Compass

1st Quarter 2024

Financial year 2023: Markets, Swiss equities and home bias

How an economic moat provides performance advantages

Innovation as a driver of economic growth

Your wealth, our responsibility.

A kaleidoscope of hopes, challenges and opportunities

The year 2023 was characterised by a complex interplay of economic optimism, geopolitical uncertainty and technological breakthroughs. At the beginning of the year, we experienced a wave of euphoria that boosted equity markets significantly. In the midst of this global dynamic, the US economy proved to be the robust foundation of the global financial system despite the turmoil surrounding some regional banks, ongoing inflation concerns and interest rate hikes. At the same time, the first signs of a possible recession emerged in Europe. The below-average performance of the Swiss equity market compared with European and US indices has once again highlighted the structural differences and the need for international diversification for Swiss investors. The basic trend section takes a closer look at the characteristics of moat companies and shows how they are able to strengthen their market position and effectively fend off competitors thanks to a strong brand identity, company size and customer loyalty. As a catalyst for growth, technology and innovation play a key role in the economy. A prime example of technological development is artificial intelligence (AI), particularly in the form of generative pretrained transformers such as ChatGPT from OpenAI. Technologies like these are paving the way for a future in which AI could fundamentally change entire sectors of the economy.

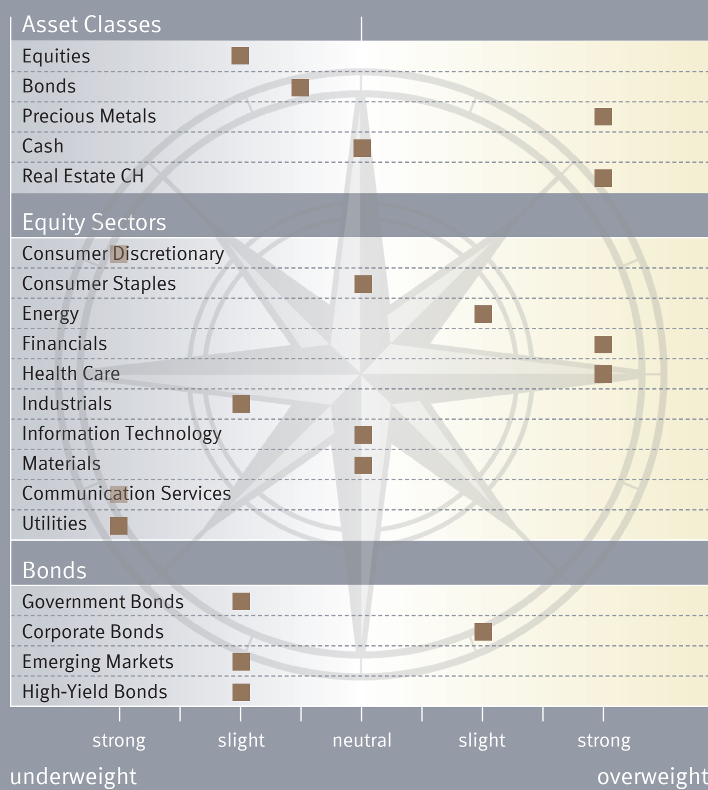
Our expectations after the year-end rally

At the beginning of the last quarter, investors were unsettled by the government shutdown in the US, which was only narrowly avoided, and the conflict in the Middle East. Since November, however, financial markets have recovered due to lower than expected inflation rates. The US Federal Reserve also signaled cautiousness, which dampened yields on US government bonds and led to a positive performance of various asset classes.

Our recommendation to slightly reduce the underweight in equities has proven to be the right decision in this market environment. After the consumer staples, energy, financials and health care sectors gained momentum in the summer months, the last two months of the year saw a sector rotation towards technology stocks, which are likely to benefit from the AI euphoria. The expected economic slowdown encourages us to maintain our defensive positioning in equities.

We have reduced our allocation to bonds in the course of increasing our equity allocation. We continue to recommend paying close attention to the credit quality of issuers and only holding bonds from first-class borrowers. Furthermore, we value the defensive nature of gold and are maintaining our strong overweight. Our overweight in Swiss real estate also remains unchanged.

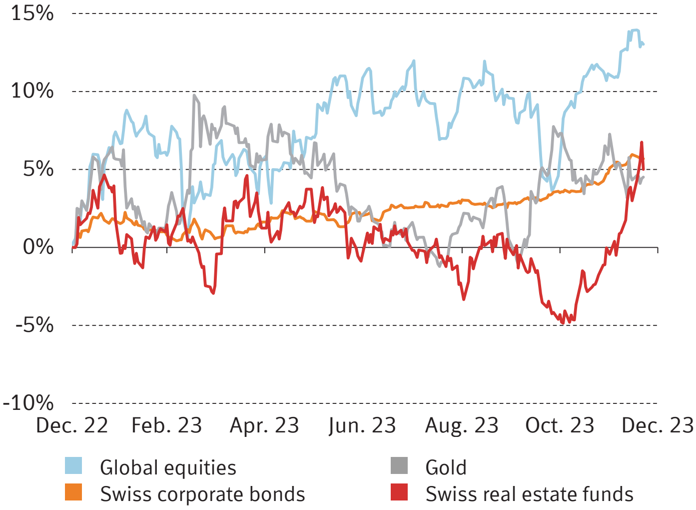
Asset allocation recommendation as of January 1st, 2024 for investors with CHF as their reference currency.



Current Topic:
Financial year 2023: Markets, Swiss equities and home bias

Current Topic 1:

Total return in CHF

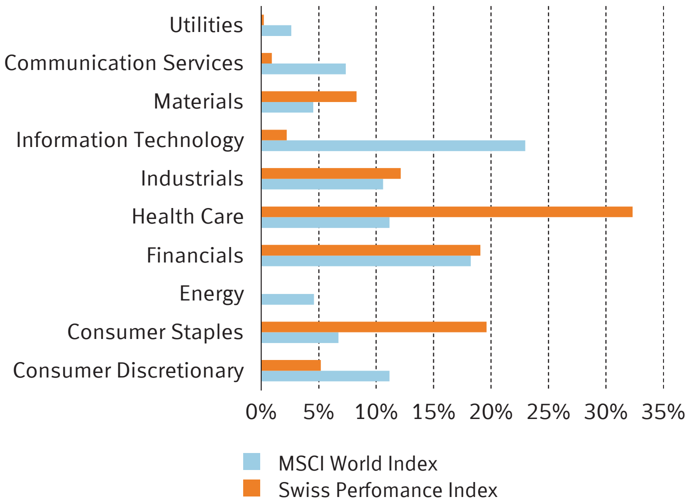


Financial year 2023 – hopes and uncertainty

The euphoria surrounding artificial intelligence, hopes that the US Federal Reserve will soon cut interest rates and the reopening of China boosted equity markets at the beginning of the year. While the US economy proved resilient despite the turmoil around various regional banks, inflation concerns and interest rate hikes, a recession is looming in Europe. Thanks to successive positive growth surprises in the US, global equities, led by technology stocks, recovered quickly from their slump in March. Swiss corporate bonds performed solidly due to lower inflation rates and fewer interest rate hikes by the SNB. Swiss real estate stocks showed a mixed performance, but recovered towards the end of the year.

Current Topic 2:

Sector weight within the index



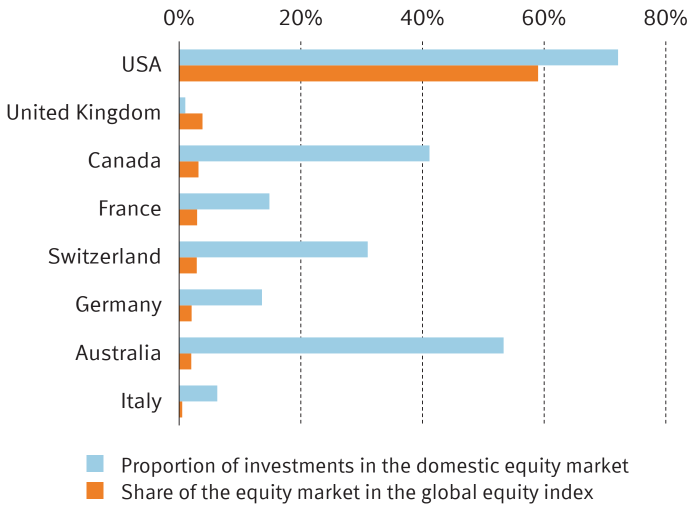
Swiss equities stable, but with little tech focus

The Swiss equity market has posted a solid performance since the beginning of the year. In comparison, however, leading European and US indices have achieved significantly higher returns. This illustrates the structural differences between the Swiss market and the global indices. The SPI has a defensive sector structure with a large weighting in the health care and consumer staples sectors. Such sectors offer security in volatile times, but in periods of growth they are often less dynamic than technology-heavy indices such as the NASDAQ or the S&P 500. Although the Swiss equity market represents a reliable investment opportunity, recent developments once again show that international diversification is advisable for Swiss investors.

Current Topic 3:

Source: IMF

As of 12/30/2022



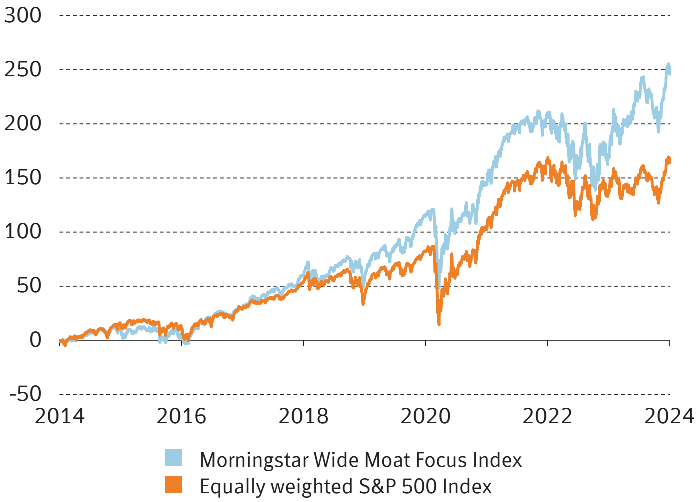
The home bias phenomenon

Investors prefer companies they are familiar with. Because they believe they understand the domestic market better, investing in domestic companies gives them a sense of being in control. The resulting disproportionate weighting of the domestic equity market can lead to insufficient diversification and makes the portfolio more susceptible to local economic trends. The overweighting of domestic equities in a portfolio is known as home bias. By investing in different markets, sectors and currencies, investors reduce their exposure to local risks. Global diversification therefore improves risk diversification and can lead to more stable returns in the long term. This is why we always recommend high-quality equities from different economic regions and sectors.

Basic Trend:
How an economic moat provides performance advantages

Basic Trend 1:

Indexed performance in percent (in USD)



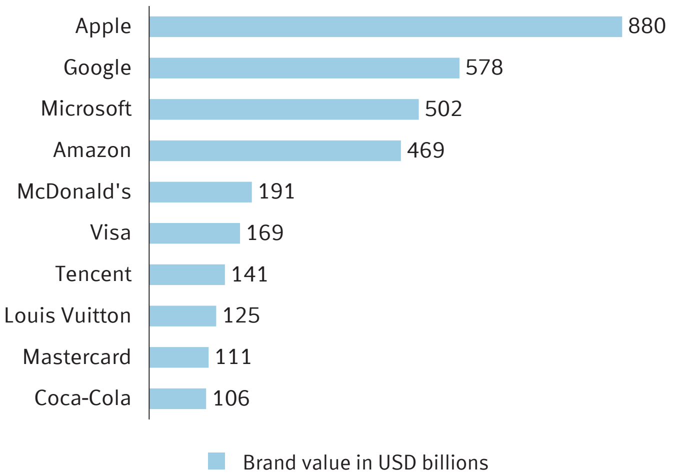
Moats protect market share

The market power of a company plays a key role for long-term investors. In this context, the term moat is often used to describe a company's long-term competitive advantages. The wider and deeper the economic moat, the better the company can fend off competitors and secure market share. As a result, these enterprises are able to retain a significant proportion of their profits and can therefore generate a better return for their shareholders in the long term. Over the past 10 years, an equally weighted Morningstar index that includes only US companies with a wide economic moat has outperformed the equally weighted S&P 500 index by 82 percentage points. This is equivalent to an excess return of 3 percent per year.

Basic Trend 2:

Source: Kantar

The 10 most valuable global brands in 2023

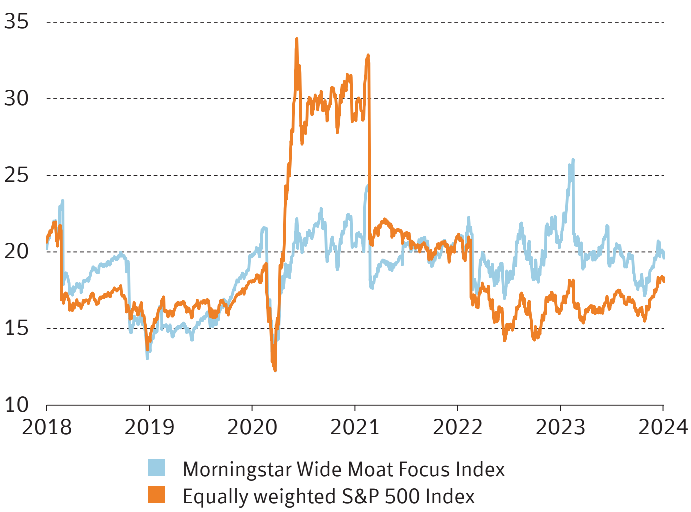


Brand strength and size as a competitive advantage

What can such economic moats be? A strong brand identity is one way of building customer loyalty. Apple has benefited for a long time from the fascination of its products and a dedicated fan base, making it one of the most valuable brands at the moment. In the short term, a company's brand strength is difficult to imitate which protects the firm from competitive pressure. Apple has therefore been able to raise prices for years without losing customers, which explains its impressive profitability. Another moat is the size of the company, which strengthens its negotiating power with suppliers and creates economies of scale. By spreading the same fixed costs over a larger quantity of products, bigger companies can offer products more cheaply than their competitors.

Basic Trend 3:

Price-earnings ratio



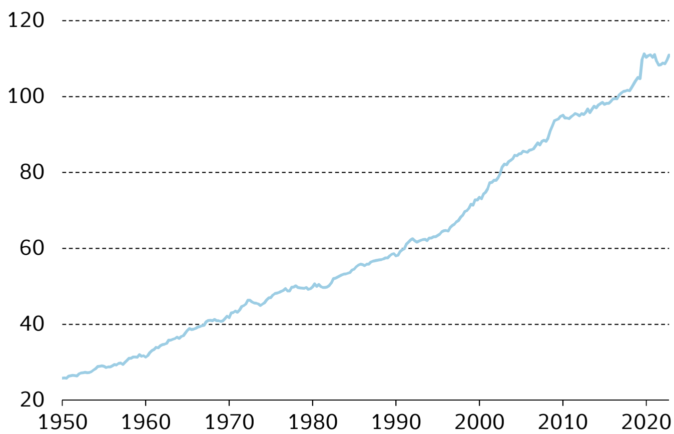
Quality has its price

The higher the switching costs, the stronger customer loyalty usually is. For example, companies that have equipped their systems with a Microsoft software will find it very expensive to switch. Convenience also ensures that Microsoft generates a high and predictable return with software licences for private customers. Companies that own patents or proprietary technologies also have very effective protection against competitors. It seems obvious that moat companies have a higher valuation due to their competitive advantages. Accordingly, their shares are rarely cheap in terms of the price/earnings (P/E) ratio. A rare exception was the Covid pandemic, when the P/E ratio of the equally weighted S&P 500 Index was significantly higher due to the greater decline in corporate earnings.

Knowledge & Experience: Innovation as a driver of economic growth

Knowledge & Experience 1:

US nonfarm labour productivity index

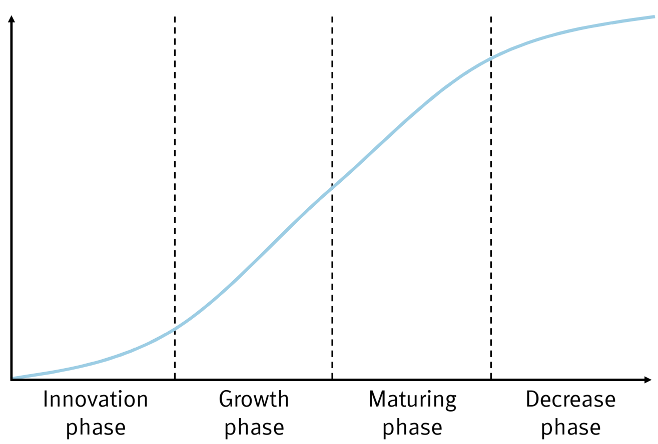


Technology as a driver of growth

In general terms, technology is the application of scientific knowledge for practical purposes. In an economic context, technology is crucial for transforming input factors such as raw materials, labor and capital into products and services. Technological progress makes it possible to increase efficiency and productivity to produce more or better output with equal or less inputs. Technologies are rapidly evolving into increasingly complex systems, where an existing technology often provides the basis for the next one. Technological progress is a key factor in economic growth, which, in addition to efficiency gains, can lead to the creation of new products, services and entire industries.

Knowledge & Experience 2:

Utiliation of the market potential



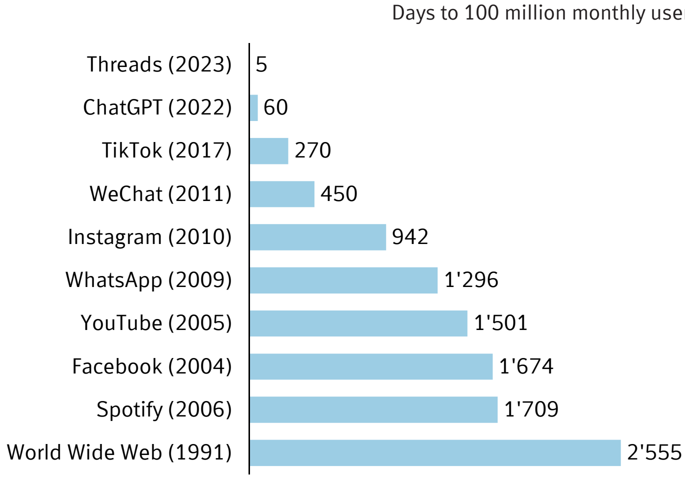
The evolution of new technologies

New technologies go through various phases known as the technology life cycle (TLC), which can be divided into four main phases: innovation, growth, maturity and decline. The first development of a technology takes place in the innovation phase. In this phase, the technology is still unproven and experimental. The growth phase is characterised by increasing acceptance and usage as well as improvements to the technology. In the maturity phase, the technology is largely standardised and widely used. The decline phase marks the end of the cycle. During this phase, existing technologies may be replaced by newer ones. However, some technologies remain relevant for decades even without major innovations.

Knowledge & Experience 3:

Source: visualcapitalist.com

Days to 100 million monthly users



Artificial intelligence: the rise of chatbots

Artificial Intelligence (AI), in particular Generative Pretrained Transformers (GPTs), are currently much discussed topics that promise significant productivity gains. These models became widely known through OpenAI's ChatGPT, a Large Language Model (LLM) that can understand and generate text, images and computer code. Remarkably, such models can already outperform humans on some tasks. But that's not all. OpenAI aims to develop Artificial General Intelligence (AGI). A system that is fundamentally more intelligent than human beings. Within the TLC, AI in the form of chatbots is still in the growth phase. These models are constantly being improved and an increasing number of applications are being explored. The technology is also gaining ever wider acceptance. Currently, Chat-GPT has more than 180 million monthly users, and the user base is growing steadily.

The prices used in our analysis are end-of-period prices. The figures used for our valuation model are estimates referring to dates and therefore carry a risk. These are liable to change without notice. The usage of valuation models does not rule out the risk that fair valuations over a specific investment period cannot be attained. A complex multitude of factors influences price developments. Unforeseeable changes could, for instance, arise from technological innovations, general economic activities, exchange-rate fluctuations or changes in social values. This discussion of valuation methods makes no claim to be complete.

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