



Wilén b. Wollerau, 16 January 2015

### **What does the Swiss National Bank's decision to abandon the floor of 1.20 for the Euro mean for our funds?**

The Swiss National Bank's decision yesterday, January 15, to give up the lower bound of 1.20 against the euro led to a decline of this currency against the frank of 13% by market close. The US-dollar and other currencies important for Switzerland dropped by similar amounts.

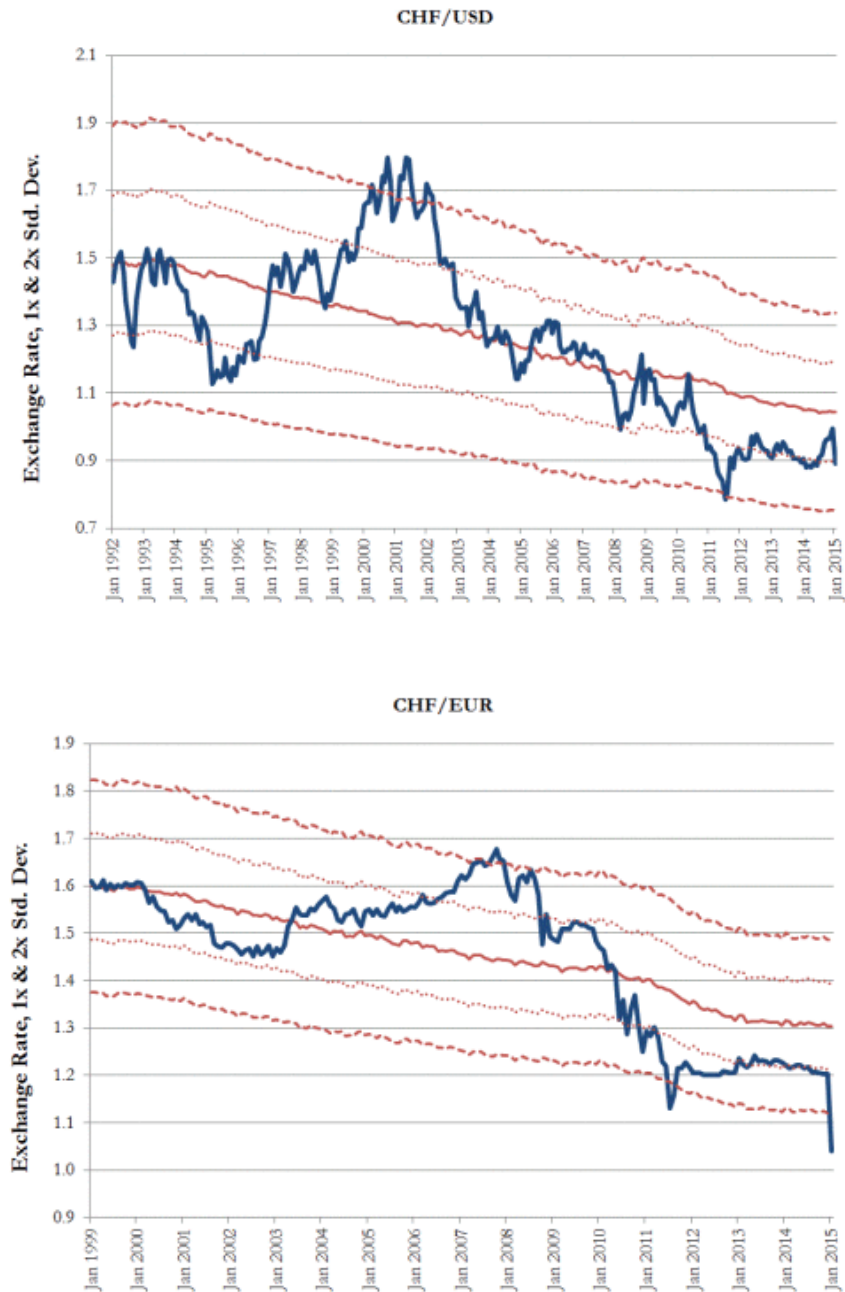
As over 85% of the investments in our funds are denominated in foreign currencies, translation losses hurt the net asset values (NAV) by around 10%. In local currency, however, these investments made slight gains. Additionally, we lost between 4 and 8% on our three Swiss holdings Adecco, EFG und Vontobel, because they will suffer translation losses on the foreign activities and, in the case of the banks, on the earnings on their client assets denominated in foreign currency. The Swiss market lost around 8.6%. Overall, the fund NAVs sank around 12% yesterday.

### **Three reasons for a weaker Franc**

Of course no-one knows where the euro and the dollar will settle against the franc in the next weeks and months. But the chances of a weakening of the franc in the long run are good for three reasons.

Firstly, exchange rates tend towards an equilibrium rate that is determined by relative purchasing power parity. As the graphs show, the equilibrium rate for the euro is at about CHF 1.30 and for the dollar CHF 1.04. The equilibrium rates change over time based on the difference in the inflation rates in the respective countries.

Unfortunately, the graphs show that exchange rates can deviate significantly from PPP over long periods of time. However, one can also see that there is a clear trend back towards the parity rate within one or two years of a very large deviation. At the moment we are observing a massive deviation from the Euro PPP and a slightly smaller one from dollar PPP (those interested in statistics will observe that we have included the one and two standard deviation lines in the charts).



Secondly the current exchange rates are a shock for the Swiss economy. One should therefore expect the Swiss National Bank to take measures to weaken the franc. Negative interest rates are one tool that it is already using and currency market interventions are another.



Thirdly, expectations for developments in the Eurozone are very low, so that any positive news would strengthen the Euro. For example, a Greek exit from the Euro would not only strengthen this currency by eliminating a problem case but also serve as a blueprint for the exit of other countries with weak fundamentals. The Euro might also rebound if the European economy were to recover somewhat, for example thanks to the lower oil price. There are negative scenarios, too, most importantly that Greece and other countries will be allowed to pursue unsustainable policies, but there is clearly more room for positive surprises.

### **Return potential has increased**

The conclusion is thus that the damage has most likely already been done and that the fund has a good deal of recovery potential on the basis of macroeconomic reasoning. While it is nice to know this, we do not base our decisions on this kind of thinking. For us, as value investors, it is most important that the events in little Switzerland have not changed the intrinsic value of our foreign companies. We need to make adjustments only for our Swiss companies, specifically taking their intrinsic values down by 5-10%. But that does not have a very large impact on the average undervaluation of our funds, which is around 25% at the moment. Meanwhile, the massive movements in exchange rates may have opened up some opportunities. We are looking for these. We are therefore even more optimistic than before that we will be able to find undervalued stocks. That, after all, is the basis for our investment success.

— Thomas Braun & Georg von Wyss