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UBAM - SWISS SMALL & MID CAP EQUITY

Quarterly Comment | Q2 2019

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

Market Comment

- After a strong start of the second quarter, equity markets faltered over the month of May before rallying again over the month of June. Swiss equities were leading major markets in terms of performance, gaining more than 6.5% over Q2 2019. US equities followed after gaining +4.3%, European equities were also up 3% while Emerging Markets lagged with +0.6% in performance. Swiss equities also lead the performance pack with more than 21.8% year-to-date performance versus +17% for the MSCI AC World. The SPI Extra performed in line with the larger SPI over the quarter with 6.3%, while slightly lagging since the beginning of the year with 20% return.
- Earnings growth expectations for global equities continued to be revised down to around 4% now, while growth expectations for Swiss equities remain close to 8% for 2019. US equities maintained positive earnings momentum except for the cyclical sectors. Earnings revisions for Europe as well as for Japan and Emerging Markets however were negative. Global equities valuation stood at 15.1x, at the end of June, still below the long term average of 15.7x. Swiss equities traded around their long term average, at 17.3x forward PE ratio at the end of June.
- Volatility returned to the market in May with the VIX index spiking above 20 over the month as trade war fears reignited. Manufacturing PMIs weakened globally while inflation remains very moderate, prompting more accommodative statements from both the Fed and the ECB. The World Bank reduced its global growth forecast for 2019 from 2.9% to 2.6%. Consumers and the service sector are the primary drivers of global growth currently which is why a trade war escalation or prolongation could present a tail risk to global growth, once again requiring more stimulus from Central Banks to protect domestic demand and employment.
- Swiss GDP came in stronger than expected for the first quarter of 2019 at 0.6% driven by domestic demand, a rebound in capex and firmer exports. The KOF index however eased for the third month in a row after rebounding in March, and stood at 93.6 at the end of June. 2019 GDP growth is expected to come in at around 1.3% with stable inflation and unemployment. In line with the downward trend in major markets, the Swiss PMI fell to 48.6 at end of May 2019. The Swiss Franc strengthened slightly trading at 1.11 against the EUR at the end of June, in conjunction with easing language from both the ECB and the Fed.
- All sectors of the SPI Extra with the exception of Consumer Discretionary returned positive performances over the second quarter of the year with IT and Industrials the biggest contributors. Temenos, Sonova and Partners Group where the biggest performance drivers while Dufry was the biggest detractor.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Performance Review

- The fund returned +6.98% over the quarter, outperforming the SPI Extra which was up 6.3% by +0.7%. Year to date, the fund is now up 24.1% with more than 4.1% in gross excess return. Both stock selection and sector allocation have contributed positively over the quarter (+28bps and +44bps respectively). The overweight in the IT sector was the top contributor to the positive allocation effect over the quarter. This was however offset by the stock selection in that sector. The selection effects in Financials and Consumer Discretionary were among the biggest contributors over the quarter (+47bps and 37bps respectively) with selection in Health Care being the biggest detractor (-65bps).
- The main contributors to performance over the second quarter of the year were the absence of exposure to Dufry (+33bps) as well as the overweights in Temenos and Belimo (+23bps and +21bps). Dufry lost over 17% in the quarter as Q1 results confirmed investors' concerns regarding concession fee inflation eating into margins and underwhelming organic sales growth trends. Temenos was up close to 19.5% after solid Q1 results with 28% growth in software licensing and an optimistic capital markets day where the company issued long-term financial targets for the first time in addition to medium-term guidance. Belimo rallied close to 23% over the quarter after it continued to trigger upgrades from analysts given sustained revenue and operating profit growth and a positive outlook for 2019.
- The main detractors to relative performance over the quarter were Polyphor (-53bps), the underweight in Flughafen Zuerich (-24ps) and the absence of exposure to Panalpina (-19ps). Polyphor's share price dropped by 45.7% following the announcement of a temporary halt of the phase III studies for one it's most advanced compounds (Murepavadin). Flughafen Zuerich was up 5% after the Federal Council partially reversed tougher regulatory proposals by the Federal Office of Civil Aviation. Panalpina surged after a takeover offer by the Danish logistics player DSV valuing the company at 4.6bn USD.

Portfolio Activity

- During the month of April, the team participated in the IPO of Stadler Rail, a leading manufacturer of suburban and regional trains.
- Flughafen Zurich was sold in May as the team was concerned that apart from tougher regulation the company could also face significantly higher capex needs limiting FCF generation in the mid-term. A new position was initiated in Tecan, the developer and manufacturer of automation parts and system solutions for laboratories, as the company's short and longer-term targets confirmed its defensive growth characteristics.
- In June, the positions in Leonteq and OC Oerlikon were sold. Leonteq's revenue growth prospects looked less promising given a slowdown in structured product turnover and the absence of major volatility spikes. The position in Oerlikon was exited after the CEO cautioned that full year margin guidance could be at risk if there was no pick up in automotive demand in H2. Given the lack of any short- to mid-term catalysts for Polyphor after they announced the surprising halt to their phase III trial for Murepavadin, the team decided to part with the company. A new position in ObsEva, a company developing novel therapeutics to address serious conditions that compromise a woman's reproductive health and pregnancy, was initiated after a positive meeting with company executives at a conference. Finally, the team participated in the IPO of the packaging company Aluflexpack, which aims to use the capital raised for its acquisition strategy and further investments in capacity expansion.

Outlook

- The second half of the year will test the recovery scenario with FX headwinds and slowing growth signals. Considering China's slowdown along with faltering PMI momentum in the US, both leading economies are expected to take steps to avoid new tariff headwinds. Global markets seem to have priced in the growth slowdown and a return of accommodative monetary policies, while valuations are in line to slightly below their long-time averages.

- With low inflationary pressures and a competitive job market, Switzerland continues to provide a stable and attractive environment for companies which has been reinforced with the acceptance of the Swiss tax reform vote in May. Like the all-cap index the SPI Extra offers diversified geographical revenue exposure while its higher weighting of the Industrial sector makes it a bit more vulnerable in a deteriorating macroeconomic environment. However, many of the Swiss SMID industrials are leaders in their respective niche industries and exposed to structural growth trends which should mitigate the impact of global tensions and a growth slowdown. The team maintains a constructive view of the Swiss equity market as a whole for the rest of 2019 and continues to see opportunities in the SMID segment offering attractive relative performance perspectives.

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