UBAM - BELL GLOBAL SMID CAP EQUITY

Quarterly Comment

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

The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

Market Comment

- After two consecutive months of relief rallies, global equity markets gave back some gains and ended December in the red. The last quarter of the year was nevertheless positive for major equity markets. The MSCI AC World ended Q4 up +9.8%, with +9.7% gains for Emerging Market equities, +9.6% for European equities, +7.6% for US equities and +3.3% for Japanese equities. This brought the full yearly loss for global equities down to -18.4%, the biggest annual loss since 2008.
- US inflation moderated again in November with +0.1% m/m increase versus +0.3% expected and +0.4% increase in the prior month. The yearly headline trend also declined from +7.7% y/y to +7.1%, while core inflation eased more moderately from +6.3% to +6.0%. The Fed remained attentive to inflationary risks and raised rates by 50bps in December.
- Business confidence declined in December with the US ISM Manufacturing coming in below 50 at 48.4. US GDP figures were nevertheless revised up for Q3 from +2.9% q/q SAAR to +3.2%, supported by firmer private and public consumption. Eurozone Q3 GDP figure also came in better than expected at +2.3% q/q, reflecting resilient post-pandemic household consumption and tourism. The ECB increased key rates by 50bps in December, with a hawkish tone on inflation trends.
- Looking at small and mid-caps ('SMID') more specifically, the MSCI World SMID Cap Index was up a strong +11.2% over Q4. All sectors of the index were in positive territory at the end of the quarter. Energy, Consumer Discretionary, Industrials and Materials were among the major contributing sectors.
- Global SMID cap valuations remain attractive with the MSCI World SMID Cap Index trading at a P/E of 14.2x at the end of December (on a 12-month forward basis). This represents a 33% discount to the MSCI World Growth Index and a 5% discount to the MSCI World Index. In an absolute sense, the P/E of global SMID caps is one of the cheapest since May 2012, indicating that the majority of the de-rating might be over.
- Earnings growth expectations for global SMID caps stand at approximately 13% for 2022 and 2023, which remains above their all-caps counterparts. Being mindful that these numbers may still have further to fall, we would argue that the downside risk is already in the numbers to some degree.
- 'Quality' was among the best performing investment styles over the 4th quarter of 2022. Looking into the new year, we are 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 in 2023 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 +13.28% during the 4th quarter of the year (Class IC USD, net of fees); it materially outperformed the MSCI World SMID Cap Index, which returned +11.21% over Q4. Since its inception in February 2021, the Fund has outperformed the MSCI World SMID Cap Index by a significant +582bps margin.
- As the year has drawn to a close, we reflect on a period that has seen extreme variations in 'style' returns. As a manager with a "Quality at a Reasonable Price" investment approach, the investment team feels that during the low interest rate cycle that fuelled equity boom in recent years, the perceived lines between 'Quality' & 'Growth' were somewhat blurred. One lesson that 2022 taught us is that 'Quality' & 'Growth' are very different animals with volatility driven by numerous macroeconomic and geopolitical drivers. As we look into 2023, the team feels that equity markets remain somewhat vulnerable to an overly aggressive US Federal Reserve. The current inflation conundrum facing all central banks shall arguably be the most important influence on equity markets for at least the first half of 2023. If valuation risk was one of the primary investor concerns in 2022, then earnings risk should be the biggest concern for 2023. As seen this quarter, the focus on pricing power and earnings resiliency has benefited the portfolio, and the team expects this trend to continue.
- In Q4, the outperformance of the portfolio was driven by strong stock selection – the rising market meant that the majority of companies made a positive contribution to returns and also performed exceptionally well from a relative perspective. Sector allocation was a slight drag due to the lack of exposure to the Energy sector (5% underweight) and the overweight to Information Technology (22% exposure, 10% overweight) since the latter was one of the poorer performing sectors over the period. Regional allocation was a small positive due to the underweight to Japan (4% exposure, 6% underweight).
- The position that contributed the most to portfolio returns in the 4th quarter was Vestas Wind Systems, which rallied over 54% (+100bps contribution). Vestas is obtaining strong pricing growth in its contracts, which is covering the inflationary headwinds of logistics and input costs and helping improve margins. Additionally, the company has seen an acceleration in order growth as the world continues its path to decarbonise and due to the extension of the US Production Tax Credit scheme, which is an incentive to install renewable energy production such as wind power.
- Other strong contributors included drinkware and cooler manufacturer Yeti Holdings, which rallied over 40% (+80bps contribution) and Danish natural ingredient company CHR Hansen, which also appreciated over 40% (+70bps contribution) after it received a takeover bid from industry peer Novozymes.
- Due to the strong performance of the portfolio, there were only a few companies that declined over the quarter. The biggest detractors were Broadridge Financial, which fell 7% from its all-time highs (-20bps contribution) and Pool Corp down just over 4% (-11bps contribution). Ritchie Bros Auctioneers was also weak down 8% (-11bps contribution) due to investor scepticism around the announcement of a recent acquisition. The stock initially fell over 20% and the investment team used this weakness to add to the position, which was a good decision given the rally off those lows. The team gained confidence after speaking to company management to better understand the rationale and synergies of the deal.
- In terms of ESG credentials, the UBAM - Bell Global SMID Cap Equity portfolio remained AAA rated by MSCI ESG Research at the end of December. Its 8.7 ESG Quality Score remains comfortably above the SMID Cap Index at 7.7. Looking at environmental risk more specifically, our strategy was showing 89% less carbon risk than its benchmark at the end of the quarter (in tonnes CO_2e/USD million sales).

Portfolio Activity

- With good opportunities to deploy capital, the portfolio began the period with a relatively low level of cash near 1%. At the end of December, the cash position remained quite low at 1.5%.
- Besides the small increase in cash, the key changes to sector allocation were a 2% reduction in Industrials (ending at 19%) and a 1% reduction in Consumer Discretionary (ending at 13%). At a regional level, after a strong performance in the US, exposure was reduced; however, at around 52% of the portfolio, it remains the largest exposure.
- In terms of trading of individual names, there were three new positions purchased in the quarter. After a drawdown of around 40%, a position was initiated in Hong Kong Exchanges & Clearing, which ended up being one of the best performing stocks in the period. Another opportunistic purchase after a 30% price decline was Danish medical products company Coloplast, which has very resilient earnings from excellent customer retention and strong market share. The third new position in the quarter was in Australian conglomerate Wesfarmers. Wesfarmers owns the premier retail home store in the region, Bunnings, which generates just over half of the group's profit. It also owns a pharmacy network and discount retail brands that are performing well in an environment where the consumer is becoming more cautious in their spending. Wesfarmers also has diversified industrial and chemicals exposure including the manufacturing of fertiliser, distribution of gases and an industrial safety and workwear business. Finally, through a 50/50 JV they are developing a project which will make them a fully integrated producer of battery quality lithium hydroxide. The management team has an excellent track record of disciplined capital allocation and has built many successful businesses over time. The position should provide stability in an uncertain market with good upside opportunity over time.
- These new positions were funded through a combination of taking profits from existing names that had rallied strongly, as well as redeploying capital from two positions that were sold. Booz Allen Hamilton was exited as the stock price had appreciated materially, limiting further upside. Additionally, a recent ESG engagement related to disclosures around some of their business exposures weakened our conviction around investor transparency and governance, which also contributed to the decision to sell. The other name that was sold was hearing aid and headset manufacturer GN Store Nord after suffering a decline in profitability due to an uncertain consumer demand environment.
- Sector allocation remained diversified, with the most preferred sectors being Information Technology (23% allocation), Industrials (19% allocation), and Health Care (18% allocation). The exposure in these sectors is skewed to businesses with well-known and stable franchises and less cyclical earnings.
- In terms of least preferred sectors, the largest underweights remained Real Estate (7% underweight) and Financials (6% underweight). The portfolio continued to have no exposure to Energy (5% underweight) or Utilities (5% underweight). These sectors are generally leveraged and have low returns, therefore are not attractive given the team's 'Quality' investment style.
- From a regional/country perspective, the largest allocation remained North America at 59%, with the US at 52% and Canada at 7%. The allocation to Europe increased slightly over the period ending at 31%. Allocation to the Asia-Pacific region was 8%.
- At the end of December, AmerisourceBergen (3.1%) was the portfolio's largest position, followed by Kroger (2.9%) and Broadridge Financial Solutions (2.8%). The investment team has maintained a consistent portfolio construction methodology through this volatile period, as this assists in the goal of generating a diversified contribution to overall portfolio returns.

Outlook

- While the current outlook for markets and the global economy is somewhat dour at this point, the team feels very optimistic about its ability to generate alpha in this environment. The low interest rate/risk-on environment is clearly well behind us now, and 2022 was the first year of ‘indigestion’ when markets began the process of pricing in the new norm for markets.
- When looking at the period 2019 to 2022 as growth ripped higher, valuations and profitability were an afterthought. 2022 saw ‘Growth’ retrace and ‘Value’ bounce meaningfully, while ‘Quality’ as a factor (as representatively measured by returns of the MSCI World Quality index) uncharacteristically lagged against an inflationary backdrop. To put things in perspective, over the last 40 years, the ‘Quality’ factor has outperformed by an average of 9% in years when US CPI has exceeded 4% – with the exception of 1988 and 2022.
- As a result, the investment team feels that ‘Quality’ is poised for a period of strong outperformance in the next few years. As macro conditions soften, inflation remains high and interest rates creep higher, companies with strong balance sheets and pricing power should collectively deliver superior earnings outcomes, which should drive better relative returns. The team also feels that the ‘Reasonable Price’ part of its ‘Quality at a Reasonable Price’ approach shall be an important driver for the strategy. 2022 gave a glimpse of how painful multiple contraction can be and how important valuation discipline can be.
- In regard to the Global SMID Cap asset class, the investment team remains very constructive, notwithstanding the macro environment. Despite being a strong performing sub-asset class over many years, the last 5 years have been an exception. SMID cap equities have indeed lagged by 2.5% annually over 5 years and arguably look attractive in terms of relative valuation, now trading at a 33% discount to the MSCI World Growth Index. The forward P/E of Global SMID Cap equities have also retraced from 18.3x to 14.2x during 2022, thereby discounting much of the current macro concerns. For opportunistic long-term investors, the investment team believes that 2023 should be a unique opportunity to gain exposure to a sub-asset class of global equities, which is both inexpensive and under-owned.

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