



Turbulent times - a calm look back

The last few months and quarters have been more than special and formative, at all levels. Therefore, with a focus on our investment philosophy, with a little distance and peace, we would like to invite you to look back on important points and thoughts for us.

Please find here the latest quarterly reports in a compact manner, with the following topics:

4Q2019	Our top three structural concerns and the ways we deal with them
1Q2020	A rigorous adherence to value now counts for more than ever
2Q2020	The relevance of deep value investing in the modern economy
3Q2020	Dividend yield: a strong source of stability and return for the portfolio
4Q2020	How we treat intangible assets in the valuation process

We hope it has some exciting thoughts for you. For questions or further information we are of course very happy to stand at your disposal personally (info@sgvaluepartners.ch).



4Q2019 Quarterly Report

Review 4Q2019

Since the markets bottomed after the financial crisis more than 10 years ago, it seems that the subsequent strong upward trend in asset prices has never been fully accepted and trusted by the investment community. Especially in the US, the phrase “the most hated rally in the history of the stock market” has become omnipresent. That is, people feel compelled to somehow participate—yet do so in reluctant and intermittent fashion. In other words, investors fear to be left out of the action but play the game with great unease and anxiety. We believe this posture could have highly adverse systemic effects, as the section below explains.

Outlook, Thoughts & Issues

Our top three structural concerns and the ways we deal with them

“Risk” as it relates to financial markets means a variety of things to different people. Most traders and investors define it in terms of the potential negative price impact created by incremental news flow (i.e., tactical and relative). In contrast, for us it connotes something more structural and absolute in nature. In this report, we describe three prominent preoccupations of ours and explain how our investment discipline is designed to cope with them.

Concern #1: The markets underestimate unknown systemic risks.

Background and implications. We think that conventional prevailing market views imply a rather benign state of global affairs going forward, something which may be imprudent. Far-reaching shocks such as natural disasters, pandemics, cyber threats/technological breakdowns, or major liquidity crises in financial markets are the most tricky to deal with because their nature, extent and impact cannot be pinpointed on an ex-ante basis.

Preparations we have in place. We always aim to plan for the unknown as prudently and realistically as we can. For us this means to concentrate the bulk of the fund’s portfolio in a modern economy’s essential goods and services. This universe includes physical infrastructure (e.g., shelter, energy, transportation); intangible infrastructure (e.g., telecommunications, electric utilities, information, financial services); and basic human necessities (e.g., food & drink, hygiene & health, clothing). At the same time, with some exceptions we tend to stay away from fancy and “nice-to-have” offerings in fashion & luxury, leisure & travel, social media & entertainment and technological gadgetry.

Concern #2: Equity pricing is extremely skewed and too narrow in scope.

Background and implications. The strong trend towards indexing and quantitative investing over the past two decades has led to an enormous concentration of investment positioning in a handful of popular, much talked-about assets, while a host of smaller companies fall below investors’ radar screens. As a result, the so-called “market-internals” may cause a protracted distortion in equity pricing, potentially leading to less equitable capital allocation.

Preparations we have in place. The exploitation of this mispricing effect goes to the very core of what we are all about as contrarian deep value investors: to find the neglected and ignored “hidden gems” that can be purchased at bargain prices. Evidently, the price we pay is that we have to wait patiently in order for these companies to be able to finance their expansion plans and for their full value to be eventually recognized and corrected by the market.



Concern #3: Interest rates are unnaturally low.

Background and implications: For a host of oft-cited reasons, post-financial-crisis yield curves globally have not recovered to more normalized levels. As a result, much of the western world is too consumption-driven rather than savings-minded. For most of Europe and the Americas, household spending on current amenities is ever tempting because cheap finance is readily available. At the same time, savings in the general population set aside for future needs is inadequate given the gradually falling payouts available from public and private pension schemes. Similarly, corporate and public entities tend to splash out on current items at the expense of future competitiveness. For example, many corporations prefer to increase dividends or buy back shares while being stingy with capital expenditures. Similarly, governments are busy meeting immediate budgetary commitments at the expense of undertaking badly needed long-range investments in public infrastructure.

Preparations we have in place: While the majority of the financial world has reduced itself to manage nominal values and relative returns on a short-term basis, we remain focused on real and absolute parameters over time. After all, only absolute returns generated on real values will pay bills — relative and nominal concepts based on momentum won't. Hence, we stay committed to generate sturdy albeit unspectacular compound rates of return over time to contribute to our investors' long-term savings goals. Our preferred way to do so structurally is by investing in long-cycle, capital-intensive businesses (i.e., machinery, materials, land & agriculture, energy, utilities and other basics). Those may not be fashionable investment areas at present but undoubtedly represent irreplaceable assets over time.

We are convinced that with these measures in place, the fund is very well equipped to handle and absorb future uncertainties whatever they may be.

Sincerely,

Gregor Trachsel,
Chief Investment Officer SG Value Partners AG



1Q2020 Quarterly Report

Review 1Q2020

The shutdown of wide parts of commercial and industrial activity around the globe due to the coronavirus spread has caused a highly incoherent price finding process in the markets. Any fungible financial instrument, including the supposedly most stable area of “hard-currency” sovereign government debt, has been subject to extremely erratic pricing behavior. By extension, the oscillations in equities markets have been all the more violent. Fortunately, the strict deep value approach we follow keeps its focus on the intrinsic value of each portfolio firm. As such, the decisive anchor point in our everyday decision-making represents a much more stable analytical variable as opposed to the daily price movements which the majority of other market participants relies upon.

Outlook, Thoughts & Issues

A rigorous adherence to value now counts for more than ever

One of the positive aspects that uncertain and frightening times like these bring with them is that they will ultimately show how earnest, diligent and thoughtful a particular investment program is being conducted. In this report we would like to highlight five of the elements showing why the fund represents these traits. **First, all portfolio firms provide demonstrably essential goods and services.** The fund is mainly engaged in areas such as public utilities (e.g., electricity, gas, water, heating); telecommunications, select services in finance, commerce and health; logistics and transportation; food; materials; energy; and basic infrastructure. All of these sectors can be considered “musthave” in nature, rather than merely “nice-to-have”. As has become clear in the current crisis, “nice-to-have” has practically no relevance anymore, certainly not in the immediate future.

Second, all of our portfolio firms have demonstrably comprehensible and transparent balance sheets.

This is so thanks to our analytical approach that features a built-in balance sheet eminency. That is, we only pursue a possible investment idea any further if we understand the respective firm’s asset and liability situation well enough. This straightforwardness in their balance sheet, in turn, tends to enable our companies to swiftly access funding sources such as loans, debt or equity in order to survive difficult operating periods such those at present. Furthermore, our customary predilection to invest in firms with controlling family, trade, government or other strategic shareholder structures is highly advantageous in that these companies generally have long-standing relations with their financing partners, which places them first in line to be able to tap capital compared to firms that previously didn’t have such ties.

Third, all of our portfolio firms are demonstrably crisisproven. The inherently difficult nature of most portfolio firms’ business in terms of competitive, cyclical and operating challenges are all contributing factors which render them undervalued and hence attractive for us to buy in the first place. When companies are accustomed to be under pressure even in normal times, they tend to be better prepared to handle sudden emergencies of the type they encounter now as compared to other firms whose business has hitherto been in smooth sailing.



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Fourth, the investment program of the fund operates entirely leverage-free. Our strategy never employs financing tools or derivatives to attempt to enhance portfolio returns. Hence, the fund itself cannot be subject to “forced-selling” measures such as margin calls. This structure enables us to stand out tough times and calmly keep our eye on what matters, i.e., the appropriate long-term strategy and positioning/composition of the portfolio.

And fifth, we have our skin in the game. All members of the portfolio management team have a significant portion of their personal savings invested in the fund. Thus, rather than merely giving well-meaning advice, we eat our own cooking. In other words, our interests and those of our clients are the same. Evidently, we are absolutely convinced that the steadfast and solid strategy we have followed over the years continues to be the appropriate one to steer all of us through the current and any other sporadic challenges towards a prosperous future.

Sincerely,

Gregor Trachsel,
Chief Investment Officer SG Value Partners AG



2Q2020 Quarterly Report

Review 2Q2020

The steadfast commitment by the world's leading central banks to provide essentially unlimited liquidity to support the economic system has led the financial markets to calm down and recover some of its pandemic-induced sell-off towards the latter part of 1Q20. The consequent wall of money hitting the equity markets mainly has been funnelled into index heavyweights and momentum trades, represented by a highly concentrated group of popular technology, internet services and pharma shares. In the quarterly commentary below, we delineate in more structural terms the likely causes shaping these dynamics. More importantly, we shed light on how we try to avoid the traps as well as exploit the opportunities they carry.

Outlook, Thoughts & Issues

The relevance of deep value investing in the modern economy

Driven by ever looser monetary conditions around the world, liquidity continues to find its way into the usual "new-economy" favorites such as high-tech; social media; fintech; and biotech. At the same time, the so-called "old-economy," i.e., asset-intensive sectors encompassing machinery and capital goods; manufacturing; logistics and transportation; energy; electricity; telecommunications; and basic financial services continue to be shunned. Indeed, it seems that many investors have given up on these areas, putting essentially all their bets on the digital and virtual world.

The prevailing situation logically begs the question whether the old economy has become incrementally irrelevant. Our unambiguous answer is "no," for logical reasons. The basic human needs of food, shelter and clothing can neither be digitalized nor virtualized. Logistics and transportation cannot be provided without physical means such as ships, planes, trains, trucks and cars.

Telecommunications are mainly enabled by fiberglass pipes, copper wires and transmission towers, linked intercontinentally via giant subsea cables. Energy and electricity, including "green power," ultimately come from natural resources and have to be procured, produced and distributed by an intricate web of heavy infrastructure. And, as the fallout from the recent lock down measures has shown, even modern finance can impossibly exist without the availability of traditional banking and insurance services.

Why, then, is this dichotomy of perception between the old and the new economy, which has accentuated itself in extreme valuation discrepancies over the last dozen years, so persistent and resilient? Although the reasons are manifold and debatable, the ultimate process of mainstream investment allocation follows a path of least resistance. That is, incremental liquidity is flowing into areas that promise the quickest returns and most obvious future growth prospects. As long as the current monetary regime persists (i.e., negligible interest rates and unlimited central bank funding), the same pattern will hold. Critical to realize here is that this path of least resistance does not concern itself with value. The market merely represents a conduit of liquidity allocation rather than a valuation mechanism. Moreover, mathematics and financial theory by themselves are not designed to provide us with the answer how to value "growth" correctly, either.



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After all, as policy interest rates hover around zero, computationally the valuation of “growth” approximates an infinite number. Accordingly, the financial markets lack an inherent or self-imposed control mechanism with respect to what makes or doesn’t make sense in valuing stocks. The capacity and responsibility of doing so is the job of the individual actor who participates in the market out of free will. He or she must use sound reasoning and diligence to reach economically rational conclusions.

That’s where deep value how we practice it comes into play. To reiterate what we have explained on previous occasions, the “hurdle rate” (the discounting mechanism whereby all future cash flows are expressed in present value terms) we apply to value businesses will ultimately hit a structurally low limit. In other words, we consciously set a minimum threshold when discounting future cash flow streams. The result is that we are willing and able to pay less for eventual future growth potential as promised by the well-known glamour equities. Meanwhile, the less flashy capital stock forming the backbone of the economy can be acquired cheaply thanks to the inherent cyclicity and uncertainty which renders the valuation process a more challenging task. Accordingly, our investment allocation continues to find a home mainly in these underappreciated and inexpensive areas. We patiently wait until the day when interest rate conditions gradually adjust towards a more economically justifiable level. This will be the time when our way of investing will redeem itself and find renewed favour with the broader investment community.

The caveat is that we do not know when it will happen. All our loyal clientele and we can recognize is that this iron patience and discipline is being rewarded over time.

Sincerely,

Gregor Trachsel,
Chief Investment Officer SG Value Partners AG



3Q2020 Quarterly Report

Review 3Q2020

World equity returns this year continue to be a decidedly lopsided affair, with a handful of markets such as the US, China, Sweden and Denmark doing relatively well while most other geographies remain in negative territory. Sectoral performance paints an equally narrow picture in which a few large tech, social media and health related issues dominate on the upside, whereas most other areas stay out of fashion. The starkest difference, at least in the US, can be observed in index-leading mega-cap vs small capitalization stocks: for example, while the S&P 100 Index of large companies is up 9.8% YTD, the S&P 600 Small is down 15.3%.

Outlook, Thoughts & Issues

Dividend yield: a strong source of stability and return for the portfolio

By definition, our deep value strategy focuses on those areas of the market that are presently shunned or neglected. While we wait patiently for individual positions to catch up to their estimated true value, one important benefit supporting the intact long-term compounding record of the fund is its underlying dividend yield. For example, at the moment the portfolio's weighted gross cash dividend accrual amounts to roughly 2.5% p.a. If we assume a 30% across-the-board non-recoverable withholding tax levy charged at source, the aggregate portfolio thus generates a current net dividend yield of 1.75%. This may not sound like much but in compounding terms this is a big number, especially seen in the context of what's currently available on a so-called "low-risk" long-term investment such as government bonds. That is, if we apply a benchmark 10-year German bund yield of -0.50% as a "riskless" investment, we get a sturdy 2.25% yield pick-up for our "risky" equity fund. Together with the expected growth of expected capital gains generated by our portfolio companies (which of course government bonds do not), the long-term profile of our fund is earnestly solid.

Let us consider a few noteworthy aspects of the dividend yield. First, so far in 2020 for example, the current dividend payout level has unsurprisingly been subject to a downward revision due to the Covid-19 pandemic as well for reasons related to the more generalized cyclical downturn evident in many industries within which our companies are active. Concretely put, slightly more than a fifth of our portfolio firms decided to reduce or omit their regular cash payout for the current dividend term. We are strongly convinced that both the virus- and cycle-related dividend reductions will normalize themselves in the form of higher payouts and reinstatements of regular dividends as business activity gradually recovers. Thus, the current dividend yield is artificially depressed if put in a context of a longer-term business perspective.

Second, as we have pointed out on many occasions, we believe that our investment approach to buy underappreciated businesses can inherently be expected to bear substantial potential for dividend growth as our portfolio selections are capable of improving their operating cash flows over time. In other words, not only is the fund's underlying dividend payout attractive at the current level, but we also estimate that it will grow incrementally in the future—above and beyond the virus- and cycle-adjusted normalization factor explained earlier.



Third, dividends represent a highly beneficial factor in our money management activities. That is, let us assume for a moment that fund flows and portfolio adjustments (i.e., subscriptions and redemptions plus any net trades in existing positions) are neutral. In this case, then, the accumulated net dividend collections from our portfolio holdings would in principle enable us to buy a full additional position during a given 12-month period. In short, receipts from dividends enhance our flexibility and add precious options to how we chose to deploy the fund's available cash.

And fourth, we maintain that dividends as a proportion of total return is generally underrated; actually the reinvestment of the same has been demonstrated by most observational studies to make up the majority of total return over time. Moreover, we believe that this proportion between dividends and capital gains becomes even more evident in the future given the likely scenario of a "lower-return" equity environment as foreseen by most rational market observers, macroeconomists and other students of long-term financial cycles. This point is especially important to consider in the case of all the savers who chose to structure their securities portfolio in terms of a balanced investment program (i.e., one part fixed-income and one part equity).

To conclude, it is clear that dividend yield continues to play a central role in our portfolio management strategy. The generation of dividends and the diligent reinvestment thereof has always been, and will remain to be, a significant pillar of the long-term return compounding equation. In fact, given its importance it seems quite surprising to us why it keeps being treated as a mere side note by common investment wisdom.

Sincerely,

Gregor Trachsel,
Chief Investment Officer SG Value Partners AG



4Q2020 Quarterly Report

Review 4Q2020

The markets continued to wear their rose-tinted glasses for the final stretch of the year. Equity prices far and broad tended to rise strongly, in many cases setting new record levels. On the other hand, many companies and people fight an unprecedented uphill battle. As diligent investors, we must make sense of, and try to reconcile, this apparent dichotomy. As always, we view it as our most important task to question the pockets of excitement in the market and focus on our core responsibility: the careful evaluation and cautious valuation of the securities we invest in.

Outlook, Thoughts & Issues

How we treat intangible assets in the valuation process

It lies in human nature to search for convincing explanatory arguments to rationalize currently observed behavior and phenomena. This is also true in the world of economics and finance. For example, one of the main justifications given by market commentators in support of the historically wide equity premium afforded to « growth » vs. « value » investing has to do with the financial treatment of intangible assets. Under intangibles, we commonly understand hard-to-assess corporate assets such as brands, patents & copyrights and software development. They may include even more subjective concepts such as network effects, the complexity of supply chains and distribution networks, the skills of employees and corporate culture.

The argument basically makes the point that in today's digital and virtual world, « growth » companies' valuation is driven by highly lucrative, cash-generating intangibles. The opposite is assumed for « value » companies which tend to be priced based on their stodgy and costly tangibles. The argument hence concludes that the « new-economy », asset-light part will continue to rise in importance in relation to the « old-economy », asset-heavy area and that the valuation discrepancy is therefore warranted. The trend is then extrapolated far into the future as this cyberspace apparently grabs an ever more dominant share of total economic activity.

It won't come as a surprise that we do not wholeheartedly endorse this view, for one chief reason. Intangible assets also connote « goodwill », which is widely open to interpretation both in terms of accounting treatment and common use. Basically, goodwill summarizes in a number all assets that in many instances cannot be readily measured and quantified. To be clear, we do not dispute in any way the potential existence of goodwill and appreciate that it can be worth a great deal, indeed. However, robust empirical evidence also shows that the premia paid in corporate takeover transactions, which must be accounted for as goodwill by the acquirer, regularly turn out to have been too generously calculated. This will then necessitate future write-offs in the form of goodwill impairment charges to its profit and loss statement. Thus, we are highly conservative in our own assessment of what a realistic goodwill number may be.

To be sure, many of our firms themselves possess exceptionally strong and readily identifiable intangibles, for example: ABB (software development); Bunge (distribution channels); Coca-Cola Bottlers Japan (patents and branding power); Ericsson (network effects); Mitsubishi Heavy Industries (complexity of supply chain); Vivendi (copyrights and licensing fees, especially those related to its subsidiary Universal Music Group).



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Nevertheless, our default approach is to apply a great degree of caution when it comes to capitalizing intangibles in our financial models. Concretely put, we rarely opt to capitalize intangible assets explicitly when valuing a firm.

We are convinced that our portfolio companies offer significant margins of safety even without directly incorporating intangible assets into our valuation process. If we did, evidently the calculated margin of safety would be even higher than what is already reflected in our base-case scenario. Hence, at least as applied to our particular investment program, the market's rationale seems to be somewhat superfluous in that it cannot properly explain away the valuation discrepancy between growth and value.

Granted, the tangible asset base required to properly maintain public infrastructure has lacked pricing power for at least 13 years running. During this time, the two-punch strike of the subprime and peripheral country debt crisis followed by Covid-19 has kept governments around the globe busy rescuing the financial system, supporting the social safety net and ultimately keeping the consumer economy going. Nevertheless, one of the central tenets of our overall investment thesis is that the tangible means of production will come back to shine once the urgent efforts to repair and improve the world's creaking physical foundation gradually gains traction. Our balanced takeaway in the debate between tangibles and intangibles is that neither should the former be under- nor the latter overestimated. The bottom line for us is that we steadfastly adhere to our time-proven independent valuation process as opposed to adopting sweeping novel theories favoring one investment style over another.

Sincerely,

Gregor Trachsel,
Chief Investment Officer SG Value Partners AG



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