bond portfolio.

Thank you for the interview.

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



by Kubilay Yalcin

Why Still Have Shares?

Following record rate hikes, bonds have become a competition for equities. In this article we look at why carefully selected equities of quality companies remain so important – and what needs to be taken into account.

Tighter monetary policy has made bonds much more attractive. Interest rates of more than three per cent are already offered on secure securities with shorter maturities and many investors may ask themselves whether it is still worth taking the (supposed) risk of investing in shares in the future.

QUALITY THAT PAYS OFF

As bonds have become more attractive, rising bond yields are putting pressure on equity valuations. It usually takes a while for the equity market to digest the higher interest-rate levels, with most of the journey likely to be behind us. However, a further rise in interest rates does not necessarily mean falling share prices in the medium to long-term – at least not for carefully selected quality companies whose profits increase in the long-term and can thus more than compensate for a moderate decline in valuation. This is because the simultaneously permanently higher inflation rates can increase corporate sales and earnings at least in nominal terms, so that attractive real returns can be achieved. In particular, in the event of persistently high or rising inflation rates, investments in companies thus offer, unlike bonds, a good chance of attractive real returns that should be higher in the long-term.

One of our most important investment guidelines is ensuring the high quality of the companies we invest in. Quality is defined by us in such a way that we are highly likely to expect attractive returns from these companies in the future. In the long-term, the share-price development of stocks follows the company's profits, although short-term price swings cannot be avoided, even for quality companies. And it is especially important to be able to trust in the soundness of the business model, especially with such a gloomy sentiment on the market. The higher the quality, the faster equities usually also recover. At least, this has been demonstrated by the development in various market downturns, such as the financial crisis or Coronavirus crisis. →

In particular, in the event of persistently high or rising inflation rates, investments in companies thus offer, unlike bonds, a good chance of attractive real returns that should be higher in the long-term.

COMPANY SELECTION IN PRACTICE

In order to find quality companies, it is not enough to simply compare key figures. The isolated view of trends, which seem to determine what happens over and over again, is also too short. For example, before the financial crisis, the profits of many US banks continued to rise over years. But this development was driven by success in trading structured securities, combined with very little equity and risky equity positions. Profits were therefore based on business models that were particularly vulnerable to crises. The situation was similar as early as the turn of the millennium, when fantasies about the future profits of some technology companies had displaced the critical view of the actual value drivers of a company.

When selecting a company, we therefore take a close look at business models, try to understand the success factors and use scenario analyses to estimate the future. We are looking for companies that are particularly likely to be able to deliver attractive earnings in the future. In doing so, we mainly rely on companies that offer products or services that, from the point of view of customers, not only have great added value, but also strong unique selling points, and are therefore not easy to replace.

THE ROLE OF PROMISING SECTORS

Basically, we find quality companies worldwide and in almost all sectors, in which at least niches offer promising growth in the long-term. However, because we prefer companies that have their own skills and whose success is less dependent on market developments, companies from particularly sensitive sectors are under-represented in our portfolios.

Some investors, conversely, speculate specifically on the rotation of selected sectors, i.e. that different sectors benefit to varying degrees from economic development in the course of the economic cycle, which is accordingly appreciated by the financial markets. In the event of a supposed upswing, they invest in pro-cyclical industries that benefit greatly from the emerging economy, for example in capital goods producers or in the raw materials industry. When the boom comes to an end and the pro-cyclical values are poorer, this strategy calls for a shift to non-cyclical, anti-cyclical sectors, such as food manufacturers or the pharmaceutical industry.

There is, however, a problem. Forecasts must be made to ensure successful implementation. But ultimately, it is extremely difficult to predict when a new market phase will be reached. Point forecasts are almost impossible, especially for a short time horizon. Developments can only be estimated with some probability in the longer term.

Investors who ignore this and, for example, bet on a rising oil price or rising interest rates, find themselves in a risky situation – in other words, they have to take a gamble on the unknown. However, this has nothing to do with our investment strategy, which is geared primarily towards participating in the long-term success of companies. We select companies based on fundamental criteria, with a focus on the ability of management to deal with crises.

IN CRISES, MANAGEMENT AND THE BUSINESS MODEL ARE IMPORTANT.

In difficult times, we are often asked why we exchange shares relatively rarely. But we believe that selecting sustainable business models and management teams is the best risk management for us. We expect top-quality companies to respond to market challenges for the benefit of the company.

An example of this is a number of well-known technology companies that have been in our portfolio for some time. They have characteristics, such as high structural growth and a good bargaining position toward customers and suppliers, as their products are often difficult to replace. During the Coronavirus crisis, the sector had raised high expectations regarding the pace of digitalisation and the prices of many stocks in this sector rose sharply at the time. As demand seemed to rise sharply, many IT companies built up capacities on a large scale. But things turned out differently. The assessment of very high demand for digital services initially proved to be wrong (at least to the extent expected).

However, these companies have responded quickly to the original misconception and reduced capacity. At the same time, the sector was significantly less affected by the inflation-related general cost explosion, so that margins, combined with still growing demand and lower costs, ultimately even increased again.

There are financial years where even the result of very carefully selected quality stocks lags behind the overall market. Prices may also fall in the short-term. This is because market sentiment often determines developments in the short term. Patience is therefore essential for investors.

In the long-term, however, the economic facts count. With carefully selected quality companies in the portfolio, investors can look to the future with confidence. ◆

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

We expect top-quality companies to respond to market challenges for the benefit of the company.

MY GREEN.

OUR GREEN?

YOUR GREEN.

by Theresa Eyerund

ESG* and sustainability are associated with conflicts and frustration in the financial sector (and beyond). This is also due to the fact that the human psyche longs for clarity. However, when it comes to these matters, clarity is not an option, even if certain regulators, rating providers or marketing experts pretend that it is.

* ESG stands for the terms "Environmental", "Social" and "Governance".

Imagine you're flicking through the business section of a large daily newspaper and spot the headline "Wind turbine producer denied loan for sustainability reasons". What would your first thought be? Astonishment, incomprehension, curiosity?

Our immediate interpretation of a situation or piece of information has more influence on our long-term trust and understanding than we might think. Even with relatively new terms cropping up all the time like green bonds, climate funds or green finance, we usually have an initial idea of what might be hidden behind it in the best case. But what if, on second glance, this initial impression turns out to be false?

The image associated with "green" is usually only one aspect of what is commonly understood to be sustainable. Definitions of sustainability usually require a combination of environmental, social, and economic aspects. The diversity of the concept makes it a complex one.

Regardless of how many and what dimensions a definition of sustainability would like to combine, it is always about goals that are considered socially desirable. But what counts as a socially desirable product or positive activity always depends on the perspective. Various aspects play a role, such as political conviction, knowledge, personal experience, origin, age, or income. Not to mention the world events around us. In times of war and crisis, the focus on sustainability is always different.

A QUESTION OF PERSPECTIVE

In addition, the sustainability dimensions can be independent of each other and may even conflict with each other. Environmental measures are likely to generate costs that could negatively impact the economic dimension of a company or person.

Economically necessary cost savings, conversely, may require redundancies that negatively affect social issues. Even if there are no direct conflicts between the dimensions, they can easily be played off against each other. A company that implements extensive ecological measures can nevertheless be accused of failing to act responsibly in social matters. Which aspect is prioritised or weighted more heavily is a matter of methodology or – as previously described – the point of view.

In terms of companies, another complicating factor is that the company's public image of sustainability can relate to two aspects – the products and services it offers, or the manufacturing conditions within the company and along the value chain.

Is a sustainable company one that currently offers desired products such as electric cars? Or is a sustainable company one that manages to produce products and services with little use of resources and under the best possible conditions? Sometimes there can be considerable differences between the two areas of action.

BEYOND GOOD AND BAD

In other words, when it comes to sustainability it is not always possible to make a clear distinction between good and bad, clean and dirty, black and white. We might think that people are able to solve much more complex problems.

Ambiguity is a condition that the human psyche finds very difficult to tolerate. The ability to accept, endure and not perceive as threatening ambiguous or contradictory circumstances and uncertain and unsafe situations is described as 'ambiguity tolerance'. Maintaining this is very strenuous and often does not lead to a clear derivation of action.

People therefore try to resolve conflicting information or ignore it from the outset. This fulfils two essential purposes: to preserve cognitive resources and maintain a positive self-image.

CLEARLY AMBIGUOUS!

The desire for clarity is so strong that people tend to ignore information that does not fit their ideas and to focus more strongly on those that fit their already established world view.

If you've had a good experience with a provider or a company (this doesn't just apply to ESG matters!), there is a tendency to focus more strongly on information that indicates a responsible use of resources than information that does not. On the other hand, positive information about a company or provider that has been painted as "dubious" or "dirty" from the outset is unconsciously ignored or treated as relative.

Especially when we lack the time (or desire) to engage more intensively with it, we use mental shortcuts to arrive at a quick and sufficiently well-perceived judgement. The halo effect means that people tend to infer other characteristics based on a person's trait, even if they have nothing to do with each other. If a person is deemed to be likeable, they are equally regarded as affable and capable of leadership.

The "halo" outshines the person in our perception. At the same time, the devil horns that we place on a person due to a negative trait are difficult to separate from other areas of their personality.

In the context of ESG, this can lead to a particularly positive ecological image of a company that makes us assume that it is also positive in social or economic matters. We tend to generate a coherent assessment.

Whenever it comes to quick assessments, we look for clues and link them to existing information. This does not mean that, once consolidated, opinions are no longer changed, but our psychological immune system makes all kinds of creative attempts to weigh and classify contradictory information in such a way that it does not pose a threat to our view of ourselves or the world around us.

WE MAKE IT (TOO) EASY FOR OURSELVES …

Sustainability is multifaceted – this is not a new insight. This makes it all the more understandable why people attempt to make the topic more tangible by trying to simplify it. The rating providers are particularly successful in this.

Similar to the Nutri score or the food traffic light system, an ESG label/seal/rating is the attempt to condense various differing levels of positive or negative properties into a single value. The Nutri score assigns points to foods in terms of energy, sugar, saturated fatty acids, and sodium/salt and calculates a score from A to E. However, a balanced diet does not only consist of A products (salmon, for example, has a Nutri score of D!). A comparison of different food categories, such as dairy products and cereals, is also not very meaningful. ESG ratings condense information from the fields of ecology, social affairs and governance and generate a score from A to E, for example.

The desire for clarity and simplicity explains the great popularity of rankings, ratings, and seals. This is because they condense a lot of information into a simple number or letter. Our brain gets a quick answer – it doesn't have to search for information and weigh it up. The methodology behind a ranking or rating, and whether certain aspects are to be classified numerically at all, is initially irrelevant.

Another form of simplification that we are happy to use are catalogues of criteria that make a clear assessment. This is known as taxonomy in the financial sector. The EU taxonomy aims to identify economic activities that are considered sustainable in order to channel capital flows into these areas. This is connected with a political negotiation process, at the end of which there is a decision that is not shared by everyone, but which has been achieved in a transparent process and is therefore valid for the time being.

Everything on this list is considered sustainable. Without the fact that, conversely, everything that is not written on →

Simplifications, definitions and clear guidelines are important in order to give sustainability the tangibility it needs. Too much uncertainty and overburdening can also lead to hesitation and tendencies towards inertia.

it would not be sustainable. Since the taxonomy currently refers only to ecological aspects, there is at least no problem of complexity. The problem of perspective is also pushed aside by the classification.

The fact that this process is not always harmonious could be seen in the discussion on the classification of electricity production from nuclear power and gas. There were a lot of pros and cons here. In the end, both technologies were classified as necessary transition technologies, under certain conditions, and thus as sustainable in the sense of the taxonomy.

These examples illustrate that simplifications, definitions and clear guidelines are important in order to give sustainability the tangibility it needs. Too much uncertainty and overburdening – as observed in consumer behaviour – can also lead to hesitation and tendencies towards inertia. The apparent clarity, however, does not protect against the need for explanation and frustration.

IT MUST REMAIN DIFFERENTIATED

ESG rankings are suitable for a quick, approximate assessment, but not for a differentiated picture of different properties. If scores are used without questioning, there is a risk of a loss of trust.

For investors, for example, it can be very disappointing if a company with a good ESG rating suddenly becomes involved in a major scandal, even if the risk of the scandal has not been considered by the rating. This is where cognitive dissonance arises again. The new information does not match our existing image of the company. A typical reflex is to question the quality of the rating, rather than admit that it was simply unsuitable to form a comprehensive judgement.

There is also frustration when investors have invested in impact funds or sustainable products, but in the long term they achieve a poorer return than "conventional" or "dirty" funds. In experiments on common goods, nothing generates more frustration than the feeling that you are contributing a great deal to the common goal, but everyone else is not only shirking their contribution, but also benefiting from what you are doing. The so-called "tragedy of the commons" shows how quickly a downward spiral ensues, in which no one wants to use resources to achieve community goals any longer, and consequently no one will profit from the benefits of these goals. A situation that means losses for everyone.

Since frustration is not a condition that people can (and want to) endure for a long time, the (psychological) reactions are sometimes drastic: a complete abandonment and rejection of the integration of sustainability criteria or the moral exaggeration and unrestricted prioritisation of the topic, which in turn generates reactance elsewhere. Both reactions can jeopardise the real purpose of aligning economic activities with socially desirable goals. Transparency and dialogue about their respective understandings and views – my green and your green – and the willingness to integrate new information into your own views are therefore essential in order to continue to work constructively toward a more sustainable world. ◆

Theresa Eyerund is a Research Analyst at Flossbach von Storch AG in Cologne.

→ THE LONG GAME

When it comes to investing money, timing is crucial. As is patience. Although it sounds simple, it is surprisingly difficult. That's why we suggest playing the long game when planning any investment strategy.

It tends to be negative events that stick in our memories the most. Black Monday, for example. Or the terrorist attacks on 11 September 2001 and, although triggered by other factors, the economic downturn that followed. We recall the collapse of the US investment bank Lehman Brothers in 2008 and its consequences as if it were yesterday. The same goes for the outbreak of a new type of Coronavirus at the end of 2019. These are all events that have caused stock markets to tremble in recent decades and generated trillions of euros in losses worldwide – at least temporarily.

A simple remedy for the chronic fear of losses: looking at long-term share-price development

The current investment environment is also a source of unease. This is partly due to the "interest-rate turnaround" and its possible consequences, partly due to the wars in Ukraine and the Middle East, and partly due to the upcoming US presidential election and the continuously simmering conflict between the USA and China, which threatens to come to a head at any point. All these past events seem to indicate that there will soon be another stock-market crash. It's all a matter of time. And as for the huge increase in share prices of late? Just one final whistle!

CRASH FORECASTS ARE NOTHING TO FEAR

And yet the future is uncertain. No one can predict it – even if the well-known crash forecasters and prophets of doom always pretend to. Their business model is to talk a crash into existence by making the same prediction every year. This is a very comfortable starting position, by the way, because they will be proved right at some point. That is also why people predicting a crash generally have a far better reputation than those who forecast that share prices will continue to increase. The latter are quickly labelled as hopeless optimists and dreamers, and the response is considerably harsher if their forecasts are wrong.

This has a great deal to do with investor psychology. There have been a number of studies on this topic, such as those by psychologists Daniel Kahneman and Amos Tversky. 40 years ago, they demonstrated that investors are far more averse

Figure 1
Despite all the crises, the success of an investment largely depends on the time you dedicate to your investment strategy
S&P 500 index (log. scale)

Source: Refinitiv, Flossbach von Storch, data as at 31 December 2023
Past performance is not a reliable indicator of future performance.

to losses than they are pleased by gains. According to their studies, the loss of a hundred euros feels like a bigger "change in value" than a gain of the same amount. Ultimately, this causes investors to overreact when stock-market trading gets heated – or to stay away completely for fear of possible losses.

WHAT HELPS AGAINST THE FEAR OF LOSS

There is a relatively simple remedy for the chronic fear of losses, and that involves looking at long-term share-price development, as illustrated in Figure 1 by the US S&P 500 Index, one of the most important indices in the world. The share-price drops, which seem dramatic when they happen and act as a deterrent after the fact, are put into better perspective the longer the period in the graph. The one thing investors have to do when investing in equities is to be patient. They should avoid checking the share prices every day. In other words, they should not let themselves be driven crazy by the clamour and frenzy of action on the stock markets.

To do this, an investor needs to have time. Only someone who has time can be patient – and wait. Investors who want to invest in equities should therefore be able to make do without their invested capital for at least five years. Ten years or longer is even better. Warren Buffett, world-renowned investor from Omaha, Nebraska, said you should buy stocks at the best possible price and preferably never sell again. There is no better way to express the importance of time when investing.

In the past, investors were unlikely to suffer losses over a 10-year period with a broadly diversified equity portfolio. In other words, the longer the investment horizon, the greater the chance of adequate returns. This is especially encouraging for young people who want to put something aside for their retirement (or, better expressed, to "provide for the future") and have the time to do so.

Investors with significantly shorter investment horizons, such as one or two years, should probably avoid the stock market. Short-term investments in stocks could go wrong.

THE REAL DANGER FOR INVESTORS

The problem facing investors is that investing in equities is more important now than at almost any other time in our history. Interest rates have recently risen – in part vigorously, there's no doubt about that. Nevertheless, given the inflation outlook, this will in most cases be scarcely sufficient to maintain the purchasing power of an asset in the long term. In fact, it's the other way round: purchasing power is declining, even if savings book balances aren't getting any smaller. Not a pleasant prospect.

In our opinion, investors who want to at least maintain the value of their assets over the long term have no choice but to invest part of their capital in liquid real assets, first and foremost the shares of blue-chip companies, instead of in savings or call money accounts. If for no other reason, they should do this to protect against the slow erosion of their assets.

In addition, investors should wonder if it makes sense in a world of ever-growing debt to lend all their money to banks. Wouldn't it be better to buy real assets, that is, productive capital, by acquiring shares in companies? To receive profits in the form of dividends?

The Norwegian sovereign fund, which has taken earnings from the country's oil and gas business since 1996 and saved them for Norwegian pensions, is a good example of a long-term investment approach. The majority of this money is invested in equities. The Swiss National Bank (SNB) is another example. In previous years, this central bank has invested heavily in foreign currencies, the US dollar, and euros, in order to weaken its own currency, the Swiss franc. And they didn't just invest in bonds from these currency areas, but also in equities.

HOLDING OUT FOR A BARGAIN

Investors that have time don't have to fear share-price changes, not even significant corrections, provided the quality of the companies in which they invest does not falter. The core competence of an investor is to constantly weigh up the risk-reward profile of potential and existing investments.

This in turn requires a business understanding of risk, which often conflicts with the interpretation of risk in financial markets. A significant decrease in price, for instance, increases the volatility of a stock. Proponents of portfolio theory would therefore say that risk also increases, even though the price is now much lower. A business investor has exactly the opposite interpretation. Provided nothing has changed in the assets underlying the company, a lower entry price means lower risk, because it increases expected returns.

From the investor's point of view, price volatility is not bad. Quite the contrary. From time-to-time volatility creates bargains, both for equities and bonds. It is common knowledge that profit (also) depends on how one buys. In this sense, a correction on the stock markets should be a good opportunity for the long-term investor.

Investors that have time don't have to fear share-price changes, not even significant corrections.

FOR ALL SITUATIONS

Flossbach von Storch AG was established 25 years ago
by Bert Flossbach and Kurt von Storch.
The turn of the millennium – with the rise and fall
of the "dotcoms" – still shapes it today.
We take a journey into the past, and back to the future.

The first year of Flossbach von Storch AG brought its clients a double-digit share-price increase. What sounds more than respectable from today's perspective was a problem back then. Because at the same time, the stock prices of technology companies, represented in Germany by the Nemax 50, the Neue-Markt Index, were climbing to absurd share-price levels. And even the German stock index, the DAX, seemed to be unstoppable, thanks to a comparatively young index member: Deutsche Telekom. Although the consolidated result was significantly worse than in the previous year at that time, the share price rose by a whopping 150 per cent over the course of 12 months!

Investors' expectations were huge at the time. Get rich overnight – or even faster. Bert Flossbach and Kurt von Storch had to answer many questions, especially why they were so reluctant to invest in tech companies? After all, the future was in the Internet. As simple as that.

"The explosive share-price development of many technology and Internet companies, which in many cases led to price gains of more than 100 per cent, is likely to be the biggest price firework of all time, but in some cases also the biggest exaggeration," wrote Bert Flossbach in his Capital Market Report for 1999.

"THIS SHOULD NOT HAPPEN TO US AGAIN"

Client pressure grew with every point that the Nasdaq and the Nemax rose. Eventually, it became almost unbearable; after all, the young company did not want to annoy its clients. There were not that many of them yet. So, in the year 2000, the portfolios were restructured. Some consumer goods manufacturers made way for US tech companies. Yes, the future belonged to the Internet.

It didn't take long – and the future was overtaken by the present. The dotcom euphoria faded.

At the latest by the time terrorists flew two planes into the World Trade Center in New York on 11 September 2001, the world had other problems. *"This experience taught us humility,"* says Kurt von Storch today. *"We had to admit to ourselves that we were part of a bubble. This should not happen to us again."*

The turn of the millennium, especially the years after, shaped the company. In early 2003, stock prices were falling ever lower. The USA was marching into Iraq; its economy deep in recession. The situation was not much better in Europe. Germany and its businesses in particular were having problems. There was talk of the sick man of Europe, even more than today. The memories of the burst Internet bubble and "9/11" were omnipresent. The agonisingly long renegade on the stock market was wearing the shareholders down. Many gave up in exasperation.

At this time, Flossbach von Storch was only looking after the assets of wealthy individuals, many of them entrepreneurs. Euphoria had long since turned into panic. *"Clients were asking us whether there were investments that were immune to crises and disasters"*, says Kurt von Storch. *"Our response: no, there are not, although we wished there were."*

BUILD FIREWALLS

Risks cannot always be avoided. Every investment has possible catastrophic scenarios that are difficult to predict. What we can do, however, is to try to understand the risks and avoid the dangers to which an asset is exposed in the long term. Build firewalls.

During that decade, Flossbach von Storch developed the Flossbach von Storch Pentagram. It is made up of five guidelines that have proven their worth in practice and that must be used to measure all future investment decisions. Von Storch is convinced that those who consistently adhere to these guidelines will not suffer a shipwreck in terms of their assets in the long-term (Figure 1). Bert Flossbach speaks – in terms of this investment strategy – of a "strategy for all situations".

Diversification is one of these five iron principles, perhaps the most important. Wealth should always be broadly based. Don't keep everything in a savings account. Don't

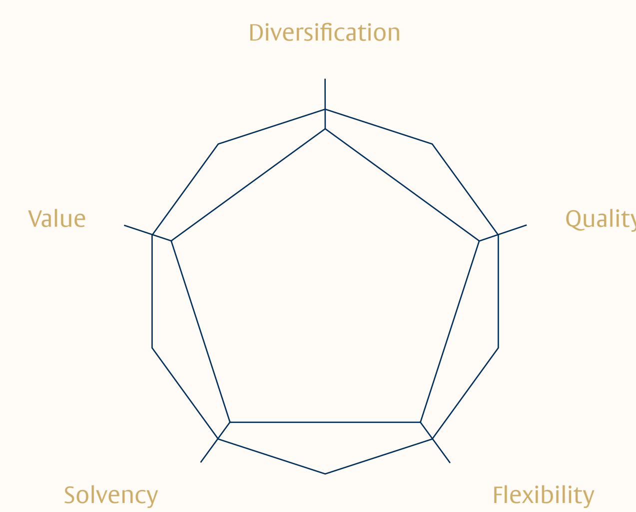


Figure 1
The Flossbach von Storch Pentagram
Five guidelines for investment decisions

This document is reserved for professional clients as defined by Directive 2014/65/EU (MIFID II) and/or for qualified investors as defined by the Swiss Federal Act on Collective Investment Schemes (CISA) – not for retail distribution.

keep everything in bonds. And don't invest everything in shares or precious metals. Diversification reflects the investor's insight that they cannot predict the future, but that they want to be as prepared as possible. For whatever might happen.

Diversification does not just mean dividing up assets between asset classes and individual securities. That would too short-sighted. Spreading wealth wisely also means dividing it into different currency areas. For example, an investor in the euro area would do well not to invest all their money in their national currency, but also in "more robust" currencies – basically, in less indebted currency areas.

However, currencies have another component: it is not just about the currency in which the bond or share that an investor acquires is listed. It is also important to consider the currencies in which a company, whose share or bond an investor holds, conducts most of its business. Currency developments are very significant for the earnings prospects of a corporation in the eurozone which generates most of its sales in the US dollar zone (and uses the US currency to account for them). This too must be taken into account by an investor in their investment decisions.

However, even if they have done all that – divided the assets into different asset classes, individual securities and currencies – they still need to put the individual building blocks together in a meaningful way. How high should the equity component be in order to maximise the probability of maintaining the purchasing power of an asset over the years as much as possible? What does this mean for the bond component, which is supposed to stabilise portfolio performance? And what proportion should gold make up (including in relation to the other asset classes) in order for the precious metal to fulfil its insurance function? And last but not least: how much fluctuation can an investor tolerate?

The composition of a portfolio is based on the capital market environment – and it should be possible for it to be adjusted flexibly over time. The environment can eventually change, or rather, it will change.

PRICE IS NOT EQUAL TO VALUE

A key feature of a robust investment strategy should also be the **quality** of the investments in which an investor invests. Betting on short-term trends is usually a gamble on the stock market and has nothing in common with long-term investing. It is much more important to consider the substance of an investment, the long-term returns generated by the investment and, above all, the predictability of those returns.

Investors should therefore always ask themselves how robust a company's business model is and thus the income it generates. Is the management capable or is it mostly made up of big talkers and champions at making announcements? Quality is a long-term asset — this is also true for investments. In the event of a crisis, it is even more important! The focus of an investor should therefore be on companies whose business models and balance sheets are so strong that they can withstand even major crises without harm. Companies that will even emerge stronger from the crisis.

Flexibility is also important. Only those who have a liquidity cushion are able to take advantage of investment opportunities should they arise. Sooner or later, that's exactly what will happen. However, that alone is not enough. The concept of flexibility, and thus also the term liquidity, should be more broadly interpreted: any investment that could potentially be of interest to an investor must be examined before acquisition to determine how easily it can be sold if necessary. What is the point of an otherwise very interesting investment if there is no market for it in an emergency?

Investors should also pay attention to **solvency**. Their solvency, and also the solvency of the party whose shares or bonds they buy. Solvency is essential for independence and the ability to act; a high level of debt, on the other hand, is the most common cause of bankruptcy and loss of assets. This, too, is all the more evident in times of crisis.

The price is what you pay — the **value** is what you get. Just as good business people do when buying and selling their wares, investors should carefully examine the value of the companies they want to invest in. Is the price possibly much higher than the investment is worth? Or is the price reasonable, or better, even lower than the actual value? Investors should never be guided by the excesses on the stock exchanges, but should always look at the true value of an investment.

AN INVESTMENT THAT SHOULD SPARE YOUR NERVES

Diversification, quality, flexibility, solvency, and value – these principles have since applied to all mandates and mutual funds of Flossbach von Storch AG – and thus not least to the Multiple Opportunities strategy, its best-known strategy today. It is a reflection of the company's philosophy.

The strategy was initially intended for the assets of company founders and their families, friends, and relatives. Today, it holds around EUR 35 billion, the money of more than one million investors, not just from Germany, but from various countries in Europe. From Spain, Italy, Belgium, Switzerland, Portugal, Austria, Luxembourg and Liechtenstein.

No strategy from Flossbach von Storch claims to beat an index (whichever one); the fund managers do not orientate themselves to any index. Instead, the aim is to generate adequate long-term returns for investors. This also applies to the Multiple Opportunities strategy. In good stock-market years, especially in rally phases, the strategy will probably lag behind the broad market; in bad years, however, it should perform (significantly) better. It is a basic investment that seeks to realise potential returns worldwide and to spare investors' nerves in turbulent stock-market times – as best it can.

That is exactly what the strategy did in the years that followed; the iron investment principles would prove their worth. When the real-estate market collapsed in the USA in 2008, the new strategy had to show that it was able to withstand major stock market storms just one year after its launch.

The financial crisis turned out to be a "crisis of the century". For years, banks, especially the US institutions, had been

> No strategy from Flossbach von Storch claims to beat an index. Instead, the aim is to generate adequate long-term returns for investors.

Figure 2
Euro in danger (part 1)
Yield development of 10-year Greek government bonds

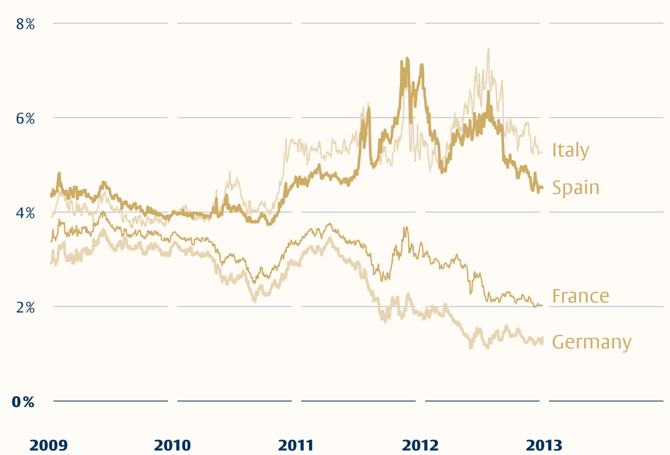


Figure 3
Euro in danger (part 2)
Yield development of 10-year Euro government bonds

Source: Refinitiv, Flossbach von Storch, data as at 31 December 2023
Past performance is not a reliable indicator of future performance.

packaging low-quality mortgage loans into structured securities and selling them to investors around the world. The major rating agencies, on the other hand, issued first-class grades to these papers. Demand was huge – given the ratings and the prospect of opulent returns.

"A SAVINGS ACCOUNT IS SAFE"

As US interest rates rose, mortgage loans failed in droves, and the house of cards began to collapse. A disaster in time lapse. Bert Flossbach noted: *"And (once again) turning a bunch of dung into a lump of gold didn't work."*

Memories of the Great Depression in the 1930s came flooding back. Banks failed as a result, all around the world, like the US icon Lehman Brothers. Or they had to be nationalised, like the German Hypo Real Estate. Prices on the international stock exchanges collapsed.

On 5 October, at the height of the crisis, the then German Chancellor, Angela Merkel, and her Federal Minister of Finance, Peer Steinbrück, were forced to stand next to each other in front of running cameras and in the flurry of flashes, and issue a guarantee for all bank accounts, savings accounts, and term deposits. True to the motto: your deposits are safe, dear savers! It is a good thing that this "guarantee" has not been put to the test (to date) …

At the end of 2008, the MSCI World equity index recorded losses of almost 40 per cent. Corporate bonds also suffered, as did some government bonds issued by countries on the eurozone periphery. The Multiple Opportunities strategy also suffered losses, but significantly less than the broad market.

A TRAGEDY, NOT ONLY FOR GREECE

Out of concern for the stability of the banking and finance sector, Bert Flossbach not only sold financial shares at an early stage, but also consistently exchanged bank deposits for safe, short-term German Bunds.

In 2010, the financial crisis calmed down, the worst seemed to be over, and the economy began gaining momentum, although there were still a few doubts. Was the worst really over? In the first Capital Market Report of the year, Bert Flossbach wrote: *"On the face of it, the central banks have stabilised the financial system and made the interest rates on safe investments disappear. But they have also driven government debt to unprecedented levels."*

The consequences soon became apparent in Greece. By the end of 2009, the euro member's national debt ratio was 129 per cent; refinancing it was becoming increasingly difficult as yields on Greek government bonds climbed and climbed. Investors' doubts were growing.

Bert Flossbach flew to Athens to get an idea of the situation on the ground. By the time he landed at the airport in the evening hours of 22 April, two-year Greek bond yields were already at 10 per cent. The next day, the Greek government called for help for the first time! Flossbach talked to numerous entrepreneurs, politicians, people on the streets. His judgement was clear: a Greek bankruptcy was inevitable, unlimited (financial) aid would not necessarily be helpful because that would mainly help the speculators – and not the Greeks.

One rescue package followed the next …

In addition to Greece, investors began to focus on other euro states too: Portugal, Ireland, Spain, Italy (see Figures 2 + 3). The financial crisis had become a sovereign debt crisis and long since also a euro crisis.

WHATEVER IT TAKES …

And the crisis threatened to escalate. Until Mario Draghi, the newly-appointed President of the European Central Bank (ECB), called the markets to order. Almost casually, in a speech in London in the summer of 2012, he said that the ECB would do everything necessary to save the euro. *"Whatever it takes"*, whatever the cost. This phrase will go down in the history books.

The words did not miss their mark. In the period that followed, risk premiums for bonds from the highly indebted eurozone countries fell significantly. The euro was safe, for the time being.

Draghi's bailout pledge was designed to give governments time to adopt necessary reforms and weather-proof the eurozone. At least that was the expectation of the head of the ECB at the time. However, this expectation was not fulfilled …

The Multiple Opportunities strategy survived the euro crisis unscathed. What helped once again was its focus on quality, especially in relation to the equity component – and not least: gold. At Flossbach von Storch, the precious metal is regarded as the currency of last resort, as insurance against the known and unknown risks of the financial system. Gold is always strong when currencies are weak. And the euro was very weak at the time. In the summer of 2010, the company's mixed portfolio contained significantly more than 10 per cent in gold.

Once again, the Pentagram's guidelines helped. Take, for example, the axiom of diversification: an investor from the eurozone should not have all their assets in the common currency. Its weaknesses were being dissected under the magnifying glass in those years. That is why fund management deliberately did not fully hedge foreign currencies, such as the US dollar, Swiss franc or Norwegian krone. Not then, and not now, even though the euro area appears largely stabilised in 2023; the risks of a very heterogeneous currency community still remain.

The fact that the eurozone still existed was due above all (or even: solely) to the ECB. With countless bailouts and large-volume bond purchases, it not only did away with interest rates in the following years, but also keeps the rapidly growing debt of the eurozone countries affordable. When money costs nothing, debt does not hurt. This was a blessing for the governments of the eurozone states. There was no need for reforms or austerity. Elections are much easier to win by giving gifts. The ECB became a kind of shadow government of the eurozone, its head, Mario Draghi, the shadow chancellor.

WHEN DEBT COSTS NOTHING

Central bank representatives always justify the massive bond purchases with the risk of deflation within the eurozone. Nobody publicly says that they are primarily relieving the financial ministers of the member states. The ECB is actually prohibited from financing the state ...

At a press gathering in Frankfurt, Bert Flossbach warned in those days of the consequences of the ultra-loose monetary policy. The massive expansion of the money supply will, sooner or later, push up inflation rates – which in turn could lead to social upheaval. The focus of the investment strategy remained the same: first-class liquid real assets, above all equities and gold. Protection against possible inflation!

However, it was not consumer prices that rose in the following years (at least not yet), but asset prices: stocks, bonds and real estate. From then on, the Flossbach von Storch Research Institute, an independent think tank co-founded in 2014 by Prof. Thomas Mayer, the former chief economist at Deutsche Bank, regularly collected information on the asset price index – and it rose from one high to the next in the years that followed (see Figure 4). Interest rates are the gravitational force on the international financial markets. They determine the valuations of all investments. These tend to be higher, the lower the interest rate.

In 2016, the yield on 10-year German Bunds fell below zero for the first time ever. Banks charged penalty interest on account balances. There had never been anything like that before. Welcome to the new world! Welcome to Absurdistan!

THE FAVOURITE EXAMPLE: BREXIT

In those years, investors were concerned above all with distinguishing the important from the unimportant. Bert Flossbach entitled one of his Capital Market Reports “Signal and Noise”. The distinction refers solely to the potential capital market impacts – and deliberately ignores other dimensions.

Let’s take the British decision to no longer want to be part of the European Union, our favourite example. The Brexit decision in 2016 had no long-term significance for the capital markets – but it certainly did for Europe’s political importance in the world.

Or Russia’s annexation of Crimea in 2014, in violation of international law. The stock exchanges took note of the invasion at the time, but not much more. The price dip was quickly ironed out again. From a (geo)political point of view, the following could be added: even then, it should have been clear to the European governments, especially Germany’s, that Russia, first and foremost President Vladimir Putin, was not the reliable partner that most had always seen him to be. It may have even been possible to prevent Russia’s attack on Ukraine in 2022, although that is pure speculation.

SIGNAL AND NOISE

All in all, the years 2014 to 2019 were good years for investors, if they were able to separate the unimportant from the important (the interest rate is the gravitational force!) and not try to anticipate every twist and turn; knowing full well that this sounds much easier than it actually is.

The rupture came in 2020, in many ways. A small coronavirus, Covid-19, forced the world into its own four walls and thus the global economy to its knees. Millions of people died worldwide, and public life came to a complete standstill at times. Stock exchanges fell faster than ever before. Within a few weeks, the MSCI world equity index lost 36 per cent (see Figure 5).

When the virus spread across Europe in February, Bert Flossbach hedged a large portion of the shares in the Multiple Opportunities strategy via the futures market. He is generally cautious about the use of hedging instruments. But this crisis was different from all the others before. Caution was advised. Navigate carefully. The significant share-price losses could be cushioned reasonably well in this way. Gold also helped during this phase.

The turnaround in the capital markets came faster than was initially expected. Share-prices were already climbing sharply as early as spring. Once again, the central bankers came to the rescue. Together with the governments, they went “all in”, as Bert Flossbach commented in his Capital Market Report. Huge aid packages were put together, and bond-buying programmes were expanded once again. The US government alone provided two trillion dollars in the first quarter. Some of the money was distributed directly to US households.

LIKE A BOTTLE OF KETCHUP

The hedges in the Multiple Opportunities strategy were gradually dissolved starting in the summer. With hindsight, one has to say: a little too hesitant. Maybe a little too late. This meant that part of the rapid upward movement was missed. Bert Flossbach and his team accepted this risk. At that stage, there were simply too many uncertainties regarding the course of the pandemic. What if the virus produced more, even more aggressive variants and vaccine research could not keep up? In this environment, no one should play the timing hero. It is much more important to protect clients’ assets.

The crisis cocktail of pandemic, the Ukraine war and loose monetary policy also caused a break in the inflation trend. Whereas asset prices, in particular, had previously been rising, now consumer prices were catching up. All the more vigorously, within the eurozone at times by more than 10 per cent. Like ketchup suddenly “shooting” out of a bottle. Such inflation rates had not been seen since 1970s.

Because the pandemic had destroyed supply chains around the world, resulting in a shortage of goods. Because Russia’s brutal war in Ukraine made energy prices soar. And because the ultra-loose monetary policy – combined with massive state aid – made sure that people had enough money in their pockets. After the end of the Coronavirus lockdowns, they used this money to buy goods that had become scarce – and thus drove up their prices.

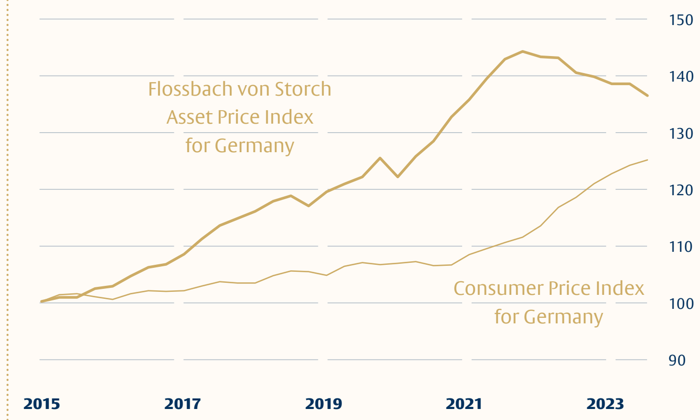


Figure 4
Asset prices lead the way ...
... and consumer prices follow
(both indexed to Q1 2015 = 100)

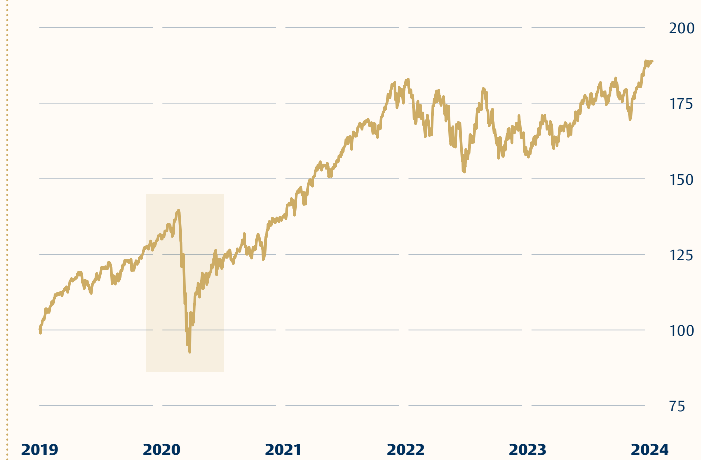


Figure 5
The world stands still, the stock markets flounder
Covid-19 triggers panic on the stock markets – but only briefly
MSCI World Index including net dividends in euros (indexed to 1 January 2019 = 100)

Source: Refinitiv, Flossbach von Storch, data as at 31 December 2023
Past performance is not a reliable indicator of future performance.

The major central banks, especially the ECB, initially saw the rise in inflation as a temporary phenomenon. It would all be over soon, don't worry. They were mistaken – and forced to react in a hurry. To fight inflation, within a year and a half, they rose their key interest rates faster and more vigorously than ever before. The ECB from 0 to 4.5 per cent. The US Federal Reserve (Fed) even went from a range of between 0 and 0.25 per cent to a range of between 5.25 and 5.5 per cent. Interest rates are the gravitational force on the financial markets ...

NEAR "ZERO" THERE IS NOT MUCH (MORE) TO BE GAINED

Bond prices were directly affected: a 10-year German Bund issued at the beginning of January 2022 lost more than 20 per cent by the end of the year, and a 30-year paper almost 50 per cent. Even five-year Bunds fell by 11 per cent, all of them uniquely poor investment results. A historic crash on the bond market! And it hit the more cautious investors; those who avoid the stock market – because they fear price volatility ...

The Multiple Opportunities strategy had no more bonds on board at this time. Bert Flossbach sold the last ones in 2021. Close to the zero line, the risk-reward profile of bonds was very poor, to put it mildly. In this respect, the bond crash did not affect investors. Gold and the high proportion of US dollars also helped in this phase.

Although that was only a weak consolation. Because in 2022, stock prices were also under strong pressure, especially the tech companies, which had previously benefited greatly from the low interest rates. Additional growth is easier to finance when loans are cheap. But stocks of companies from more defensive, less cyclical industries were also suffering. Their valuations had risen in previous years mainly because investors saw them as a kind of "interest-rate substitute". If the interest rate turns around again, less substitute is needed.

The Multiple Opportunities strategy could not completely escape the significant price correction on the stock market. Which is explainable, but still annoying, since many decisions, such as not using bonds at all, were the right ones.

Nevertheless, there will always be calendar years that do not go according to plan. The "long term" is more important. And the long-term investor recognises not least the yield potential inherent in corrections.

In the conclusion of his Capital Market Report for the full year 2022, Bert Flossbach wrote: *"That said, the risk-reward profile of many investments has improved looking forward. This is also true for segments of the bond market, where returns that also compensate for inflation can once again be generated. As long-term investors, we are therefore confident that the future will bring better years for investors again, even if the road ahead is initially rocky."*

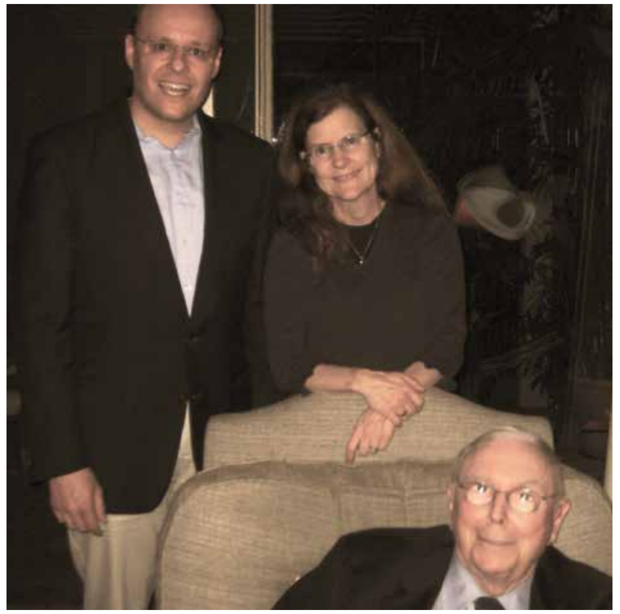
2023 will be a better year. Stock markets are rising, as is the price of gold. And bonds can also be used to generate decent returns. The composition of the Multiple Opportunities strategy has also shifted. While equities and gold still make up the majority, the bond share was again more than 10 per cent at the end of 2023. A large part of this is attributable to first-class, short-term government bonds, which serve as attractive, interest-bearing cash substitutes. There are also selected corporate bonds and so-called hybrid bonds.

In the end, also the 2023 year was nothing but a snapshot. Or, to put it another way: individual calendar years are simply unsuitable for assessing whether an investment strategy works, that is, whether it is successful in the long-term.

What is much more important is the sum of many snapshots.

by Ludwig Palm

TEACHER OF LIFE



Charles T. Munger,
known as Charlie,
has died at the age of 99.
Memories of a brilliant investor
and wonderful person.

When I learned of Charlie Munger's death in early December, I was shocked. I had probably hoped that life, Charlie's life, would never end since he had been around for so long. That he would just continue living ... a very naïve idea, I know. Charles T. Munger, the eternal investor, so close to his 100th birthday. It would certainly have been a nice celebration, on 1 January!

In the days that followed, my thoughts drifted to Charlie again and again. I remembered his wisdom, his friendly and extraordinarily interested nature. With each additional moment of reflection, the dismay gave way to a sense of gratitude.

"The school of life is not limited by semesters."

Especially since I was lucky enough to visit Charlie at his house in Los Angeles a few years ago. An encounter I will never forget.

HOW DID IT COME ABOUT?

I am a regular visitor to the Berkshire Hathaway annual general meetings in Omaha, Nebraska – the company Charlie made great with his friend Warren Buffett. I had met Charlie's daughter-in-law, Mandy Lowell, at one of the previous shareholder meetings. I got into conversation with her and through her I met him. She said she would like to invite me to Charlie's for dinner. He would certainly like the fact that I was a German engineer and married to a Chinese woman. Charlie liked engineers – and he liked Germany and China.

WHAT MAKES A GOOD INVESTOR?

I had read Charlie's publications and speeches in Poor Charlie's Almanack – about good companies, a sensible long-term investment strategy and things that make a good investor. I was also driven by my own investment thoughts. Should I invest in technology companies, for example, when Charlie and Warren were rather cautious about them? I would have loved to talk to Charlie about it.

At some point Mandy called me and asked if I would like to visit Charlie at his home, in Los Angeles. Of course, I wanted to – very much so! But I also had just as much respect, as I had the desire to visit him.

After I had landed and acclimatised in the hotel, I received a message from Mandy: she had arrived at Charlie's, she wrote – at his home. I should come round at 6.00 pm. Great, I thought, he's at home! Then I hadn't travelled all the way from Germany for nothing ...

I was excited, my stomach was tingling. What would Charlie's house look like? Who would open the door for me? How should I behave – and what should I talk to him about?

UNCOMPLICATED, FRIENDLY, AND MODEST

But there was no reason to be nervous. Charlie was different from most of the people I have met so far, that is, much more interested, therefore more intelligent, and wiser. But he was also perfectly "normal": uncomplicated, friendly and modest.

When I arrived at his beautiful, but by no means extravagant house, his butler opened the door and led me into the library. There Charlie was sitting bent over a construction drawing for student housing. He was wondering whether it would be advisable to do without windows in the bedrooms to save space; to have more room for larger common areas instead. So he planned LED lamps and ventilation in the student rooms instead of windows. This led to a lively discussion about the importance of light and fresh air for well-being.

In contrast, we touched only marginally on capital market issues, on investing in general. We also talked about good books, outstanding personalities – their biographies. About the world and its challenges.

The library was probably the place where Charlie spent by far the most time of his life. A place of knowledge. His thirst for it seemed endless and at the same time his most powerful source of motivation.

DO STUDENT DORMITORIES NEED LIGHT?

We then went to his dining room and had dinner together. During the hour and a half, I had the opportunity to ask all my questions. Charlie answered every single one. I was impressed by how deep he went into the details of numerous companies – companies from all over the world.

And yes, it's perfectly okay for us young people to invest in technology stocks. But he didn't want to get into it in his old age, even though he was also very knowledgeable about the technology sector. His grandson works for Google, and Charlie had visited their headquarters several times. I diligently took notes.

After dinner, Charlie said: *"Let's go back to the library, it's more cosy there."* We ended the evening in his favourite place.

Charlie always used to say that the school of life is not limited by semesters. He saw himself – modest as he was – as an eternal student. I, on the other hand, would say that Charlie was not just a student, but rather a teacher. A teacher of life.

Many have benefited from his knowledge and acumen, especially his congenial partner, Warren Buffett. Together, through many decades and stock-market crises, they have made Berkshire what it is today: a wonderful and remarkable company!

It was Charlie who once convinced Buffett to change his investment style: instead of buying a fair company at an excellent price, it is better in the long-term to buy an excellent company at a fair price. Buffett followed this advice, even if he had a hard time at first.

Many years later he said about his partner: *"It was the power of Charlie's mind. He broadened my horizons."*

Charlie will be missed by Buffett and he will be missed by Berkshire – that much is certain. He will be missed by so many. Heaven, on the other hand, can look forward to someone who can tell good companies from bad companies like no other. And who also knows so much more. ◆

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

by Shenwei Li

MAIL FROM SHANGHAI

Economic engine, superpower, party dictatorship. If you are interested in global trends, look to China. Analyst Shenwei Li provides a subjective report on her experiences from the perspective of a Chinese citizen. This time it is about imminent withdrawal from social security.

Like Europeans, we like to chat with our hairdressers. Sometimes we even talk about personal needs. And so, I learned during my visit that my hairdresser is considering not paying social insurance in the future because he can no longer afford the contributions. He had previously only paid the minimum amount with the help of service providers. However, since Shanghai is increasing the tax base for social security by 12 per cent this year, even the minimum amount is no longer affordable for him.

In principle, social insurance, which includes contributions to the pension and health insurance, is mandatory for everyone. It does not seem to be a good option either, because only a few years of membership entitles you to buy real estate or cars, to be kept in the local household register of major cities, to receive pensions or to receive medical expenses when you are retired.

Nevertheless, the same can be heard more and more often, especially from low-income people and solo self-employed people. The reasoning is always in the same vein: “I can only afford to take care of myself in the present moment. The future is too expensive”. But what’s behind this?

STAGNATING INCOMES AND RISING CONTRIBUTIONS

For us, the available average income has risen very sharply over decades. However, for a few years now, this increase has been only single-digit, or the development has been declining. Nevertheless, the tax base for social security increases by double digits every year. Only in the Coronavirus year of 2020 was there a break.

But the burden on contributors is enormous. For example, since 2018, the lower limit of the tax base in Shanghai has risen from 4,300 renminbi (about 550 euros) per month to 7,310 renminbi (about 940 euros), i.e. an average of 11 per cent per annum or a total of around 70 per cent.

HUGE BURDEN ON PEOPLE WITH LOW INCOMES AND THE SELF-EMPLOYED

And, unlike in Germany, the person who earns less than the lower limit must also pay contributions, but at a level as if the 7,310-renminbi earnings limit has already been reached. In such cases, the share of workers in Shanghai is 700 renminbi, and employers pay 1,900 renminbi. Now, if you are self-employed, you have to pay both the employee and the employer’s share, i.e. a total of 2,600 renminbi. This can therefore leave low-income or self-employed people with little stable income pretty empty-handed. It is therefore understandable if someone tries to reduce the contributions in such a situation.

But why is it possible to pay less at all? To answer this question, it is important to know that social security is a regional issue in China, and that each province sets its own base for calculating contributions, as well as upper and lower limits. “Service providers” help to take advantage of the regional differences that arise. Many people work in City A, for example, but have an employment contract with a company in City B, because the lower limit of the tax base is much lower there.

Although this practice was never legal, it is tolerated, partly because it relieves companies, which have to pay a higher contribution share for low-income earners, from financial burdens. A study by an HR service provider “China Enterprise Social Insurance White Paper”, which has been published annually since 2012 and for which about 5,000 companies are surveyed, shows that in recent years only just under 30 per cent of the companies surveyed were able to pay the social security contributions in full compliance with the regional tax bases. This share has fallen even further since 2020. The proportion of companies that use the local minimum wage as orientation has also declined.

So, if wages do not also move up, it just does not work to raise contributions further in the two-digit range. In order to prevent an imminent wave of withdrawal, the government should therefore come up with something. As a society with more and more pensioners, we simply cannot afford to lose more and more young contributors. ◆

Analyst Shenwei Li reports from China.

Beijing is Decoupling

China is becoming increasingly estranged from the West. The enthusiasm for the seemingly endless economic possibilities has given way to mistrust. How do the Chinese actually see this?

LEHR: **You've been to China recently, Philipp – why?**
VORNDRAN: Well, let's start with this: why not?! China is one of the most important trading partners from a European perspective, especially from the German perspective. I have always been fascinated by the country.

LEHR: **How would you describe China?**
VORNDRAN: Let's take Shanghai as an example. The city has grown up! Their infrastructure sometimes clearly exceeds that of western nations. The wild, aspiring city of the early 2000s, as in everything we recall from television reports about booming emerging economies – the many mopeds and loudly honking vans – are a thing of the past.

LEHR: **So, what's there instead?**
VORNDRAN: Shanghai's roads are much more controlled. There's still a steady flow of traffic, but nowhere near as many vehicles. As you look out of the window of your taxi, you see parks and leafy streets. The cityscape is green rather than grey. And on that subject, a significant number of the cars are powered by electric motors, including taxis. The manufacturers? Many are now Chinese.

LEHR: **You've been there more often in the past. Has the country changed?**
VORNDRAN: Definitely yes.

LEHR: **In what way?**
VORNDRAN: China is self-sufficient.

LEHR: **What do you mean by that?**
VORNDRAN: English doesn't get you ahead there today, not even in Shanghai. If you don't speak Mandarin, you need a translator. It didn't used to be that way. And if you want to pay, for example for the underground or the bill in a restaurant, you need Alipay or WeChat Pay, best linked to a Chinese account. Western credit cards are barely accepted anywhere any more. The proverbial Chinese wall seems to be taller than it looks from its other, western side.

LEHR: **This is also because Chinese citizens are travelling less and less.**
VORNDRAN: That's right. Chinese travel groups were once notorious in the West. From year to year they increased – until the Coronavirus pandemic. Since then, the Chinese have remained at home. This is also due to pressure from the party leadership.

LEHR: **How do you view the development?**
VORNDRAN: Beijing is decoupling – and that is not good.

LEHR: **You speak Mandarin. What are the Chinese people saying about this?**
VORNDRAN: My Chinese is mediocre at best, so I don't want to give you false expectations! But it helps to ask questions, especially the younger Chinese people – they're the ones shaping the future. What quickly becomes clear is that the perceived distance to the West is now much greater than it used to be. Questions about relations with Europe or the USA were usually answered with a counter-question.

LEHR: **Like what?**
VORNDRAN: "What did we actually do to you?"

LEHR: **And what do people mean when they say that?**
VORNDRAN: That the western nations have one thing above all, namely the fear of losing their power and influence. It's that simple.

LEHR: **It didn't used to be that way.**
VORNDRAN: I can still remember the time of the financial crisis – 2007, 2008. At the time, economists were discussing a possible decoupling of emerging economies from industrialised nations. China in particular was highlighted as an economic engine. The global economy was continuing to merge. Globalisation was nearing its peak. Today, two US presidents, a pandemic and a war in Ukraine later, the term "decoupling" appears in another, more dimmed light. Globalisation is being reversed.

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.

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

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

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.

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

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

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.

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.

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.

Portfolio – A collection of investment securities.

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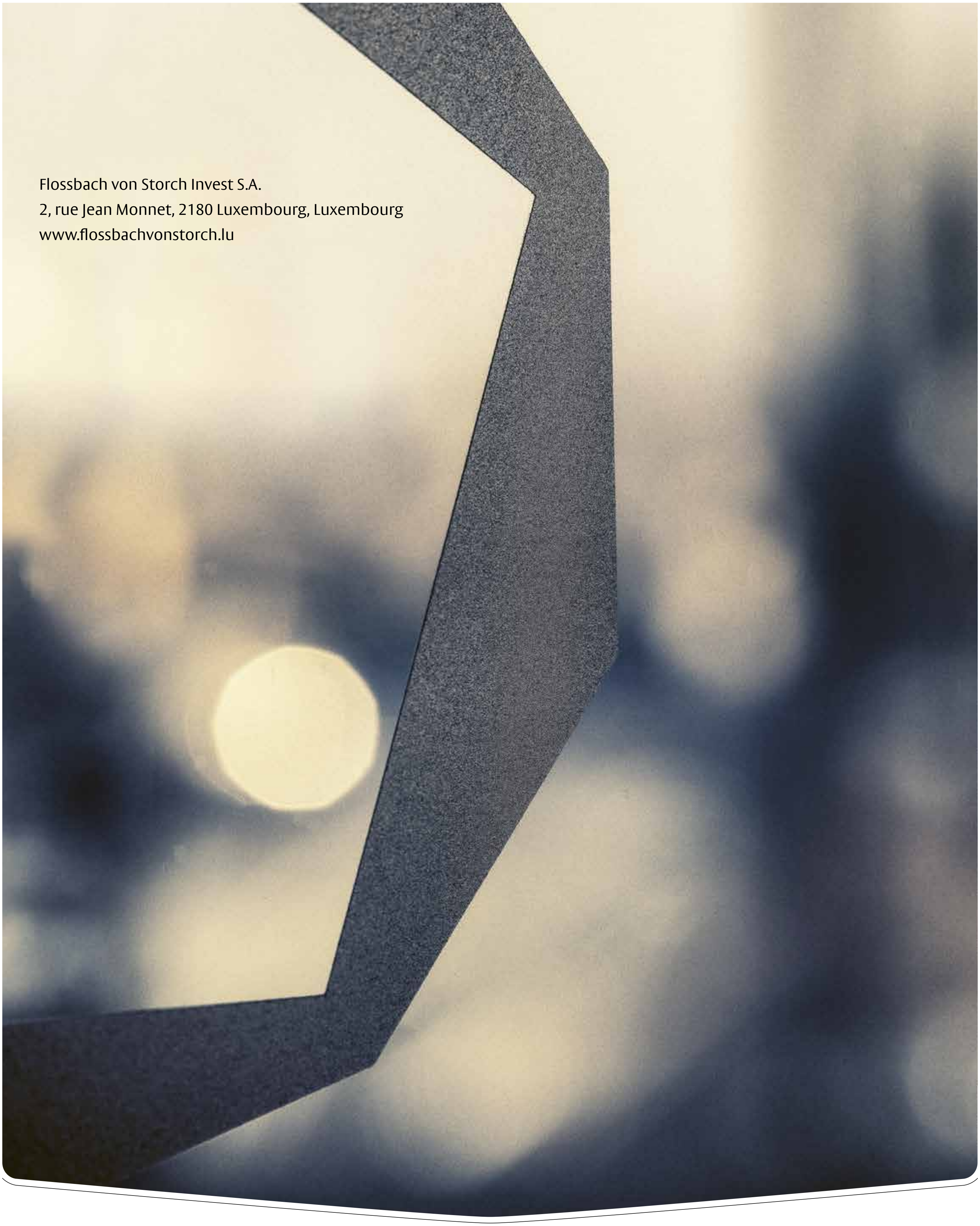

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