Q4 2022

# 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*

- 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.
- ‘Value’ remained the best performing investment style YTD and outperformed massively in Q4 with the MSCI World Large Cap Value outpacing the MSCI World Large Cap Growth by more than 11%.
- Looking at large caps more specifically, the MSCI World Large Cap Index was up +9.4% over the last quarter of the year. With the exception of Consumer Discretionary, all sectors were in positive territory over Q4. Materials, Energy and Industrials were the major contributing sectors.
- Large cap valuations remain attractive with the MSCI World Large Cap Index trading at a P/E of 15.2x at the end of December (on a 12-month forward basis), which represents a 10% discount to its 5-year average. In an absolute sense, the P/E of large caps is the cheapest since January 2014, indicating that the majority of the de-rating might be over.
- Earnings growth expectations for large caps currently stand between 6% for 2022 and 9% for 2023. 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’ 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, UBP Flex - Bell Global Large Cap Equity offers this “Quality at a Reasonable Price” potential throughout this cycle.

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*Performance Review*

- UBP Flex - Bell Global Large Cap Equity returned +11.60% during the 4th quarter of the year (Class IDq USD, net of fees); it materially outperformed the MSCI World Large Cap Index, which returned +9.43% over Q4.
- 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, which added over 500bps to relative returns, primarily from stocks in the Information Technology, and Consumer Discretionary sectors, which saw a strong bounce. From an absolute perspective, the rising market meant that most companies made a positive contribution to returns. Sector allocation was a drag of just over 200bps due to the lack of exposure to the Energy sector (6% underweight) and from Consumer Discretionary where although stock selection was excellent, the overweight was a negative contribution (16% exposure, 5% overweight) since it was the poorest performing sector over the period. Regional allocation was neutral.
- The position that contributed the most to portfolio returns in the 4th quarter was Oracle, which rallied over 30% (90bps contribution). The company is one of the largest suppliers of database software, which is critical in running many large enterprise companies. The company recent reported quarterly results and is seeing a larger than expected acceleration in top line revenue growth as customers increase their use of Oracle's cloud-based infrastructure. Even after this rally, the valuation of Oracle remains attractive on 16x (12-month forward P/E ratio), which is a discount to the benchmark. Similar positive growth trends were reported by German based peer SAP, which was also one of the top performers over the period rallying around 25% (78bps contribution).
- Other strong contributors included industrial conglomerate Honeywell International up 29% (82bps contribution) driven by its aerospace division growing in excess of 20% following the recovery in the airline industry; Dutch based semiconductor equipment manufacturer ASML rising 27% (80bps contribution) and apparel and shoe manufacturer Nike bouncing 41% (75bps contribution).
- Due to the strong performance of the portfolio, there were only a few companies that declined over the quarter. The biggest detractor was Amazon.com falling 26% (-72bps contribution), which has suffered from a deceleration in e-commerce growth and a decline in margins. On the positive side, their overall subscription services continued to grow, and the AWS cloud business remained exceptionally strong. Given the magnitude of the stock price fall, the position was built up since the investment team believes there is good upside. Alphabet (parent company of Google) was also weak in the quarter falling 8% (-30bps contribution) primarily driven by a softening in the outlook for digital advertising spend, which is the key revenue source for the company. That position was also increased to 4.0% of the portfolio as the valuation looks attractive.

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*Portfolio Activity*

- The portfolio began the period with a relatively low level of cash of 1.2%. After what has been a strong quarter, at the end of December the cash position was at 4.0%, which is a more typical level.
- Besides the small increase in cash, the key changes to sector allocation were a 3.2% reduction in Consumer Discretionary (ending at 13.4%) and a 4.1% increase in the more defensive Consumer Staples sector (ending at 17.5%). At a regional level, the UK increased by 2.7% (ending at 10.1%) adding to Consumer Staples positions including Reckitt Benckiser, Diageo and Unilever. Most of the funding came from trimming names that had rallied strongly throughout the rest of Europe where exposure was reduced by 4.8% (ending at 10.1%). Names that were reduced included two of the largest contributors in the period, ASML and SAP, as well as luxury Consumer Discretionary names Hermes and LVMH.
- Given the strong rally in the markets over the three months, other keys trades included reducing exposure to other 'consumer facing' companies such as Starbucks, Home Depot, Lowe's, Visa and Mastercard. The position in Hong Kong Exchanges & Clearing was also sold due to uncertainty around future trading volumes in the region, which are a key revenue driver for the company. Two new positions were initiated being risk and insurance broker AON and beverage company Coca-Cola. Both companies are benefiting from strong pricing dynamics, which is very important in this inflationary environment. For example, AON's insurance broking business accounts for over half of the group's revenue and has benefited from inflation in insurance premiums since they receive a larger commission from the policies that they sell. AON's other segments also remain strong since the tight employment market is good for their HR, compensation, benefits and health advice business. We see good upside given the positive tailwinds and attractive valuation of the stock.
- Turning to the current positioning of the portfolio, the most preferred sectors remain Information Technology (29% allocation), Consumer Staples (17% allocation) and Health Care (15% allocation). 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 (3% underweight) and 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 will weigh on their profitability given the higher interest rate environment. Other significant skews from a relative perspective are to Financials (5% underweight) and Industrials (5% underweight) due to the potential profitability risks in banks and cyclical industrials.
- From a regional/country perspective, the most significant exposure remains the US at 76% of the portfolio, 2% higher than the benchmark weight. The remainder of equity exposure is to Europe, with the largest allocation being 10% to the UK and the remainder across continental Europe.
- At the end of December, the portfolio's top 5 positions were Alphabet (4.0%), Microsoft (3.8%), Diageo (3.3%), Verizon Communications (3.3%) and Reckitt Benckiser (3.1%).
- In terms of ESG credentials, the UBP Flex - Bell Global Large Cap Equity portfolio remained AAA rated by MSCI ESG Research at the end of December. Its 10.0 ESG Quality Score is 18% above the MSCI World Large Cap Index at 8.5. Looking at environmental risk more specifically, our strategy was showing 84% less carbon risk than its benchmark at the end of the quarter (in tonnes $CO_2e$/USD million sales).

*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 7% 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.
- Looking specifically at global large caps, the asset class does exhibit an attractive valuation since the forward P/E of the MSCI World Large Cap Index has retraced from 19.7x to 15.2x during 2022, discounting much of the current macro concerns and trading at a 28% discount to the MSCI World Growth Index. The combination of a Quality tailwind and a disciplined approach to valuation should bode well for the portfolio in 2023.

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