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UBAM - SWISS EQUITY

Quarterly Comment | Q4 2018

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

Market Comment

- The Swiss equity market fell close to 9% over Q4 2018, ending the year down 9%, the biggest year-on-year percentage loss in over a decade. The small & mid cap segment recorded a drop of 18% in Q4 2018 with YTD performance of -17%.
- October and December brought significant losses and important swings in major stock markets and sparked fears that the deep corrections marked the beginning of a bear market. Uncertainty factors for investors mounted towards the end of 2018 around global growth slowdown, Trade War fallouts and revealed vulnerabilities along with a rate hike and a less dovish outlook delivered by the Fed in December. Further political pressure was also sensed by the market after a partial government shutdown over disagreements concerning a package of bills and the US-Mexican border wall budget.
- For the first nine months of the year, Swiss companies demonstrated healthy top line growth, reflecting global GDP trends and very good earnings growth. This led to positive earnings revisions and at the peak consensus expected over 15% EPS growth for Switzerland in 2018. In Q4 however, earnings revisions turned negative in concert with most major equity markets reflecting the above mentioned concerns. While consensus still stands at close to 13% earnings growth for 2018 and 10.5% for 2019, the stock market did not hold up despite this continued rather positive environment for Switzerland and investors were faced with a substantial multiple compression of approximately 20%.
- In the first half of 2018, the Swiss equity market underperformed major indices (SPI down -4% vs. -0.1% for the MSCI World AC), despite above average GDP growth trends and better earnings growth than most major markets. This was mainly due to the poor share price performance of Nestlé, Novartis and Roche. In the second half of the year, the three large stocks recovered. This in part led to the SPI outperforming global markets in the second half of the year (SPI down -5% vs. -9% for the MSCI World AC). This is typical of how the Swiss equity market behaves: it participates in periods of market performance (doing just better than MSCI World in 2017) and outperforms significantly in periods of global volatility, due to the superior quality of its companies in terms of value creation.
- Over the fourth quarter of the year, Telecom Services and Utilities were the only two sectors in the SPI delivering positive performances (up 4% and 7% respectively). The biggest performance detractors were the Financials and Industrials sectors (-270bps and -202bps contribution respectively). Over the full year, only the Healthcare and Utilities sectors registered positive performances while the Financials and Industrials sectors delivered 70% of the negative index performance.

Performance Review

- The fund returned -14.7% in gross performance over the last quarter of 2018, while its benchmark was down 9%. Sector allocation detracted -3.1% of relative performance and stock selection -2.5%. The fund's overweight in Information Technology (-113bps) cost the most in terms of relative performance; stock selection in that sector was nevertheless positive (+10bps). Stock selection was also positive in the Materials and Financials sectors, while the Healthcare sector was the biggest drawback in terms of selection (-214bps).
- The main relative performance contributors over Q4 2018 were the absence of exposure to Credit Suisse Group (down 27%, +46bps), Swiss Life Holding (+21bps) and the absence of exposure to Lafarge Holcim (down 16%, +13bps). While Credit Suisse management confirmed at its capital markets day in December that restructuring has been done and that the bank was positioned more conservatively now, investors have so far not given them credit for those improvements. Swiss Life was the best performing large cap name in the SPI over the full year and held up very well in Q4 as investors were positively surprised by the company's new financial targets announced during an investor day at the end of November. Lafarge Holcim continues to suffer from disruptive management changes as part of the restructuring that started a year ago.
- The biggest relative performance detractors were the underweights in Nestlé (-79bps) and Novartis (-59bps) which held up better than the overall market, in addition to Lonza (-57bps). Lonza remains a strong conviction for the team (+3.7% overweight) despite the recent share price weakness. Lonza should be able to demonstrate continued reliability in terms of sales and results. The continued successful integration of Capsugel offers new opportunities for growth in the healthcare sector and the divestment of the Water business reduces the cyclicality of the business.

Portfolio Activity

- During the month of October, Sonova was exited completely on growing concerns regarding the introduction of the new OTC category by the FDA in the US hearing aid market. Proceeds from the exit were reinvested into Novartis in a move towards a more defensive stance.
- During November, a new position was initiated in Swisscom as the stock was trading at historically attractive multiples compared to European peers and Sunrise and the close to 5% dividend yield provided some downside protection. Swatch Group and Richemont were taken down to a neutral weight on deteriorating EM situation and weaker export numbers to the key Chinese customer base. The team decided to participate in the Zur Rose capital increase, which the company undertook to finance the acquisition of medpex and other organic growth initiatives.
- In December, the remaining position in Swatch Group was sold and the exposure to Richemont further reduced on the back of a worsening outlook for watch sales to final consumers. Additionally, the social unrests in Paris – which is a key luxury destination market – potentially led to disrupted spending patterns and travel arrangements for traditionally important Swatch customers (Chinese tourists). VAT Group was sold across the whole franchise and the proceeds reinvested into Inficon, a leading manufacturer of gas analysis and leak detector instruments, which boasts leading market shares of 50% and more in most of its end markets. A new position in PSP Swiss Property was initiated as the company traded on attractive multiples relative to its Swiss real estate peers and the team had had a constructive meeting with management earlier in the year.

Outlook

- In terms of sources of risk, the delayed vote on the Brexit deal in January, Trade War escalation fears, Yellow Vest protests in France, as well as more marked signs of a global growth slowdown continue to be the main global headlines to watch for the new year.
- There has been an expectation that growth will slow down globally in 2019. Note however the reference to slower growth, but growth is still expected in 2019. Earnings growth expectations are still at 10.5% for Switzerland compared to 8% for the MSCI AC World for 2019. It would not be surprising to see these numbers being revised down, after what may turn out to be a difficult fourth quarter and in view of the high base that needs to be overcome in the first half of the year. However, the second half of 2019 is likely to be more benign in terms of the comparable base and companies may again be able to show healthy earnings growth, provided that the macro-economic back drop remains supportive.
- In this context, the team continues to expect volatile markets in the coming months (VIX above 20) and possibly further downgrades to earnings growth as companies may give conservative guidance during Q4/FY 2018 reporting season. The team maintains a constructive view for the Swiss equity market for 2019 as high earnings growth forecasts (team expectation of 8% EPS growth vs. current consensus at +10.5% for 2019) combined with an attractive dividend yield of 3% should allow it to outperform global equity markets and offer protection from European weakness. The portfolio is currently skewed towards names with stable / high CFROI profiles whose growth drivers are sufficiently solid to limit risks of profit warnings and/or earnings downgrades. The team has reduced the allocation to the small- and mid-cap segment and currently focuses more on defensive sectors (Healthcare, Insurance, Telecom) and large cap names. For the medium to long term, the team stands ready to take advantage of any market exaggeration related to companies with cyclical CFROI profiles but established business models.

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