Q4 2023

UBAM - BELL US EQUITY

Quarterly Comment

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

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Market Comment

- In Q4, Global equity markets rallied and ended the year sharply higher than investors expected a year ago, making 2023 the best year for global equities since 2019. The MSCI ACWI rallied 11% during Q4 and delivered a return of +22.8% for the year. The S&P500 gained +26.3%* for the year, though most of the gains can be attributed to a small group of Mega cap stocks. The MSCI Europe gained +20.7% and MSCI Japan +20.8%**.

- In the US, economic activity has been more resilient than expected and the inflationary pressures have eased (CPI +3.1% in November) from their highs (CPI +9.1% in June 2022).

- Q3 real GDP growth came strong at 4.9% however projections for 2024 stand at 1.4%. A weakening of the economy and further drop of the inflation should allow the FED to lower rates.

- In December the Federal reserve announced no change in its key rate policy at 5.25-5.5% in line with expectations and admitted that it may have finished its tightening campaign, as inflation dropped further than expected. US policymakers at the Fed have raised the prospects of cutting interest rates during 2024.

- Looking at US Equities more specifically, the S&P 500 Net Total Return Index was up 11.6% over Q4, bringing its YTD return to 25.7%. Most sectors of the index registered gains over the year led by Information Technology (which rallied substantially thanks to AI), Consumer Discretionary and Communication Services, all of the three sectors up more than 40%. On the other hand, Utilities, Energy and Consumer Staples were negative contributors for the year.

- US Equity valuations remain fair with the S&P 500 Net Total Return Index trading at a projected P/E of 21.8x at the end of December. This represents a 9% discount to the MSCI ACWI Growth Index P/E.

- 2024 EPS growth projections for US equities remain strong at 9%, well above global equities at 5% and European equities at 1%.

- Growth and Quality were the investment styles with the best positive performance, while the Value style underperformed the broader MSCI AC World index over the year. Looking further into the 2024 and the 2025, the investment team is confident about Global Equities and the potential of 'Quality' US cap companies "at a reasonable price".

*Sources: MSCI, S&P Dow Jones Indices *Total return**Gross returns*

Performance Review

- UBAM - Bell US Equity returned 17.1% over the year (Class IC USD, net of fees); it underperformed the S&P 500 Net Total Return Index, which returned 25.7% over the period.
- At the risk of stating the obvious, 2023 was a year of mixed performance in global equities – where a handful of well-known names dominated index returns. More specifically, the 'Magnificent 7' – Apple, Microsoft, Amazon.com, NVIDIA, Alphabet, Meta and Tesla – represent ~28% of the S&P 500 Index but accounted for 60% of the index return.
- When we look at broader global indices, the concentration of returns is similar and evident in the fact that only 34% of MSCI World index constituents actually outperformed the index over the year. When it comes to the MSCI World Quality Index which also has a tilt toward the 'growth' factor, only 25% of the index constituents outperformed the Quality Index. The performance differentials between Large & SMID Cap equities were also meaningful, as the SMID Cap index lagged the Large Cap index by nearly 10%.
- This divergence in global indices was also reflected at a style level where Value rose 12%, but Growth jumped by 37%. Additionally at a sector level we saw material performance differentials whereby the Information Technology and Communication Services sectors materially outperformed while Utilities, Consumer Staples, Energy, Health Care and Real Estate materially lagged.
- As far as the macro environment is concerned, despite the numerous 'recession cries' from market pundits in January 2023 – global economies have for the most part held up quite well. As we look into 2024, the steady deceleration in economic growth and inflation is looking more and more like a soft landing in the US – which should be applauded by markets. From our perspective, we are in the camp of moderately declining inflation and possibly 1-2 moderate rate cuts in the second half of the year.
- Looking in more detail at performance over the full year, stock picking was a drag and the 'batting average' of the portfolio (i.e. the proportion of individual stocks in the portfolio that had a better return than the benchmark) was lower than we would typically expect. However, there was also a strong cohort of positions that did exceptionally well during the year. The best performer was Arista Networks which rallied over 90%. Their strong product range of routers and switches continues to gain market share in the cloud networking market, especially in AI applications. The company reiterated their guidance for revenue growth in excess of 25% for 2023 and they also continue to expand margins. The fundamentals growth story remains solid; however, we have locked in some profits and trimmed the position given this euphoric performance.
- Other IT and Communication Services names were also top contributors including Microsoft and Alphabet (parent company of Google) which both rallied 58% contributing over 210bps of return to the portfolio over the year and remain the two largest positions in the portfolio. Creative software company Adobe was up 77% (+118bps contribution) and Amazon.com jumped 82% (+89bps contribution).
- While small and mid-cap names lagged as an asset class, many portfolio companies performed very well with a strong contribution from a 55% rally at Broadridge Financial Solutions (+85bps contribution) who provide investor communications, proxy materials and other services to the investment community and a 53% rally in Advanced Drainage Systems (+80bps contribution), one of America's largest users of recycled plastic, whose products such as storm water and sewage pipes are taking share from concrete pipes, due to their good value, ease of installation and eco-friendly nature.

- The largest performance detractor from a stock perspective was Estee Lauder which was down 41% (-86 bps contribution). While the company's brands such as Clinique, MAC Cosmetics and La Mer, remain market leading, the near-term headwinds have not abated. Weakness in the high margin Asian Travel Retail channel persists as retailers reduce inventory due to a slower than expected recovery of the Chinese international traveller. The investment team remains confident in the long-term investment case and expect that earnings shall rebound well over 30% once the current situation normalises.
- Other detractors included offroad vehicle and bicycle suspension manufacturer Fox Factory which declined 31% (-52bps contribution) after announcing a significant acquisition which ultimately resulted in the company being sold from the portfolio. IT services company Genpact declined 24% (-48bps contribution) largely due to fears that AI might automate and replace some existing outsourcing projects. This also coincided with the retirement of the long-term CEO and softer profit guidance. As a result of the increased uncertainty, we have seen a big de-rating in Genpact's valuation from ~16x forward P/E at the start of the year (in-line with long term average) to ~11x currently. Our view is that the market is currently taking an overly pessimistic view and therefore the investment case over the long term looks very attractive and we have been adding to the position. Finally, health care company Masimo dropped (-30bps contribution) after issuing a material full year guidance reduction. Masimo is a med-tech company that produces non-invasive patient monitoring and sensor technologies and more recently is pursuing an expansion into consumer wearables following the acquisition of an audio equipment company in 2022.
- Looking at sector allocation, the key drivers of returns was from Information Technology (19.2% weight, +738bps contribution) and also Communication Services (6.1% weight, +203bps contribution) since they were the best performing sectors, both up over 30%. Health Care was also a good contributor (22.4% weight, +229bps contribution) and while sector returns were lower, it was helped by the large allocation and good stock picking. Contribution from other sectors was less meaningful.
- In terms of ESG credentials, the UBAM - Bell US Equity portfolio was AA rated by MSCI ESG Research at the end of December. Its 7.3 ESG Quality Score represented a 10% excess to that of the S&P 500 Index at 6.7. Looking at environmental risk more specifically, our strategy was showing 81% less carbon risk than its benchmark at the end of the quarter (in tonnes CO2e/USD million sales).

Portfolio Activity

- The cash level of the portfolio was fairly stable over the year beginning at just under 3% and finishing just above. Our confidence in the upside potential of the market is reflected in the skews of portfolio stocks and the cash position is generally kept fairly low.
- Reflecting on portfolio activity during 2023, portfolio turnover was a little more elevated than usual as the rapidly evolving economic environment and fluctuating investor confidence contributed to heightened market volatility. This provided opportunities to make some wholesale name changes, along with adds and trims to existing positions, all with the view of driving better long term returns for the portfolio.

- At a stock specific level there were several incremental changes made to reflect conviction levels and our investment team's prevailing view on the overall risk / reward profile for relevant names. From a buy perspective, we introduced a number of new stocks to the portfolio, each of which having an attractive combination of quality characteristics and solid valuation support. Examples of the new names added to the portfolio during the year included Motorola Solutions (Information Technology), Advanced Drainage Systems (Industrials), McDonald's (Consumer Discretionary), Agilent Technologies (Health Care), MSCI (Financials), Booking Holdings (Consumer Discretionary) and Automatic Data Processing (Industrials). In many situations, these were names that we had followed closely over the long term (including holding a number of them previously) and had been waiting for more attractive entry points. As well as the new names purchased, we also took advantage of the temporary market dislocations to add to a range of existing holdings throughout the year including Icon (Health Care), Alphabet (Communication Services), UnitedHealth (Health Care) and PepsiCo (Consumer Staples).
- On the sell side of the equation, we exited stocks such as Idexx Labs (Health Care) and Church & Dwight (Consumer Staples) due to elevated valuation risk. Other positions sold included, Electronic Arts (Communication Services) and Procter & Gamble (Consumer Staples) as we felt they could be replaced in the portfolio by higher conviction ideas that have potential for much greater upside over the long term. We also trimmed a range of existing positions where the upside potential had reduced after strong outperformance, including Adobe (Information Technology), Broadridge Financial Solutions (Industrials), Arista Networks (Information Technology) and Zoetis (Health Care).
- Overall sector and regional weights remained relatively stable, with no major deviations compared to the end of 2022. IT and Communication Services were reduced slightly after a strong performance whereas Health Care and Industrials were increased. The largest seven names account for around 28% of the benchmark, the portfolio is around 17% underweight due to the elevated valuations and currently only holds three of those names. The portfolio also holds around 37% in what the manager considers small and mid-cap stocks due to their attractive valuation and good upside potential.
- Sector allocation remains diversified, with the most preferred sectors being Health Care (22.4% allocation, 8.6% overweight) followed by Information Technology (19.2% allocation, 7.5% underweight) and Financials (15.0% allocation, 1.9% overweight).
- The portfolio continues to have no exposure to the Energy sector (4.5% underweight) or the Utilities, Materials or Real Estate sectors (each are approximately 2.4% underweight). These sectors are generally more leveraged, have more cyclical earnings and lower returns, therefore are not attractive given the team's 'Quality' investment style.
- At the end of December, the portfolio's largest positions were Microsoft (6.2%), Alphabet (4.9%), UnitedHealth Group (2.8%), American Express (2.4%) and Johnson & Johnson (2.3%). The team generally has a relatively balanced approach to position sizing to generate diversified and more consistent overall portfolio returns.

Outlook

- As we start the new year, we are actually very optimistic about markets and the opportunity set that we have available to us. As far as markets are concerned, we feel that equities – for the most part – are quite attractively valued. If we exclude the ‘Magnificent 7’ stocks from the S&P 500 benchmark, the valuation falls by around 8 points to a 1 year forward P/E ratio of approximately 14x at the end of December which is why the portfolio remains underweight these stocks. Additionally, the expected earnings growth rate in small and mid-cap stocks is also higher than the broader market and is expected to provide a strong tailwind to portfolio returns in the new year.
- Overall, there is a reasonable valuation underpinning to equites more generally and if we do see moderating interest rates in the back half of 2024, we wouldn’t be surprised to see some multiple expansion, especially in small and mid-cap stocks. We would also note that we see numerous opportunities in the market where the valuations are depressed and should mean revert in 2024.
- While 2023 was a somewhat frustrating year for us from a relative perspective, we feel the set-up for 2024 is very positive. It is also somewhat analogous to 2016 which was also a tough year for broad-based quality – as the Brexit vote and Donald Trump’s election victory triggered numerous anomalies in markets. At that point we stuck to our process, opportunistically added mispriced quality exposure and in doing so our Core strategy outperformed for five consecutive years. While the background music is a little different now, we are sticking to our process and have been able to opportunistically improve our quality exposure in recent months. With that in mind, we are confident that 2024 & 2025 will be positive years for our global strategies.

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