UBAM - BELL GLOBAL SMID CAP EQUITY

Quarterly Comment

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

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Market Comment

- Global equity markets were weaker in Q3 after strong gains in the first half of the year. The MSCI ACWI* contracted by 3.4% but was still up 10.1% for the year. US equities lost -3.3%, Emerging Market equities -2.9% and European Equities -2.1% while Japanese equities gained +2.4% (performance in local currencies).
- In September, US inflation figures picked-up, which threatens to complicate the Federal's reserve battle to keep prices under control. The consumer price index showed that prices in August were up, more than expected, +3.7% compared to a year ago. The increase is largely attributed to the rising energy costs. Aside from energy and foods costs, core inflation is still coming down (from +4.65% to +4.35%).
- As for business confidence, the US manufacturing PMI increased from 47.6 to 48.9 in September. Also, September marked the 20th consecutive month in which unemployment had remained below 4%. Considering this mixed bag of data, the FOMC voted in September to hold the federal funds rate steady at a target of 5.25% to 5.50% but comments from Fed policymakers suggested a further rate hike is on the table before year end.
- In the Eurozone, CPI and core CPI yearly trend slowed to +5.2% y/y and +5.3% y/y respectively. The ECB raised interest rates by +25bps and indicated that while a peak might have been reached, interest rates would probably stay elevated to meet the 2% inflation target.
- Looking at small and mid-caps ('SMID') more specifically, the MSCI World SMID Cap Index was down -4.2% over Q3. Most sectors of the index were in negative territory at the end of the quarter, led by Health Care and Communication Services. Only two sectors avoided falls and were positive contributors for the quarter: Energy and to a lesser extent Financials.
- Global SMID cap valuations remain very attractive with the MSCI World SMID Cap Index trading at a P/E Fwd of 14.7x at the end of September. This represents a 36% discount to the MSCI World Growth Index and a 9% discount to the MSCI World Index.
- Earnings growth expectations for global SMID caps over the next 12 months stand at approximately 12%, which remains above their all-caps counterparts. Being mindful that these numbers may still evolve, we would argue that the downside risk is already in the numbers to some degree.
- 'Quality' has lagged compared to other investment styles over the 3rd quarter of 2023. Looking into the Q4 and 2024, the investment team is confident about the rebound potential of 'Quality' SMID cap companies as many names are out of favour and mispriced leading to buying opportunities.

Performance Review

- UBAM - Bell Global SMID Cap Equity corrected by 7.39% during the third quarter of the year (Class IC USD, net of fees); compared to a decline of -4.20% for the MSCI World SMID Cap Index. Since its inception in February 2021, our Fund has outperformed the MSCI World SMID Cap Index by a significant +341bps margin*
- Global equity markets had a more subdued Q3, as investors seemingly accepted the ‘higher for longer’ interest rate mantra that has been pushed by the U.S. Federal Reserve. Stubbornly high inflation and a particularly resilient US economy saw US 10yr bond yields jump 0.73% over the quarter – putting a dampener on the ‘hope’ that the US Federal Reserve would start reducing rates any time soon. The net result being the MSCI World Index giving back 3.4% (USD terms) having peaked at the end of July – led by the three largest index constituents – Apple, Microsoft and Amazon – that all posted negative returns. This quarter was also interesting in that it was the first time the IT sector had lagged for quite some time.
- One interesting anomaly this year relates to the performance of the ‘Quality’ factor and its related indices. At the time of writing, August data suggested that while the MSCI World Quality Index has outperformed so far in 2023, the Quality factor itself has actually lagged. The MSCI methodology doesn’t do much by way of distinguishing between Growth & Quality – 8 of the top 10 names in each index are the same. Another interpretation of the Quality factor (according to Citigroup) defines Quality by earnings certainty, profitability & balance sheet strength. This definition of the factor actually suggests that ‘Quality’ has lagged YTD by 3.2% and stocks considered as ‘Low Risk’ have lagged by 11%. Upon digging deeper into the MSCI World Quality index constituents, only 20% of the constituents have outperformed the MSCI World Quality Index, and 36% have outperformed the MSCI World Index. Probably the most interesting observation we would make is that ‘Quality’ has actually lagged this year after a difficult year in 2022 – making it one of the longest periods of underperformance in recent years. We believe that the narrow rally we have seen year to date should normalise and become more balanced as we head into 2024. When we look at the small and mid-cap asset class, the MSCI World SMID Cap Index now trades on a forward P/E ratio of 14.7x vs. the 5-year average of 18.1x so with the expectation for earnings to grow well above 10% in 2024, this valuation discount should become a strong catalyst.
- These trends contributed to the weaker relative performance outcomes in 3Q. The portfolio skews towards quality stocks and those with lower volatility which was a contributing factor to poor stock selection and a lower batting average during the period.
- There were some strong performing names, with the Partners Group best individual stock performer during the September quarter. The Swiss listed private asset manager rose over 20% for the quarter (+46bps contribution) after reporting better than expected first half results on the back of strong performance fees, particularly from the company’s infrastructure investments. The company has grown AUM every year since 2010 at an average rate of close to 15% per annum and we believe they remain well placed to continue growing well into the future, helped by increasing allocations to private markets and Partners Group’s strong reputation and business model.
- Other strong contributors during the quarter included drinkware and cooler maker Yeti up 24% (+29bps contribution), membership food retailer BJ’s Wholesale Club rallying 13% (+25bps contribution) and Broadridge Financial Solutions (+21bps contribution) which has benefitted from equity market activity through their provision of technology-based solutions that help clients serve their retail and institutional customers including pre-trade, trade and post-trade processing. They have a strong and dominant franchise with an estimated 90% market share of all proxy information distributed by custodians and trusts to shareholders.

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- The largest performance detractor from a stock perspective was health care company, Masimo, which dropped sharply (-112bps contribution) after issuing weak Q2 results and a material full year guidance reduction. Masimo is a med-tech company that produces non-invasive patient monitoring and sensor technologies and is also pursuing an expansion into consumer wearables following the acquisition of an audio equipment company in 2022. The weak outlook issued by management was disappointing, especially in the core healthcare business, which makes up the majority of profits and has typically been a consistent performer over time. One positive is that the company has continued to sign new health care contracts at a record pace, which potentially bodes well for future revenue. Additionally, with earnings expectations now materially re-based and the valuation trading at a significant discount to the long-term average, the set-up for the stock is arguably looking quite attractive at current levels.
- Other weak stock performers during the quarter included Japanese business broker Nihon M&A Center falling over 30% (-38bps contribution). The position had already been reduced significantly in recent months with the remainder of the position exited due to the increasingly aggressive competitive environment. Two technology related stocks were also weak, Zebra Technologies (-48bps contribution) and Keysight Technologies (-51bps contribution), both falling around 20% due to a near term reduction in customer demand.
- At a sector level, the overweight allocation effects were slightly negative with the overweight to Healthcare (8% overweight, -50bps contribution) which was the poorest performing sector in the quarter and an underweight to Energy (2.5% underweight -43bps contribution) since the sector rallied strongly due to the recent rise in oil prices. Regional effects were minimal with the only meaningful drag from a 9% underweight to Japan (-45bps contribution) since it was one of the better performing markets over the quarter.
- In terms of ESG credentials, the UBAM - Bell Global SMID Cap Equity portfolio was AA rated by MSCI ESG Research at the end of June. Its 7.6 ESG Quality Score represented a 18% excess to the SMID Cap Index at 6.4. Looking at environmental risk more specifically, our strategy was showing 88% less carbon risk than its benchmark at the end of the quarter (in tonnes CO_2e/USD million sales).

Portfolio Activity

- The cash level was held steady during the quarter at around 3.5% of the portfolio, with buy / add activity offset by sell / trim activity.
- At a stock level, the investment team introduced various new positions into the portfolio which included: Agilent, Auto Trader, Factset Data Systems, Houlihan Lockey and Toro.
- Factset Research Systems provides data and analytical applications to investment professionals and has a high level of recurring revenue with compound growth around 8% over the last 5 years. In what is a very consolidated industry, we expect the company to be able continue to grow consistently with a high level of visibility providing excellent risk-adjusted returns over time.
- Market volatility and uncertainty has also allowed the investment team to be oportunistic with new additions. Agilent Technologies has fallen 25% this year, but its franchise remains strong as a leading global manufacturer of analytical instrumentation and related consumables and services. Its customers are diagnostic and pharmaceutical labs, academic and government institutions, as well as industrial, environmental, and food companies. While growth in some end markets has slowed down in the near term, we believe investors are overly discounting the strong industry tailwinds which drive Agilent's longer-term growth algorithm of high single-digit sales growth and low double-digit EPS growth. This has created a disconnect between the quality of the company and the current valuation providing an excellent entry point into the stock.

- These new positions were funded through the sale of various names. In addition to Nihon M&A Center, two other names that were sold include selling the remainder of CHR Hansen since the approval of its merger with Novozymes is now complete. Another was Vestas Wind Systems where although the long term trends for wind power generation remain strong, the volatility in profitability and cash conversion has become a concern. We don't expect recent headwinds to abate in the near term as there is continued margin uncertainty in the industry as onshore wind becomes more mature and offshore wind opportunities are not as prevalent as expected. Due to ongoing uncertainties and reduced conviction, we decided that the capital would be better allocated to the new ideas.
- Looking at sector allocation, the portfolio remains diversified and fairly conservatively placed, with the most preferred sector being Industrials (24%), where earnings exposure of the companies is much less cyclical than what might typically be expected in this sector. The allocation to Industrials did decrease by 3.0% during the quarter, attributable to the exit of Nihon M&A Center, Vestas Wind Systems and Fortune Brands Innovations. Other notable changes included a 2.5% decrease in Materials (ending 4% of the portfolio) and a 3.0% increase in Financials Consumer with the introduction of Factset and Houlihan Lockey.
- In terms of least preferred sectors, the largest underweights remain the Real Estate (8% underweight) and Utilities sectors (5% underweight) where there is zero exposure since these sectors are generally more leveraged, have more cyclical earnings and lower returns, therefore are not attractive given the team's 'Quality' investment style. Other underweights include Materials (5% underweight) and Energy sector (3% underweight) with the portfolio only holding one stock in each of those sectors.
- From a regional/country perspective, the largest allocation remains North America at 57% with the US at 54.5% and Canada 2.5%. The outcome of bottom-up stock changes meant that the allocation to Europe increased slightly over the period, ending at 32% and North America decreased slightly. Allocation to the Asia-Pacific region also increased, just over 8%.
- At the end of September, the largest positions were industrials company Genpact (2.9%), airline and hotel IT platform provider Amadeus (2.8%), pharmaceutical distributor Cencora (2.7%), private market asset manager Partners Group (2.7%) and lock and door system manufacturer Assa Abloy (2.7%). The investment team has maintained a somewhat diversified approach to portfolio construction with the goal of generating a diversified contribution to overall portfolio returns.

Outlook

- Notwithstanding the recent negative turn in market sentiment – we remain very optimistic as we look into 2024. More generally, we regard the aforementioned market 'anomalies' as a precursor to a strong period of alpha generation. The reality is that we are finding numerous opportunities to improve the quality of the portfolio and buy names that are out of favour and mispriced. Moreso, when we look at the TER (total expected return) of our portfolios over the next 12-24 months, we currently see more upside than we have in the last 12 months.
- As far as our portfolio biases are concerned, as always we skew to where we see the best opportunities – whether that be at a size, sector, geographical or factor level. Overall, the manager believes that 2024 shall be a strong year for the small and mid-cap asset class and for the portfolio overall as the strong fundamentals that underpin the portfolio biases play out.

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