Q2 2023

UBAM - BELL GLOBAL SMID CAP EQUITY

Quarterly Comment

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

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Market Comment

- Over Q2 2023, global equity markets delivered strong results with the MSCI AC World up +6.2%. Japanese equities gained +14.2%, US equities +8.3%, Emerging Market equities +2.3%, Swiss Equities +2.2% and European equities +0.9%.
- In June, inflation figures remained resilient which led central banks to keep a hawkish stance. In the US, while the yearly headline inflation trend was down from +4.9% to +4.0%, core inflation only decreased moderately from +5.5% to +5.3% y/y and the 2023 outlook for core PCE was revised up from +3.6% to +3.9%. Key rates did not change, but Chairman Powell mentioned potential further hikes in the coming months – though at a slower pace. In the Eurozone, the outlook on inflation was revised up for the next 3 years, especially for core inflation from +4.6% to +5.1% for 2023. Key rates increased by +25bps as expected and the ECB mentioned that rates should be brought to sufficiently restrictive levels to meet the 2% inflation target indicating further hikes. Business sentiment weakened further with the US Manufacturing PMI decreasing from 48.4 in May to 46.3 in June. The Eurozone Manufacturing PMI also declined from 44.8 to 43.6.
- The Federal Reserve (Fed) raised interest rates by 25 bps in May. However, it did not hike rates in June, adopting a hawkish pause. The rate predictions indicated two further rate rises in 2023. There were some concerns around US debt ceiling at the beginning of the second quarter. However, US Congress approved a legislation that suspended the debt ceiling in the first days of June, in a deal that included concessions on spending expected to have little effect on economic growth.
- The European Central Bank (ECB) raised interest rates twice in the quarter, taking the main refinancing rate to 4.0%. Headline inflation declined during the period, with annual inflation estimated at 5.5% in June, down from 6.1% in May. However, the core inflation rate went up to 5.4% in June. The eurozone composite purchasing managers' index (PMI) fell to 50.3 in June from 52.8 in May.
- 'Growth and 'Quality' were among the best performing investment styles over the 2nd quarter of 2023. Looking into the Q3, the investment team is confident about the potential of 'Quality' SMID cap companies in an inflationary environment, thanks to their pricing power to offset the likely weakening consumer demand and their low leverage balance sheets to withstand rising interest rates better. As a matter of fact, UBAM - Bell Global SMID Cap Equity offers this "Quality at a Reasonable Price" potential throughout this cycle.

Performance Review

- UBAM - Bell Global SMID Cap Equity returned an +1.94% during the second quarter of the year (Class IC USD, net of fees); it underperformed the MSCI World SMID Cap Index, which returned +3.18% over Q2. Since its inception in February 2021, our Fund has outperformed the MSCI World SMID Cap Index by a significant +747bps margin*
- Equity markets delivered a solid Q2 and strong first half against the uncertain backdrop. Looking at the broader market, the 'narrowness' of the rally in equities this year has been unprecedented, given that there has been a handful of mega-cap names that have driven the broader cap indices higher. This has arguably come at the expense of many SMID cap names which have been left behind as the focus has been firmly at the larger end of town. To put this in perspective, while the MSCI World Index has appreciated by 15% this year (USD terms), Apple, Microsoft, NVIDIA, Meta, Amazon, Tesla & Alphabet (16% of the index) have collectively accounted for 49% of the index return. Of the remaining index constituents, only 34% managed to outperform the index in the first half. In some ways, it feels as though the bulk of the market is accurately reflecting the precarious macro conditions we currently face, while the mega-cap tech names have marched to their own beat as the AI theme has taken hold.
- This divergence in performance has also created considerable divergence in valuations within the index, which has arguably had the effect of exaggerating valuation concerns in the market. While the MSCI World Index rose by 15% in the first half, the Small & Mid Cap Index appreciated by 8% while Large Cap stocks rose by 17%. The average forward P/E ratio of the mega-cap tech names stands at 36.6x, which is more than double the MSCI World Index P/E of 17.0x and at a meaningful premium to their recent history, all at a time when EPS growth for many of these names is moderating. The positive side of this discussion lies in the fact that there is still excellent relative value to be found through the rest of the market, particularly in the small and mid-cap segment where this strategy is focused. More specifically, the MSCI World SMID Cap Index now trades on a forward P/E ratio of 15.5x vs. the 5-year average of 18.1x.
- The first half divergences do not end there – we also saw materially different outcomes at a sector level within the MSCI World SMID Cap Index, where the IT and Industrials sectors delivered returns of greater than 15% (USD terms), while Energy, Financials, Real Estate, Utilities, Health Care and Consumer Staples all posted returns less than 5%.
- In Q2, there were several puts and takes to the relative performance outcomes, with the modest underperformance largely attributable to stock selection factors. The best individual stock performer during the June quarter was Advanced Drainage Systems which rallied 35% (+65bps contribution). Advanced Drainage, which was introduced to the portfolio in February this year, is a leading manufacturer of thermoplastic corrugated pipe and other water management products, serving a range of end markets across non-residential, residential, agriculture and infrastructure, predominantly in the United States. The stock rallied on the back of a reassuring set of Q1 results.
- Other strong contributors during the quarter included US pharmaceutical distributor AmerisourceBergen (+53bps contribution), pharmaceutical and biotech contract research organisation ICON Plc (+51bps), home and security product provider Fortune Brands Innovation (+46bps), and financial services technology solutions provider Broadridge Financial Solutions (+42bps).

- The largest performance detractor from a stock perspective was Genpact which declined 18% (-49bps contribution). Genpact provides consulting, digital transformation and BPO services to many of the world's largest and most well-known companies. Recent weakness in the stock has been driven by concern that we could see a slowdown in demand due to the uncertain macro environment and broader uncertainty around the impacts of AI. The investment team met with management during their recent research trip and retained confidence in the long-term investment case, thus have used the recent pullback to add to the position.
- Other weak stock performers during the quarter included Finnish renewable energy company Neste (-35bps contribution), manufacturer of precision instruments Mettler Toledo (-25bps), US club warehouse retailer BJ's Wholesale Club (-22bps) and specialty chemical producer Croda (-20bps).
- At a sector level the overweight to more defensive sectors such as Consumer Staples (2% overweight) and Healthcare (8% overweight) was a drag from an allocation standpoint, partially offset by positive impact of being overweight to Industrials (4% overweight) and IT (2% overweight) and underweight Real Estate (7% underweight), Materials (3% underweight) and Utilities (5% underweight). On a regional basis, the overweight allocation to Western Europe and underweight to North America detracted from relative performance.
- In terms of ESG credentials, the UBAM - Bell Global SMID Cap Equity portfolio was AA rated by MSCI ESG Research at the end of June. Its 7.39 ESG Quality Score represented a 16% excess to the SMID Cap Index at 6.35. Looking at environmental risk more specifically, our strategy was showing 87% less carbon risk than its benchmark at the end of the quarter (in tonnes CO_2e/USD million sales).

Portfolio Activity

- The cash level was held steady during the quarter at around 3.2% of the portfolio, with buy / add activity offset by sell / trim activity.
- At a stock level, the investment team introduced three new positions to the portfolio which we believe all have strong long-term investment cases: BJ's Wholesale Club, Paylocity and MSCI.
- BJ's Wholesale Club is a membership-based warehouse grocery retailer in the US, similar to Costco, which has high membership retention rates, a solid store rollout opportunity and attractive value proposition for consumers in an inflationary environment. The stock is trading at an attractive valuation (16x P/E ratio).
- Paylocity is a US based provider of cloud-based payroll and HR software that has been growing rapidly and gaining market share due its high-quality product and service offering. The investment team had a positive meeting with management recently which helped to reinforce conviction in the strength of the franchise and growth prospects, while also giving comfort around some of the external risk factors.
- MSCI is a global leader in the provision of investment research and data. It is an extremely high-quality company with exceptionally strong profitability characteristics (80%+ gross margins) and dominant market share reflective of its franchise strength. With the stock having lagged the market for the past 1.5 years the investment team used the share price weakness to establish a position in this high-quality compounder which is expected to continue growing earnings at a double-digit rate for the foreseeable future.

- These new positions were funded through the sale of four holdings: CBRE Group (global commercial real estate services and investment firm), Electronic Arts (software gaming producer), Hong Kong Exchanges & Clearing (one of Asia's leading stock exchanges) and RB Global (heavy machinery auctioneer). The investment team also took profits by trimming a number of existing holdings which had performed very well, including Arista Networks, AmerisourceBergen, Hoya and Broadridge Financial Solutions.
- Looking at sector allocation, the portfolio remains diversified and fairly conservatively placed, with the most preferred sector being Industrials (25%), which is an array of predictable business that are much less cyclical than what might typically be expected in this sector. The allocation to Industrials increased by 2.4% during the quarter, attributable to the introduction of a new position (Paylocity) and good performance from the sector. Other notable changes included a 1.5% decrease in Communications Services (ending 4% of the portfolio) and 1.2% increase in Consumer Discretionary (ending 16% of the portfolio). Health Care (17%) also remains a significant exposure.
- In terms of least preferred sectors, the largest underweights remain Real Estate (8% underweight) and Financials (4% underweight). The portfolio also continues to have very low exposure to the Energy sector (3% underweight) and no exposure to the Utilities sector (5% 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.
- From a regional/country perspective, the largest allocation remains North America at 59% with the US at 55% and Canada 4%. The allocation to Europe decreased slightly over the period, ending at 31%. Allocation to the Asia-Pacific region is just under 6%, decreasing by 1.8% in the quarter as strong performance in the region was offset by the sale of Hong Kong Exchanges & Clearing.
- At the end of June, Broadridge Financial Solutions (3.2%), ICON (3.1%), Genpact (2.7%), Keysight Technologies (2.6%) and Charles River Laboratories (2.6%) were the portfolio's largest positions. The investment team has maintained a consistent portfolio construction methodology through this volatile period as this assist in the goal of generating a diversified contribution to overall portfolio returns.

Outlook

- Looking forward, while inflation is showing signs of abating, at this point most central banks are still leaning towards additional interest rate increases before the end of the year. The investment team would argue that the lag effect of the material interest rate increases is yet to be fully absorbed by the global economy, as such is maintaining a relatively cautious posture within the types of stocks owned.
- While the manager has been pleased with first half performance in both absolute and relative terms, they see good opportunity for the SMID cap segment of the market to deliver outperformance moving forward. The portfolio is positioned to benefit from a) Quality outperformance, b) SMID Cap stocks rebounding, and c) 'Quality laggards' rebounding. Most importantly, the investment team remain very confident in the names owned in the portfolio – not only have they seen very solid fundamental performance but in many cases still see valuation disconnects, thereby making the alpha opportunities all the more attractive. At this point, the investment team believe the portfolio is well positioned for the environment that is expected to play out over the next 12-18 months.

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