May 31, 2013

Dear clients and colleagues,

Market sentiment in Europe has improved significantly in the past few months. Like their U.S. counterparts, German stocks are now trading at new all-time highs although revenues and earnings have been falling short of expectations. Indeed, the Q1 results season saw its lowest beats-to-misses earnings ratio since 2008. In this environment of earnings downgrades and weak fundamentals, we remain cautiously optimistic on German small caps. In general, we think that German smaller companies are better positioned than most of their European peers. Here are a few reasons why:

Corporate culture:

German small and medium companies tend to adopt a much longer-term perspective when it comes time to state new investment initiatives and set targets. The high percentage of family ownership of these companies can explain that long term vision. Also very unique, in our view, is the close relationship that exists between employers and employees which facilitates cooperation.

The majority of German companies are positioned either in the premium category when competing in big markets or act as clear leaders in niche markets. To give you an example, think of BMW or SAP which are premium players within huge markets. In the smaller space, Carl Zeiss Meditec, which competes in the ophthalmology market, is the leader in that field. We have owned this company in our portfolios since inception, and the stock has been a strong contributor to the fund's performance.

Strong competitiveness:

A study by the International Cluster Competitiveness Project has ranked Germany first as the country that is most often positioned in the number 1, 2 or 3 position across various industries. Their results showed that Germany has 142 market segments in the top 3 position, China with 107 ranked second, and the U.S. with 97 third.

Thanks to a sophisticated production process and a high level of R&D spending, Germany is rank sixth in global competitiveness studies. Within the EU, only Sweden outperforms Germany.

German's special attention to detail is also widely recognized. The U.S., Japan and France, which count many more companies within the top 500 of global companies, don't achieve the same export success as Germany. With more than 50% of its economy represented by exports, there is a strong demand for German expertise globally.

Financially sound:

Credit unavailability is causing problems for many small companies as they tend to rely more on bank loans than corporate bonds. Over the years, German small companies have become less dependent on bank loans. Part of this comes from the new Basel II rules that require more equity to cover borrowing. With a net debt to equity of 45%, German small companies are less leveraged than their European peers at 65%.

Thanks to their favourable global positioning and strong innovation attribute, Germany small caps should continue to perform well in the long term. In the short term, as long as the excess liquidity remains, German small caps should continue to perform in line.

Have a good weekend.

The Global Alpha team