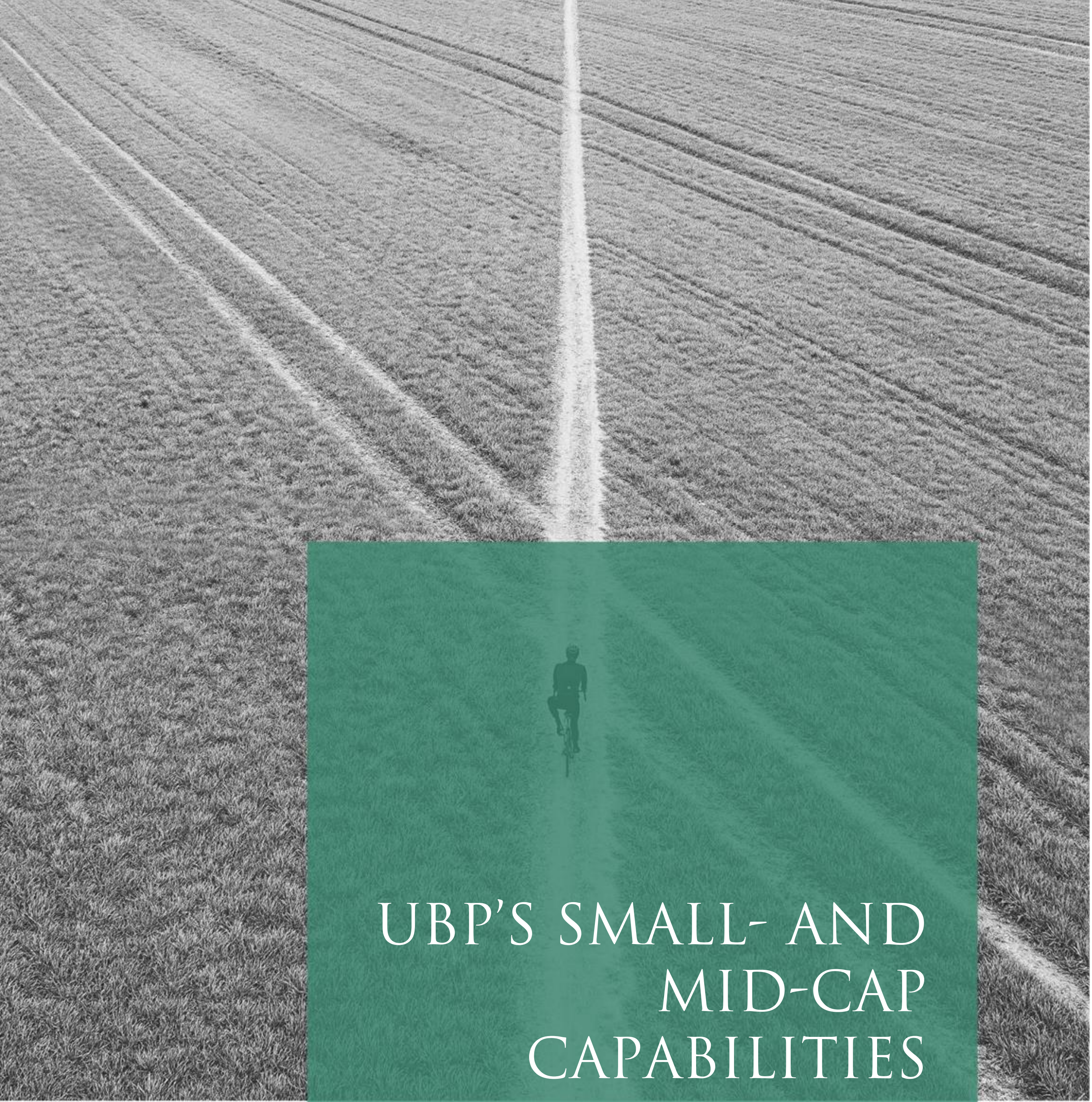


UBP'S SMALL- AND MID-CAP CAPABILITIES

White Paper

Marketing Communication
For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws

Wealth Management | January 2021

UNION BANCAIRE PRIVÉE

Key points

- *SMID-cap equities are poised to mean revert and outperform over the next three to five years. The best time to allocate to SMID caps is when earnings are "depressed", i.e. now.*
- *Global SMID caps have traditionally had higher growth rates and returns over the long term than large-cap companies, primarily due to the fact that they are in the "sweet spot" of their business cycle, meaning they show great potential for growth and earnings.*
- *As the SMID-cap universe is under-covered by financials analysts, it can lead to market inefficiencies and attractive entry points for investors seeking exposure to "hidden gems" and innovative companies operating in diverse niche sectors.*
- *Looking at diversification power, not only do SMID caps have the potential for strong growth, but they also have less valuation risk than their large-cap growth counterparts and less absolute risk than emerging market equities.*

In recent weeks, investors were relieved by the positive newsflow around the successful COVID-19 vaccine trials and subsequent implementation of roll-out programmes. However, experts agree that the positive effects on the recovery and getting back to "normality" is not likely to happen before the end of this year. As 2021 looks like a bumpy road, many investors are willing to increase equity risk and directionality, subject to selectivity.

Against this backdrop, the wider small- and mid-cap ("SMID cap") universe represents a fertile ground for investment opportunities and one of the last efficient frontiers for active equity investors to express their convictions. However, the high-potential SMID-cap segment requires proven active management skills to find the hidden gems of tomorrow and apply the necessary risk management rules.

In this paper, we will take a closer look at the benefits of SMID caps and why they offer an attractive opportunity set in the current environment. We will also provide a roadmap to SMID-cap investing through various examples of UBP's key capabilities in the SMID-cap space.

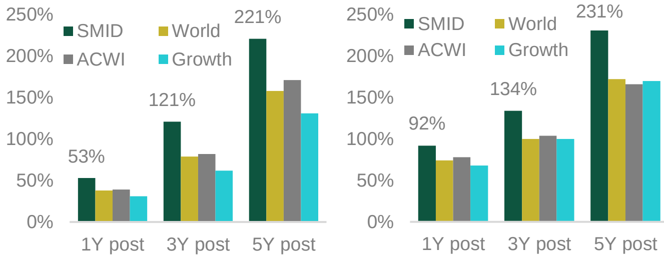
Why invest in SMID caps today?

- **A valuable risk-on option during bullish market trends, including post-crises**

Global SMID caps tend to outperform during bull markets. In the calendar years when the MSCI World Index performed well, i.e. 2006, 2009, 2010, 2012, 2013 and 2017, global SMID caps always outperformed. The only exception, although minimal, was the recent 2019–2020 period, which was more a function of large-cap growth driving markets.

Just as important, global SMID caps have also shown stronger rebounds after a major crisis, as was the case following the dot com bubble and the global financial crisis. As vaccine breakthroughs put COVID-19 protection within reach and offer a way out of the current crisis, it is likely that we will see a more pronounced rebound coming from global SMID caps than from the broader market or other equity segments.

Charts 1 and 2. SMID rebound post-dot com crisis (left chart) from 9 October 2002 and GFC (right chart) from March 2009



Source(s): UBP, Bell Asset Management, MSCI, Bloomberg Finance L.P. Indices used: MSCI World SMID (SMID), MSCI World (World), MSCI World ACWI (ACWI), and MSCI World Growth (Growth).

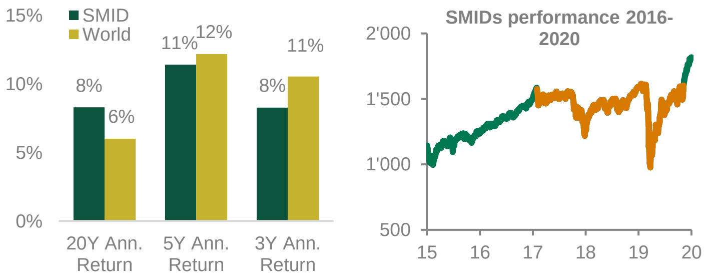
- **An ideal entry point**

While global SMID caps have outperformed the wider market over the long term, they have lagged behind in recent years (Chart 3).

Moreover, it was only recently that global SMID caps surpassed their previous highs seen in early 2020 and back in early 2018 (Chart 4).

This recent underperformance has generated an attractive entry point into the space.

Charts 3 and 4. "Filling the gaps", SMIDs vs. the broader market (left chart) and themselves (right chart)



Source(s): UBP, MSCI, Bloomberg Finance L.P. Indices used: MSCI World SMID (SMID) and MSCI World TR (World). Data as at 31 December 2020. Past performance is not a guide for current or futures results.

In view of the above, should investors be worried about this performance lag in recent years and consider it as a structural weakness of the SMID-cap segment?

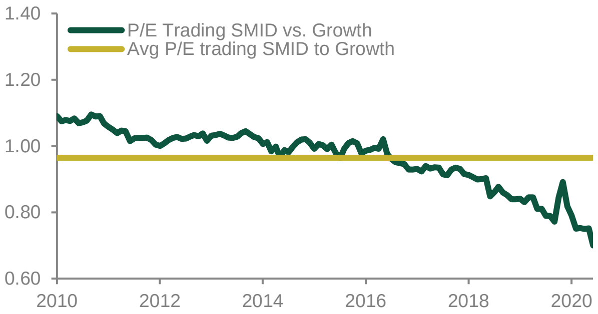
We actually think the opposite. First and foremost because the underperformance of global SMID caps vs. larger caps can be easily explained by the latter's tech rally driven by a handful of major names. Moreover, we are convinced that one of the key strengths of SMID-cap companies lies in the fact that they are more closely tied into the real economy and represent a universe with less sector distortion than larger-cap indices. This explains the less pronounced recovery of global SMID caps since the March 2020 trough so far and paves the way for a stronger catch-up in the months to come.

In reality, this catch-up between SMID caps and broader equities is currently happening, as shown by the significant outperformance of the MSCI World SMID Index compared with the MSCI World Index during the last quarter of 2020.

- **Better earnings leverage and less valuation risk versus large-cap growth**

The chart below, which compares the P/E ratio of global SMID caps to that of large-cap growth, shows that SMID caps are currently much cheaper than their growth counterparts and that they are trading well below what the relationship between the two has averaged over the last ten years.

Chart 5. Forward P/E ratio – SMIDs relative to Growth



Source(s): UBP, MSCI, Bloomberg Finance L.P. Indices used: MSCI World SMID (SMID) and MSCI World Growth (Growth). Data as at 31 December 2020.

Against a backdrop of lowered earnings for 2020 (circa -50%), global SMID caps are currently offering relatively better earnings leverage and attractive valuations by trading at a much lower P/E ratio than large-cap growth stocks.

By simply applying conservative EPS forecasts for 2021, 2022 and 2023 to the MSCI World SMID Cap's current 12-month forward P/E ratio, this would translate into significant upside potential for the index.

With the combination of corporate cost-cutting, COVID-19-related stimulus packages and the reopening of global economies, we are highly confident that this earnings rebound – even a very conservative one – should happen, given how highly distressed 2020 earnings have been for SMID stocks.

Roadmap to SMID-cap investing

In order to extract the most potential out of SMID caps, there are several key aspects to be considered by active investors.

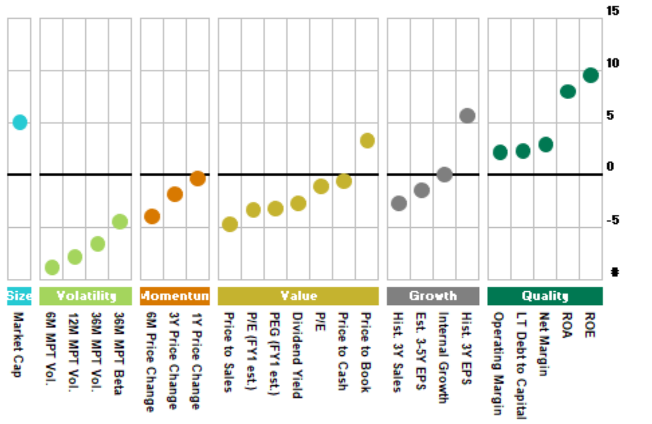
- **Search for quality at a reasonable price (QARP)**

QARP reflects a specific investment philosophy and style under which the two most important risks in equity investing are addressed, namely fundamental risk and valuation risk. In a practical sense, this means building portfolios that simultaneously have much higher average profitability levels and considerably lower leverage, while having valuations that are comparable to the broader index. Once a company has been identified as "quality", the valuation piece of the process is the trigger that determines decisions.

UBP's Global SMID Cap Equity partner Bell Asset Management has 18 years of experience in selecting Global SMID stocks under their unique 'QARP' approach. Their factor mapping is best illustrated in Highlight 1 below.

Their investable universe focuses on (i) 23 developed markets of the MSCI World SMID Cap Index and (ii) companies operating within the USD 1–34 market cap range (indicative limits). The endgame of their disciplined investment process – including ESG criteria – is a high-conviction portfolio of 35–55 positions with no sector bias.

Highlight 1: QARP mapping of UBP partner's Bell Asset Management Global SMID Cap Equity Strategy vs. MSCI World SMID Cap Index



Source(s): Factset, Bell Asset Management. For illustrative purposes only.

This pattern is extremely stable over time and is built on the following pillars:

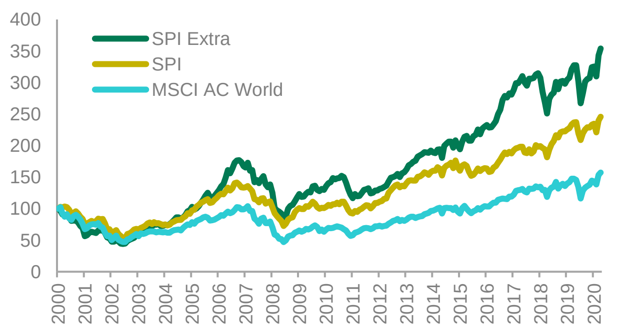
- Overweighting "quality" factors rather than "growth" factors (more expensive) or "value" factors (more vulnerable);
- Underweighting "momentum" and "volatility" factors is critical to maintain a fundamental QARP approach;
- A mid-cap focus enhances the strategy's liquidity profile.

- **Invest in value creation and innovation**

Highlight 2: UBP's Swiss small- and mid-cap equity strategy

The Swiss SMID-cap equity market remains one of the most resilient markets, offering superior risk-adjusted returns over the short and longer term versus other regional and global equities. This structural outperformance is linked to the high level of value creation, as measured by the spread of the cash flow return on investment (CFROI) over the cost of capital of the Swiss SMID universe.

Chart 6. Swiss SMID caps long-term outperformance versus Swiss all-cap and global equities



Source(s): UBP, Bloomberg Finance L.P. Data as at 31 December 2020. Performances shown in CHF. Past performance is not a guide for current or futures results

The space is made up of firms which are generally at the forefront of innovation and exposed to niche but mission-critical activities, and a lot of them have succeeded in becoming global leaders in their fields. Their success can be traced back to their disproportionate spending on research & development. As these companies keep innovating new products, services and processes, they are able to maintain their competitive advantages and strong pricing power, which are the foundations for their healthy organic growth and for their outperformances on the stock market.

These factors are enhanced by the excellent reputation of the “Swiss made” label globally. Indeed, Switzerland has long proved to be a politically and socially stable country with one of the most efficient market economies. Moreover, SMID-cap companies tend to be well managed, soundly financed and keen to respect ESG standards.

UBP’s Swiss and Global Equity team focuses on attractively valued opportunities, investing in companies along the CFROI lifecycle. It invests in sustainable, quality growth business models: strongly financed, well managed, competitively advantaged companies with high or improving returns that are exposed to strong secular growth drivers in their end markets.

- **Seize unique opportunities from market inefficiencies and low research coverage**

Highlight 3: The benefit of being small to seize market inefficiencies and low research coverage – the case of UBP’s partner Angel Japan small-cap equity strategy

One of the key elements in Angel’s business model is that they focus exclusively on smaller companies, from their IPO to their accelerating growth, following a bottom-up, research-intensive process. The IPO portfolio often serves as an incubator for the other portfolios, in particular for those Angel recommends to UBP.

By nature, small caps are less well covered by the sell-side, providing seasoned investors with more market inefficiencies and very often higher growth compared with large caps, such as banks and car manufacturers. Japan has managed to maintain an edge in several key industries, for example robots and digitalisation, but is also constantly adjusting to millennials’ new consumption patterns, such as gaming. With domestic consumption growth resuming in several key sectors, it is contributing to the revival of smaller Japanese companies and is well reflected in the strong performance of UBP’s partner’s Japan small-cap strategy. Dependency on the Japanese yen is much lower than in large-cap portfolios given its bias toward more domestic-oriented industries and business models.

Small caps are also a good diversification in an overall equity allocation. In Japan, it is particularly the case that small caps have a neutral impact on risk while enhancing performance. Consequently, adding small caps to a pure-index exposure, but especially (thanks to high alpha generation) an active manager like UBP’s partner Angel, enables a portfolio’s risk-return profile to be enhanced.

- **Choose a market that is politically stable and that offers diversification of expertise**

Highlight 5: The case of small caps in the Nordics & SEB’s Nordic small-cap equity strategy

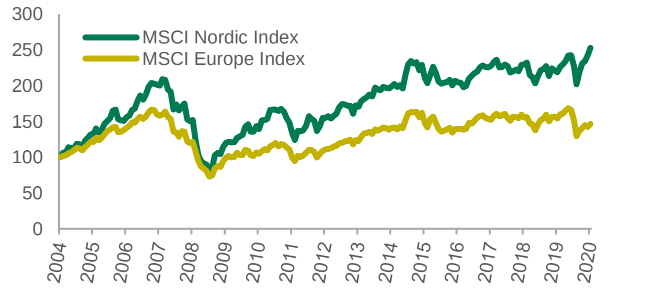
Stable political conditions, strong macroeconomics and the scope of investment opportunities make the Nordic region an interesting space to get exposure to. The Nordic region is geographically small, but still almost all the main sectors and niches are represented on Nordic stock exchanges. The region hosts a number of leading global players within their respective niches, having demonstrated their ability to grow both more profitably and more quickly than the underlying market.

The Nordic region has access to a highly educated workforce, strong corporate governance and a high ESG scoring; Nordic companies enjoy ESG ratings well above the European average and especially so in global ratings.

The Nordic area offers an attractive exposure to growth niches benefiting from major global trends, including green technology and digitalisation.

Nordic equities have outperformed their European peers for more than 15 years, in particular due to their exposure to a high-growth segment.

Chart 7. Nordic SMID-cap equities’ long-term outperformance versus European SMID-cap equities



Source(s): Bloomberg Finance L.P, August 2020. Past performance is not a guide for current or futures results

In general, Nordic companies are in good shape both operationally and financially, thereby improving their ability to deal with headwinds.

Each Nordic country specialises in different sectors, meaning the Nordic region as a whole offers a wide range of diversification.

In Denmark, the healthcare sector is predominant; in Norway, the best investment opportunities are primarily within the energy and seafood sectors; Finland is big in the materials sector with its forestry companies; while Sweden is strong in industrials and information technology.

SEB’s Nordic small-cap equity strategy delivers exposure to a high-growth segment of the equity market in a stable region with a proven investment process with tight focus on company fundamentals. The team has solid access to companies, not least through the strength of their partner’s brand and their long track record in the Nordics.

- **Integrate an ESG process, as many SMID-cap companies are often early adopters**

Highlight 4: Implementing an ESG process within European SMID caps – The case for UBP’s European small-cap equity strategy & SEB’s European small-cap equity strategy.

Engagement with companies’ senior management teams is key, particularly for SMID caps. Understanding business model sustainability and investing with a long-term time horizon has always been at the heart of UBP's European small -cap equity strategy. To this end, the team spends a lot of time engaging with the management teams of companies held in the fund and those of potential candidate companies.

Discussions with management teams not only include topics such as a broad assessment of competitive positioning, operational structures or balance sheet positioning, but also their approach to ESG and their sustainability strategy. Discussions on ESG are informed by our analysis of companies' annual reports, sustainability reports and research from our partners.

Chart 8. MSCI ESG Score of UBP's European small-cap equity Strategy vs. MSCI Europe Small Cap Index

	Portfolio	Benchmark
Weighted Avg ESG Score	6.73	6.33
Adjustment		
+ ESG Trend Positive	12.10%	20.53%
- ESG Trend Negative	4.64%	3.68%
- ESG Laggards	0.00%	4.10%
Adjustment Total	7.46%	12.75%
Score Adjustment	0.50	0.81
ESG Quality Score	7.23	7.14
ESG Rating	AA	A

Source(s): MSCI ESG Research, October 2020.

Under-covered companies are not necessarily poor performers from an ESG perspective. The team organises additional direct engagement with companies that are not rated by the ESG research partner, MSCI ESG Research (typically companies that are lower down the market-cap scale) or companies with weak or negative ESG rating trend momentum. The aim of these discussions is to gain additional insights into a company's approach to ESG matters and to make an assessment of the progress that is being made as regards the overall sustainability strategy.

The team's ESG engagement framework features a range of discussion points that are systematically reviewed and monitored to assess where progress is being made and where more attention is required.

Similarly, UBP's partner, SEB, has a European small-cap equity strategy which also focuses on ESG and meetings with companies. This SEB European small-cap equity strategy benefits from having high-quality, cherry-picked companies that are innovative, agile and operating in niches, with the portfolio being overweight in IT and healthcare, yielding a strong backdrop for the future economic transformation.

Chart 9. SEB's approach to sustainability

Both UBP's and SEB's European small-cap equity strategies benefit from market inefficiencies and focus on engaging with companies to better assess their ESG profiles and integration, or to encourage improvements in respect of ESG considerations.

Conclusions & key points

In a market environment characterised by a brighter horizon due to vaccine optimism and relatively high valuations, equity allocators should more than ever rely on selectivity.

We would argue that SMID caps could be key to solving this dilemma as their inherent value could be further magnified given the natural differentiation of their return drivers, their strong mean reverting potential and their better earnings leverage.

UBP's 'Small & Mid caps' franchise give a unique value proposition to SMID caps investing through a multi-manager expertise whose key principles are as follows:

- Bell Asset Management's Global SMID cap equity strategy: 'Quality' at A Reasonable Price or the ongoing balance between fundamentals and valuations.
- UBP's and SEB's European small-cap equity strategies: An Investment process which integrates ESG and Engagement with companies.
- UBP's Swiss SMID cap equity strategy: Value creative, innovative and sustainable business models within a stable country and an efficient economy.
- SEB 's Nordic small-cap equity strategy: Benefits from a stable market and offers diversification of expertise.
- Angel's Japan small-cap equity strategy: Innovation drives successful IPOs to accelerating growth.

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