Flossbach von Storch

3/2020

POSITION

Thought-provoking issues for investors

D€BT is rescuing the world

FLOOD OF MONEY

Who is paying for the Coronavirus aid programmes?

MONETARY POLICY

The consequences of the debt explosion

INVESTMENTS

The zero-interest rate is driving stock markets

... but at a price

The Coronavirus crisis is accelerating developments that would otherwise take many years to determine our daily lives. For example, the billions provided by government aid and economic stimulus programmes. They prevented an economic collapse, but the price is high. National debt is exploding. Central banks are funding the (ongoing) flood of money. This is making them prisoners of their ultra-loose interest-rate policy, doomed to provide the world with cheap money ad infinitum, since the massive level of debt can only be financed with zero and negative interest rates. Inflation will likely make a comeback in the medium term. Those who invest like their parents and grandparents did can no longer maintain the value of their investments over the long term. You will find our cover stories on pages 6, 12 and 40.

Flossbach von Storch

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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

Among all the bad news, there is also some that is good, including the following admittedly very subjective observation with respect to investing. More and more people are becoming interested in equities and have recently asked whether it would be sensible to buy them now during a time of crisis – and then they are actually doing so. They buy when prices have fallen, just like good business people would do. I like this attitude.

It reflects the realisation that savings accounts can no longer be used to increase capital, but instead lead to a decrease in value. Interest rates will remain low – indefinitely. There is no other way to fund the massive levels of national debt over the long term. Equities are therefore a necessity for long-term investors. But which ones?

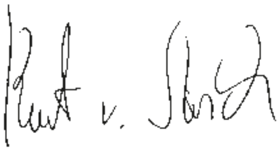
It is essential to examine this question carefully. A "fallen" equity is only attractive if the value of the company's assets has not changed. This aspect of the analysis is more important than ever, as Covid-19 is an "asset changer". Business models that were still considered reliable in January might no longer be in the future. It is therefore important to find companies that not only survive Covid-19 somehow, but instead end up even stronger. Companies with robust business models, soundly funded balance sheets and first-class management. Quality outperforms the average in the long run.

For this reason, I would always prefer a portfolio of carefully selected companies over an investment in the broad market, such as passive exchange-traded funds (ETFs). ETFs do not distinguish between business models that are good and those that are not so good. They invest in everything. And when the index concerned plunges, the ETF also plunges. Just as much. And investors have to weather the storm. My hat goes off to those who are able to do this. ETFs are definitely a cost-effective alternative for them to invest in equities. Most, however, are unable to hold out.

Instead, they become nervous when prices collapse and run the risk of selling around the low point, because that is when the pressure is highest. Even worse, they then tend to no longer want anything to do with equities – precisely during a period in which they are dependent on the long-term returns offered by the stock market.

On the other hand, investors with patience and confidence in the quality of their carefully selected companies don't have to worry about even large drops in stock-market indices. They can wait – and presumably sleep soundly with their portfolio of high-quality equities.

I wish you an enjoyable read!



Kurt von Storch
Co-Founder and Board Member of Flossbach von Storch AG

Flossbach von Storch

POSITION

3/2020

D€BT

is rescuing the world

by Bert Flossbach and Philipp Vorndran

Governments are approving economic stimulus packages and central banks are flooding the capital markets with liquidity on an unprecedented scale in order to reduce the economic effects of Covid-19. As always, this rescue will also come at a price. And someone will (have to) pay for it.

Covid-19 is putting the world to the test – both in terms of people's health and their economic livelihood. It is an exceptional situation requiring exceptional measures, in particular a massive amount of money.

The US government alone made USD three trillion available. And it stated that if more is needed, more will be provided. By the end of June, USD 521 billion (of a total of USD 659 billion) had been drawn under the "Paycheck Protection Program" (PPP) in the form of corporate loans at preferential terms. If the borrower, i.e. the company, satisfies certain criteria, such as not firing its employees during the crisis, none, or only part of the loan has to be repaid. So it is more like a gift than a loan.

THE HELICOPTER IS ALREADY IN THE AIR

One should not forget the "Federal Pandemic Unemployment Compensation" (FPUC), an increase of USD 600 per week in unemployment benefits. Thanks to the Coronavirus, many of the unemployed in the USA are receiving more money today than if they were working, at least until the end of July. Everyone earning less than USD 75,000 a year (twice this amount for couples) also receives USD 1,200 and a further USD 500 for each child. Helicopter money is therefore no longer just an academic dream, but instead is being implemented in practice today. One could also say that the helicopter is in the air – and has already dropped its first sacks of money.

No time is being lost in the eurozone either. The German federal government abandoned its balanced budget within a matter of hours and approved a supplementary budget of EUR 218 billion for the current year. EU Commission President Ursula von der Leyen presented a EUR 750 billion economic stimulus programme that is to be funded using bond issues. And the EU countries are prepared to provide guarantees. This is essentially the same as introducing the euro bonds that were previously a source of conflict for what feels like an eternity.

Worldwide there are more than USD five trillion in fiscal measures affecting government budgets, together with further government guarantees of around USD 3.7 trillion. This goes far beyond anything in the past.

DEBT IS INCREASING BY AN ABSURD AMOUNT

Expected budget deficits will also likely make everything in the past appear insignificant and drive national debt to absurd levels. The International Monetary Fund (IMF) expects US national debt to increase from 109 per cent of gross domestic product (GDP) at the end of 2019 to 141 per cent by the end of this year.

Europe, in contrast, appears almost conservative, with an increase from 84 per cent to around 105 per cent for the eurozone as a whole. There are, however, major differences within the eurozone. While Italy, the third largest economy in the eurozone, will likely have a national debt equal to 166 per cent of its own GDP at the end of 2020 (see Figures 1 and 2 on page 9), Germany's debt will likely "only" be 77 per cent, an increase of around 17 percentage points. One shouldn't, however, praise its solid budget management too much. Population ageing and a loss of competitiveness partly due to this ageing will likely also increase the debt ratio further in Germany in coming years.

As necessary as the pandemic aid packages are, it is likely that Covid-19 will be used in a few years to explain why debt has totally spun out of control. The virus, however, is just one of the reasons that expenditures have continued to rise, increasingly faster, for decades. In other words, the Coronavirus is only accelerating the trend, not causing it.

POLITICS: ALWAYS IN THE MOOD FOR GIVING

The Austrian politician Karl Pisa once said that debt is the only thing people can make even if they have no money. And so they do so. As a politician, Pisa knew what he was talking about. His profession has succumbed to this temptation all too often in past decades. Many election promises had to and still have to – depending on the perspective – be financed before or after each legislative period. Whether in the USA, Europe or the Far East. Even China, not known as an eager debtor even a few years ago, is seeing a rapid increase in debt, both government and private sector (see Figure 3). The legislative period doesn't play a role there. The mechanism of "politics buying the goodwill of people" is nevertheless the same. Dissatisfied comrades are the worst fear of the Communist Party.

The idea that these massive mountains of debt could ever be eliminated appears to be a complete fantasy from today's point of view, particularly when keeping the annual budget deficit from increasing too much is considered a success – and the end goal is a balanced budget, something that was greatly celebrated in previous years by the German Federal Minister of Finance as head treasurer.

In the 1950s, Germany still had a so-called "Julius Tower", an imaginary treasury for Germany's surpluses that were kept as emergency funds for bad times. Today, it only exists in the history books, a relic of long forgotten times.

THERE ARE FOUR WAYS A GOVERNMENT CAN ELIMINATE ITS DEBTS

Future generations will have to pay the bill, one way or the other. The big question is, what can we do to prevent even more zeros from being added to the amount?

As a rule, governments have four options for eliminating debt. Since it requires no sacrifices, the first option, namely growth, is the most acceptable by far. When an economy grows, tax revenues and the number of jobs also increase. Social expenditures – e.g. for unemployment insurance – or government pension subsidies decrease at the same time. The surplus funds are used to repay debts, and budget deficits fall as a percentage of GDP. So much for the theory.

Unfortunately, it doesn't work the way we would like in practice. Real growth rates have been falling for decades in the developed industrialised countries – and are much too low to pay off the mountain of debt in the long term.

THE PROBLEMS OF THE INDUSTRIALISED COUNTRIES ARE STRUCTURAL IN NATURE

There are structural reasons for the slow growth in industrialised countries, such as increased population ageing and the fact that easily achievable prosperity and globalisation gains have likely already been largely met. The debts themselves also prevent the debts from being paid. This is because paying out a large part of your revenues for interest and principal repayments leads to a shortage of funds for other purposes. This is the case, for example, for investment and research.

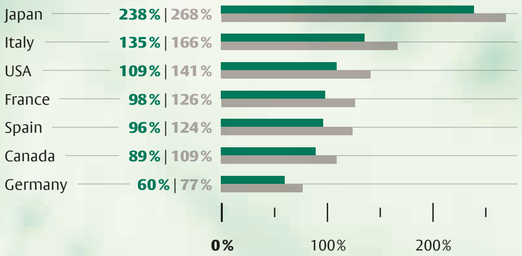
The second option for eliminating debt is considerably more painful. Governments can improve their revenue situation by raising taxes and radically cutting expenditures at the same time. This requires that the cuts be borne by a broad majority of the population. All groups must be affected, without exception, and people have to believe the cuts will be successful. Otherwise, sooner or later people will revolt.

And even if there is a broad consensus in the population, this does not mean that a radical austerity programme would achieve the goal. Large expenditure cuts will do little on their own if the country's economy is not made more competitive at the same time.

This is made worse by the fact that many restructuring concepts are restricted to individual economies, so that the consequences are not apparent. In a globalised world, cutting expenditures in country A would naturally have an effect on countries B and C. If all the countries experiencing financial difficulties were to reduce their expenditures, we might end up in a period like the Great Depression of the 1930s.

Option three, on the other hand, is guaranteed to help governments solve their debt problems, at least temporarily, and would be accompanied by a massive loss of capital-market confidence: declaring bankruptcy. A country might simply stop making payments. Either because of economic reasons that make it unable to pay, →

Figure 1 **Japan as a "model"**
Dramatic increase in national debt in 2020

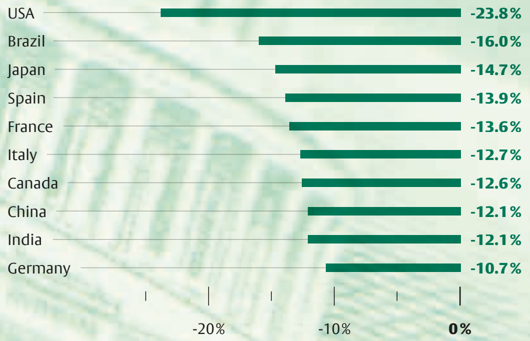


National debt ratios as a percentage of GDP:
2019 2020*

* Estimates from the World Economic Outlook in June 2020

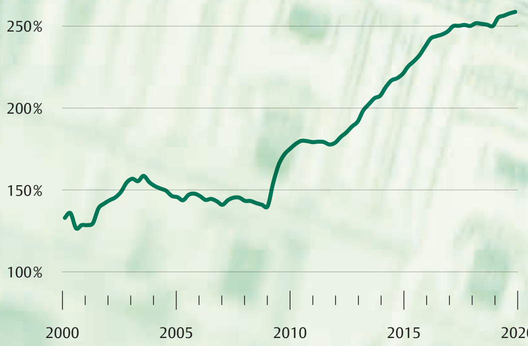
Source: International Monetary Fund, Flossbach von Storch, data as at 30 June 2020

Figure 2 **Saving will take place in the future ...**
Estimated budget deficit as a percentage of GDP (2020)



Source: International Monetary Fund, Flossbach von Storch, data as at 30 June 2020

Figure 3 **China catches up**
Private and public debt as a per cent of GDP



* Cumulative gross debt of private households, government and companies (or non-financial corporations).

Source: Refinitiv, Flossbach von Storch, data as at 30 June 2020 or because it has decided not to pay based on political considerations. A large haircut, like the one in Greece several years ago, could help in such a situation. History teaches us that haircuts alone are not a long-term solution. Without reforms, the situation after the haircut is generally the same as it was before, with the problem only appearing to be solved because it is a short-term solution.

That leaves option four, central banks as the funding providers of last resort. Although independent and above all reproach on paper (they are actually not permitted to provide government funding), they long ago became government helpers, even though representatives from both sides still consistently state the opposite. Reality caught up with them a long time ago. This applies to the US Federal Reserve (Fed), the European Central Bank (ECB) and especially the Bank of Japan (BoJ).

Japan already began moving in the direction of these new large-scale amounts of debt 20 years ago. National debt is now 240 per cent of GDP there – making the country the undisputed record debtor. There is a simple reason why the Japanese can live quite well with this, and visitors simply do not notice the state of the budget. The average coupon on all outstanding Japanese government bonds is just 0.8 per cent and will continue to fall in coming years. Since the BoJ holds around half of the government bonds and transfers its interest income back to the government, the government's actual interest burden is even smaller. That is why Japan can cope so well with its debt, because it costs (practically) nothing and can therefore still be funded over the long term.

CENTRAL BANKS GO "ALL IN"

The situation is not quite as favourable for the eurozone countries. The average coupon is 2.5 per cent for Italy's national debt and 1.4 per cent for Germany. The ECB will use the Pandemic Emergency Purchase Programme (PEPP) it initiated in March to help further reduce the interest burden. The programme was already increased by EUR 600 billion to EUR 1.35 trillion in June and has a term running to at least June 2021 and longer if necessary. In addition, its bond purchase programme (BPP), which has already been running for a long time, is purchasing around EUR 20 billion in bonds each month. In an emergency, the ECB will not hesitate to increase its efforts again. And again. And again.

The Fed is also going "all in". After taking three months to reduce its key interest rate from two to zero per cent during the financial crisis, it only took two weeks this time. On top of this, Fed Chair Jerome Powell announced an unlimited securities purchasing programme allowing limitless purchases of US government bonds and mortgage backed securities. "Whatever it takes," as the former ECB President Mario Draghi said in the summer of 2012.

The bond purchases continue to expand central bank balance sheets. Total balance-sheet assets of the Fed will likely more than double from USD 4.2 trillion to an estimated USD 8.6 trillion this year alone (see Figure 4).

In previous years, we repeatedly stated that given the massive level of debt worldwide, a return to "normal" interest rates was scarcely possible any more. In our reports, we wrote that the major central banks had long ago passed the "point of no return".

Savers could lose confidence in central banks and, therefore, the monetary system in the future.

MANY EXIT SCENARIOS! WHICH ONE THEN?

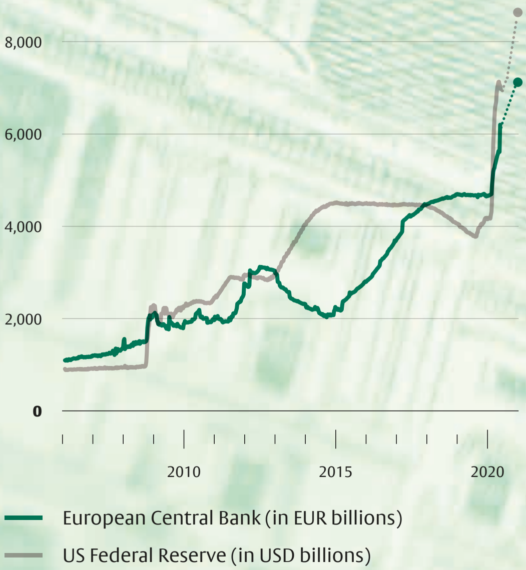
Covid-19 has made such a return practically impossible. This is in spite of the fact that Philip Lane, the Chief Economist at the ECB, recently stated to the Reuters news agency that many exit strategies were available to the ECB, just like other central bank representatives consistently stressed in previous years that monetary policy would soon normalise. Lane did not want to reveal exactly what those exit strategies were.

Central banks and governments have to keep the liquidity tap open to ensure financial system stability. They depend on each other greatly, with governments especially dependent on low interest rates. But central banks are also in a fix. Ending the policy of cheap money would ruin countries and who wants to risk that?

Things will therefore continue as they are. On and on. And savers will pay the price. They are waiting in vain for higher interest rates on call money accounts, premium savings, building loan agreements and endowment life insurance. How long will they continue to play along? When will they notice they are being fed false hopes for a future that will never come? If inflation picks up significantly, and they notice their savings melting away like butter in the sun, they could lose confidence in central banks and, therefore, the monetary system. The possibility cannot be completely ruled out.

Dr Bert Flossbach is Co-Founder and Board Member of Flossbach von Storch AG in Cologne, Philipp Vorndran is a Capital Market Strategist at Flossbach von Storch AG in Cologne.

Figure 4 **Let there be money**
Comparison of central bank total assets*



* Flossbach von Storch projections for further balance sheet increases to the end of 2020.

Source: Refinitiv, Flossbach von Storch, data as at 30 June 2020

“There are alternatives to debt-financed assistance”

Europe is also increasing debt far more than in the financial crisis to handle the Coronavirus crisis. The consequences could be dangerous, warns Thomas Mayer, Founding Director of the Flossbach von Storch Research Institute.

Prof Mayer, governments and central banks in Europe have also promised rescue packages on an unprecedented scale to cushion the economic effects of the Coronavirus crisis. What does this mean for the level of debt, which is already high?
These measures will likely cause an even bigger increase in national debt than the financial and European sovereign debt crises. This was shown by a simulation we previously performed at the end of March this year, long before we had knowledge of all the aid programmes. We assumed the global economy would shrink by five per cent in 2020. Based on these two assumptions, the debt ratio for the G7 countries would increase by 22 per cent of gross domestic product (GDP) this year. Germany might also see its gross debt approach the one hundred per cent threshold.

German GDP was around EUR 3.4 trillion in the previous year. Who is going to pay for amounts of this magnitude?
Debt will be an enormous burden for younger generations. After all, it is not as if we will be using existing savings to finance the debt. We have not put away a mountain of money and therefore cannot use cash reserves to carry us through an emergency situation. We are therefore using debt to defer the needed savings into the future and are mainly creating new money now with no counterpart in additional production.

A great deal of new money with no additional production. What does that mean for inflation? Consumer prices are still rising very slowly in the eurozone at the moment, with some eurozone countries even recording decreases in June.
That is correct. But there are good reasons to expect inflation to increase in the medium term. The money supply, for example, has increased in the USA and Europe. In the eurozone, the M1 money supply, which consists of currency in circulation and overnight deposits, rose around eight per cent by the end of May this year to a level around 13 per cent higher than the previous year. GDP fell sharply at the same time.

Prices were also expected to rise during the financial crisis due to expansive monetary policy, but the inflation rate in the eurozone actually remained below the two per cent line for years. What is the difference now?
Only a small part of the massive increase in central-bank money reached the real economy at that time. The banks absorbed it all but were too weak to create bank money for the real economy by lending it out. Central banks are now using the banks as intermediaries to lend to the government, which is then putting the money into people's pockets. The new money would, however, disappear if it was saved. Nevertheless, since fear of the Coronavirus will →

> "Debt will be an enormous burden for younger generations."

not continue forever and bank deposits provide almost nothing in the way of interest, people will likely end up spending it sometime in the future. Some have already bought assets, especially gold and equities. Major equity indices and the price of gold rose sharply in a matter of a few weeks from their lows this year. Such an increase would have been impossible without the new money.

The increase in asset prices is actually nothing new. Why, however, should expenditures on goods and services follow the asset purchases – and also increase?
The new money is still there. It has only changed hands from the asset buyer to the seller, who can now spend it. And the printing presses are still operating at full speed, so that even more money is going into circulation. If the supply of goods and services was also limited, like the supply of equities and gold, consumer prices would have to rise. The ECB, however, feels that relaxing the lockdown will allow free capacity to be used to expand supply.

Instead of causing consumer prices to rise, therefore, the new money is expected to stimulate production and turn labour idled by the lockdown into food and wages again. Why do you think otherwise?
One has to consider that the supply of money in the economy will be significantly higher after the crisis than it was before. The structure of demand could also change. Instead of airline travel, computer equipment might be in demand. The trend to increased trade protectionism and the shortening of supply chains will also likely decrease supply. If the increased supply of money in the hands of consumers then meets a lower level of supply than before the crisis and the demand for some goods is greater than before, then rising prices will likely have a greater effect on the overall price level than falling prices. Consumer price inflation would then have to increase. The chain of effects, however, is complex and it will likely take some time before the increase in money supply drives up consumer prices.

And how serious do you think this will be? Do you expect to see hyperinflation, as occurred during the Weimar Republic when money became totally worthless?
No, I do not expect that. Hyperinflation occurred in Germany in 1923 under very extreme conditions. However, if money is not saved now and the new money is not used to expand production capacity, then we will have a problem, at least in the long run. Lending is typically used to create new money for borrowers, who use it to increase the capital stock. This produces new products to cover the new money. That is, however, not what is happening at the moment. I have seen no indication anywhere that investments are soaring. That means new money is being created, while capacity is probably shrinking during the crisis.

But the representatives of the ECB say interest-rate increases could decrease the demand for loans if consumer price inflation rises sharply. Do you think otherwise?
In the case of an interest-rate increase, the amount of loans repaid would actually exceed the amount of new lending, bank money would be destroyed and inflation would likely fall. However, given the high level of debt, increasing eurozone interest rates would threaten very many debtors with bankruptcy – and could also

cause problems for some countries. A new debt crisis would occur and central bankers would have to backpedal.

Interest rates therefore have to remain low and cannot be used to make adjustments?
Precisely.

But low interest rates have a positive effect on economic growth, don't they?
The previous ECB President Mario Draghi already wanted to stimulate eurozone investment and growth by introducing low interest rates in 2012. But it didn't work. Both remained low, even when he brought about zero interest rates in 2016.

How can you explain that?
The economy of Japan, where low interest rates were already introduced in 1995, is also caught in a vicious cycle of low interest rates, low inflation and low growth. Growth has fallen considerably compared to the long-term trend from 1980 to 1990, since permanently low interest rates cause a "zombification" of the economy. That means the monetary policy is actually keeping insolvent companies alive and preventing bad loans from being written off. Companies that are only still alive because of cheap loans tie up financial resources so that no loans are available for more successful newcomers. This reduces growth, dampens inflation and perpetuates the reasons for low interest rates.

Growth and inflation are therefore negatively affected when interest rates can no longer rise.
Yes, but that is not all. If inflation were to rise sharply, central banks would likely prove to be paper tigers. This could have a negative effect on confidence in the purchasing power of our money.

Do you mean the value of the euro would decrease versus other currencies?
Some countries that were already heavily in debt will be overindebted after the Coronavirus crisis. In the worst case, emerging markets, where debt is often denominated in foreign currencies, would be in danger of national bankruptcy. If their debt is in the local currency, on the other hand, the exchange rate would probably fall.

The pressure on the euro would therefore increase?
The focus is on the eurozone countries, as their debt is in a currency they cannot control. Some countries mainly remain solvent because the ECB continues to provide support by buying their government bonds. Currency market participants feel the quality of the euro could decline significantly, causing it to depreciate versus the currencies of other industrialised countries.

"Permanently low interest rates cause a 'zombification' of the economy."

Rising inflation, fixed-interest rates, a weak euro and low growth do not create good prospects for the future. But now there are aid packages aimed at helping the hard-hit southern eurozone countries to get back on their feet. EUR 390 billion is being provided for transfers alone – won't that generate new stimulus?
Aid programmes alone will not solve the main problem in the eurozone, namely real economic divergence, which will only be worsened by the measures being used to fight the Coronavirus crisis. A completely new approach is needed to protect the European Union.

What do you mean?
When the European Monetary Union, or EMU, was created, it was assumed that the common currency would be for a small group of countries. →

It was thought that France, Germany and the Benelux countries would create an optimal currency area requiring only a common monetary policy but no fiscal transfers. Many other countries were added, however, and the end result is anything but an optimal currency area.

Are you referring to the worsening of economic differences between the northern and southern economies?

The new EU members were expected to converge rapidly at the time. However, that turned out to be just wishful thinking. A consumption boom in the southern part of the EMU led to an ongoing lack of competitiveness in the southern European economies, especially starting in 2008.

But couldn't the aid packages be used to improve this problem?

The southern European economies have received multiple large loans from the new European rescue fund since the European debt crisis, but their economies have not grown. Quite the contrary. At the end of 2019, real GDP was five per cent lower in Italy compared to the first quarter of 2008, and 23 per cent lower in Greece. Germany had a similar economic experience following reunification, which led to an economic, monetary and social union being created in 1990. Over the course of 23 years, EUR 1.5 trillion flowed into the region of the former German Democratic Republic (GDR), an amount equal to 12 times the GDP of the GDR in 1991. Unemployment nevertheless continued to rise and many young people have left the region.

Are there are no alternatives that could help the southern countries and benefit the stability of the euro?

Yes, there are. Instead of giving them money, the countries in the southern eurozone need relative price changes to improve their competitiveness. If there was no euro, the southern countries could simply devalue their currencies to stimulate growth. There are unconventional alternatives that could be used.

Such as?

Relative prices could also be lowered by introducing parallel currencies, or mini-BOTs, as suggested in Italy. These could, for example, be in the form of government bonds that pay no interest and are never redeemed. If the government issued mini-BOTs to finance part of its expenditures and accepted them as partial payment for tax liabilities, they could become a parallel currency for domestic use. The value of the mini-BOTs would then presumably decrease versus the euro, causing prices in euros to decrease and relative prices in Italy to fall for its trading partners in the eurozone.

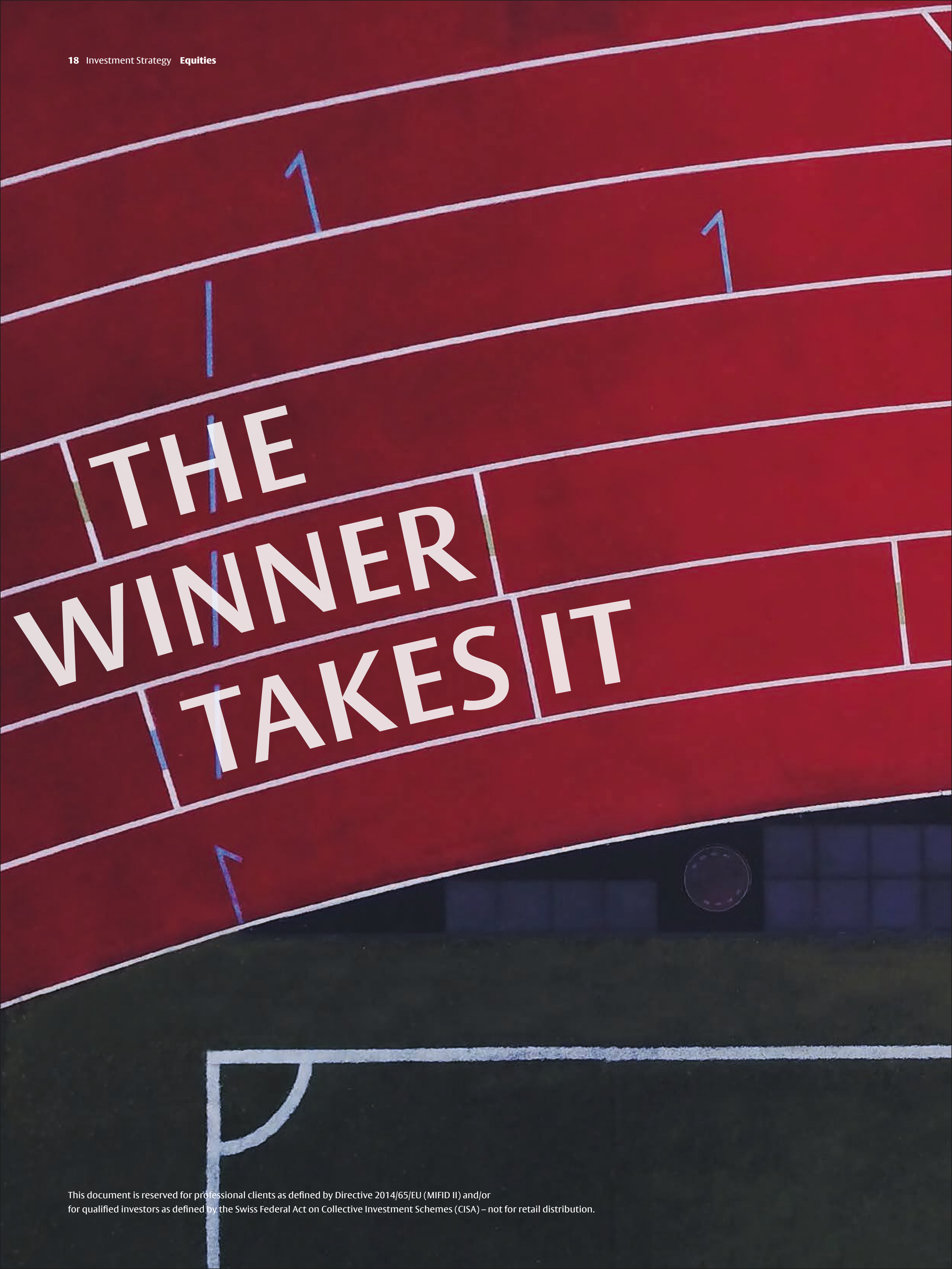
Would that increase growth?

The income support alone would increase foreign demand for Italian goods, especially for services in the tourism sector, which generate an important part of the economic activity in Italy. This would benefit economic growth and employment. The Italian government, however, would receive less tax in euros and might no longer be able to service its euro-denominated debts. The introduction of a parallel currency would therefore have to be accompanied by a decrease in debt.

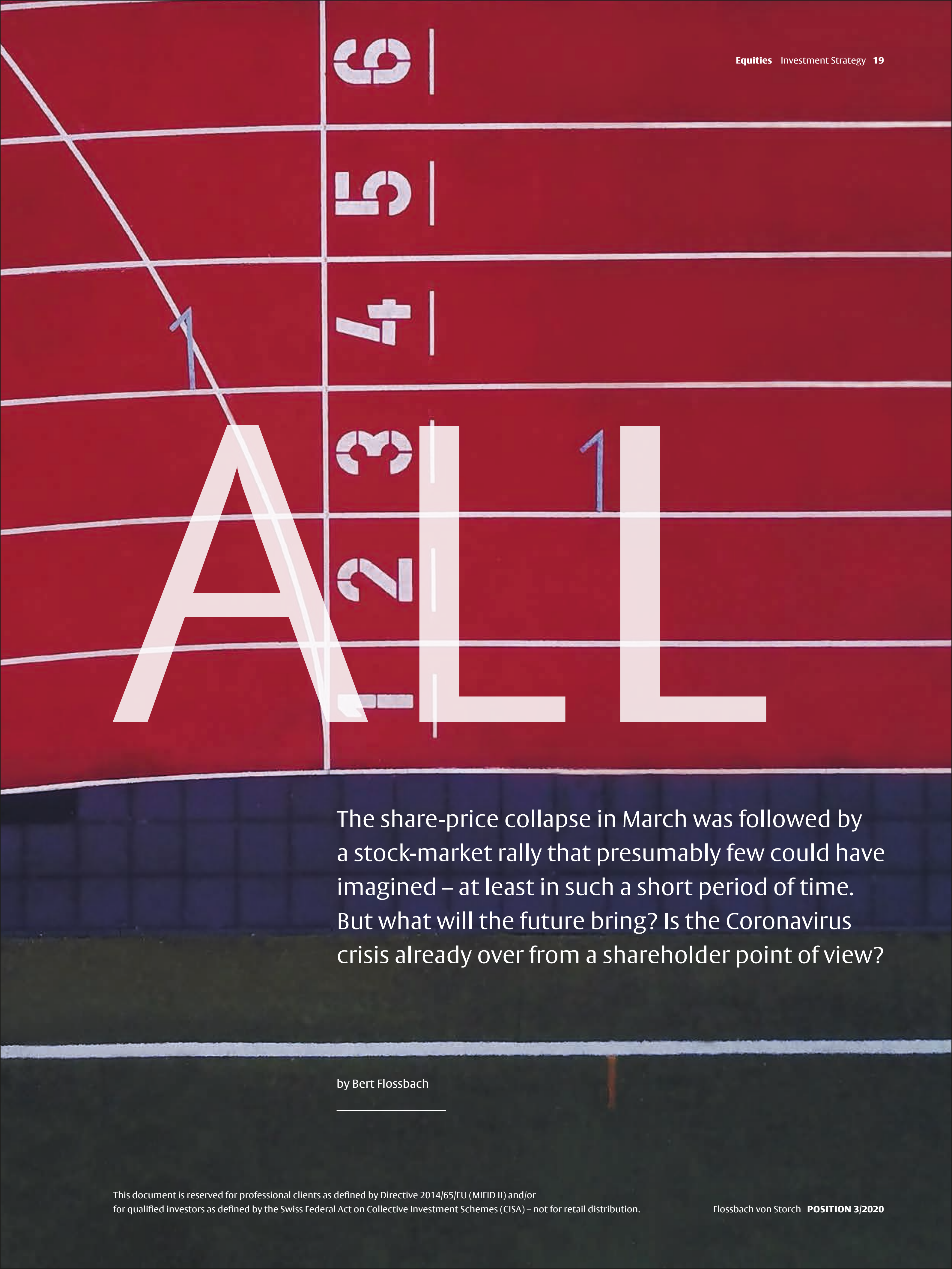
Thank you for the interview, Prof Mayer.

Prof Thomas Mayer is Founding Director of the Flossbach von Storch Research Institute.

"Some countries that were already heavily in debt will be overindebted after the Coronavirus crisis."



THE WINNER TAKES IT



ALL

The share-price collapse in March was followed by a stock-market rally that presumably few could have imagined – at least in such a short period of time. But what will the future bring? Is the Coronavirus crisis already over from a shareholder point of view?

by Bert Flossbach

The stock-market recovery seems almost surreal given the economic collapse (see graph to the right). It is normal for stock markets to move before economic changes. But they have never been decoupled to such an extent during a crisis like this. Many sectors have hit bottom and are only recovering slowly. More and more jobs are being lost. And the big wave of bankruptcies is likely still to come.

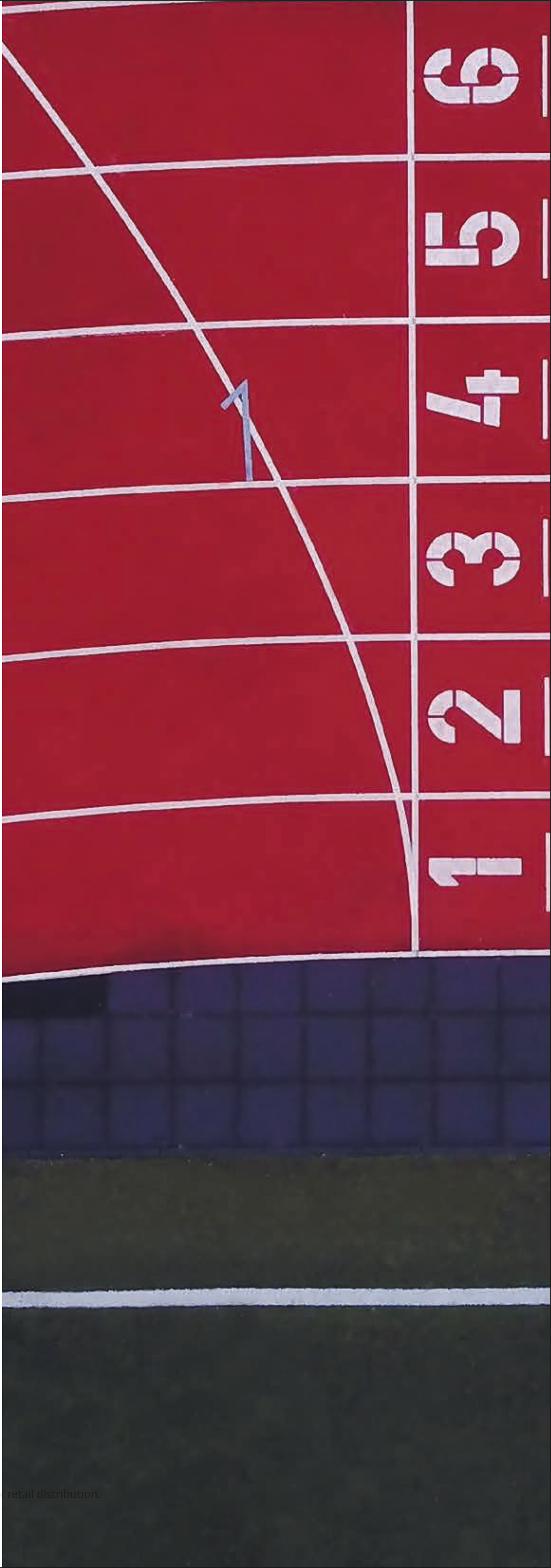
At first glance, there are therefore many reasons to be sceptical. New waves of Coronavirus infections continue to occur (without adequate amounts of vaccine), the conflict between the two great powers, China and the USA, internal political problems in the USA, as well as the upcoming presidential election, whose outcome and consequences are almost impossible to foresee. And, and, and.

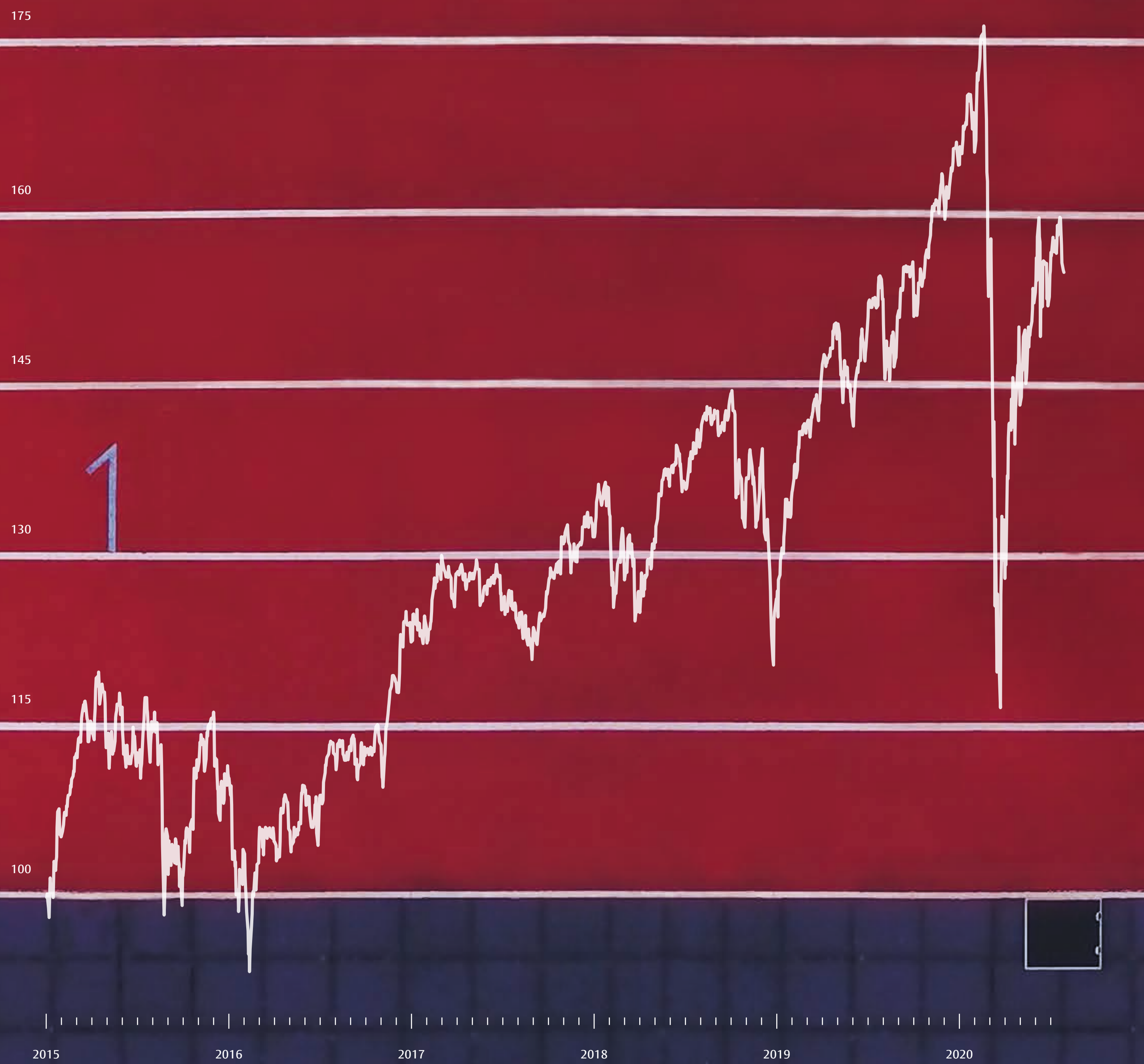
KEYNES WOULD HAVE BEEN HAPPY

On the other hand, we are seeing central banks and governments implementing aid programmes that even the famous economist John Maynard Keynes could never have imagined in his wildest dreams. Almost any wish, any gift of money can be justified by invoking the Coronavirus and can be easily funded thanks to the low level of interest rates. In countries where the interest rate is less than zero, additional debt even provides a source of extraordinary revenue for government budgets. If the German Minister of Finance issued EUR 20 billion in 10-year German Bunds, for example, he would collect EUR one billion in profits from the issue. And since a central bank exit from this low interest-rate policy is no longer possible, little will change in the future.

Equity prices and upside potential would be seriously affected if the majority of investors expected the interest rate to actually remain low.

→





Crisis, what crisis?
Global equity index in euros
MSCI World Index, incl. net dividends (indexed to 1/1/2015 = 100)

Source: Refinitiv, Flossbach von Storch, data as at 29 July 2020

Past performance is not a reliable indicator of future performance.

The situation in the USA is especially important. Interest rates there have also fallen significantly, with 10-year Treasuries yielding only 0.6 per cent at times. This is important to know, because US investors use the US Treasury yield as the relevant risk-free rate for valuing equities. This applies not only to US equities, but also to European and Japanese equities. In other words, a drop in US interest rates makes global stock markets more attractive to US investors.

Companies with better-than-average growth prospects and earnings that have proven relatively crisis-resistant will probably benefit the most. These Covid-19-resistant equities have benefited greatly from the drop in yields.

THE LOW LEVEL OF INTEREST RATES IS HELPING THE LOSERS VERY LITTLE

In contrast, the losers in the crisis, namely companies with a sustained drop in demand for their products and services (e.g. airline companies), inadequate digital capabilities (e.g. traditional department stores), or those whose business models are being put under pressure by digital alternatives (e.g. the traditional media), will probably receive little or no benefit. Although low interest rates do help these companies by reducing their future interest burden somewhat, this is small consolation given the drop in earnings. The "winners", on the other hand, benefit in two ways. First, from an increase in growth potential due to the Coronavirus and, second, from a potentially significant increase in valuations. The question is, how much further can valuations rise in coming years, given the low level of interest rates?

There was a period at the end of the 1960s and beginning of the 1970s when rising national debt and fear of inflation (with the Vietnam War as backdrop) caused investors to look for a safe haven for their assets. Private ownership of gold was not yet permitted in the USA, which meant that shares of large companies with good growth prospects offered the best protection against inflation. Investors were willing to pay up to 80 times annual earnings for certain equities at that time. The average price-to-earnings (PE) ratio for companies like this, also referred to as the "Nifty Fifty", reached a peak value of 42 – in spite of the fact that the risk-free yield on US Treasuries was seven per cent at the time!

VALUATIONS HAVE FREQUENTLY BEEN DRIVEN BY FEAR AND GREED

Valuations rose strongly again at the end of the 1990s. Not due to fear of inflation this time, but due to the tremendous growth spurt promised by globalisation and the World Wide Web. Many of the Internet stars at the time had never even earned a profit.

Although both periods saw just a small group of companies record massive valuation increases, the reasons were very different. In the 1970s, the main reason was security (flight to real assets), and in the late 1990s it was the outlook for rapid long-term economic growth, followed by the desire for quick profits, speculation. Interest rates were comparatively high in both periods.

Although the situation is different today, the outcome could be the same. The situation today is affected by a combination of two factors, both ironically strengthened by the Coronavirus crisis, namely the ongoing low level of interest rates and signs of an improvement in growth prospects for individual sectors and companies. Millions of new securities accounts were opened with brokers in the USA in the first quarter of this year alone. Many private investors clearly felt the stock-market crash was a good time to enter the market. The zero interest rate provided by savings accounts likely made the decision to purchase equities significantly easier. The trend was strengthened by the rapid market recovery and spectacular price gains recorded by some equities, and investors became increasingly motivated by speculation during the spring. Although this also drove up the valuations of the heavyweights in the technology sector, their PE ratios of 25 to 35 are still considerably lower than the level during the boom phases described above.

Many investors will be relying on regular returns to protect their assets against inflation in future years, which is why we feel there is no alternative to the equities asset class. Investing money in bank accounts or money market funds that earn zero interest is simply too "risky" in the long run. Investments should, of course, not only be made in high flyers in the technology sector. Shares of promising companies with solid balance sheets, like those in the consumer and healthcare sectors, also belong in a broad-based portfolio that provides both value preservation and long-term growth.

A DREAM SCENARIO FOR TOP QUALITY EQUITIES, EXCEPT …

Ironically, equities would become even more attractive if the Coronavirus crisis continues to worsen, since more central bank-funded aid packages would be needed. If the flood of liquidity actually generated inflation at some point, the flight to real assets would provide another reason for investing that might be even more important, since the mountains of debt can't be eliminated without inflation. Although the combination of high inflation and artificially low interest rates would be a dream scenario for high-quality equities, it would also leave a bitter aftertaste, since many people who prefer to keep their money in bank deposits and savings accounts would gradually see the value of their money melt away.

As a liquid real asset, gold would also benefit from higher inflation. According to the World Gold Council, gold ETFs bought 734 tonnes of gold in the first half of the year, more than in the entire previous record year of 2009. This reflects a steady increase in investor demand that has less to do with the Coronavirus crisis itself than its consequences. The massive increase in national debt, permanent low interest-rate environment and concerns about inflation make gold attractive as a "safe haven" for many investors. It is noteworthy, but not surprising, that the increase in gold ETF holdings was particularly large in the USA. Record low US interest rates and a record high level of national debt motivated both private investors and institutional investors to increase their investments in gold in spite of the recent stock-market rally.

We feel that gold provides protection against inflation and potential crises in the financial system, and are happy to have this form of insurance, although we would be even happier if we didn't have to use it. ◆

Dr Bert Flossbach is Co-Founder and Board Member of Flossbach von Storch AG in Cologne.

"It is important to start early."

We got to know Marita and Heribert Schlüter through "the newspaper", so to speak. We saw a picture of them in "Euro" magazine in the summer of 2014, sitting on a bench in the garden and smiling. The article was titled "Our favourite fund". The Schlüters were particularly happy with one of their funds, and we were pleased to read that it was one of ours! What they said was more than just a nice confirmation of the value of the fund. They expressed what our work is ultimately all about, what motivates us, namely helping investors achieve their financial goals and meeting – or even better – exceeding their expectations.

The author of the article was not interested in confirming the value of the fund and even less about the current situation at the time, but was instead interested in whether their favourite fund would still be their favourite tomorrow. Whether good funds remain good forever. Unfortunately, like so many other things, there are no guarantees. Just hard work and an analysis of opportunities and risks. Each and every day.

We have talked with the Schlüters several times since then to see whether they are still satisfied with their fund. The first time was a while ago, when Bert Flossbach called them shortly before Christmas. The last time was just recently, in May during the Coronavirus, when the POSITION editors interviewed them by video conference. The fund is now the biggest in their portfolio. And the Schlüters told us that, yes, they were still satisfied, very satisfied in fact. Our interview – or parts of it, at least – is summarised below, naturally with their permission ...

What are your thoughts about the Coronavirus?

MARITA SCHLÜTER: It is strange and frightening, but we are trying to make the best of it.

HERIBERT SCHLÜTER: Like everyone else, we have no other choice. Even though it is sometimes difficult, it is better to remain optimistic!

What are you worried about, in spite of your optimism?

MARITA SCHLÜTER: The news reports about the effects it is having and where it could lead. Companies going bankrupt and the many jobs that are in danger. And the massive amounts that have to be paid out because people everywhere are short of money due to the Coronavirus. Who is going to pay for all of this? It will be a huge burden for the next generation. And I wonder whether we are going to see massive inflation appear at some point, like the newspapers are reporting.

Are you more worried about the economic effects or potential health effects?

HERIBERT SCHLÜTER: Health is most important. If you aren't healthy and remain healthy, you also can't spend any money.

MARITA SCHLÜTER: Even though money is also important and provides security, it is far less important than health.

You invest your money in funds. Why is that?

HERIBERT SCHLÜTER: It started with the financial crisis in 2008/09. We noticed that we were receiving less and less interest on our bank deposits. Although savings accounts used to be a safe, easy way to save money, whether it was bonus savings, surplus savings, or any other kind of savings account, the returns decreased steadily over the years.

MARITA SCHLÜTER: We felt we were at a disadvantage as savers and were being treated as second-class customers, so to speak. We therefore began to look more closely at investments and found that our bank offered more than just the savings accounts we were previously familiar with.

HERIBERT SCHLÜTER: We then went to an asset management company and found an excellent advisor we have been working with since then.

MARITA SCHLÜTER: He also recommended the fund to us.

What does your bank advisor have to say about that? Has he tried to encourage you to use savings accounts again?

HERIBERT SCHLÜTER: He naturally asked, but we quickly explained the situation to him. This is also not easy for him. I am sure he would be happier if interest rates were considerably higher, as that would make savings accounts more attractive. And marketing them to customers would also be easier, as I think most people are very cautious when investing their money. Most importantly, they don't want to lose anything.

Are you not being cautious enough?

MARITA SCHLÜTER: On the contrary. We have always been cautious. We never had large debts, for example.

HERIBERT SCHLÜTER: Except for the house ...

MARITA SCHLÜTER: Yes, of course. Now you've distracted me (laughs). Where was I?

“Who is going to pay for all of this? It will be a huge burden for the next generation.”

HERIBERT SCHLÜTER: That we are cautious and always have been.
MARITA SCHLÜTER: That's right. Thank you! We also naturally don't want to lose any money. We had to work hard for it. And that is exactly why we want it to increase over time, not decrease. After all, that is the whole reason for saving. That is what we learned, and we think it is normal.
HERIBERT SCHLÜTER: I think time is the most important factor. As an investor, you have to have patience, which sometimes means just gritting your teeth and bearing it! The situation will pass, like so many other times in the past.

Like in March, when the market crashed?
HERIBERT SCHLÜTER: Yes, that was a crazy situation and a bit painful for a while!

Does it make you nervous?
MARITA SCHLÜTER: Yes, of course. Although we come across it in the newspaper, Internet and television news, we try to remain relatively calm.

Are you actively following what is happening in the stock market?
HERIBERT SCHLÜTER: We are typical newspaper readers. The financial section is definitely one of the parts we are interested in.

Do you check the prices of the funds in your portfolio regularly, particularly in previous weeks?
HERIBERT SCHLÜTER: Not all the time. Just once in a while.
MARITA SCHLÜTER: We have great confidence in our advisor – and the funds he recommended to us.
HERIBERT SCHLÜTER: It is also not the first time the stock exchange has gone down.
MARITA SCHLÜTER: And presumably not the last. The good overall performance of the funds also made it easier to bear in the past.

Do you have a specific goal for your investments?
HERIBERT SCHLÜTER: We always wanted to set aside something extra for our old age. You never know. We might need nursing care at some point and have to move again. It is reassuring to build up a reserve you can fall back on if needed.

"Just grit your teeth and bear it! The situation will pass, like so many other times in the past."

> "If there is one thing they have that older people do not have, it is 'more time'. "

What is your biggest worry when you think about your investments?

MARITA SCHLÜTER: We are actually quite confident. Other people who have most of their money in term deposits are not earning returns. Although inflation will affect everyone if it arrives, savers will be hit much harder.

Will interest rates ever increase again – what do you think?

MARITA SCHLÜTER: I don't think so. How could they pay for everything? Take real estate, for example. No one would be able to afford it any more if there was a big increase in interest rates.

HERIBERT SCHLÜTER: I can't disagree with my wife on that. Or anything else, for that matter (laughs). Young people do have a great deal of time, but not that much.

You have grown-up, working children. Do you talk about investments when they visit?

HERIBERT SCHLÜTER: We don't give any investment tips, if that's what you mean (laughs). But we do naturally talk about it. About interest rates, for example. Fortunately, because of their independence and education, they are familiar with these topics. Providing for retirement is very important for young people. They are going to have a harder time with their pensions than we did, and therefore have to deal with the issue and learn about the possibilities.

MARITA SCHLÜTER: We taught them to be careful with debt and put money aside, and I think they are doing that.

HERIBERT SCHLÜTER: I think so, too.

We would nevertheless like a tip – or even better – some advice from you. What would you recommend to your children's generation with respect to investing?

HERIBERT SCHLÜTER: It is important to start early.

MARITA SCHLÜTER: I agree. If there is one thing they have that older people do not have, it is "more time".

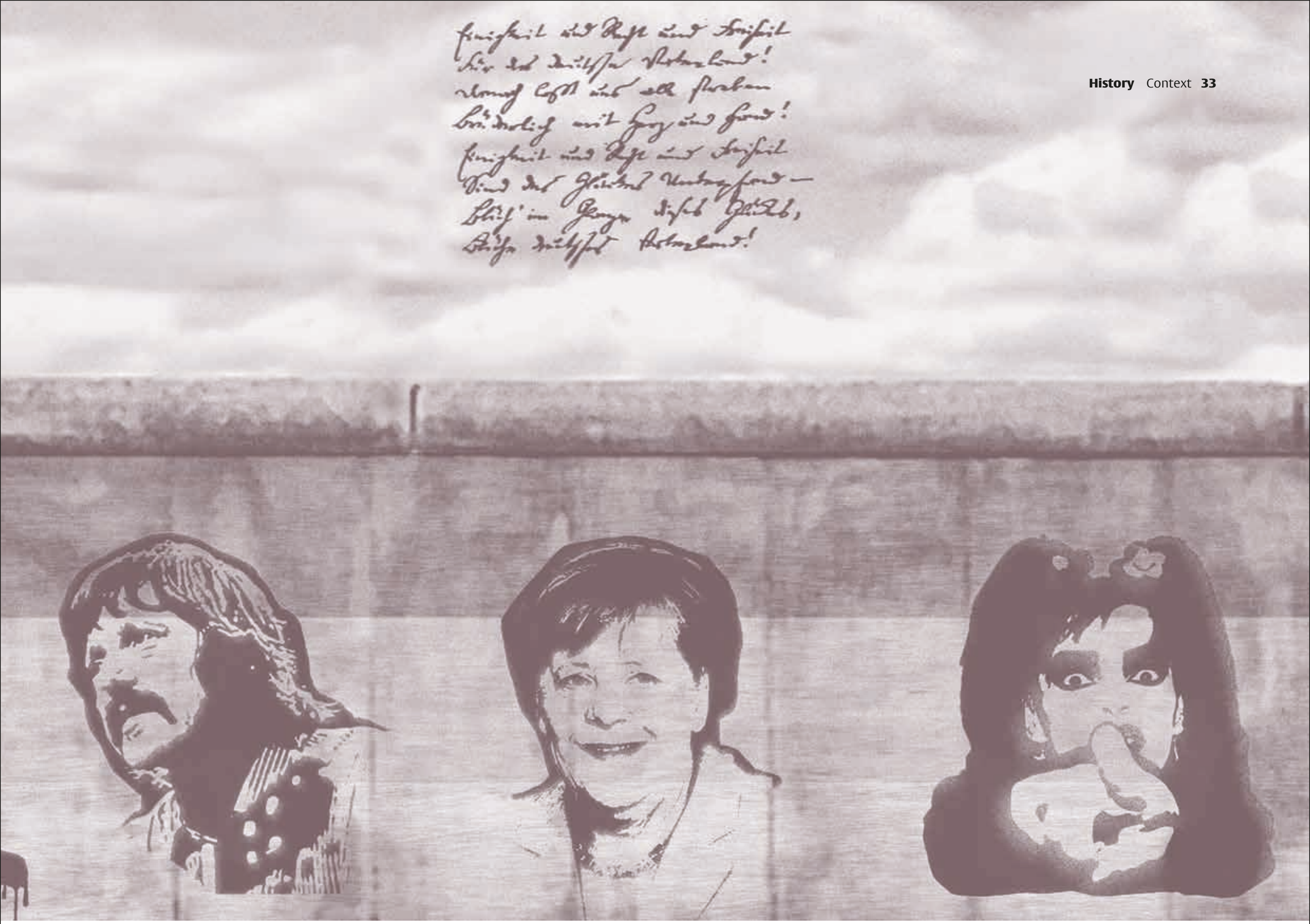
Thank you for the interview.

THE PRICE OF UNITY

When political will moved mountains (of debt)

by Julian Marx

Europe is implementing aid packages on an unprecedented scale during the Coronavirus crisis. Governments are calling for solidarity. Some are invoking the vision of a United States of Europe. This is similar to the reunification of Germany. Here is a comparison.



What a massive flood of money! After the usual negotiating marathon, EU member states reached agreement at the end of April on a EUR 540 billion solidarity package for the countries hit hardest by the Coronavirus pandemic. Only a month later, France and Germany initiated a European economic stimulus programme that provided a further EUR 750 billion under the "Next Generation EU" recovery plan, which was approved in July. Although this is just an exception, implementation of the French-German plan means debt communitisation is now a fact.

We are at the start of a new era. This is because the European Union (EU) is not actually allowed to borrow on its own, but is instead funded solely through member state contributions. Those in favour of euro bonds say the ability to issue its own bonds would make the EU more effective in the future. Some are even calling for a "Hamilton moment", referring to the suggestion made by the first US Secretary of the Treasury, Alexander Hamilton, shortly after the founding of the United States of America in 1790, namely transferring the debts that the individual states had accumulated during the War of Independence to the new federal government and issuing bonds. The United States of America as we know it today was born with adequate financial resources.

Can the United States of Europe be realised in the same way? Solidarity in spite of different languages and the lack of a common public? Solidarity like this was not even guaranteed during German reunification 30 years ago, when two (temporarily) independent states with completely different economies were united: the Federal Republic of Germany, a Western democracy, global export champion and economic miracle, and the former German Democratic Republic (GDR), a single-party dictatorship based on Marxist-Leninist ideology that had built a wall to separate itself from the West.

Unresolved property ownership issues were a major source of conflict in the years following reunification. Wrongful →

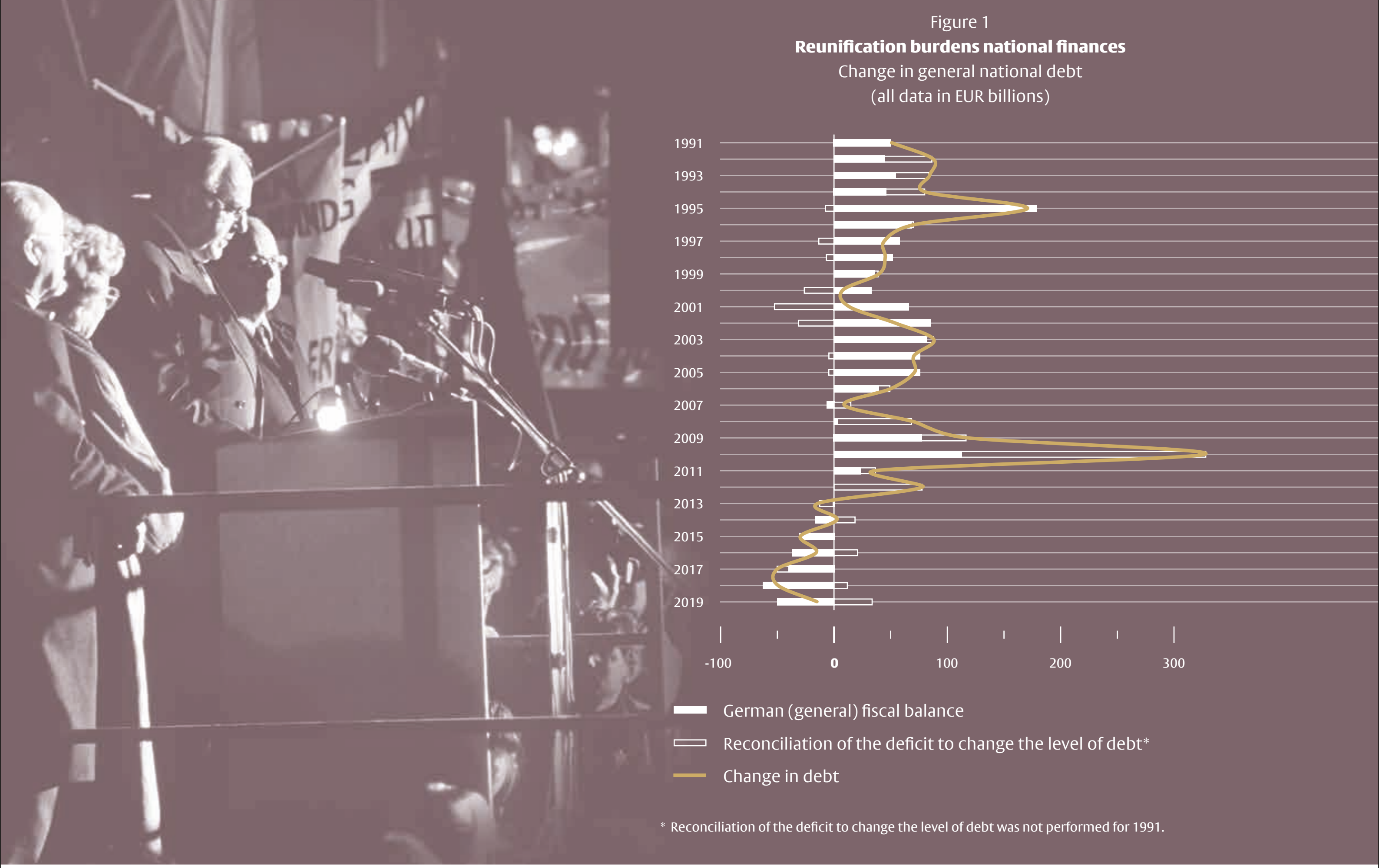


Figure 1
Reunification burdens national finances
Change in general national debt
(all data in EUR billions)

* Reconciliation of the deficit to change the level of debt was not performed for 1991.

expropriation by the GDR had to be weighed against the possibility of committing new wrongs by intervening in the ownership structures that had developed during the four decades the GDR had existed. Other past issues also had to be dealt with. Social integration was needed. Many in the western part of Germany, including those who had escaped the GDR, worried that those who had been in power would gain power again, and those who were persecuted would once again be at a disadvantage. Many in the eastern part of Germany were concerned that the onslaught of Western consumer society might also destroy the good aspects of the GDR they identified with. German reunification was therefore a *tour de force* that was definitely worthwhile, but still continues today.

FLOURISHING LANDSCAPES, MASSIVE NATIONAL DEBT

Unification of the GDR and the Federal Republic of Germany was an enormous challenge for Germany and a historical example of different political systems being merged while economic interests took a back seat. It demanded a great deal of solidarity from the government and people in the end, as shown, for example, by Germany's national debt, which more than tripled during the era of Chancellor Helmut Kohl.

The enormous increase was mainly due to reunification, which officially took place on 3 October 1990. A common currency had already been introduced in July 1990. Massive fiscal measures were especially needed in the initial years in order to realise the promised gradual convergence of living conditions in the new eastern German states to the standard enjoyed in the western states. This is shown by the budget records starting in 1991, when the GDR and Federal Republic of Germany first began presenting a common budget.

Although the German government introduced a permanent solidarity surcharge in 1995, which still has the effect of an

Figure 2
Fiscal balance over time
History of the fiscal balance of the reunified Federal Republic of Germany

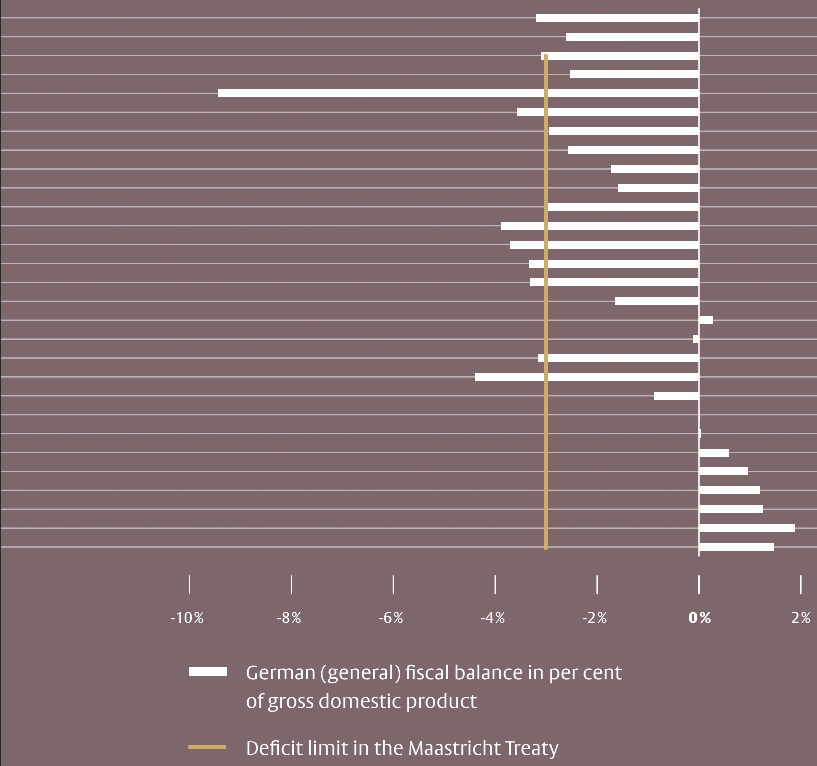
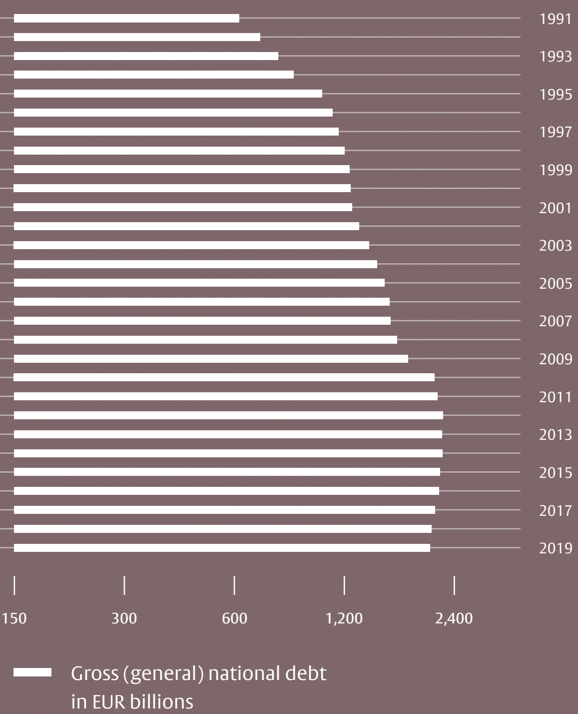


Figure 3
Political will can move mountains of debt
Debt of the Federal Republic of Germany since reunification (logarithmic scale)



Sources: German Bundesbank, Flossbach von Storch, data as at 30 June 2020

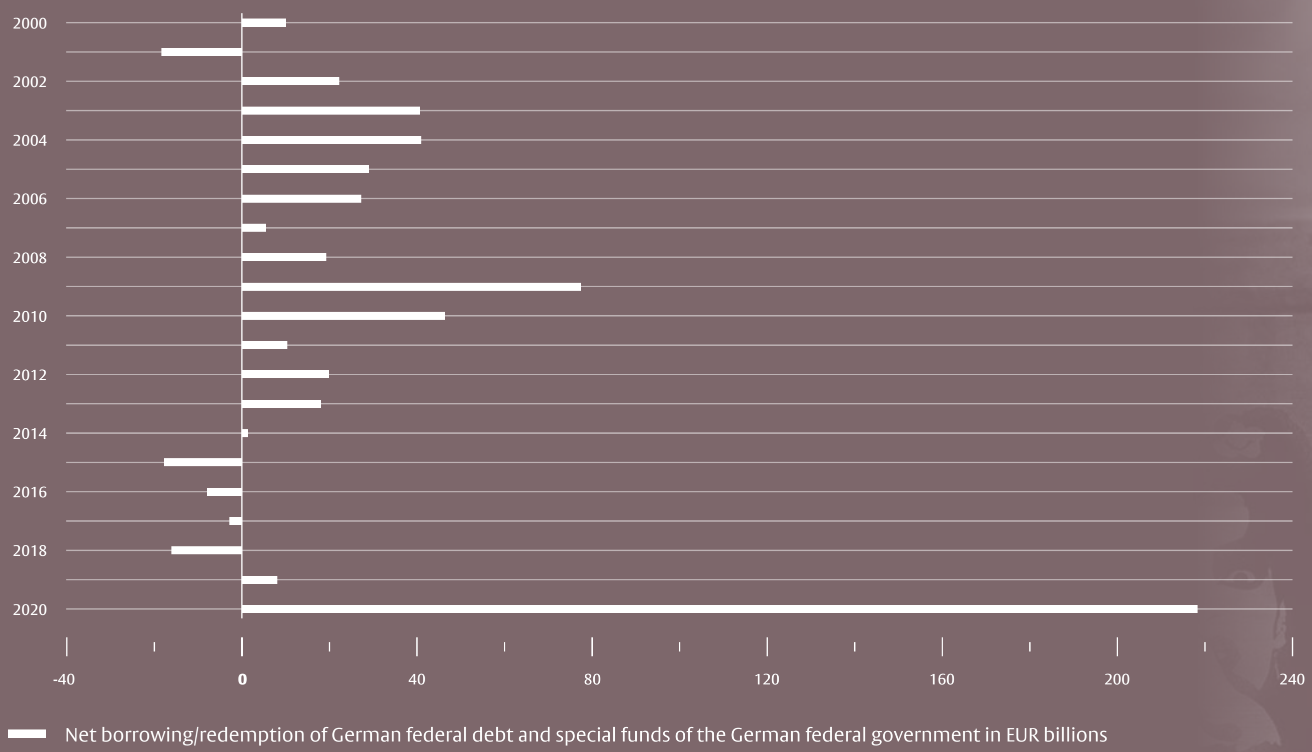
increase in income tax today, this new revenue source was unable to stop the German mountain of debt from rising from EUR 618 billion at the end of 1991 to EUR 1,239 billion at the end of 1999. National debt as a percentage of gross domestic product (GDP) rose from 39 to 60 per cent of GDP during this period.

SPECIAL FUNDS OF THE GERMAN FEDERAL GOVERNMENT FOLLOWING REUNIFICATION

There are special reasons the year of reunification was not the "most expensive" year for the government. But why was 1995 a record year for new debt, not 1991? This was because a special accounting method was used. After reunification, a large part of the new debt was initially transferred to special funds of the German federal government (*Sondervermögen*). The debt assumed by these special funds did not necessarily affect the deficit. If an assistance loan was fully repayable, for example, it was deemed an acquisition of financial assets. This meant the national debt initially increased significantly more than the government deficit reported at the beginning of the 1990s (see Figure 1).

These new special funds included the "German Unity" (*Deutsche Einheit*) and "Debt Processing" (*Kreditabwicklungsfonds*) funds, which were used, among other things, to fund the economic development of the new eastern German states and assume liabilities of the former GDR. This was followed by the creation of the "Redemption Fund for Inherited Liabilities" (*Erblastentilgungsfonds*) in 1995. In addition to debts assumed from the former GDR, this fund also assumed the debts of the Treuhand agency, which was created prior to reunification to privatise and restructure state-owned companies. Transferring the debts of the Treuhand agency to this fund increased the deficit by EUR 122 billion, generating a record deficit of EUR 178.7 billion in 1995, equivalent to 9.4 per cent of GDP at that time (see Figure 2).

Figure 4
The German government goes all in
Massive borrowing in 2020*



* Preliminary estimate for 2020 based on the German federal government's second supplementary budget of 17 June 2020.
Source: Federal Ministry of Finance, Flossbach von Storch, data as at 30 June 2020

MONETARY UNION AND THE "DEBT BRAKE"

The government also had the courage to show solidarity with respect to government finances during this extraordinary time. But Chancellor Kohl assumed other obligations. In 1992, he was one of the founders of the European Monetary Union, which obligated member states to follow a common monetary policy and introduce a common currency. The Maastricht criteria were introduced to maintain stability. Since then, member states have been required to limit annual new borrowing to three per cent and total debt to 60 per cent of GDP.

Germany has violated these limits multiple times. Germany passed legislation introducing a "debt brake" (*Schuldenbremse*) in 2009, the middle of the financial crisis, aimed at achieving long-term stabilisation of federal and state government finances. In principle, German federal budget expenditures may not exceed revenues – structural net borrowing is limited to 0.35 per cent of GDP. This limit was suspended, however, due to the Coronavirus pandemic. While the balanced budget policy followed in previous years limited the national debt to 60 per cent of GDP, it also led to heated discussions. Critics complained that insufficient investments were made during this period. Proponents, on the other hand, stated the government had to save during good times in order to have adequate reserves if a crisis occurred. There was one point, however, on which they all agreed. When Germany approved the debt brake, it was fully capable of complying. And Germany's debt actually did decrease for a number of years (see Figure 3 on the previous page).

OLD DEBTS STILL ON THE BOOKS

That does not mean, however, that German national debt, which now exceeds EUR two trillion, was massively reduced – even though the economy was running smoothly for long

periods of time. The lion's share of the costs of German unification is still on the books today, and whether they will ever be repaid remains an open question.

Germany suspended the debt brake in response to the Coronavirus crisis. The fiscal packages that were passed to (economically) fight the Covid-19 pandemic will make the mountain of debt even larger. Under German Federal Minister of Finance Olaf Scholz, the deficit in 2020 will soon significantly exceed the record deficit in 1995. He was already using new superlatives during the negotiations on EU aid packages. The supplementary budget published on 23 March 2020 estimates net borrowing of EUR 156 billion for 2020. A further EUR 62.5 billion was provided for in another supplementary budget in June. Aside from this, the federal government can borrow up to another EUR 200 billion if the Economic Stabilisation Fund (ESF) that was created specifically to stabilise the economy requires more firepower. And the actual amount of borrowing could be even considerably higher by the end of the year, even though this level is already three times as high as during the peak times of the financial crisis (see Figure 4).

THE UNITED STATES OF EUROPE

The aid packages for Europe are in addition to this and should already be mentally added to the German budget today. Similar to the special funds following reunification, there will be a delay before they affect government finances. In the end, the planned borrowing by the EU should be funded by major increases in EU contributions. This *financial tour de force* can only be managed over generations. Polls nevertheless show German solidarity with the countries hard hit by the pandemic. Most Germans remain convinced Europeans.

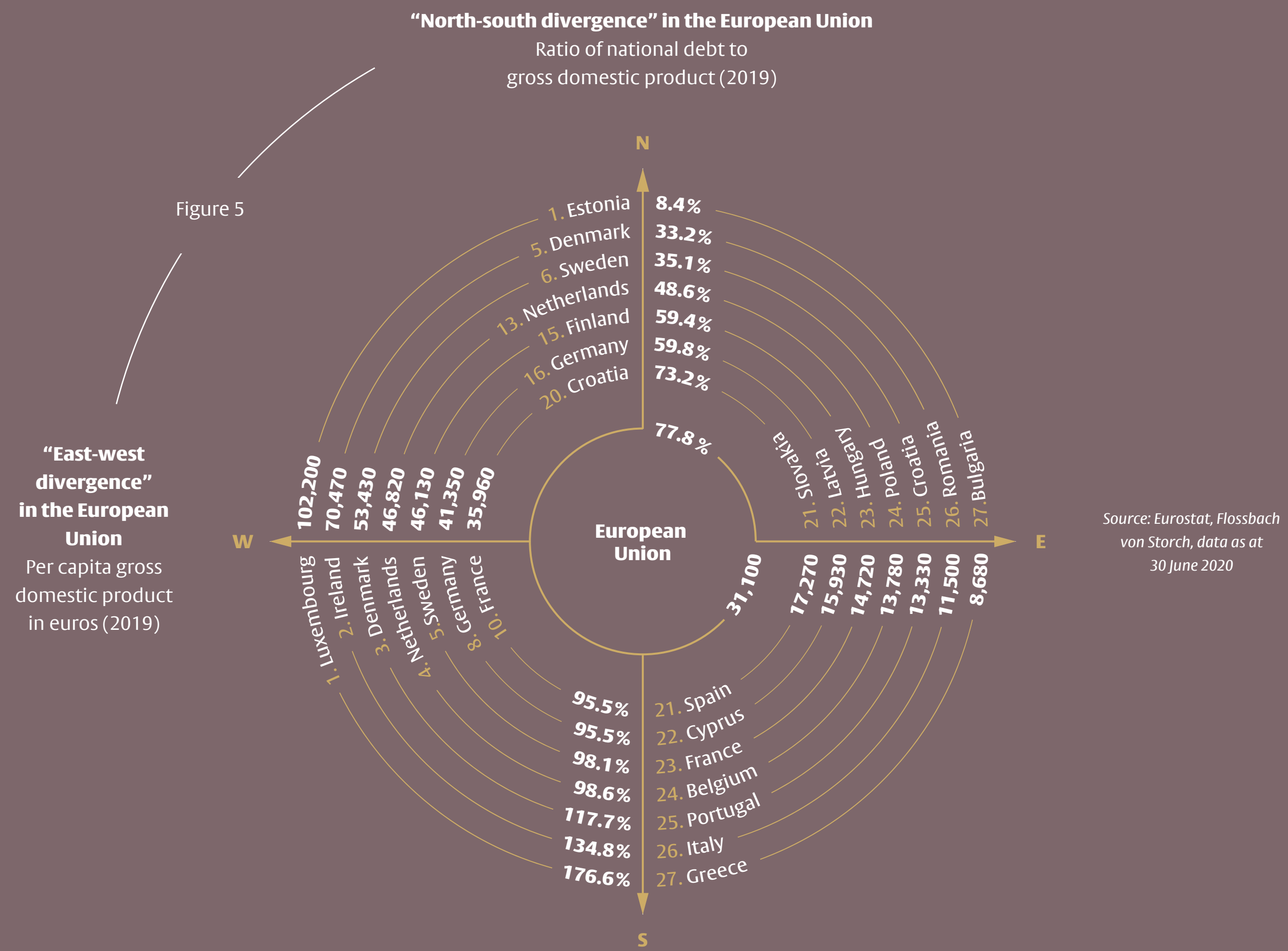
But will they remain that way if mountains of debt are permanently communitised and money is continuously →

Europe is perhaps the most successful peace project in the recent past.

transferred to neighbouring countries? Solidarity is easier for many people if they have some influence on what happens with their money. When everybody is in the same boat. At least that is what the experience of previous generations shows.

As was the case during German reunification, a high level of cultural and historical identification of the population and political leaders likely also helped make the founding of the United States of America a success. The EU, on the other hand, is a disparate collection of 27 individual countries, making such identification more difficult, and the eurozone is a collection of 19 countries. In both cases, they are communities with a purpose that are (also) aimed at improving the prosperity of their member states. The differences between the north and south, however, are enormous. The national debt of the member states ranges from eight per cent of GDP in Estonia to 177 per cent in Greece (see Figure 5, top to bottom). Europe is diverse. These differences also create immense challenges with respect to economic performance (see Figure 5, left to right).

In addition, the economically weak countries with many years of high, rising or constant debt ratios and repeated violations of the Maastricht criteria are being particularly hard hit by the Coronavirus pandemic. They are now demanding – quite rightly, during a global crisis that is not their fault – European solidarity. Critics, focusing on the previous non-compliance with deficit limits, are complaining that transfer payments are being made to precisely those



countries that apparently felt little obligation to meet the agreed stability criteria in previous years. When listening to such criticism, however, Germans should remember that they are also quick to throw out their own rules, such as the debt brake, as soon as it appears necessary.

Europe is perhaps the most successful peace project in the recent past. Solidarity can be seen in the cross-border treatment of Covid-19 patients and EU-wide coordination of aid transport to the most hard-hit areas. This solidarity, however, is fragile. Attempts to increasingly shift national economic responsibilities to the EU run the risk of creating major disharmonies between the individual member states and economic blocs.

European politicians are therefore walking a fine line if they want to avoid jeopardising the achievements of the past with a controversial pooling of authority. A shift of economic responsibilities to the EU level should not become an end in itself, but should instead reflect the convictions of all member states as best possible – particularly so that the risk of further member states following the example of the United Kingdom can be avoided.

Political will can, therefore, move mountains of debt in special situations, as shown by the example of German reunification. The future will show whether this is sufficient to increase the political and economic solidarity of the EU member states – or whether it leads to envy, resentment and finally a return to individual national interests. ◆

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MODELS OF WISDOM

What actually makes
a good investor?

What is needed,
what qualities
and knowledge?

What attitudes?

The thoughts of Charles T. Munger

What is elementary, worldly wisdom? Well, the first rule is that you can't really know anything if you just remember isolated facts and try and bang 'em back. If the facts don't hang together on a latticework of theory, you don't have them in a usable form.

You've got to have models in your head. And you've got to array your experience both vicarious and direct on this latticework of models. You may have noticed students who just try to remember and pound back what is remembered. Well, they fail in school and in life. You've got to hang experience on a latticework of models in your head. What are the models? Well, the first rule is that you've got to have multiple models because if you just have one or two that you're using, the nature of human psychology is such that you'll torture reality so that it fits your models, or at least you'll think it does. You become the equivalent of a chiropractor who, of course, is the great boob in medicine.

A HAMMER – MANY NAILS … WRONG!

> "If the only tool you have is a hammer, then every problem looks like a nail."

It's like the old saying, "To the man with only a hammer, every problem looks like a nail.". And of course, that's the way the chiropractor goes about practicing medicine. But that's a perfectly disastrous way to think and a perfectly disastrous way to operate in the world. So, you've got to have multiple models.

And the models have to come from multiple disciplines because all the wisdom of the world is not to be found in one little academic department. That's why poetry professors, by and large, are so unwise in a worldly sense. They don't have enough models in their heads. So, you've got to have models across a fair array of disciplines.

KNOWING IS NOT PARTICULARLY DIFFICULT

You may say, "My God, this is already getting way too tough.". But, fortunately, it isn't that tough because 80 or 90 important models will carry about 90% of the freight in making you a worldly-wise person. And, of those, only a mere handful really carry very heavy freight. So, let's briefly review what kind of models and techniques constitute this basic knowledge that everybody has to have before they proceed to being really good at a narrow art like stock picking.

First there's mathematics. Obviously, you've got to be able to handle numbers and quantities, basic arithmetic. And the great useful model, after compound interest, is the elementary math of permutations and combinations (see the Glossary on page 48). And that was taught in my day in the sophomore year in high school. I suppose by now in great private schools, it's probably down to the eighth grade or so. It's very simple algebra. It was all worked out in the course of about one year between Pascal and Fermat. They worked it out casually in a series of letters. It's not that hard to learn. What is hard is to get so you use it routinely almost every day of your life. The Fermat/Pascal system is dramatically consonant with the way that the world works. And it's fundamental truth. So, you simply have to have the technique. Many educational institutions – although not nearly enough have realized this.

At Harvard Business School, the great quantitative thing that bonds the first-year class together is what they call decision tree theory. All they do is take high school algebra and apply it to real-life problems. And the students love it. They're amazed to find that high school algebra works in life ...

WE NEED TO TRAIN IN ORDER TO REALISE OUR POTENTIAL

So you have to learn in a very usable way this very elementary math and use it routinely in life – just the way if you want to become a golfer, you can't use the natural swing that broad evolution gave you. You have to learn to have a certain grip and swing in a different way to realize your full potential as a golfer. If you don't get this elementary, but mildly unnatural, mathematics of elementary probability into your repertoire, then you go through a long life like a one-legged man in an ass-kicking contest. You're giving a huge advantage to everybody else.

One of the advantages of a fellow like Buffett, whom I've worked with all these years, is that he automatically thinks in terms of decision trees and the elementary math of permutations and combinations ...

Obviously, you have to know accounting. It's the language of practical business life. It was a very useful thing to deliver to civilization. I've heard it came to civilization through Venice which of course was once the great commercial power in the Mediterranean. However, double-entry bookkeeping was a hell of an invention. And it's not that hard to understand. But you have to know enough about it to understand its

The world's wisdom is not found in a small academic department.

limitations – because although accounting is the starting place, it's only a crude approximation. And it's not very hard to understand its limitations. For example, everyone can see that you have to more or less just guess at the useful life of a jet airplane or anything like that. Just because you express the depreciation rate in neat numbers doesn't make it anything you really know.

In terms of the limitations of accounting, one of my favorite stories involves a very great businessman named Carl Braun who created the CF Braun Engineering Company. It designed and built oil refineries – which is very hard to do. And Braun would get them to come in on time and not blow up and have efficiencies and so forth. This is a major art.

And Braun, being the thorough Teutonic type that he was, had a number of quirks. And one of them was that he took a look at standard accounting and the way it was applied to building oil refineries and he said, "This is asinine.". So, he threw all of his accountants out and he took his engineers and said, "Now, we'll devise our own system of accounting to handle this process.". And in due time, accounting adopted a lot of Carl Braun's notions. So, he was a formidably willful and talented man who demonstrated both the importance of accounting and the importance of knowing its limitations.

To understand the world, you have to use interdisciplinary thinking.

REMEMBER THE "FIVE Ws"

He had another rule, from psychology, which, if you're interested in wisdom, ought to be part of your repertoire – like the elementary mathematics of permutations and combinations.

His rule for all the Braun Company's communications was called the five W's – you had to tell who was going to do what, where, when and why. And if you wrote a letter or directive in the Braun Company telling somebody to do something, and you didn't tell him why, you could get fired. In fact, you would get fired if you did it twice.

You might ask why that is so important? Well, again that's a rule of psychology. Just as you think better if you array knowledge on a bunch of models that are basically answers to the question, why, why, why, if you always tell people why, they'll understand it better, they'll consider it more important, and they'll be more likely to comply. Even if they don't understand your reason, they'll be more likely to comply.

Charles Thomas Munger
(born on 1 January 1924)

is a US investor, businessman and philanthropist. He is Vice Chairman of Berkshire Hathaway and a close confidant of Warren Buffett. Like Buffett, Munger was born in Omaha, Nebraska. After studying at the University of Michigan, he was a meteorologist for the US Army during the Second World War. In 1948, he graduated from Harvard Law School. He got to know Warren Buffett at a dinner party 11 years later. They are an example of successful value investors for many investors worldwide.

This article is a short excerpt from a speech that “Charlie” gave at the USC Marshall School of Business and authorised us to print.

“Dividends are not interest”

What is more important for shareholders – the potential price gains of an investment or the dividends?

LEHR: There is no general answer to that question, and an answer also would not help investors. After all, a company that is growing well and prefers to invest its profits in research and development instead of distributing them to shareholders might be a much better long-term investment than a company that pays good dividends over many years.

VORNDRAN: And possibly can’t even afford to do so!

Do you have a personal preference?

VORNDRAN: It has nothing to do with preferences. If you buy shares in a good company with a fantastic business model, excellent management, robust growth and a well-funded balance sheet, there is a good probability you will earn decent long-term returns. The breakdown of those returns is not important. But I know what you are getting at ...

We can hardly wait to hear ...

VORNDRAN: The new hit song one hears being loudly sung everywhere is that dividends are the new interest. This overemphasises the importance of dividends to investors.

Does that mean dividends are being overvalued?

LEHR: That depends on your expectations. In any case, dividends are not the new interest. I wouldn’t sing along with that song. Recent weeks have shown that dividends are not a fixed source of income and, in fact, cannot be.

Then what do you say to investors that ask about dividends and their importance?

LEHR: That they are an important component of returns, but shouldn’t be the sole deciding factor when making an investment decision.

VORNDRAN: Many investors make the error of only looking at the dividend yield. The price section of a newspaper or financial website could say six, seven or even eight per cent – which is naturally attractive in a period of zero interest rates.

There are a great deal of exciting developments happening in the capital markets. We would like to talk about them – the major trends, but also their side issues – over a cup of coffee with Philipp Vorndran and Thomas Lehr.

LEHR: But is it really? Has the share price recently dropped significantly? Are there good reasons why this happened, and do the reasons indicate that the dividend might no longer be reliable in the future?
VORNDRAN: Many companies pay high dividends to keep their shareholders happy, even though they can't actually afford them. The payments therefore decrease the company's underlying assets and might even affect its ability to keep operating in the future. Long-term investors should be careful in such cases.

What is the first thing you look at for dividends?
LEHR: We look at the individual companies, their business models, balance sheets and management. That is, the overall quality of the company! Everything else follows from this.
VORNDRAN: That's right, the dividend is only, and please put the word "only" in quotation marks, the first step in the analysis.

And what is important for this first step?
LEHR: The quality of the dividends.

Can you be more specific?
LEHR: It is important to determine whether a company can actually afford the dividends in the long run, that is, whether you can rely on the dividends. And if you have decided this is true for a company, you should check whether the dividend could also be increased over time based on future business growth. Even though the current dividend yield might only be one or two per cent, in five years it might be a multiple of this amount due to good growth of the company that is also reflected in the dividends.

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

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.

Debt ratio – The ratio of a country's debt to economic performance as represented by its GDP.

Disruption – The displacement of an existing business model due to innovation.

Diversification – Distributing assets among different asset classes, securities, regions, sectors and currency areas, with the aim of broadly spreading investments to reduce the potential risks of each individual asset.

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

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

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

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

Key interest rate – Is set by the central banks; interest rate at which commercial banks can refinance themselves with the central banks by depositing a security.

Moral hazard – This occurs when one party gets involved in a risky event knowing that it is protected against the risk and that the costs will be borne by another party (taxpayers, for example).

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

Performance – Performance of a security or portfolio.

Permutations and combinations – Blaise Pascal and Pierre de Fermat developed the theory of permutations and combinations, which forms the basis for mathematical disciplines like statistics. It deals with the different ways that objects can be arranged. For example, there are 20 different permutations, or possible ways to combine pairs of letters using the five letters A, B, C, D and E.

Portfolio – A collection of investment securities.

Price-to-earnings (PE) ratio – A ratio for valuing a company that measures its current share price relative to its earnings per share.

Protectionism – A trade policy aimed at shielding domestic markets from foreign competition.

Rally/stock-market rally – This usually describes a period of sharply rising stock market prices during a short period of time.

Real interest rate – The interest rate that remains after deduction of the inflation rate in real terms.

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

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

Volatility – A mathematical measure of the range of fluctuation for security prices, commodity prices, interest rates or investment fund shares.

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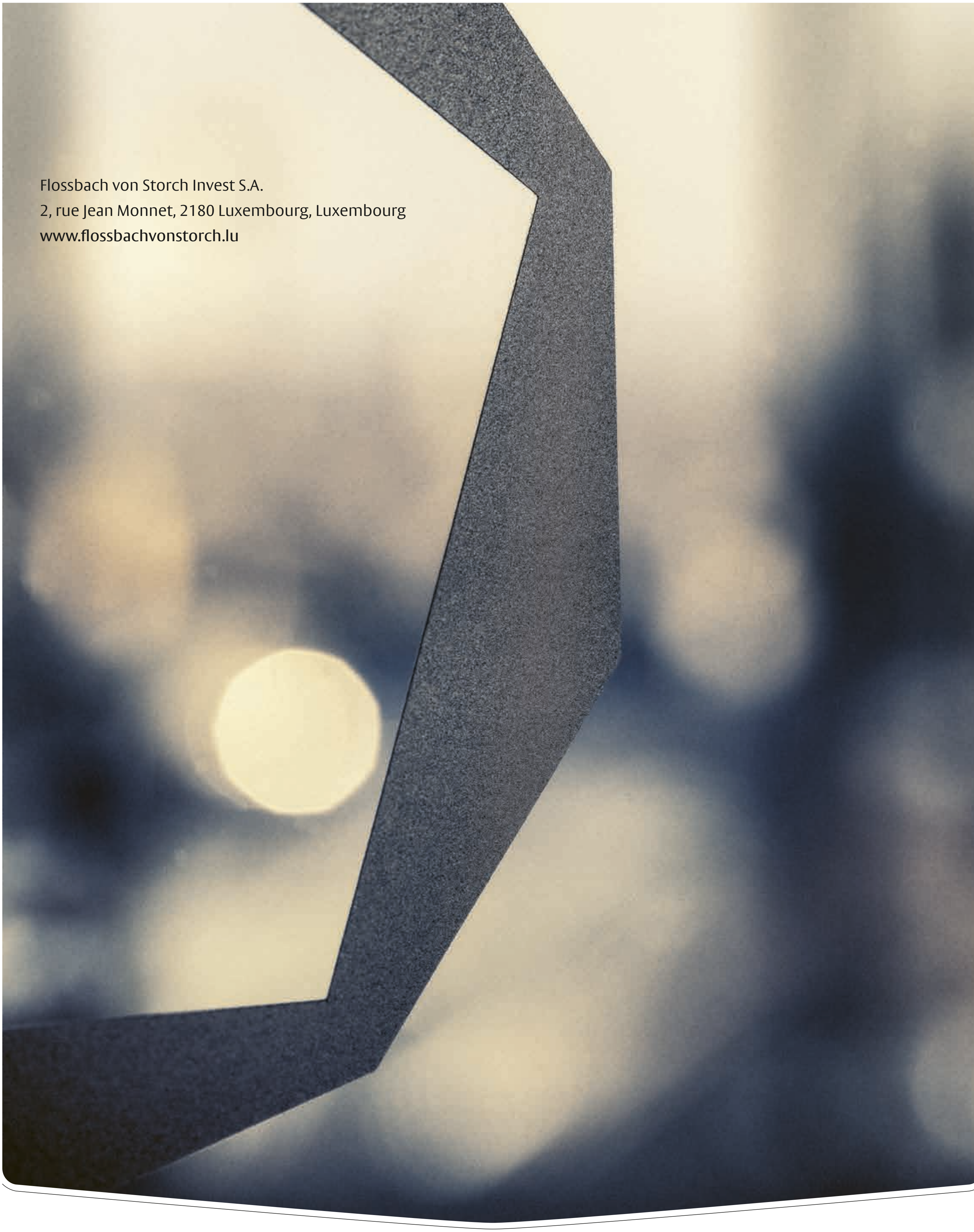

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