UBP FLEX - BELL GLOBAL LARGE CAP EQUITY

Quarterly Comment

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

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Market Comment

- Despite the volatility brought by the banking sector fallouts over the month of March, major equity markets still delivered positive performances over the first quarter of 2023. Driven by a strong start of the year with receding recession fears and overall easing inflation prints, the MSCI AC World ended Q1 up +7.3%, with European equities gaining +8.6%, US equities +7.5%, Japanese equities +7.1% and Emerging Market equities +3.9%.
- Major central banks maintained their tightening stance announcing rate hikes during the month of March, confirming their confidence in the resilience of the banking sector. Balancing between price stability and financial stability, the Fed raised key rates by 25bps on the back of modest growth, high inflation, and ongoing job gains. The ECB also raised rates by 50bps citing inflation concerns.
- The global earnings momentum continued to deteriorate with 2023e EPS growth falling to 0.2% for global equities at the end of March, as the tensions in the banking system increased the odds of a recession in the coming quarters. Helped by declining energy prices, the US headline inflation eased to 5.6% yoy for the end of March, with the Eurozone yearly inflation trend also slowing down to 6.9% for March.
- The US Manufacturing PMI came in slightly higher in March at 49.2 vs. 47.3, with sentiment increasing on production and employment. The Eurozone Manufacturing PMI came in slightly lower for March at 47.3 vs. 48.5 for the prior print, but better than the 47.1 expected, with sentiment decreasing on production, new orders, and exports.
- Looking at large caps more specifically, the MSCI World Large Cap Index was up +8.3% over Q1. Most sectors of the index were in positive territory at the end of the quarter, led by Information Technology, Communication Services and Consumer Discretionary. On the other hand, Energy, Health Care and Financials were negative contributors for the quarter.
- Large cap valuations remain attractive with the MSCI World Large Cap Index trading at a P/E of 16.5x at the end of March (on a 12-month forward basis). This represents a 31% discount to the MSCI World Growth Index.
- Earnings growth expectations for large caps stand between 1% for 2023e and +8% for 2024e. 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 1st quarter of 2023. Looking into Q2, the investment team is confident about the potential of ‘Quality’ 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, UBP Flex - Bell Global Large Cap Equity offers this “Quality at a Reasonable Price” potential throughout this cycle.

Performance Review

- UBP Flex - Bell Global Large Cap Equity returned an excellent +7.62% during the first quarter of the year (Class IDq USD, net of fees); it slightly underperformed the MSCI World Large Cap Index, which returned +8.32% over Q1. March was a particularly good month where the Fund rose by 4.91%, outperforming the benchmark by a strong +106bps margin.
- Equity markets delivered a strong Q1 against a very uncertain backdrop that culminated in a series of bank failures and bailouts. For the avoidance of doubt, the portfolio had no exposure to the US regional banks or any company that was meaningfully impacted. The remarkable rebound in growth stocks is clearly a reflection of an almost belligerent ‘risk on’ stance taken by investors. Investors have seemingly adopted a view that inflation would meaningfully decline in the latter year, and interest rate cuts would follow thereafter. The investment team feels that interest rates and inflation will stay higher for longer. One of the key risks for markets is that central bankers go too far with rate hikes and economies slow materially.
- One of the unintended benefits of the recent banking crisis in the US ‘could’ come in the form of slowing credit growth and the corresponding economic cooling. If we were to see loan growth softening in the US, we would lean toward the view that rate hikes have peaked and the Fed adopts a ‘wait and see’ approach. While the various banking failures in March have been well covered, we would rather make the more general observation that equity markets are essentially transitioning into a very different environment. Prolonged periods of low interest rates shall inevitably encourage reckless capital allocation decisions and imbalances that become quickly exposed by rapid rate hikes. While the US government’s decision to backstop the regional banks have had the desired effect on markets, the investment team would be surprised if they did not see further “accidents” in markets between now and the end of 2023.
- In Q1, there were a number of puts and takes to the relative performance outcomes. However, the beneficial impact of the portfolio’s ‘Quality’ bias was arguably the most meaningful positive, while relative sector allocation was a small drag. Exposure to Financials was meaningful at 15% (1% underweight); however, it was a key positive contributor from a relative perspective since the Financials industry lagged the broader market by more than 10% in the wake of the SVB and US regional bank crisis. The Information Technology allocation at 21% (1% overweight) performed strongly with the sector up 24%; it was the biggest contributor to returns during the quarter, yet was a drag from a relative perspective as the stocks in the portfolio are less skewed to growth than the broader market. The allocation to Industrials and Communication Services was also a negative in the quarter.
- IT stocks dominated the performers for the period with the biggest contributor being Alphabet (parent company of Google), which is the largest position in the portfolio at 4.7% and contributed 76bps to returns after rallying over 17%. The company had lagged as investors worried that slower growth in advertising spend would impact Google’s growth, and from a competitive standpoint, new entrants and technologies such as ChatGPT could take share. The investment team’s analysis shows that growth in the ad market remains robust and that any impact from new technologies should be minimal and Alphabet should still be able to grow revenue and EPS strongly. Ultimately the initial fear that investors had abated, and the rally was underpinned by the attractive valuation of the company – which was around 18x P/E earlier in the year –, as well as their cash balance of over $80 billion.
- Other positive contributors were also very tech-oriented being Microsoft (+65bps contribution), ASML (+54bps contribution), Amazon (+54bps contribution) and SAP (+51bps contribution), which all rallied over 20%.

- Due to the strong performance of the portfolio, there were only a few companies that declined over the quarter. The biggest laggards were both large cap pharmaceutical companies: Johnson & Johnson down 12% (-33bps contribution) as well as UnitedHealth Group down 11% (-28bps contribution). Both companies remain core positions in the portfolio with a solid earnings outlook.

Portfolio Activity

- The cash level of the portfolio was stable over the period, beginning with 4.0% and, after trading, also ending the quarter at 4.0%.
- There were some reasonably meaningful changes in sector allocation to improve earnings resiliency of portfolio companies and move away from valuation risk. Profit was taken from names in the Consumer Discretionary sector (ending at 10% and reduced by 3%) and in the Financials sector (ending at 14% and reduced by 2%). Key increases were in Health Care (ending at 19% and increased by 4%) with the addition of Pfizer and GlaxoSmithKline (GSK), as well as in Consumer Staples (ending at 19% and increased by 2%) where Colgate-Palmolive was introduced. Colgate is a global consumer products company focused on products across categories including Oral Care (c.46% of sales), Personal care (18%), Home care (16%) and Pet Nutrition (20%). They hold an enviable track record of long term revenue and earnings growth and a very strong profitability profile driven by its exceptionally strong oral care brand. In fact, Colgate is the most penetrated brand in the world with excellent brand recognition. Its overall high quality and consistency over many years provides the portfolio with resilient earnings in the current environment. Additionally with valuation having come off peak levels, from a 70%+ premium relative to the market down to around 40%, it now sits in line with longer term averages; this is now attractive given the potential for various upside surprises in their model over the next 24 months.
- Funding for the new positions came from trimming names that had rallied strongly given the strong market environment and particularly driven by the rebounding consumer spending patterns in China. Key trims were Estee Lauder, Starbucks, Nike and LVMH. Visa and Mastercard were also reduced. As mentioned, this has helped reduce exposure to ‘consumer facing’ companies.
- Turning to the current positioning of the portfolio, the most preferred sectors remain Information Technology (21% allocation), Health Care (19%) and Consumer Staples (19%), which is the largest overweight at 9%. The majority of exposure in these sectors is skewed to businesses with well established, stable franchises and less cyclical earnings.
- In terms of least preferred sectors, the portfolio continues to have no exposure to Energy (6% underweight), Utilities (2% underweight) or Real Estate (2% underweight). The investment team remains comfortable with not having any allocation to these sectors, as the companies are often more capital intensive, highly regulated and have poor pricing power. Additionally, they are often reliant on large amounts of debt, which should weigh on their profitability given the higher interest rate environment. The other significant skew from a relative perspective is the 5% underweight to Industrials.
- From a regional/country perspective there were no material changes. The most significant exposure remains the US at just over 76% of the portfolio, 6% higher than the benchmark weight. However, the revenue diversification of these companies is wide and many should benefit from the recovery in China, such as Estee Lauder, Starbucks, Nike, and various consumer staples companies. The remainder of the equity exposure is to Europe, with the largest allocation being 10% to the UK and the remainder across continental Europe.

- At the end of March, the portfolio's top 5 positions were Alphabet (4.7%), Reckitt Benckiser (3.4%), Cisco (3.3%), Microsoft (3.3%) and Diageo (3.3%).

Outlook

- As we have alluded to already, the investment team suspects equity markets will be quite turbulent for the course of 2023, as the side effects of low interest rates continue to come to the surface. As far as earnings estimates are concerned – notwithstanding downgrades in recent months, the team still feels like there is downside to earnings estimates in 2023. They therefore would expect to see a more material 'flight to quality' as 2023 unfolds. Investors shall arguably be attracted to companies with strong balance sheets and pricing power, while shunning those with vulnerable balance sheets. The team suspects 2023 will see 'Quality' mean revert and quite possibly outperform for a prolonged period.
- From a valuation perspective, the MSCI World Large Cap index traded at 16.5x consensus 12-month forward earnings at the end of March, a slight premium to the 16.2x average over the last 10 years. However, the fed funds rate currently sits at 4.83% after a prolonged period of sub 1% interest rates, therefore the investment team still believes expensive valuations will need to rebase lower.
- As active managers, such an environment should very much play to the team's strengths, as quality companies are increasingly sought after, and the valuation sensitivity is rewarded by way of outperformance. The investment team remains very optimistic that their investment approach will be rewarded in the current environment.

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