Q3 2020

UBAM – EUROPE SMALL CAP EQUITY

Quarterly Comment

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

Market Comment

- After a strong Q2 with widespread positive performance, the third quarter of 2020 shows regional disparities reflecting the local evolutions of Covid19. Indeed, as the different containment strategies yield their results, the spread of the virus is not uniform across countries and stimulates a range of economic responses – resulting in different market performance between regions.

- The gap between growth and value stocks also persists as growth companies are up +19.2% year to date while value is down -14.1%. A cold winter without enough positive vaccine development news would be negative for value stocks and widen the gap further.

- In year to date terms, the S&P500 is the leading index with +5.6% return followed by MSCI EM with flat performance and ahead of the MSCI Europe ex-UK index displaying -7.4% returns. The lack of progress of Brexit negotiations and the fading fiscal stimulus causes the UK to lag, with the FTSE All-Share down -19.9%. Following the Internal Market Bill which seeks to modify the terms of trade between the UK and Northern Ireland, the most likely Brexit scenario is a limited free trade agreement with significant arrangements to ease the transition.

- While hospitalisations in Europe and the UK seemed under control during the summer, the effect of travelling abroad for the holiday season lead to a new rise in the number of cases – most notably in Spain, France and the UK. This fueled concerns that dropping temperatures in Autumn could lead to a second wave of Covid19 and caused European equity markets to lag as the MSCI Europe ex-UK index returned +1.8% and the UK FTSE All-Share was down -2.9% this quarter, whilst the MSCI Europe Small Cap Index was up 6.2%. The worsening sentiment is also displayed by volatility levels – the VIX index has increased to the 25-35 range during September compared to the 20-25 levels in June and July.

- The United States experienced a rise in cases at the start of Q3 but thanks to the use of face masks was able to reduce hospitalisations significantly from the end of July. Combined with the transition to online commerce, this resulted in strong performance from US technology and growth companies for most of the quarter. Unemployment also displayed a modest reduction, but as valuations expanded and the risk for a vaccine-driven rotation increased in September, the market slowed down to favor cheaper stocks. This resulted in a quarterly return of +8.9% for the S&P500.

- Emerging markets performed strongly too as the MSCI EM index returned 9.7%. Similarly, MSCI Asia ex-Japan was a notable performer of the quarter with 10.8% returns, stimulated by China’s success in containing the virus after the first wave.

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.

- Credit markets display lower performance than previous periods, but positive nonetheless. On the corporate side the US high yield rallied by 4.7% during the quarter, followed by Euro high yield which was up 2.5%. More broadly, the Global Investment Grade instruments returned +3.1% during the period. Similarly, Euro Government bonds returned +1.7%, followed by US Treasuries at +0.2% UK Gilts down -1.3%.

- Overall, an undeniably uneven quarter, but investors will now prepare for an eventful end to the year – the US election outcome will soon be known, a Brexit scenario will be determined, and news on a potential vaccine could accelerate – which would be a game-changer for the market and help many stocks that have lagged throughout the year recover.

- All indices are total return in local currency, except global ones in US Dollars.

Performance Review

- During the third quarter, UBAM - Europe Small Cap Equity returned 7.5%, outperforming the MSCI Europe Small Cap Index return of 6.2%. Since the start of the year, UBAM Europe Small Cap Equity has outperformed the index by 6% (gross performance figures).
- More growth-oriented segments of the market that stand to benefit from long term trends that have been accelerated under the 'new normal', performed strongly during Q3. On the other hand, those sectors that have seen a disproportionately negative impact on their earnings and cash flows from renewed lockdowns and disruption to operations have lagged.

- Amongst the former category, our holdings of video gaming company Stillfront Group AB, outdoor leisure equipment company Dometic Group AB, online financial savings company Avanza Bank Holding, building insulation company Kingspan Group PLC, and media and education company Sanoma OYJ were amongst the top performing stocks.

- Stillfront continued its run of strong share price performance following strong Q2 earnings numbers, continued progress on its external growth strategy with the announcement of the acquisition of Nanobit and upgraded mid-term targets released at the company's September capital markets day. Dometic performed strong after releasing Q2 numbers that pointed to an improving sales trend and a positive demand outlook for outdoor leisure products. Newsflow on registrations of recreational vehicles and caravans in Europe and North America has been increasingly positive over the summer months and into the autumn, reflecting consumer willingness to spend on more on outdoor leisure activities. Avanza reported very strong first half figures and remains well placed as a strong innovation leader and extremely customer centric company to continue to disrupt the market and take market share from incumbent financial services companies. Kingspan reported strong figures as construction activity resumed across most of their key territories, and investors continue to be attracted to the longer-term growth potential offered by their insulation products especially against a backdrop of increasing environmental regulation. Finally, our holding of Sanoma performed strongly on the back of solid earnings numbers and evidence of continued progress in the implementation of the management strategy to shift the mix of the business towards educational and digital learning solutions.

- Underperformers during the quarter included visualisation equipment company Barco NV, online fashion retailer Boohoo Group PLC, distribution company DCC PLC, travel retail group WH Smith PLC, and hotel company Dalata Hotel Group PLC.

- The Barco share price suffered on the back of disappointing topline and cash generation figures at the first half results, against a challenging backdrop in particular for the entertainment segment. Nevertheless, we believe that Barco's strong balance sheet, focus on value engineering and continued optimism about the prospects for the enterprise division should put the company in a strong position for the longer term. Fashion retail Boohoo suffered on the back of allegations of issues in its supply chain but later recovered as the company published full details of an independent review and an action plan to drive supply chain best practise. We continue to actively engage with management on the subject to attain a clearer picture of the progress that is being made in implementing the accelerated sustainability programme, and we have slightly reduced our holding following the strong share price recovery. DCC suffered during Q3 on continued lack of newsflow or progress on their M&A strategy and the stock is now trading at attractive multiples compared to historical levels.

- Finally, our holdings of WH Smith and Dalata suffered somewhat on the back of rising Coronavirus infection rates and concerns about renewed travel restrictions. Whilst the immediate outlook remains challenging for both companies we believe that opportunities for the longer term remain in their favour and both companies have improved their balance sheets and liquidity positions by raising additional capital.

Portfolio Activity

- During the course of the quarter, we initiated a new holding in semiconductor manufacturing equipment company Aixtron SE, and we participated in the IPO of Unifiedpost Group, a Belgian listed provider of software solutions for digital invoicing and payment solutions. We purchased Aixtron following a screening exercise that focused on R&D intensive companies with increasing levels of sales productivity on their innovation spend. Aixtron has invested heavily in manufacturing platforms for a number of complex compound semiconductor materials used in applications such as electric vehicles, 5G infrastructure, data communications and specialist LEDs, all of which are displaying promising growth signals. Unifiedpost is a leading player in the rapidly growing market for digital invoicing and payment solutions focused on SMEs across a number of European territories. Regulation is a key driver behind the shift from paperless to digital office processes, and Unifiedpost is now well placed to consolidate a rapidly growing but still fragmented market.

- We also took the opportunity to add to a number of our existing holdings, taking advantage of continued short-term market induced price volatility. This included increasing our position in ventilation and heat recovery company Volution Group PLC, adding to multi technical services company SPIE SA, and increasing our exposure to industrial recycling company Befesa SA. Elsewhere, we increased our weight in our holding of pharmaceutical packaging company Gerresheimer AG on continued evidence of improved operational rigour and focus on growth from the new management team, and topped up our holding in D'Ieteren SA after further evidence of operational progress and strong cash flow generation in H1.

- We continued to build our holding of semiconductor equipment company ASM International NV, and we participated in a fundraising from hotel group Dalata which will put them in an even stronger position to trade effectively through the coronavirus crisis and put them in a strong position to take advantage of market opportunities as they arise.

- In contrast, we took advantage of strong share price performance from a number of holdings that have benefited strongly against the backdrop of the Coronavirus pandemic to trim our positions to a more manageable size and to control risk within the portfolio. These weight reductions included video gaming companies Codemasters Group Holdings and Stillfront, outdoor leisure equipment companies Thule and Dometic, medical diagnostic company DiaSorin SpA, building insulation company Kingspan, environmental consultant Arcadis, online financial savings company Avanza and industrial holding company Chargeurs SA.

- We made total exits of three companies from the portfolio: specialist insurance company Sabre Insurance Group PLC, industrial biotechnology company BRAIN AG, and building materials company Ibstock PLC.

- We exited our holding of Sabre on concerns about renewed price competition in the sector as well as our preference for other areas of the insurance market as discussed in our Q2 report. Following our enhanced ESG engagement with BRAIN earlier in the year, which highlighted the lack of progress being made internally with respect to the development of their sustainability strategy we decided not to participate in the recent capital raise and we exited our position. We also sold our holding in Ibstock, preferring to focus on building materials companies such as Volution Group and Kingspan that stand to benefit more from the drive towards more energy efficient buildings.

Outlook

- The continued recovery seen from smaller companies in the third quarter now puts the asset class ahead of large cap European indices since the start of the year. Part of the explanation for this outperformance can be gleaned from the polarisation in returns experienced within European equity markets and the sectoral composition of the smaller companies universe, which has a higher exposure to more innovative and disruptive companies in sectors such as technology, healthcare equipment, engineering, clean tech, communication services, and online retail.

- Despite the obvious challenges presented by the ongoing Coronavirus pandemic, we remain convinced about a number of longer-term secular growth trends that are often disproportionately represented by companies in the small and mid-cap universe. Whilst the increasing polarisation between growth and value segments of the market and ongoing equity market volatility are making markets particularly difficult to navigate, they can also provide interesting valuation entry points in out of favour quality companies with sustainable business models for investors prepared to take a mid to long term approach.

- Against a continued challenging backdrop, we maintain a well-balanced portfolio from a country, sector and market capitalization perspective. We believe that effective stock picking will remain crucial to investment returns in the remainder of 2020, and our focus on sustainable business models – strongly financed, well managed, competitively advantaged companies with strong or improving returns and secular growth drivers in their end markets - should continue to stand the fund in good stead.

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