European Capital Partners

Friday Morning Coffee

Nr. 41 – Minsky moment?

When I switch on my Bloomberg on this snowy Thursday morning in Luxembourg to write the 41st edition of the morning coffee, I cannot help comparing the current environment to the experiences I gathered over the past 20 years I am active in this industry as a portfolio manager. First my apologies to quote Karl Marx in a column about investing, however his following quote is probably too good to ignore: "History repeats itself, first as tragedy, second as farce". So how do we make sure our portfolio is not ending as a farce? **Are we potentially entering a Minsky moment** that we in short can define as **"a major collapse of asset values which generates a new credit cycle"?** As a reminder, Russian economist Roman Minsky defined 4 stages in an economic cycle starting with a period of stability encouraging risk taking, leading to a period of instability when risks are realized as losses, then a period of capitulation with deleveraging followed by a period where stability is restored preparing for the next cycle.

While this theoretical framework is intellectually very appealing, we do not believe we can make a lot of use of it in current financial markets in order to bullet-proof our portfolios against bear markets. **As value investors we are long-term investors by nature and we are not trying to time the market.** We invest in the corners of the market, the market caps and the industries, where we find undervalued earning power. We are of course humble enough to take into account the current operating environment the companies are facing when we assess their earning power. Did that shield us against Minsky Moments over the last 20 years? Yes and no.

Over the past 2 decades we experienced 3 recessions: Dotcom, Great Financial Crisis and the double dip recession in the Eurozone. Each of these recessions came at the costly price to investors under the form of a bear market where European markets lost up to 60% of their value.

As the Dotcom bubble burst in 2001-2002 large parts of the value investor community had low exposure to the overvalued TMT stocks. That saved the day for the value investors back then, at least relative to the severe losses faced by those investors who put all their eggs in the TMT basket without an eye on the valuation of those companies. The 2008 crisis was to a good extent also a liquidity crisis in which valuation alone proved being a weak defense. Personally, I recall too well the company meetings I had during the second half of 2007 for the simple reason that not ONE company management I met saw the financial crisis of 2008 coming in its full violence. I find it hard to read too much into the double dip recession in the Eurozone as it did not leave a lasting impression for *Mr. Market* recovering the losses within a year.

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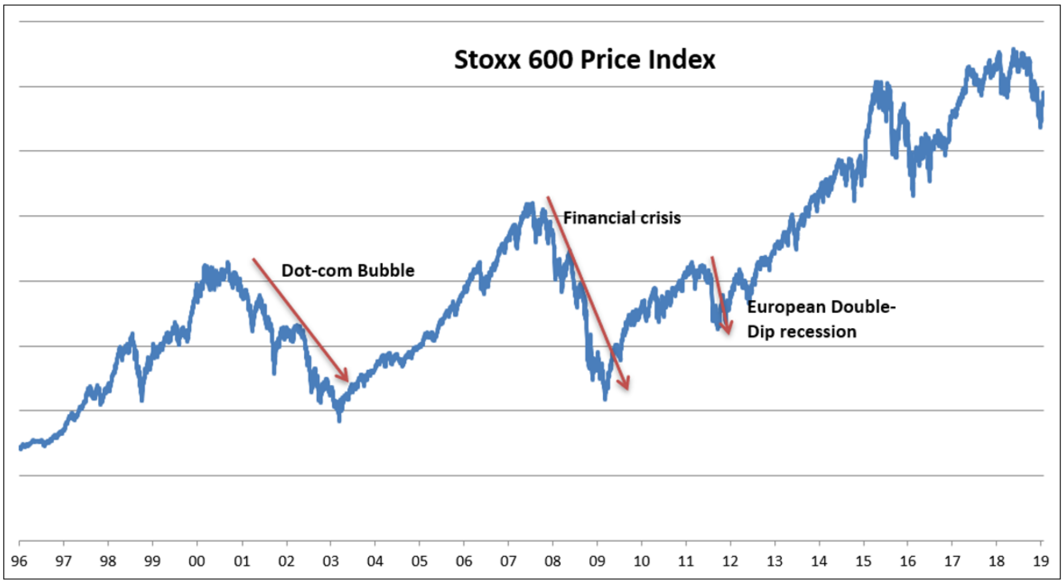

Source: Bloomberg, ECP

In the long run however, **I remain convinced that investing into lowly valued profitable businesses with a long-term perspective is the most efficient tool an investor has at his disposal** to generate returns in the long run. European markets trade currently at 12.8 forward earnings and a 4.1% dividend yield. There will be downward revisions for sure as analyst adjust their forecast to a slowing economic environment. However, we believe a lot of these are already priced in the most cyclical parts of the market with auto&parts down 30%, banks down 28%, construction down 18% and chemicals down 16% over the last 12 months. So instead of spending our time looking for Minsky moments, I believe our time is much better spent following our existing holdings in the portfolio and looking for new investment opportunities in the most unloved parts of the market.

I wish you a great weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
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