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Erlen Insights

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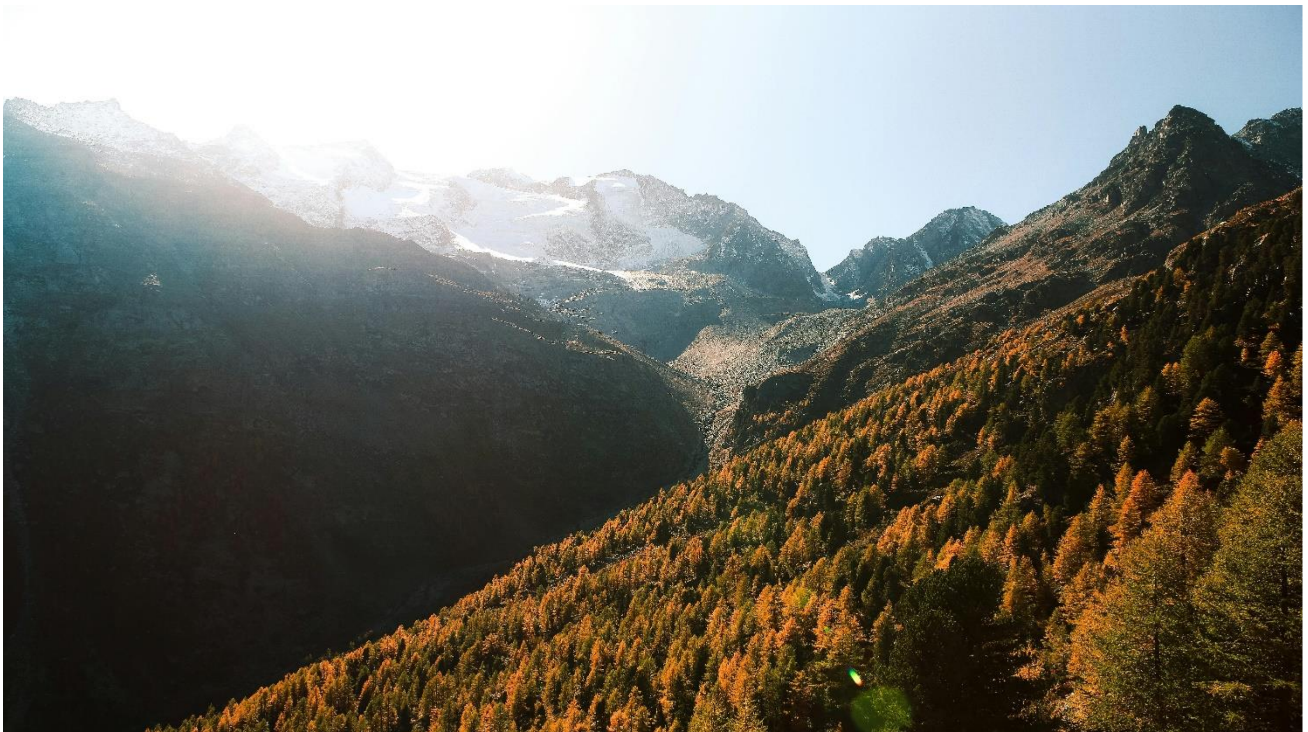

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LOWER INTEREST RATES LEAD TO HIGHER SHARE PRICES

When timing our investments, we focus on interest rate trends—falling interest rates signal investment opportunities for us. These are the main reasons:

Companies pay less interest, which increases profits

When interest rates fall, companies can borrow more cheaply or refinance existing debt at better conditions. As many companies are heavily leveraged, a reduction in interest costs has a direct positive impact on their income statements. Lower interest costs increase the proportion of operating profit that goes to shareholders, thereby increasing net profits. These rising profits are one of the key drivers of higher share prices.

In addition, cheaper debt capital promotes company growth. Businesses can invest more in new projects, expansions, or innovations, which can further increase future profits. Investors recognize this growth potential, leading to increased demand for the company's shares.

Future profits are valued higher (DCF valuation)

Another important mechanism through which lower interest rates lead to higher share prices is the way investors value future cash flows. The discounted cash flow (DCF) method is often used for this purpose, where a company's future cash flows are discounted to determine their present value. The discount rate consists of the risk-free interest rate and a risk premium.

Falling interest rates reduce the discount rate, meaning future profits are discounted less and therefore appear more valuable from today's perspective. This results in a higher valuation of the stock and increased demand from investors.

A low interest rate, therefore, signals that a company's future cash flows are worth more, driving up the stock's valuation.

Lower interest rates make equities more attractive than bonds

Interest rates also influence the relative attractiveness of equities compared to other forms of investment, particularly bonds. In a low-interest-rate environment, bond yields are severely limited, pushing many investors—especially institutional ones like pension funds and insurance companies—toward higher-yielding alternatives. Equities, which generally offer higher returns, become more appealing during such phases.

This phenomenon is often referred to as "TINA" ("There Is No Alternative"). When bonds yield extremely low returns, there are few alternatives to equities for achieving adequate returns. This leads to an inflow of capital into the equity markets, increasing demand and, consequently, stock prices.

Dividend yields on stocks also become more attractive during periods of low interest rates. For example, if government bonds offer just a 1% yield, dividend yields of 2% or 3% look much more appealing. This shift from bonds to stocks further drives up share prices.

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Lower interest rates make company takeovers more attractive

Low interest rates also encourage mergers and acquisitions. If financing costs decrease, potential buyers can borrow more cheaply to fund acquisitions. Lower financing costs increase companies' willingness to pursue takeovers.

This competition for takeover targets can cause the share prices of these companies to rise as investors speculate on takeover premiums. The share prices of acquiring companies often benefit as well, as acquisitions are seen as growth and expansion strategies.

The prospect of future acquisitions creates positive momentum in the stock markets. Investors begin purchasing shares in potential takeover targets, further driving share prices upward.

We are focusing on lower interest rates

Slow economic growth and recession in some countries, like Germany, combined with low inflation, are pushing interest rates lower. To stimulate the economy, central banks often slash short-term interest rates dramatically, which in turn supports the market. We aim to take advantage of these interest rate cuts to generate profits with our investments.

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THE SWISS FRANC: REASONS FOR ITS STRENGTH

We often invest a large portion of our clients' money in Swiss francs, even if they reside outside Switzerland. We are confident that the Swiss franc will remain strong and continue to generate profits for investors. The reasons for this are as follows:

Positive trade and current account balance

Switzerland has had a consistently positive trade and current account balance for years, meaning the country exports more than it imports. This positive balance significantly strengthens the Swiss franc, as it generates constant demand for the currency. A trade surplus means international companies and trading partners need Swiss francs to purchase Swiss goods and services. This continuous demand supports and stabilizes the currency.

In particular, high-quality products from the pharmaceutical, watchmaking, and financial sectors contribute to this positive result. These sectors enjoy high demand abroad and continue to bolster the confidence of international investors. Supported by a well-trained workforce and innovative technologies, the Swiss export economy remains competitive.

Low national debt

Compared to many other industrialized countries, Switzerland maintains remarkably low public debt. While other nations have significantly increased their debt levels since the 2008 financial crisis and the COVID-19 pandemic, Switzerland has managed to keep its debt at a stable level. This fiscal discipline creates confidence in the Swiss franc, as lower debt means the government is less reliant on external borrowing and isn't forced to increase the money supply—actions that could lead to currency devaluation.

Thanks to its low debt, Switzerland can respond flexibly during crises without immediately needing to resort to loans. This financial strength reinforces the perception of the Swiss franc as a stable and secure currency.

No government deficit

Another important factor contributing to the strength of the Swiss franc is the lack of a significant government deficit. While many countries regularly spend more than they earn, Switzerland maintains a balanced budget, keeping government spending in line with revenue. This fiscal discipline reduces the risk of future increases in public debt or the devaluation of the franc to pay down debt.

A balanced budget also creates room for investment in infrastructure, education, and research, which ensures the long-term competitiveness of the Swiss economy. This stability attracts both domestic and international investors who view the Swiss franc as a safe investment.

High political stability

Switzerland's political stability is another significant factor in the strength of the Swiss franc. The country is known for its political system, which is characterized by direct democracy and federalism. This structure allows citizens to actively participate in important decisions, leading to broad acceptance of political measures and minimizing social tensions.

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This stability is highly valued by investors worldwide. In times of geopolitical uncertainty or economic crises, investors seek safe havens, and the Swiss franc is considered one of the safest currencies. Confidence in the country's political and legal stability makes the franc an especially attractive currency during times of crisis.

Stable economic development without dependence on automotive and heavy industry

The Swiss economy has proven to be extremely stable, as it does not rely on cyclical industries like automotive or heavy industry. These sectors are often heavily affected by economic fluctuations and tend to suffer during crises. In contrast, the Swiss economy is driven by more stable sectors such as finance, pharmaceuticals, precision engineering, and tourism.

These sectors exhibit lower volatility, enabling the Swiss economy to better withstand economic shocks. The focus on high technology, services, and innovation makes Switzerland's economy more resilient to crises, which positively impacts the Swiss franc.

The trend continues – the Swiss franc remains strong

The strength of the Swiss franc is the result of several long-standing factors. We expect this trend to continue and will maintain our focus on investing heavily in Swiss francs. Our clients from the dollar and euro zones have already greatly benefited from these investments.

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WHY SHARES IN THE BIOTECH INDUSTRY ARE ATTRACTIVE

The share prices of biotechnology companies have underperformed in recent years—this sector has not been in the spotlight for most investors. However, we believe there are significant opportunities in this sector right now.

The ageing population is increasing demand for medicines

The world's population is ageing rapidly, particularly in industrialized countries. Forecasts suggest that the proportion of people over the age of 65 will rise sharply in the coming decades. As people age, the demand for medical care increases, since older individuals are more prone to chronic illnesses and require regular medical attention. This leads to growing demand for innovative drugs and therapies to treat age-related diseases such as cardiovascular diseases, cancer, diabetes, and neurodegenerative diseases like Alzheimer's and Parkinson's.

Biotechnology companies are at the forefront of research and development in therapies for these diseases. They frequently develop groundbreaking treatments, including gene therapies and cell-based therapies, which are particularly well-suited to addressing complex diseases. Due to their specialization, the biotech sector directly benefits from demographic shifts and offers attractive long-term opportunities for investors.

Innovative strength in drug research

Biotechnology is known for its innovative power and the development of revolutionary drugs. While traditional pharmaceutical companies focus on established treatment approaches, biotech firms leverage cutting-edge technologies like genetic engineering, immunotherapy, and personalized medicine to develop more specific and effective treatments. These technologies offer enormous potential for treating diseases that were previously considered incurable or had limited treatment options.

Thanks to its continuous innovation and research, the biotech sector offers significant growth potential. Once a drug reaches market maturity, the potential for substantial returns rises, making biotechnology companies particularly attractive for long-term investments.

Low interest rates lead to higher valuations

Biotechnology companies often require substantial initial investments in research and development before generating profits. Since their earnings are usually far in the future, they are especially sensitive to high interest rates, which discount their future cash flows. In a low-interest-rate environment, however, future earnings are valued higher, prompting investors to pay more for biotech stocks, which in turn drives share prices upward.

As we anticipate further declines in interest rates, we expect the share prices in this sector to continue rising.

Acquisitions by large pharmaceutical companies

Another advantage of biotech stocks is the ongoing consolidation in the industry. Large pharmaceutical companies are under pressure to constantly refresh their pipelines and bring new products to market. Since they often struggle to generate sufficient innovation internally, they acquire biotechnology companies that are developing promising new therapies.

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Such acquisitions offer investors considerable opportunities, as acquisition bids usually come with a premium on the share price. Additionally, speculation over potential takeovers can drive up the share prices of biotech companies even further.

Potential for personalized medicine

Another attractive aspect of biotechnology is the growing potential of personalized medicine. Advances in genetic engineering and molecular biology enable biotech companies to develop customized therapies tailored to patients' genetic profiles. These therapies often offer higher success rates and fewer side effects than conventional treatments.

Personalized medicine is expected to be one of the main growth drivers in the biotech sector over the coming decades. Companies leading the charge in this area have enormous growth opportunities. Investors who position themselves early in this trend stand to benefit greatly from the future returns of these technologies.

Support from governments and institutions

The biotech sector is also benefiting from increasing support from governments and international institutions. The importance of innovation in medicine became especially clear during the COVID-19 pandemic. The rapid development of mRNA vaccines demonstrated how quickly and efficiently the biotech industry can respond to urgent health challenges.

This government support is expected to continue long term, as many countries increase their investments in the healthcare and biotech sectors. These additional funding opportunities lower the risks for investors and strengthen the sector's future growth prospects.

We invest in biotech

The biotech industry presents numerous compelling reasons for investment. Since the beginning of 2024, we have focused on the dynamic growth of the biotech sector and launched the "ZKB Tracker Certificate Dynamic on Erlen Biotech Basket" in collaboration with Zürcher Kantonalbank (ISIN: CH1218247190). This investment product offers broad diversification within the biotech sector, comprising 30 carefully selected global companies at the forefront of medical innovation.

Investment product details:

- Structure: The product is dynamically structured and allows for flexible adjustments based on market developments. It is based on a basket of biotech stocks compiled and continuously reviewed by us.
- Focus on leading companies: The basket includes companies that have made significant strides in areas such as gene and cell therapies, oncology, and treatments for neurodegenerative diseases. These firms are known for strong research pipelines and high innovation, offering long-term growth potential.
- Issuer – ZKB: Zürcher Kantonalbank, a bank with a state guarantee, acts as the issuer, providing investors with additional security and confidence.
- Performance: Since its launch in January 2024, the certificate has achieved a return of around +10% by mid-September, significantly outperforming benchmarks such as the Solactive Genomics Index, which has lost approximately -10% over the same period.

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The Erlen Biotech Basket provides investors with an opportunity to invest in a sector that will benefit long term from global trends such as an ageing population and increasing medical needs. With a focus on leading companies and a dynamic adjustment strategy, the portfolio is well-positioned to respond to market developments. For more information, please visit our homepage: www.erlencapital.com or contact us directly.

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WHY WE ARE NOT INVESTING IN THE AUTOMOTIVE INDUSTRY AND ITS SUPPLIERS

The shares of car manufacturers and suppliers are currently trading at very low prices, which might tempt some investors to see this as a buying opportunity. However, the low share prices reflect the profound changes putting both manufacturers and suppliers under pressure.

The switch to electric motors driven by political mandates

Global political pressure to reduce CO_2 emissions and promote zero-emission mobility is forcing traditional car manufacturers to fundamentally change their business models. Electric vehicles (EVs) are widely viewed as the future of transportation, and companies like Volkswagen are facing the challenge of managing the transition to electric mobility while continuing to offer gasoline and diesel vehicles. This results in a significant drain on resources, as they must maintain two parallel production lines—for combustion engines and electric motors. This dual burden reduces the competitiveness of traditional manufacturers, particularly compared to new entrants that focus exclusively on electric vehicles. Tesla, for example, operates without the legacy burden and has become a dominant competitor in the electric vehicle market.

Volkswagen is responding to this challenge by investing billions in electrification and launching its ID series of electric cars. Despite these efforts, VW is struggling with delays and high development costs. All traditional manufacturers face the dilemma of protecting their established models while investing in an uncertain future.

The rise of new competitors from China

China has quickly become a key player in the electric vehicle market. Numerous new companies, supported by government subsidies, specialize in electric vehicles. Brands like BYD, Nio, and XPeng are gaining traction, not only domestically but also internationally. These companies benefit from lower production costs and strong government backing, giving them a clear competitive edge.

Traditional manufacturers like Stellantis, Toyota, and Volkswagen find themselves in unequal competition with these Chinese players, who are not burdened by the legacy of combustion engine production. Additionally, Chinese manufacturers are increasingly adopting innovative business models, such as selling electric vehicles with battery subscription services, further expanding their market access.

Shrinking market for suppliers

Electric vehicles have far fewer moving parts compared to combustion vehicles. A traditional gasoline engine consists of hundreds of components, whereas an electric motor and its control unit are relatively simple. This reduction in complexity leads to a drop in demand for supplier parts, which has a dramatic impact on traditional suppliers.

Many automotive suppliers specialize in producing components for combustion engines. As the industry moves away from these engines, these companies face a shrinking market. Bosch, one of the world's largest automotive suppliers, has already announced plans to shift parts of its production. However, many smaller companies will struggle to adapt to this new reality.

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Consumer behavior in times of crisis

Another factor weighing on the automotive industry is the change in consumer behavior during periods of economic uncertainty. In times of economic downturn or high uncertainty, many consumers delay the purchase of new vehicles. Modern cars have become more reliable and durable, allowing them to be used for several years longer. This reduced demand for new vehicles puts pressure on manufacturers to lower their margins and adjust production capacity.

Chip shortage and supply chain problems

An additional challenge for the automotive industry is global supply chain disruptions, particularly the shortage of semiconductors. These chips are essential components in modern vehicles, which rely increasingly on electronics and software. The chip shortage has led to production delays for many car manufacturers. Volkswagen, for instance, has had to shut down production lines several times due to a lack of key electronic components. The shortage highlights the growing dependence of the automotive industry on high-tech components and its vulnerability to external shocks.

Software and technology issues

The increasing digitalization of the automotive industry also brings challenges that many traditional manufacturers underestimate. Modern vehicles, especially electric cars, are increasingly reliant on software for engine performance, infotainment systems, and autonomous driving features. However, traditional manufacturers often struggle with software issues. For example, Volkswagen had to delay the launch of several models because the software did not meet expectations. This illustrates the difficulties traditional manufacturers face in the rapidly evolving, technology-driven automotive world.

Conclusion – Avoid investing in this sector

The automotive industry is facing an unprecedented challenge: political pressure to transition to electric mobility, the rise of new competitors from China, shrinking markets for suppliers, changing consumer behavior, as well as additional issues like chip shortages and software problems. Traditional manufacturers are struggling to balance defending their market positions with adapting to the future. In this highly uncertain environment, where the outcome remains unclear and margins are shrinking across the board, we recommend avoiding investments in the automotive sector.

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Erlen Capital Management AG
T +41 44 267 99 47
info@erlencapital.com

www.erlencapital.com

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