Samuel S. Weber, based in Zug, Switzerland, shared his perspective during a Q&A session at our special event, Intelligent Investing in Crisis Mode 2020.

In addition to providing his general insights into the investment environment, Samuel shared his assessment of Lanxess (Germany: LXS) and updated his investment thesis on Deutsche Bank (NYSE: DB). Samuel had presented his in-depth thesis on Deutsche Bank at European Investing Summit 2017.

The following transcript has been edited for space and clarity.

John Mihaljevic: I know you've prepared some remarks, Sam, so let's start with those.

Samuel Weber: Thank you very much for including me in such an illustrious group of investors. I'm happy and honored that you consider my opinion worthwhile to listen to, and I'll try my best not to let you down.

There are many ways to be active in financial markets. Some people exclusively focus on specific assets, such as bonds, stocks, alternative assets, or gold, and there are many different strategies, such as macro, event-driven, or value-driven. Being a value investor, I focus on specific companies. I might buy their debt, but at current interest rates, I consider their stocks to be much more attractive, so my portfolio currently consists exclusively of common stocks. I look for value, and to determine it, I analyze the real businesses behind the common stocks in detail before and after making an investment decision and try to determine whether what I get in value is worth the price I have to pay.

What we are currently experiencing is an event-driven macro crisis. It doesn't affect only a few companies but all of them, some more than others. Stock market participants are indiscriminately selling all companies irrespective of their prospects. Every company is part of the world and the circumstances it finds itself in. My clients understandably ask me, "If you are focused on companies, those are affected by the current crisis, and the current crisis is a macro event. Shouldn't you focus on a macro analysis instead of a micro analysis of individual companies?" My clear answer, which is surprising to many people, is no. This paradoxical answer is more easily understood once we realize that we must distinguish between what we can and cannot know. Even though macro events are extremely important and significantly affect my portfolio of companies, they are also enormously complex. Each event is influenced by and, in turn, influences many different aspects of reality. Since macro is so complex, I know that I am not skilled and intelligent enough to form reliable conclusions about current events that help me make the right investment decisions. That doesn't mean I ignore macro. It simply means I don't try to make macro forecasts. I handle this whole topic differently.

One pillar – perhaps the most important one – of my analysis is to ask myself how this company is affected by a crisis. How do its revenues react? What happens to price and volumes? How adaptable is its cost structure to a change in circumstances? As a value investor, the most important question for me right now is how this crisis affects the companies in my portfolio. It is clear by now that this crisis will probably lead to a recession in the short term and possibly to a significant recovery after a few quarters. The main problem for companies is that as people and governments fight the virus, they consume less, leading to declining revenues, while the costs still have to be covered. In short, cash becomes very scarce. In order to survive, companies need access to it. If they get the cash they need, they will probably survive and recover, so there won't be lots of permanent damage should this crisis be managed well.

The big question here is how many businesses out there are running on such wafer-thin margins that they can't handle a few months of no revenues. The fear is that there are quite a lot of such businesses as the low-interest environment of the past 10 years was highly conducive to them. However, fundamentally, the virus has a relatively low mortality rate, and therefore, if managed well, should not permanently reduce the productive capacity of the world economy. We will see how all those factors play out.

As a value investor, I know that recessions happen occasionally and that I don't know when or how big they turn out to be. In a situation like this one, it is enormously important to me that I have done my homework. The companies I have invested in will survive this shock and may even profit from it. Take Lanxess as an example – this company divested its commodity chemicals business in recent years and reinvested the proceeds in its specialty chemical segments, which performed very well also through the last financial crisis. This transformation is the reason why the company's outstanding CEO is convinced that he can keep marching volatility to around 2% to 3% in any given year.

Last week, the company showed very solid results for 2019, and it expects a profit impact from the virus of a maximum of 10% in 2020. It is taking advantage of the low stock price by buying up to 10% of its outstanding shares, and the CEO and CFO just bought shares in the open market on their own account. Furthermore, it is a lucky coincidence that in April this year, Lanxess will receive proceeds of around €800 million pre-tax (more than 25% of its market cap after tax) from the sale of its stake in Currenta, which, by the way, was valued at zero on its balance sheet. These funds can now be employed in highly attractive conditions in the current low-price market environment as the company plans to grow by acquisitions, as it has done successfully in the past. Lanxess is almost certain to profit significantly from the current crisis and the fact that its stock price moves with other cyclical chemical companies because Mr. Market has not yet realized that this one is fundamentally different.

Let's also take a look at one of my more controversial investments, Deutsche Bank. In the beginning of 2020, the company finally managed to get some tailwinds after many years of difficult restructuring. It delivered on its targets and gained a significant new investor, which was reflected in a very strong share price performance of more than 40% during the first two months of this year, outperforming practically all other bank stocks globally. With this virus showing up, we are back to square one, or I should say minus one, in terms of share price. However, as a business investor, I think about how the current situation is affecting this company, and again, I see many positive factors that work. Deutsche Bank massively de-risked its balance sheet over the past years. It has significant liquidity, is mostly financed by cheap deposits guaranteed by highly credible insurance from a very solvent and trustworthy government, and its assets are of extremely high quality, mostly German mortgages. I'm not scared at all about the upcoming recession.

On the contrary, there are some significant benefits. From a business profitability standpoint, Deutsche Bank has too many deposits costing it money because the company has to hoard the cash at the ECB at negative interest rates. Therefore, if deposits should decrease now, it would have a beneficial impact on profitability, as long as the decrease in deposits doesn't surpass the cash reserves, which currently stand at around 40% of deposits. There is not a lot of danger there. Furthermore, this crisis will help Deutsche Bank establish a reputation for reliability and quality. In the crisis of 2008, the write-downs on its assets were very low, and in this crisis, the banks are not the problem but have to be part of the solution. The main issue today is to make sure that healthy companies don't go bankrupt because of a liquidity squeeze, and banks will play a major role in ensuring this.

Last Friday, I listened to the joint press conference of Germany's federal ministers of finance and economy, and they tried to avoid the upcoming liquidity issues by letting their banks decide whether and how to use their unlimited credit supply. We now have banks and governments working in concert to avert this crisis. This is a significant difference from 2008 and will help Deutsche Bank show that, contrary to past experiences, it can be relied upon to help its customers and employees. This will help market participants understand that the bank is safe and sound, and this should be great for the relative share price performance in the medium term, considering the bank's significant relative undervaluation.

Furthermore, as we may see significant fiscal stimulus in the coming months, we may also see rising interest on government debts. No other bank is as poised to gain from such a development as Deutsche Bank due to the structure and quality of its asset base. Of course, in the short term, the market is in total turmoil, and almost no company can detract from these dynamics.

You probably get the main point by now. The time to prepare for a recession is before it hits, and the best way to do that is with a sound company-specific analysis, not with a futile attempt to predict the timing or the extent of the next macro crisis.

The current environment presents significant opportunities for long-term investors. The value of a business is the present value of all future income streams, and the current crisis will affect only a tiny portion of them. The decrease in market values is almost certainly much bigger than the decrease in intrinsic business values, widening the discrepancy between price and value. However, taking advantage of the situation is easier said than done. That's because the problem now is not to figure out what to buy – because bargains are all over the place – but what to sell in order to be able to buy. I'm not a market timer because such timing skills elude me, so I don't sit on a lot of cash. This means that my stock positions decreased in value more or less proportionately with the market, that is, their relative attractiveness didn't change. Absolutely speaking, of course, they are much more attractive now than only a few weeks ago as the lower their price, the higher their expected future returns.

Let me cite here one of the best and most famous value investors besides Warren Buffett – Seth Klarman. He says, "To maintain a truly long-term view, investors must be willing to experience significant short-term losses. Without the possibility of near-term pain, there can be no long-term gain." The ability to remain an investor and not become a day trader or a bystander confers an almost unprecedented advantage in this environment. Personally, I am extremely lucky because my clients know the difference between stock price volatility and permanent capital loss. This gives me the staying power to go through times like this without unnecessary collateral damage and even to profit from times like this if there is a chance to do so.

Yet, I am very reluctant to realize losses on my existing portfolio stocks by selling some of them just because the market throws up so many opportunities. I have analyzed my holdings for many months or even years in significant detail, while many of the new opportunities are also new to me. This knowledge advantage about my existing investments stops me from turning over my portfolio in this environment. However, if one of my holdings should move against the market and come close to break-even, I might consider selling it in order to reinvest the proceeds in some new opportunity. Alternatively, if some other stock unjustifiably decreases by much more than one of my current holdings, and the relative attractiveness changes, I might even realize a substantial loss in order to be able to buy that new stock. Again, I'm very careful here, and in all probability, I won't do it.

The following are excerpts of the Q&A session with Samuel Weber:

Mihaljevic: Sam, thank you so much for those remarks, which are extremely helpful in this context. I also appreciate your touching on a couple of specific names. Lanxess is a company you have not presented in depth in the past, but I'm glad to hear the name because we had it presented at one of our online conferences by Jim Zimmerman in 2017. Could you go a bit deeper into Lanxess in terms of the investment thesis there and why you believe it could make for a good investment over the long term?

Weber: Lanxess has changed significantly during the past few years. It always had those specialty chemical segments. It has four of them, but in the past, it was very big in commoditized business, selling basic materials to big companies and undifferentiated base chemicals. That was like a rubber chemical company, competing with the likes of Exxon Mobil and Saudi Aramco. However, it didn't have a competitive advantage because it wasn't vertically integrated, as were those big players.

One or two years ago, it sold this chemical business to Saudi Aramco and got significant proceeds, which it reinvested in the acquisition of Chemtura. That strengthened its specialty chemical segments of chemical additives and transformed Lanxess from a mostly commoditized chemicals company into a true specialty chemicals business. Until today, this transformation has been mostly ignored by the market. You see that clearly when you look at its stock price, which moves almost exactly as that of, for example, BASF – a major chemicals company also selling commodity chemicals. You could see that in one day, when BASF warned that its profits would be significantly lower, the stock price of Lanxess reacted as much as BASF's. Then, when Lanxess announced that its profit would not be affected by the current environment, the stock price shot back up. It is abundantly clear that Mr. Market has a tough time differentiating between Lanxess and other mass chemical companies, and it's only a matter of time until it realizes that Lanxess should be valued differently from them. If you look at other specialty chemical groups, their stock price performance is much more stable on a much higher level compared to Lanxess.

Mihaljevic: I believe Jim pointed out in his presentation, which was just after the Chemtura acquisition closed, that Lanxess was moving into flame retardant chemicals similar to Lubrizol, which is owned by Berkshire Hathaway.

Weber: Exactly. Warren Buffett, Berkshire Hathaway, or one of his key deputies, Ted or Todd, also bought a part of Lanxess a few years ago.

Mihaljevic: You said Lanxess will have €800 million in pre-tax proceeds coming its way. How do you see that cash likely deployed?

Weber: That will very likely be deployed for an acquisition. Lanxess aims to grow organically and also with acquisitions, and it has already done so successfully with the Chemtura deal. Such active portfolio management is an integral part of its strategy. In the current environment especially, it will probably use those proceeds to buy some other company, most probably in the specialty additive segment.

Mihaljevic: Deutsche Bank is another one I'm greatly interested in because you made a strong case for it in the past, and the stock price has been materially affected by this market downturn. The question there is whether you see a material impact now from an even lower interest rate environment, to the extent that's even possible in Europe.

Weber: The most fundamental thing to understand is that there are two effects from interest rates on banks. First is the revenue effect. Lower interest rates lead to lower net interest margins and, therefore, lower profits. That's a significant effect, but there is also a more indirect one, namely that lower interest rates reduce the discount rate in a discounted cash flow valuation – the remaining earnings the bank still generates have to be discounted with a lower interest rate, so that increases the value of the earnings. You have an effect that decreases the earnings but another one that increases the value of the earnings. That's one part to the answer.

The other part is that a low interest rate environment is nothing new. It's definitely not something I didn't think about when investing in the company, and this didn't change significantly due to the current crisis. Low interest rates have to be counteracted first and foremost with efficient cost management, then the bank can also increase its fees, but there is no way around it. The higher the interest rates, the better. Deutsche Bank is significantly and more than other banks exposed to a rise in interest rates. If that should happen, it would also be great for Deutsche Bank in a negative scenario because it will earn much more with rising interest rates even though in a negative scenario – for example, stagflation, where you have inflation combined with a recession – you would also see increasing provisions for credit losses. In this event, even Deutsche Bank should be so exposed to the rising interest rates that it will more than offset the rise in credit loss provisions. Yes, it is a negative, but it's factored in, especially if you look at the current price.

The whole bank is currently valued at around €10 billion, and it owns 80% of asset manager

DWS, which is valued at around €4-€4.5 billion. Excluding the value of the publicly quoted company it owns, this comes to around €6 billion, which is a 10th of Deutsche Bank's book value. That book value, in my opinion, is quite a conservative estimate of the value of its balance sheet and its revenue and earnings generating capacity because it has a very high-quality asset base. This is the most important thing in this investment thesis. Many people out there think that Deutsche Bank has overvalued assets on its balance sheet, so once it gets tested, it has to write down assets, and the book value will be much lower than people think. My opinion is contrary to this one. I think the bank has a very high-quality balance sheet, and it is not endangered by significant write-downs on those assets, so valuation also counteracts the effects of low interest rates.

Mihaljevic: How were you able to build confidence around your view of the balance sheet? I mean, banks have a lot in the way of assets, so just a small change in the value of those assets has a big impact on the equity. Can you elaborate a bit more on the sensitivity of that? How do you maintain your confidence, especially if there is a recession ?

Weber: That's the most important part of the company analysis I made 1.5-2 years ago, and I continuously make every day. There are many different aspects involved in this balance sheet analysis. First of all, you always have the danger of a classic bank run where the deposits decrease, and there is a drain on liquidity. Deutsche Bank has around €200 billion of liquidity reserves at the Central Bank, so I think it's very safe from a liquidity perspective.

That's also highly important if you look at the derivatives book. It is quite sizable and has two main aspects. One, you may face some asset write-downs and a liquidity drain if the liabilities increase. You have those two key effects, and the liquidity part shouldn't be a problem – Deutsche Bank is very liquid. With the asset part, there are some things to look at. First of all, Deutsche Bank had around €2.5 billion of write-downs on its assets in the financial crisis, and €2.5 billion is much less than its ongoing profitability once this restructuring is finished in 1.5-2 years from now. It's not much compared to what the bank earns. You can also see it today if you focus on the core bank, which it publishes in its segment results. Today, it already earns more in profits from this core bank than what it had to write down in the financial crisis. That's one part.

The second part is the derivatives. There are two main risk-managing tools here when it comes to the possible asset write-downs. You have these netting agreements where you net the receivables from one counterparty with the payables to the same counterparty. Thus, if one counterparty goes bankrupt and cannot pay the receivables, you don't have to pay your payables to that counterparty. You net those two, and you also subtract the value of collateral you have collected with respect to those derivatives businesses. If you look at the risk after netting and collateral, you see that it's around 35% or 40% of the equity of Deutsche Bank. This is in line with, for example, JP Morgan, but you have a bearable residual risk from those derivative operations, so no danger from liquidity and write-downs. Last but not least, you can see on the balance sheet that if you subtract cash from the total assets, the netting, and the collateral, you get to an equity capital ratio (equity capital as a percentage of total assets) of more than 10%, which should be enough given the credit quality of the assets.

Mihaljevic: Please, walk us through your thought process when it comes to rebalancing the portfolio and thinking about what you might want to buy more of and perhaps what to sell.

Weber: What I told you was basically the conclusion of a thought process that has been going on for three weeks now. Before deciding what to do, you have to form an opinion on what you're definitely not going to do. What I'm definitely not going to do is to switch positions, realizing significant losses, and switch positions into new companies where I think the value is even greater. If you do that repeatedly, you always realize losses. You accumulate realized losses, and you go into a hypothetical intrinsic value that first needs to be realized. On paper, in the real world, you get poorer and poorer, while in your head, you become a billionaire pretty quickly. This is an extremely dangerous thing to do, so I'm very careful about realizing losses. The only occasion where I will realize losses is to either grab an opportunity too good to pass or if I have made a mistake. The first case is exceptionally rare, and I don't see that in the current environment. As for mistakes, they happen, and it's critically important, as an investor, to be honest with yourself, otherwise, Mr. Market will destroy you. It's better to realize the loss if you have made a mistake, even if it's painful, instead of keeping the company in your portfolio and let it write down to 90% or 95% of losses.

My main point is I'm extremely careful of hunting intrinsic value while realizing losses in the real world. The most important thing for me is to differentiate between what is permanent loss and what is market price fluctuation. We, investors, are compared to an index when our performance is assessed, but in the current environment, the index is so irrational that it's obviously not a reliable performance benchmark. I'm under no pressure right now from any false comparisons. I simply focus on the companies I own and how they are affected by this crisis, and I ride out the unrealized losses because as long as you don't realize those losses, they shouldn't affect you if you have permanent capital. It's a structural point. I have permanent capital, and I only have clients who have entrusted me with permanent capital, so I am under no pressure whatsoever to realize losses that are not necessary.

Mihaljevic: Speaking of permanent capital, are you doing anything differently at the moment in terms of how you communicate with your clients? Are you communicating more? Are they telling you anything? Tell us a little about that side of the equation.

Weber: For me, it's much more difficult to have a bad performance when everybody else has a good performance than to have a bad performance when everybody else also suffers. Right now, it's quite obvious that you have to stay rational. Very few alternatives didn't significantly decrease in value, so it's also quite obvious that it's not a mistake I made but an unforeseen event. This virus spread. Two or three weeks ago, most business leaders believed they wouldn't be seriously affected by all of this. It's important to have done your homework, and when something like this happens, you don't have to correct any mistakes. If you haven't thought through the implications of a possible recession and have to make corrections now, those corrections can be extremely painful. My clients know that now is the time to be rational and have no emotional responses to the current situation. We have done our homework, and we feel confident about the future.

Mihaljevic: Sam, you seem to be able to keep a level head in all of this and stay long termoriented. Tell us a little about how you're doing that. How do you spend your time? Have you changed your routine at all?

Weber: My routine hasn't really changed. I mean, I've been reading all day long for 10 years, so that isn't significantly affected by the virus. It's a bit ironic, but the solitary state of spending my days has become an advantage in this environment. I haven't had to change anything so far. I am quite safe from this current virus and from getting other people sick. The lifestyle I have turned out to be especially helpful in this situation. It's also an extremely interesting time to observe. Who knows, maybe a significant opportunity comes up, and I will act on it, but so far, my routine hasn't changed. I'm observing and learning and studying, as always.

Mihaljevic: Thank you very much for taking the time to join us and share your perspective.

About the instructor:

Samuel S. Weber is an independent wealth manager based in Zug, Switzerland. He is a passionate value investor, who is focused on generating long-term, market beating returns by investing in high-quality opportunities in the stock market and providing patient capital to SMEs with the overall aim of fostering productive investments in Switzerland and Europe. To achieve the latter, he founded the SW Kapitalpartner GmbH (www.swkapitalpartner.com). Samuel holds a master's degree in strategy and international management from the University of St. Gallen.