Q1 2023

UBAM - BELL US 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 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. The US Manufacturing PMI came in slightly higher in March at 49.2 vs. 47.3, with sentiment increasing on production and employment.
- Looking at US Equities more specifically, the S&P 500 Net Total Return Index was up +7.4% 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, Financials, Energy, Health Care and Utilities were negative contributors for the quarter.
- US Equity valuations remain fair with the S&P 500 Net Total Return Index trading at a P/E of 18.3x at the end of March (on a 12-month forward basis). This represents a 24% discount to the MSCI World Growth Index.
- Earnings growth expectations for US equities stand between -1.5% for 2023e and +10% for 2024e. Being mindful that these numbers may still evolve, 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 the Q2, the investment team is confident about the potential of ‘Quality’ US cap 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, UBAM - Bell US Equity offers this “Quality at a Reasonable Price” potential throughout this cycle.

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Performance Review

- UBAM - Bell US Equity returned +6.36% during Q1 (Class IC USD, net of fees); it underperformed the S&P 500 Net Total Return Index, which returned +7.36% over the period. Bell Asset Management took over the portfolio management on October 3rd, 2022. Since this takeover, the Fund has posted a +16.69% net total return, outperforming the S&P 500 Net Total Return Index by a significant +137bps 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 large cap 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. The strategy benefitted most due to not holding any banks within the Financials allocation (3% underweight). The Financials industry lagged the broader market by more than 10% in the wake of the SVB and US regional bank crisis. From an absolute perspective, the strongest contribution to returns during the quarter was from the Information Technology sector (5% underweight), which was the best performing sector up 16% and bouncing strongly after a period of lacklustre performance; however, the underweight did mean it was a drag from a relative perspective.
- The position that contributed the most to portfolio returns in the first quarter was Arista Networks, which rallied nearly 40% (+82bps contribution). The company reported very strong results and has guided for revenue growth in excess of 25% for 2023. This shows the strong product range that continues to gain market share in the cloud networking market. With such strong sales growth, the company has also expanded margins significantly. Given the strong performance, the position in Arista was trimmed from nearly 3.0% to around 1.5% at the end of the quarter.
- Large cap technology companies were also significant contributors with Alphabet (parent company of Google) up 18% and Microsoft rallying 20%, adding 76bps and 64bps respectively. Other good contributors were Amazon.com (up 23%, +39bps contribution) and handheld asset tracking computer maker Zebra Technologies (up 24%, +37bps contribution).

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- 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%, -30bps contribution) and UnitedHealth Group (down 11%, -28bps contribution). Both companies remain core positions in the portfolio with a solid earnings outlook.
- In terms of ESG credentials, the UBAM - Bell US Equity portfolio remained AAA rated by MSCI ESG Research at the end of March. Its 9.24 ESG Quality Score represented a 15% excess to that of the S&P 500 Index at 7.99. Looking at environmental risk more specifically, our strategy was showing 85% less carbon risk than its benchmark at the end of the quarter (in tonnes CO2e/USD million sales).

Portfolio Activity

- After the strong rally, cash level increased slightly over the period. The portfolio began the period with cash at 2.7%. At the end of March, the cash position had increased to 3.8%.
- Besides the small increase in cash, the key changes to sector allocation were a 2% reduction in Information Technology (ending at 18%) and a 3% increase in Industrials (ending at 8%). Note that there were some significant changes to the GICS industry and sector classification in the period, which changed the historical, absolute sector allocations within the portfolio. On a comparable basis, the actual changes due to portfolio activity were minor.
- In terms of trading, there were a few changes during the quarter, with the introduction of three new names: Pfizer, Colgate-Palmolive and Advanced Drainage Systems. 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.
- These new positions were funded through a combination of taking profits from existing names that had rallied strongly, as well as redeploying capital from the sale of Toro. This company posted solid results and has outperformed many peers, reinforcing the market leading position the company has in premium turf maintenance machinery. The stock price rallied strongly and there was little upside relative to the price target, so being prudent in an environment where sales of high-priced machinery could come under pressure, the position was sold.
- Sector allocation remains diversified, with the most preferred sectors being Health Care (21%), Information Technology (18% allocation), Financials (14%) and Consumer Staples (14%). Most of the exposure in these sectors is skewed to businesses with well established, stable franchises and less cyclical earnings.
- In terms of least preferred sectors, the largest underweights are Information Technology (18%, 9% underweight), which is the result of not holding some large index constituents as the team believes valuations are too expensive. The portfolio continues to have no exposure to the Energy sector (5% underweight) or the Utilities sector (3% underweight). These sectors are generally leveraged,

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capital intensive with less pricing power, therefore are not attractive given the team's 'Quality' investment style.

- At the end of March, the portfolio's largest positions were Alphabet (4.0%), Accenture (3.0%), UnitedHealth Group (2.8%) and Microsoft (2.7%). A relatively balanced approach to position sizing should help to generate diversified and more consistent overall portfolio returns.
- The changes that were made to the portfolio at a stock level reflect the investment team's view that macro conditions may deteriorate, so the focus is on minimising valuation risk and increasing earnings resiliency.

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.
- In terms of valuations, the manager remains quite cautious about equity markets more generally. The valuation of the S&P 500 index at the end of March was 18.3x consensus 12-month forward earnings, a slight premium to the 17.5x 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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