Dear Sir, dear Madam,

Market interest rates are at an all-time low. The German ten-year sovereign bonds, emitted by the most solid issuer of the Eurozone, barely quote above 0%. German government paper with maturities up to eight years yields negative.

The driving force behind the low market interest rate is inflation, which is currently fluctuating around zero. And the inflation expectations for the coming years remain exceptionally low, which implies that interest rates will probably remain subdued for a while.

But this does not mean we should settle with a quasi-zero rate.

Corporate bonds:

We invest the majority, roughly 60%, of our fixed income allocation in corporate issues. Corporate euro-denominated bonds carrying an investment grade credit rating yield approximately an extra 1%. We have a bottom-up approach:

1/ First and foremost, companies need to meet our select criteria in terms of Free Cash Flow generation.

2/ Additionally, we require our companies to be able to withstand a financial crisis on their own strength. Companies that meet our strict requirements include AB Inbev, Bayer, Publicis, Schneider Electric, Solvay, Deutsche Börse, … . These are the companies we invest in. On the other hand, we strongly underweigh bank issues because of their high risk profile.

3/ On top of that, we invest in USD-denominated corporate bonds. The market rewards these investments with roughly a 3% extra yield. In fact, the credit spreads in USD amount to approximately double the reward for comparable risks in Euro. Even as the so-called risk free curve, US Treasuries, which also rewards much better than the German curve. In our opinion, companies like Apple, Comcast, Expedia, Alphabet (Google), the Swiss Roche or the Chinese Tencent are definitely worth the investment. Moreover, we partially hedge USD/EUR currency risk against a cost that only represents a fraction of the excess return.

4/ For more expected return, we selectively operate in the high yield market. Here, more than ever, our fundamental analysis prevails. Additionally, we almost exclusively invest in the BB segment, which is the qualitatively better part of the high yield market.

Sovereign Bonds:

1/ In government bonds, we have a solid foundation of sovereigns in the northern part of the Eurozone, unsurprisingly at low yields. We avoid the southern part, including the periphery.

2/ On top of that we invest a large part in US Treasuries, but also in Norwegian, Australian, and Canadian government bonds, each in their domestic currency. These represent better yields than government bonds of the Eurozone. We also spot decent value in government bonds of emerging countries such as Mexico or India, in local currency.

Currently our complete fixed income allocation has a running underlying yield of 2.25%. The duration of this allocation adds up to approximately four years. The longer the duration, the larger the interest rate risk, or the sensitivity to rising or declining interest rates, having, respectively, a negative or positive impact on market values.

Given the current low interest rates, we keep a close eye on this risk. Last year, between April and June, the interest rate suddenly went up by 1%. Since then, the rates have caved again.

However, it is an illustration of how fast rates can move. An allocation duration of roughly four-years supports the compromise between interest rate sensitivity and return. In addition, this allows us to reinvest a quarter of the portfolio at potentially higher rates within approximately one year. Our base scenario, however, remains that interest rates will stay low for some time. But, rates of 0%,1%, or even 2% still correspond to this characterisation.

Inflation-linked bonds:

For defensive reasons, say inflation unexpectedly starts to rise, we allocate 20% of our investments to inflation-linked bonds. Even though the market is somewhat sceptical about this, it is a fact that central banks of the Western World will do everything in their power to restore the level of inflation to 2%. Inflation-linked bonds are immune to rising inflation. Indeed, the yearly coupons and the amount received at expiration are indexed to inflation, which protects them against a potential rise in inflation.

A preference for higher expected returns? That is why we prone a partial allocation to equities, where we do take a higher volatility into account.

Stocks in a volatile market environment:

In the context of low to ultra-low interest rate levels, we remain convinced about our maximum weighting in equities within every risk profile. The expected return and free cash flows on investments in equity remain very attractive compared to the returns we can expect on sovereign- and corporate bonds.

The so-called risk-premium, which is the additional premium we can expect for investing in more risky stocks on top of the yield on a 'riskless' sovereign bonds, amounts to about 5.6% in both the US and Europe. From a long term perspective, this is a significant premium, especially if we take the force of capitalisation in to account.

A small example will clarify this. If you were to invest €100 at the current long term interest rate of European government bonds of 1.4%, you would be left with €115 after 10 years. Investing the same amount in equities at a risk premium of 5.6%, would theoretically yield up to an amount of €197 for the same period. Of course, these differences are becoming larger with time. As such, if we invest the same amount for 20 years, we would have saved, €132 and €387, respectively, or 3 times as much. This represents a huge difference in purchasing power. At Capital*at*Work, we call this "Time at Work". If companies manage to meet the earnings expectations year after year, sooner or later this will be reflected in equity valuations.

As mentioned above, this means we have to accept volatility and market emotions, both which have peaked only recently. Halfway February, European indices declined 17% to 18% only to rebound significantly. Indeed, by the end of April, the same indices quoted a mere 3%-4% lower. Being an active manager, this was a great period for us to grasp many opportunities. In previous newsletters, we already discussed the reasons for this increased volatility. This is why, this time, we would like to deepen the discussion on our selectivity approach.

Selectivity

As with fixed income investments, selectivity is key when dealing with equity. A profound screening of the companies in which we invest, combined with further close monitoring therefore belong to our core tasks.

Aside from solid fundamentals, in which we search predominantly structural competitive advantages and growth catalysts, we also wish to see companies that employ their capital in an efficient manner and thus maximize free cash flow. We also look for companies with a healthy capital structure, which requires an in-depth analysis of the level of debt.

A second important aspect is valuation. At this stage, we solely invest in companies whose valuation looks interesting with regards to their corresponding future growth prospects. A process we accomplish consequently and devotedly.

We hope to have provided you with sufficient information. If you have any further questions, we will be happy to assist you.

Yours Sincerely,

The Executive Committee of Capitalatwork Foyer Group