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WHAT IF THE FINANCIAL MARKET IS REVERSING...

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Until April we have seen how the quantitative easing programme launched by the European Central Bank has created two notable effects. On the one hand the interest rates of European bonds have been declining significantly to new lows: down to 0.07% in the case of the German 10 Years. On the other hand, the stock market has risen sharply as a result of the need to replace low yielding assets with other assets showing better expectations but higher risk.

During May it seems that this trend in the markets has changed. Financial markets have stopped showing optimism in the form of gains. I mean, the stock exchange has stopped rising as in previous months; it has even corrected the previous month highs slightly. In the case of German and American sovereign debt, the price of bonds has fallen, causing an increase in their financing cost. And the dollar, which was doing so well, has depreciated against the euro.

Movements of financial markets are difficult to predict and, when they occur, are even harder to understand. As you know, we have been reducing the risk of our portfolios because we anticipate a potential correction in equity, bond, and US dollar markets: we believe that asset prices have increased significantly because of quantitative easing and that we must protect the gains obtained to date.

In the case of the stock market, valuation ratios (PER, EV / EBITDA, etc.) of companies have risen sharply. Reported earnings should be increasing to validate current high prices. On the contrary, share prices have risen more than earnings, and this in turn has expanded valuation ratios.

In recent months our task as value managers, directed to finding quality companies at fair prices, has been difficult. We struggle to find new ideas at fair prices. The rise in price of some of our positions has even led us to sell them.

Let me give an example: in 2013 we invested in a leading company managing mainly Dutch, Belgian, and American supermarkets. At that time the company was trading at PER 11.5, i.e. 11.5 times its earnings, it had a dividend yield of 4% and expected a medium-term growth of 5% with an operating margin also near 5%. We liked its cash generation, the recurrence of its earnings, its share buyback policy, which improved earnings per share, its exposure to US dollar, and its goal of improving margins. In short, we wanted to incorporate a defensive company in our portfolio at a very low price, with a good safety margin.

We have decided to sell it with significant gains. Today it is trading at PER 18 with a dividend yield of 2.5%. Although the company, since we sold it, has expressed its willingness to merge with a competitor for greater operating efficiency, our selling price and the current price do not differ much. Paying 18 times earnings for a supermarket company with such a low profitability in an environment of low growth and low inflation does not look like a sensible investment to us. Despite its quality, we know that later on we will be able to buy this and other good companies back, cheaper and with a higher potential of medium-term appreciation. Therefore we have decided to take a break and maintain our low exposure to equity.