Schoellerbank EquityRating

Schoellerbank investment strategy

for stock selection in asset management and for individual investment advice

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Selecting the best

Schoellerbank applies strict quality criteria when selecting shares, both in asset management and investment advice to its customers, the Schoellerbank EquityRating.

In more than 25 years, the criteria have proven invaluable as protection against errors in capital allocation. Schoellerbank EquityRating identifies and assesses the characteristics which in our experience are the features of a sound company.

A long-term investment accompanied by clearly defined principles increases the chances of success. It is, of course, possible to make profits based on short-term oriented investment decisions – we refer to this as "speculation". However, these profits depend excessively on chance. In the short term, stock markets respond to many factors most of which are not related directly to the companies themselves and cannot be reliably predicted. Over the long term, the success of an investment is closely related to the development of the respective company.

We do not define risk as short-lived fluctuations of stock prices. Rather, risk is the threat of permanent loss of capital. And this threat in the selection of financial instruments can only be mitigated by a clearly defined, long-term investment strategy.

CRUCIAL FACTORS: QUALITY OF AN INVESTMENT AND PRICE PAID

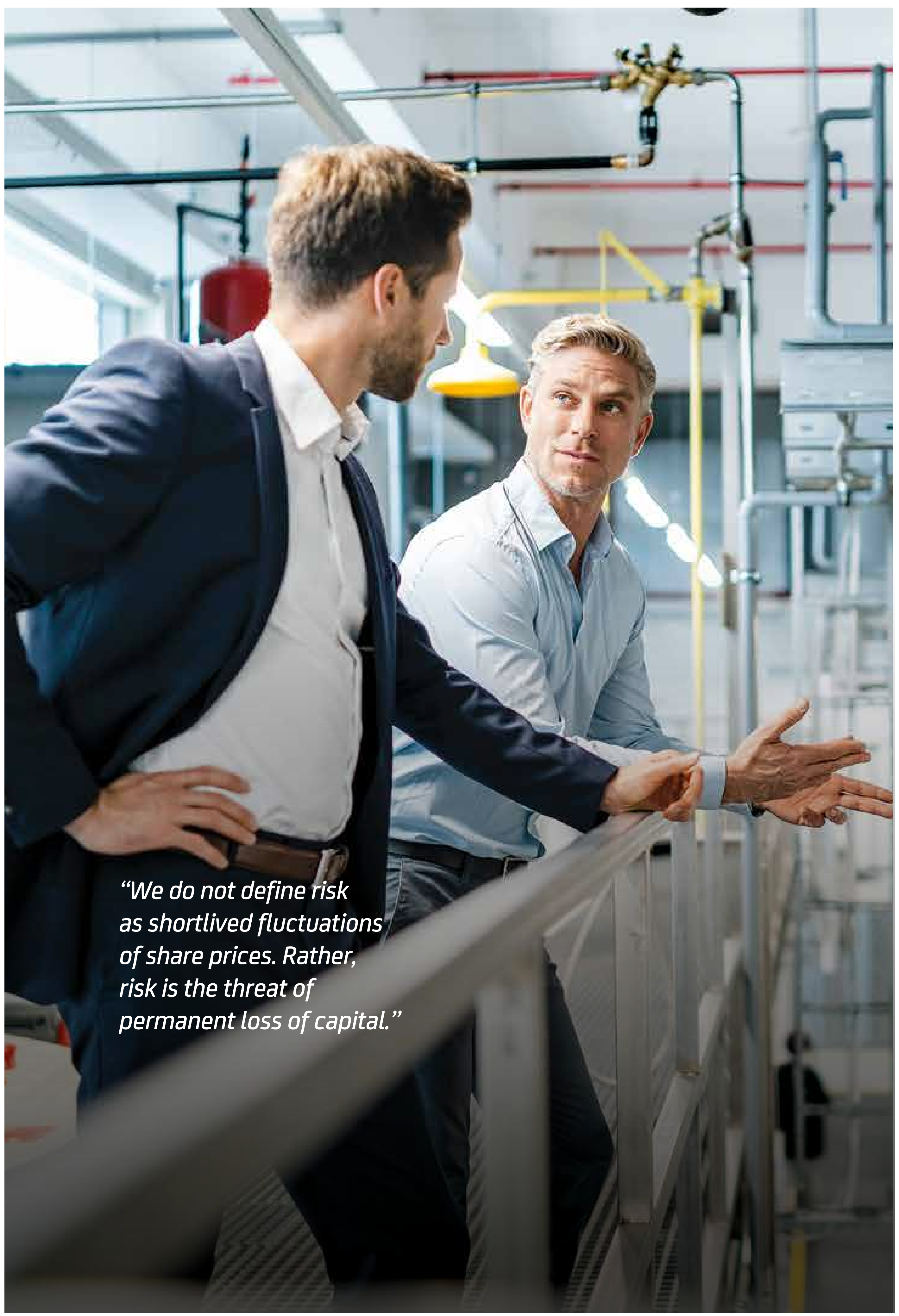
In this context, the different aspects of a company (e.g. business model, management, financial statements) are evaluated carefully along with the long-term outlook for the industry. The price paid for a share must be assessed as to whether it is commensurate with the market environment.

WHAT PRICE IS JUSTIFIED FOR A SHARE?

Only shares of companies should be acquired whose prices represent at least the fair value of the entire company. Even better is buying the share below the fair value. The founding father of value investing – Benjamin Graham – created the concept of "margin of safety". In his view, a margin of safety is necessary because any assumptions regarding a company's fair value are merely an approximation within a bandwidth.

Good things seldom come cheap, but a reasonable price is nonetheless essential. An investor's goal is the appreciation of the value of the capital invested. When an investor buys an overpriced share, not only is it uncertain if the share's price will continue to rise, but the risk of a price drop is also higher. Experience shows that such price drops often do not stop at the fair value but continue. This happens when market participants start thinking more intensely about the real value of the company. Price corrections are then inevitable.

This brochure presents an overview of the principles we apply when selecting equities for asset management and individual investment advice. We will first take a closer look at the concept of fair value and then proceed to the other quality criteria.


“We do not define risk
as shortlived fluctuations
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Some thoughts on the fair value of a share

IT IS ABOUT FUTURE EARNINGS POWER

Free cash flows, return on capital, indebtedness, earnings per share and price-to-book value are examples of the key criteria that flow into equity investment decisions – depending on an investor's personal investment strategy. Often though, buy decisions are based on only a few ratios, charts, personal preferences, and even more frequently on apparent market sentiment and rumors disseminated by the media. However, long-term investment decisions should not be based on just a few criteria. The risk is too high that a specific parameter, which might be supportive of an investment one day, could turn out to be detrimental on the next. Frequently, the mistake is made of basing investment decisions on current sentiment or investment tips. However, successful investment decisions must be based on criteria that can be assessed with a long-term perspective.

FOCUS ON REALISTIC EARNINGS EXPECTATIONS

Basically, all considerations revolve around the earnings of a company, or more specifically, its future earnings, which – when discounted to the present value – represent the company's current value. Being able to assess future profits is the key to success. In this brochure we speak of 'profit'. In practice, however, operating income or free cash flow play a more important role than the net profit.

The factors that influence profit are numerous and complex. Current data, the balance sheet, the income statement, and the cash flow statement provide a basic set of data. Past data and ratios are indicators of past trends and give an indication of the stability of profits. Normalized profit expectations over the business cycle are also an important factor.

THE OUTLOOK DERIVED FROM HISTORIC AND CURRENT DATA PLAYS A CRUCIAL ROLE

- The company must be able to increase profits under realistic assumptions continuously and over the long term. If this is the case, an investment is promising.
- The company must have the potential of attaining even higher revenues – the market should not be saturated or an environment so competitive that increasing revenues poses a major challenge.
- The company must be able to increase profits through higher revenues, not only based on higher margins, because margins cannot be enlarged infinitely. In this context, the competitive situation is also very important.
- Lowering costs must also be viewed with caution, regardless of how useful cost-cutting may be. Profits cannot be increased indefinitely by lowering costs without posing a risk to the assets of the company.
- Profits should not be burdened by future problems that are known today, (e.g. gaps in company pension funds, potential costs arising from the issuance of employee stock options, etc.).
- Profits should not be heavily dependent on external factors that can hardly be influenced (e.g. over-sensitivity to business cycles, political influence).

“Being able to assess future profits is the key to success.”

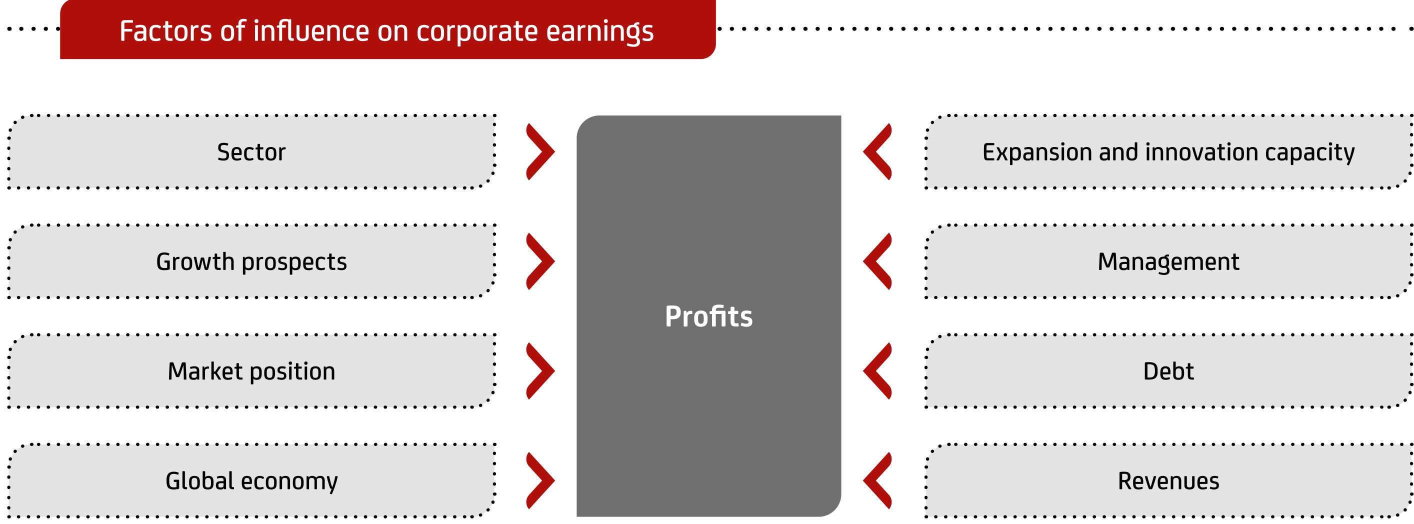
DEBT LEVELS CAN MASSIVELY INFLUENCE PROFITS

The financial situation of the company is critical for future profit trends. The amount of debt and the historic development of this indicator permits conclusions regarding earnings capacity, quality of the income statement, etc. Rating agencies will give a company a lower credit rating when debt levels or financing needs increase markedly or when liquid funds or cash flows from operations are not sufficient.

A lower credit rating increases the cost of capital for a company. Individual interest rates and, of course, the level of market interest rates influence earnings expectations. As a consequence, high levels of debt can limit a company’s capacity to expand. High sensitivity to interest rate fluctuations (especially rising interest) can massively undermine the profits of a company, making interest rate trends more important than business operations.

FACTORS THAT INFLUENCE PROFITS

The key factors of influence on corporate earnings – current and future – are presented in the table below.



The quality criteria of Schoellerbank selection in asset management and for individual investment advice

THE LONG-TERM FOCUS IS ON A COMPANY'S PROFITS, IN OTHER WORDS ON THE HARD FACTS. THE VALUATION MUST BE REASONABLE AND NEVER OVERPRICED.

A fair price alone is not enough reason to invest in a stock. Stocks are not simply pieces of paper, but rather pieces of a company. Every investment must therefore be reviewed regularly and on the basis of clearly predefined criteria.

The number of Schoellerbank quality criteria that are met is decisive for the selection of the company for asset management and individual investment advice.

A company must meet at least four quality criteria to be considered for a long-term investment in line with the Schoellerbank investment strategy– and two of the quality criteria are even mandatory.

The six quality criteria for stock selection in asset management and for individual investment advice below are considered in detail:

- Long-term defensible competitive advantages (mandatory)
- Solid balance sheet (mandatory)
- Low sensitivity to business cycles
- Capable management
- Long-term growth prospects
- Sustainable earnings per share

LONG-TERM DEFENSIBLE COMPETITIVE ADVANTAGES

This quality criterion is mandatory for a stock to be eligible for inclusion under the Schoellerbank investment strategy.

Only companies with defensible long-term competitive advantages will be in a position to earn more than their cost of capital on a regular basis. Without a competitive advantage, profits will drop or even be decimated when competitors attack.

This is the reason why the legendary investor, Warren Buffett, calls the long-term defensible competitive advantage a "moat", i.e., a protective trench around a castle. Long-term defensible competitive advantages are therefore something like a protective barrier around a company to keep other market participants from detracting from its earnings capacity.

The reasons for the competitive advantage may be diverse. Several examples are given below how companies can protect their earnings from competitors.

Switching costs
Switching costs are costs incurred by customers of a company when they switch products or choose another service provider. The costs are not only monetary in nature but also refer to time and effort. Because even if a competitor's offer is less expensive, it may involve substantial implementation or training costs – and this may be a disincentive.

Even private individuals are familiar with these costs and will hesitate to switch their text processing or spreadsheet software to a free application because of the time and effort needed for the changeover.

Network effects
Network effects occur when a product or service improves with the number of customers that use it. For example, an online retail trading platform benefits when millions of customers use the service, which in turn renders it more attractive to merchants and who then enlarge the range of products. This illustrates how this cycle can steadily expand the network, making it harder and harder for competitors to copy it.

Intangibles
Companies with competitive advantages often have intangible assets such as strong brands, patents, or regulatory licenses.

Many well-known brands have become part of everyday life. The best companies know how to maintain and protect their brands. This is true for product brands as well as for the company itself as a brand. It deepens and secures customer loyalty over the long term.

Products and services whose brands stand for outstanding quality are well accepted by customers world wide. Brand products imply character, prestige, and security. Customers are often willing to pay more for higher quality. This permits corporations to earn higher margins, and therefore, create higher added value for shareholders.

Brands play an essential role in expansion plans. Globally recognized brand names support a company's entry into new markets and are often instrumental for achieving this goal.

Patents are a further example of intangible assets. For example, in the pharmaceutical industry, patents mean years of above average earnings from individual medications, because competitors are barred from introducing identical products to the market.

Regulatory licensing can also help keep competitors at bay. Often, supervisory bodies are reluctant to issue additional licenses (e.g. for environmental protection reasons), thus creating an advantage for existing producers.

Cost advantages
Companies with lower costs than their peers have a competitive advantage. These cost advantages may have different sources. A cost advantage can be greater negotiating power in procurement for companies as of a certain size or the possibility of distributing fixed costs over a large number of units sold. A further advantage may arise from an advantageous location (e.g. low-cost resources or efficient access to transport systems).

Advantages in the production process can also create competitive advantages. The process should not be easy to replicate by competitors.

SOLID BALANCE SHEET

This quality criterion is mandatory for a stock to be eligible for inclusion under the Schoellerbank investment strategy.

Every equity investment carries major uncertainties and risks – this is the nature of investment. Still, risk can be mitigated by applying clear quality criteria such as those of Schoellerbank EquityRating. It is not about eliminating all risks – this is never possible – but to take calculable risks and to avoid other risks with the potential of causing the permanent loss of capital.

An important factor for avoiding the permanent loss of capital is the quality of the balance sheet. It is much easier to ascertain how a company finances itself than trying to estimate future earnings trends. Nonetheless, this topic is often not paid sufficient attention.

The quality of the balance sheet depends on the mix of equity and debt financing. Companies with high levels of external financing are dependent on the goodwill of their creditors and on well-functioning capital markets. The crisis of the years 2008/2009 illustrated clearly that these two aspects cannot be taken for granted.

Furthermore, the quality of the assets is decisive. Do off-balance sheet obligations or balance sheet items with a stable value exist that are not reflected in the stock market valuations (e.g. real estate)?

Finally, the special features of the various industries must be taken into consideration. Many established service com-panies operate without any external capital at all, while other capital-intensive industries have higher debt levels secured by stable cash flows.

"To finish first, you must first finish."[1] This is a statement by an American racing car driver. The same is true for equity investments. An investment in a company will only be successful if the company is able to survive several business cycles – also over the long term.

1 "To finish first, you must first finish" (Rick Mears, born 3 December 1951 in Wichita, Kansas).

LOW DEPENDENCE ON BUSINESS CYCLES

Often, there are phases on stock markets during which investors are especially attracted to cyclical stocks. These are the stocks of companies whose profits traditionally move in line with business cycles such as the metallurgy, automotive, paper, and chemical industries.

Is it worth investing in companies from cyclical industries?
No company can completely decouple from global economic cycles, especially when it reaches a certain size and has cross-border business activities as a result. The drive for corporate expansion inevitably results in the emergence of networked markets. Globalization is not only a blessing but can also be a scourge. Although local spells of weakness can be compensated by other activities in emerging regions, a global corporation cannot ward off the effects of a global downswing. Nonetheless, there are significant differences in the quality of companies and the stability of economic output during such phases. In this context, a company whose products cannot be easily substituted or are indispensable in everyday life will be more appealing. On the other hand, cyclical industries will struggle with greater difficulties in the form of declining orders. This will affect primarily companies that produce expensive durable goods which consumers can postpone purchasing under certain circumstances.

There is no doubt that cyclical companies can attain above average returns in times of economic expansion that boost a company's stocks. Such temporary comebacks of cyclical stocks are not a lasting phenomenon though, but usually just limited upwards movements followed by price corrections. Therefore, it is difficult for these companies to report long-term stable growth and earn continuous returns for investors.

There is no long-term value in market timing.
As with most booms, a rally of cyclicals is noticed by the wider investing public only when media coverage becomes more intense and the price rally is essentially over. We therefore invest mostly in high quality companies from sectors that feature sustainable growth and are less cyclical. Examples include the healthcare and consumer goods industries. Although stocks from these sectors succumb to pressure at times, over the long term they offer much more stable returns – and this is crucial for achieving long-term returns. Food and medication are needed even in a sluggish economy, but buying a car, for example, is something that can be postponed. There will always be times during which money can be made with cyclical stocks, but a period of several months is not decisive for the long-term success of an investment. It is almost impossible to identify the right time for entry or exit. This has been proven by many studies as well as by our own market observations: there are no viable models for long-term successful market timing.

CAPABLE MANAGEMENT

A successful management team will always act on market considerations rather than administrative aspects. The constantly changing economic environment calls for dynamic and flexible leadership. A company's management is responsible for the taking the steps needed to achieve sustainable growth and to establish lasting relationships of trust with all stakeholders. The focus on a company's core areas of competence, the constant drive for expansion, and a clear commitment to research and development are just a few of the virtues of successful managers. The management is responsible for the constant improvement of the quality of the company.

Modern management qualities include an open and fair communication policy. Naturally, it is useful to exhaust the accounting options available that have positive effects on costs such as tax optimization. But in no case should the income statement of a corporation be presented in a light that does not represent reality. What is necessary is open communication regarding expected expenses or other exceptional factors. Only when shareholders have full confidence in the statements made by the management will the company be able to establish a lasting relationship of trust.

When assessing the management of a company, attention should be less on current statements (earnings reports, information events, interviews etc.), but rather on past actions and achievements, as well as past disclosure policy. The managers of global corporations excel at communicating a positive vision of expected business developments – otherwise they would not be in their positions. A review of past work gives a better view of the strengths and weaknesses of the management.

For investors, it is not only the operating talent of the management that is important, but being able to reinvest profits with prospects of earning returns. Having an aptitude for allocating capital can create significant value for shareholders, but under certain circumstances, it can also destroy it.

The keywords to watch out for when assessing the management include dividend policy, stock buybacks, acquisitions, capital increases, stock options, total remuneration, management stock options, balance sheet development, etc.

Every one of these topics invites more questions. For example, with regard to stock buybacks one should look at whether the company has already carried out stock buybacks in the past and how these were managed. Did the management consider the fact that the stock price in relation to the intrinsic value of the company plays an important role?

Our experience has shown that it is important not only to evaluate the horse (= company) but also the jockeys (= management).

LONG-TERM GROWTH PROSPECTS

A company cannot restrict itself to merely defending its share in sales markets to be successful over the long term. Apart from expanding in existing markets, the goal must be to enter new markets and create new demand with product innovation and optimization. Ambitious but nonetheless realistic efforts to expand market shares and to acquire new markets are indispensable to companies wishing to achieve long-term success. Targeted acquisitions at reasonable prices and organic growth are contributing factors to lasting success.

When assessing long-term growth prospects, it is necessary to review the company's markets and peers, as well as the potential for growth in the company's respective sector.

Recognizing opportunities in emerging markets is also gaining significance. These opportunities can be exploited by investing in expanding companies with their headquarters in highly developed countries.

Selected companies transfer their successful business models to these growth regions. Many globally active companies are already earning a growing share of their revenues and profits in emerging markets and offer considerable advantages over direct investments in these countries – especially with respect to risk. A strong position in their home market and long years of experience in the emerging regions reduce the economic, political, and legal risks as well as the direct influence of negative trends of currency exchange rates.

SUSTAINABLE EARNINGS PER SHARE

The development of corporate earnings is important when investing in stocks. A number of factors influence market trends over the short and medium term. In the long run, stock prices follow the development of a company's earnings. High quality companies know how to steadily increase their earnings.

Sustainable corporate earnings are the foundation of a successful investment. Profits increase the assets of a company, create room for expansion, and also make capital available for research and development. Revenue trends are also decisive for the sustainability of profits. Profits can also be achieved in some cases by measures such as cost-cutting or temporary increases in margins. The optimization of costs is, of course, a major contribution to the success of a company, but massive savings cannot be repeated permanently. Earnings can also be increased through higher prices or an improved purchasing policy. However, sustainability is also decisive in this context.

The aforementioned quality features of companies – long-term defensible competitive advantages, growth strategies and the management – are the foundation of sustainable profits and thus of higher returns for investors.

Also important is keeping track of earnings per share because some companies build ever-expanding 'empires' at the expense of shareholders. For example, they grow through expensive acquisitions financed by capital increases that dilute shareholders' equity. This may help to raise overall profits, but earnings per share and thus stock prices may suffer.

The capacity of a company to earn sustainable profits can be measured by various ratios, including return on equity (RoE). Companies with long-term defensible competitive advantages have high returns on equity – more or less proof of their competitiveness. They generate free cash flows that the management must use intelligently. This illustrates quite impressively how the quality criteria interact and why these must be assessed within a broader context.

INVESTORS SHOULD NOTE THE FOLLOWING/IMPORTANT RISK DISCLOSURE:

Every capital investment involves risk. The value of the investment and the earnings generated by the investment can change suddenly and considerably and therefore cannot be guaranteed. Currency fluctuations can also influence the performance of the investment. The investor may fail to recover the full amount of capital invested, for example, if the capital is only invested for a short period. Under extraordinary circumstances, it is possible to lose all of the invested capital, including the purchasing fees. Please note that the provided figures and performance information refer to past performance, which is not a reliable indicator of future performance.

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