Q4 2022

# UBAM - BELL US EQUITY

Quarterly Comment

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

The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

## *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 Russell 1000 Value outpacing the Russell 1000 Growth by more than 10%.
- Looking at US Equities more specifically, the S&P 500 Net Total Return Index was up +7.4% over Q4. All sectors of the index were in positive territory at the end of the quarter, except Consumer Discretionary and Communication Services. Energy and Industrials were the best performing sectors.
- US Equity valuations remain fair with the S&P 500 Net Total Return Index trading at a P/E of 16.9x at the end of December (on a 12-month forward basis). This represents a 20% discount to the MSCI World Growth Index.
- Earnings growth expectations for global US equities stand between 7% 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’ US cap 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, UBAM - Bell US Equity offers this “Quality at a Reasonable Price” potential throughout this cycle.

Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

*Performance Review*

- UBAM - Bell US Equity returned +9.72% during Q4 (Class IC USD, net of fees); it strongly outperformed the S&P 500 Net Total Return Index, which returned +7.42% over the period. Bell Asset Management took over the portfolio management on the 1st trading day of the quarter (October 3rd).
- 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 2.3% outperformance of the portfolio was driven by strong stock selection – the rising market meant that the majority of companies made a positive contribution to returns and also performed exceptionally well from a relative perspective. Sector allocation was a slight contribution due to the lack of exposure to the Energy sector (5% underweight), the overweight to Consumer Discretionary (13% exposure, 3% overweight), and the underweight to Industrials (5% exposure, 3% underweight). The overweight to Consumer Staples was a clear tailwind (13% exposure, 6% overweight).
- The position that contributed the most to portfolio returns in the fourth quarter was Nike, which rallied 40% in the period (+78bps contribution). The brand continues to dominate the sports apparel and shoe category, outperforming a generally more challenging consumer environment. The company has drastically improved their inventory position, which is helping profitability. The investment team expects solid mid-high single digit sales growth underwritten by the reopening of China, which could improve from around 15% of the group towards 20% of overall sales.
- Honeywell International was another significant contributor (+26%, +55bps contribution), where its aerospace division is growing in excess of 20% following the recovery in the airline industry. Home and personal care company Procter & Gamble (+18%, +43bps contribution) rallied after reporting strong results, which highlighted their strong pricing power, a key element in such an inflationary environment.
- Due to the strong performance of the portfolio, there were only a few companies that declined over the quarter. The biggest detractor was Alphabet (parent company of Google), which fell 8% (-12bps contribution) primarily driven by a softening in the outlook for digital advertising spend, the key revenue source for the company. The investment team has built the position to 4% of the portfolio as the valuation looks attractive and good upside over the medium term is expected. The position in Amazon was reduced significantly in early October, which helped reduce the impact of the subsequent decline in the stock price (- 26%, -16bps contribution) due to a deceleration in e-commerce growth. Given the magnitude of the fall, the team has added to the position more recently.
- In terms of ESG credentials, the UBAM - Bell US Equity portfolio was AAA rated by MSCI ESG Research at the end of December. Its 9.1 ESG Quality Score represented a 9% excess to that of the S&P 500 Index at 8.3 Looking at environmental risk more specifically, our strategy reported 86% less carbon risk than its benchmark at the end of the year (in tonnes $CO_2e$/USD million sales).

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## *Portfolio Activity*

- With good opportunities to deploy capital, the portfolio began the period with a relatively low level of cash near 1%. At the end of December, the cash position was at 2.6%, which is a more typical level.
- Besides the small increase in cash, the key changes to sector allocation were a 3% reduction in Industrials (ending at 3.5%) and a 1% reduction in Consumer Discretionary (ending at 11.5%). There was a 2% increase in Consumer Staples (ending at 14%).
- In terms of trading, there were some significant changes to individual positions. In early October, there was a focus on improving the overall profitability metrics of the portfolio and reducing exposure to names where earnings downside and valuation risk was more prevalent. The most significant changes were the exit of Apple due to demand uncertainty going into their seasonally largest quarter and news that various suppliers had been instructed to reduce volumes. The position in Meta (parent company of Facebook and Instagram) was also sold due to the continued headwinds to growth and profitability, as well as poor governance and management of data security and consumer privacy. Given the continued pressure on more richly valued names, especially where there was heightened risk of earnings downgrades, the investment team reduced this downside risk by selling Netflix, NVIDIA, Salesforce, Tesla and ServiceNow. Some of the newer names with more significant positions that were added at the beginning of October included AmerisourceBergen, Oracle, Johnson & Johnson, Kroger and Texas Instruments; all of which are trading at valuations at or below the benchmark. With a view to being more opportunistic in the small and mid-cap space, a number of other positions were initiated such as Service Corp, Mettler-Toledo, Fiserv, Broadridge Financial Solutions and Cognizant.
- Sector allocation remained diversified, with the most preferred sectors being Information Technology (29% allocation), Health Care (20%) and Consumer Staples (14%). 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 largest underweights are Industrials (4% exposure, 5% underweight) and Financials (9% exposure, 3% underweight). The portfolio continued to have no exposure to the Energy sector (5% underweight) or Utilities sector (3% underweight). These sectors are generally leveraged and have low returns, therefore are not attractive given the team's 'Quality' investment style.
- At the end of December, the portfolio's largest positions were Microsoft (3.8%), Alphabet (3.8%) and Kroger (2.7%). Position sizing is designed with the goal of generating a diversified contribution to overall portfolio returns.
- When we reflect on some of the changes that were made to the portfolio at a stock level, an important aspect of understanding the current environment is the investment team's continued engagement with portfolio companies. The main takeaway from recent travel was that the outlook and the ability of management teams to forecast demand remains difficult. Many executives cited limited visibility and a heightened level of concern about the negative impact that underlying macro conditions could likely have on demand and margins. The changes to the portfolio implemented have resulted in good performance in the fourth quarter, and the investment team is now more confident in the resilience of the portfolio as we enter into the reporting period.

*Outlook*

- While the current outlook for markets and the global economy is somewhat dour at this point, in regard to the US, the team remains very constructive given the strength of the economy. The key dilemma that Jerome Powell is attempting to resolve is the structurally tight labour market. Having repeatedly referenced the number of people that have come out of the workforce due to COVID (e.g. early retirement, death, and lack of immigration), labour costs would appear likely to stay higher for longer. The biggest near-term risk for equities being that investors are seemingly discounting the Fed's resolve to stop inflation through more aggressive rate hikes. The investment team's biggest concern for 2023 is that the Fed does overreach with rate hikes in an attempt to fight a 'structural' employment imbalance. The 'hope' then is that some heat comes out of the labour market as corporates rebase for a more subdued macro environment and consumer behaviour softens. Pleasingly – for markets – we started to see signs of both in November and December.
- While we are cautious that estimates for 2023 still appear to be unrealistically high given forecasts for US GDP growth in 2023 are only at 0.3%, the forward-looking valuation of the S&P 500 Index is not overly expensive at 16.9x the 12-month forward earnings estimates.
- Most importantly, from a style and portfolio construction perspective, the investment 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 9% 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.

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