UBAM - BELL GLOBAL SMID CAP EQUITY

Quarterly Comment

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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). Against this background, in December the Federal reserve announced no change in its key rate policy 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.
- The US GDP growth projection for 2024 was revised slightly down from 1.5% to 1.4%, whereas Q3 2023 growth came in strong at 4.9%, lower than the 5.2% expected, but higher than the 2.1% for the prior print, reducing hard-landing fears.
- In the Eurozone, inflation significantly dropped during 2023 and the yearly trend slowed to +2.4% in November (down from an all-time high of 10.6% in October 2022). The ECB, similarly, to the FED, maintained its interest rates unchanged in December 2023. 2024 earnings growth expectations for global equities remained stable at 10%, coupled with 16.6x forward PE ratio.
- Looking at the small and mid-caps (SMID) more specifically, the MSCI World SMID Cap Index was up 16.2%** over 2023. All sectors of the index were in positive territory at the end of the year, with the sectors best performing being Information Technology, Industrials and Consumer Discretionary.
- Global SMID Cap valuations remain attractive with the MSCI World SMID Cap Index trading at a P/E Fwd of 16.1x at the end of December. This represents a 36% discount to the MSCI World Growth Index and an 8% discount to the MSCI World Index.
- Earnings growth expectations for Global SMID Caps over the next 12 months stand at approximately 12%, which remains much higher than the broader market.
- Looking into 2024, the investment team is confident about the rebound potential of Quality SMID Cap companies and opportunistically is adding mispriced quality exposure.

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

Performance Review

- UBAM - Bell Global SMID Cap Equity was up 11.7% in 2023 (Class IC USD, net of fees) compared to an increase of 15.6% for the MSCI World SMID Cap Index NR. Since its inception in February 2021, our Fund has outperformed the MSCI World SMID Cap Index by a significant +298bps margin.
- At the risk of stating the obvious, 2023 was a year of mixed performance in the broader global equities' universe – where a handful of well-known names dominated index returns. More specifically, six names – Apple, Microsoft, Amazon.com, NVIDIA, Alphabet and Meta – which represented over 16% of the MSCI World Index, accounted for approx. 40% of the index return.
- This 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.
- The concentration of returns is evident in the fact that only 34% of MSCI World index constituents 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%.
- 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 – which would likely be well received by markets and should be a good catalyst for strong performance in the SMID Cap segment of the market. 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 alternative asset manager Partners Group, which started the year weaker but rallied strongly afterwards, as the company continued to grow their AUM in line with their guidance. A more stable market environment also improved investor confidence in their ability to complete various deals before the end of the year and also boost revenue contribution from performance-based fees. After building the position into weakness, the 70% rally this year made it the largest contributor to returns adding 135bps.
- Other strong contributors include Broadridge Financial (up 54%, +125bps) and Arista Networks (up 52% during the holding period, +104bps) and Advanced Drainage Systems (up 53%, +105bps), who are one of America's largest users of recycled plastic. Their 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. While we had been monitoring the company for some time, a position was only initiated early in the year after it had a decline, so this opportunistic purchase has worked well.

- The poorest performing name was Nihon M&A Center which suffered as competition in the business broking market intensified and profitability was impacted. While a smaller position, it still cost 134bps in performance contribution and ultimately it was sold from the portfolio. IT service company Genpact was also weak with the share price down 24% in 2023 (-77bps contribution). This was 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.
- Other names that lagged included health care company Mettler-Toledo (down 17%, -39bps) and specialty chemical company Croda (down 18%, -40bps). While near term fundamentals softened, we added to each position as we believe the longer-term investment case remain strong and this has been reflected in the stock prices beginning to recover over the last few months.
- Sector allocation was a positive of 1.6% relative to the benchmark. With the strongest returns of over 20% coming from both the Information Technology sector (12.7% average exposure, 3.1% contribution to returns) and the Financials sector (10.5% exposure, 2.8% contribution to returns). The portfolio was also underweighted some of the poorer performing sectors being Real Estate (0.6% exposure, 7.3% u/w), Energy (1.5% exposure, 3.0% u/w) and Utilities (no exposure, 4.6% u/w). While the overweight to Health Care was a negative from an allocation perspective, the large allocation and good stock picking within the sector still meant that it delivered a good contribution to returns (18.1% average exposure, 3.1% contribution).
- In terms of ESG credentials, the UBAM - Bell Global SMID Cap Equity portfolio was AA rated by MSCI ESG Research at the end of December. Its 7.8 ESG Quality Score represented a 21% excess to the SMID Cap Index at 6.4. 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).
- The cash level averaged around 3.3% of the portfolio over the year, and while modest, the strong returns in the market meant that it was a -0.5% drag from an allocation perspective.

Portfolio Activity

- 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.
- There were a number of new stocks introduced to the portfolio, each of which had an attractive combination of quality characteristics and solid valuation support. Examples of the new names added to the portfolio during the year included Advanced Drainage Systems (Industrials), Auto Trader (Communication Services), Agilent Technologies (Health Care) and MSCI (Financials).

- 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), Deutsche Boerse (Financials), Assa Abloy (Industrials) and RightMove (Communication Services).
- 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, while other names such as Nihon M&A Center (Industrials) and Novozymes (Materials) were sold due to our investment thesis changing as the quality characteristics and fundamental outlook for the company deteriorated. We also trimmed a range of existing positions where the upside potential had reduced after strong outperformance, including Broadridge Financial Solutions (Industrials), Cencora (Health Care) and Partners Group (Financials).
- At a sector level, the most material changes to portfolio positioning included an increase in exposure to Financials and a decrease in exposure to Information Technology and Materials. These changes are more reflective of underlying risk / reward of individual names in each sector, rather than any major top-down influence. For example, within the Information Technology sector we exited Arista Networks after a very strong rally and trimmed other names such as Cognizant Technology Solutions and CGI Inc after strong performance, while opportunistically introducing new names within the Financials sector including MSCI, FactSet and Houlihan Lokey.
- At the end of 2023 the portfolio remains overweight Health Care (10% o/w), Consumer Discretionary (4.3% o/w) and Consumer Staples (2.7% o/w), while the largest underweights at a sector level are Real Estate (7.9% u/w), Materials (5.7% u/w) and Utilities (4.5% u/w).
- From a regional/country perspective, the largest allocation remains North America at 55.3% with the US at 53.4% and Canada 2.2%. The allocation to Europe increased slightly over the period, ending at 31.8% and the Asia-Pacific region decreased slightly, just above 8%. All allocations were quite stable over the year with major changes being at a country level with a reduction in Canada and an increase in the U.K.
- At the end of December, the largest positions were Asian stock exchange Hong Kong Exchanges (2.7%), IT services company Genpact (2.6%), distributor Bunzl (2.6%), exchange operator Deutsche Boerse (2.6%) and lock and door system manufacturer Assa Abloy (2.6%). The investment team has maintained a somewhat diversified approach to portfolio construction with the goal of generating a diversified contribution to 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. The valuation of the MSCI World SMID index was on a fwd P/E of 16.1x at the end of December which is more than a point lower than the MSCI World Index at 17.4x and at a material discount to long term averages. The expected earnings growth rate in small and mid-cap stocks is also higher than the broader market.
- In other words, we feel that 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 for the SMID Cap cohort of the market and our ‘Quality at a Reasonable Price’ strategy in general. 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 SMID Cap strategy subsequently outperformed very strongly over the following five-year period. 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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