Q3 2021

UBAM - BELL GLOBAL SMID CAP 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

- Volatility returned over the third quarter of the year with mixed results for equity markets. The MSCI AC World ended Q3 down 1.0%, while US equities were up +0.6%, European equities +0.7% and Japanese equities +5.2%. Emerging markets on the other hand lost more than 8% over the period.
- At the end of Q3, a sector rotation back into Energy, Financials and IT drove global equity markets, with these three sectors finishing the quarter as the largest contributors to the MSCI AC World's performance; whereas Materials, Consumer Discretionary and Communication Services were the largest detractors.
- With increased worries coming from the Chinese real estate sector, rising commodity prices and supply disruptions, equity markets came under pressure over the third quarter. The last days of September saw bouts of a sector rotation back into value names, with investors moving to end the quarter by booking profits on performing names. While the pace of positive revisions on global equities earnings growth moderated somewhat, it stood at an impressive 49% at the end of the quarter.
- The US PMI unexpectedly came in higher at 61.1 for September vs. 59.9 for the previous print, supported by solid consumer demand and business investment. Pressure, however, was recorded in the other segments with the shortage of materials, rising commodity prices and goods transportation difficulties. Following the Fed's meeting in September announcing that tapering should start before the end of the year, inflation forecast were raised for 2021 and 2022, and the Fed dots were revised up for 2022. The Fed confirmed its expectation for a transitory inflation driven by bottlenecks, which should slow down to 2% over next year.
- Looking at small and mid-caps ('SMID') more specifically, the MSCI World SMID Cap Index was down 0.9% over Q3, in line with broader equities. Since September 2020 though, the MSCI World SMID Cap Index has largely outpaced the MSCI AC World Index by 10%, a phenomenon mainly explained by the high potential nature of global SMID caps in a recovery scenario, coupled with better earnings leverage – the 12m forward PE of the MSCI World SMID Cap Index stood at 19x at the end of September.
- As markets seem to transition to the next stage of the recovery, quality corporate earnings streams and durable valuation floors become paramount. Our UBAM - Bell Global SMID Cap Equity fund offers this "quality at a reasonable price" attribute. Our strategy is well positioned to benefit from a good array of small and mid-cap companies that grow strongly through a cycle along with highly visible revenue streams, strong customer retention and relatively high ESG standards.
- In terms of asset allocation, UBAM - Bell Global SMID Cap Equity can be seen as an efficient complement to other growth asset classes by showing less valuation risk than large-cap growth, less absolute risk than emerging markets, and less liquidity risk than pure small caps.

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Performance Review

- UBAM - Bell Global SMID Cap Equity returned +0.07% (Class IC USD, net of fees) over the third quarter of 2021. From a relative perspective, it outperformed the MSCI World SMID Cap Index, which lost 0.88%. Since inception in late February, the Fund has rallied 11.60% (Class IC USD, net of fees), well ahead of the benchmark return of 5.95%.
- After a very strong 2Q earnings results period, equity market appreciation slowed due to a combination of concerns around the Delta variant, inflation, moderating economic growth, energy prices and Chinese property developers, which collectively drove profit taking later in the quarter. The drawdown in September was arguably overdue after what has been an incredibly strong rebound from the market lows of March last year.
- As investors became more risk averse, they favoured value as a style later in the quarter. The Fund outperformed overall, however, sector allocation was a slight drag as Energy (zero exposure, 3.1% underweight) and Financials (7.3% allocation, 5.3% underweight) performed well. Our overweight to Information Technology (24.9% allocation, 9.7% overweight) was a positive since the sector was the third best performer during the quarter.
- The company that contributed the most to portfolio returns in the third quarter was ICON, rising 26% in Q3. ICON is a US$21 billion global contract research organisation (CRO) that offers outsourced services to pharmaceutical and biotechnology clients including conducting clinical trials and consulting. It has been one of the highest conviction positions in the portfolio (3.0% position, +77bps contribution) as the investment team sees excellent synergies from their recent acquisition of PRA Health. In addition to cost efficiencies, the meetings with management have highlighted various tangible revenue opportunities that the team believes are not fully appreciated by the market. More generally, the company benefits from broader industry tailwinds of increasing R&D spending and more outsourcing from pharma and biotech companies. As a recent example, ICON have played a critical role in the development and trials for COVID-19 vaccines. Using 2020 earnings as a base, the team forecasts that the combination of top line growth drivers and margin expansion should see earnings more than double by the end of 2024 and continue to see solid upside.
- Croda International was another significant contributor to returns (2.2% position, +34bps contribution). This £12 billion U.K. specialty chemical company's primary business is supplying oleochemicals to its customers. Oleochemicals are made from animal and plant based oils and generally replace products made from fossil fuels. It rose by 14% in the quarter and has appreciated over 40% since inception of the Fund in February this year.
- The biggest detractor during the period was U.S. home improvement product company Fortune Brands Home & Security (2.6% position, -29bps contribution). Although organic revenue growth was 30% for the quarter and their plumbing division performed strongly, their cabinets and door & security segments suffered from rising input prices. The investment team expects the company to overcome these headwinds and ultimately perform strongly. Valuation is also attractive at 17x P/E, a discount to the broader market.
- Other detractors included U.S. health services provider Amedisys (0.6% position, -27bps contribution), which was recently added to the portfolio and is a relatively small position; and CHR Hansen, the Danish health and nutrition company (2.3% position, -26bps contribution), which lagged due to slower growth across its culture, enzyme and probiotics businesses.

Portfolio Activity

- The portfolio remained relatively fully invested during the quarter, ending the period with 2.9% in cash. Cash levels are expected to remain around these levels, as the investment team's preference is to manage volatility and downside risk by taking a slightly more conservative portfolio positioning, rather than increasing cash.
- From a trading perspective, the recent spike in volatility has and shall continue to present the team with buying opportunities in high quality names on the watchlist that have until now been too expensive. Over the three-month period, the team has been active opportunistically deploying capital into names that had temporarily lagged, buying gaming software company Electronic Arts, health services provider Amedisys, hearing aid and communications company GN Store Nord, wind turbine manufacturer Vestas Wind Systems, as well as Intertek, one of the leading global testing and inspection businesses. Patience with respect to valuation has held the team in good stead as all of these positions were initiated after drawdowns from recent highs.
- To highlight Intertek in a little more detail, their testing and inspection business is driven by customer innovation in new products as well as overall volumes. Global lockdowns have stifled innovation, which should rebound over the next year. From a volume perspective, many consumer related categories have been strong, but there is room for improvement in some industrial and commodity related verticals. An additional revenue driver is Intertek's growing assurance business where they review and certify things such as procedures and systems. This segment is growing due to customers wanting to better understand their supply chains, plus importantly, the need for customers to measure and report various ESG factors. The investment team forecasts that revenue growth can accelerate to a high single-digit level and for EPS to compound at about 10% p.a. giving upside in excess of 20% over the next 12 months.
- There were also various names that the team built up, often because they had lagged in the near term and are attractively valued. These included CHR Hansen, IT service company Booz Allen Hamilton, and industrial equipment auctioneer Ritchie Bros. Auctioneers.
- There were two companies sold from the portfolio during the quarter. The investment team exited O'Reilly Automotive, the U.S. based aftermarket car parts supplier after it reached the price target. Their franchise remains strong and they have benefited from excellent customer demand over the last 12 months. However, looking forward there is risk to the downside considering softening customer demand as well as logistics related cost headwinds and higher salary related expenses given the tight labour market. The team also exited FleetCor Technologies, the payment platform provider whose key business is managing fuel cards for vehicle fleets, as it did not meet expectations and the team felt the capital could be better deployed elsewhere.
- In addition to these sales, other names were trimmed over the quarter, many for valuation reasons after recent rallies. These included Zebra Technologies, Rightmove, Novozymes, ICON and Croda. Reducing these positions has been beneficial as they have pulled back slightly in recent weeks and has given the team the opportunity to add to names with more attractive valuations.
- From a sector allocation perspective, the most preferred sectors remain Information Technology (22.9% allocation), which has been reduced in favour of adding to Industrials (17.9%), which is now the second most favoured sector. Health Care (14.4%) and Consumer Discretionary (13.2%) also remain significant allocations and are reflective of where the investment team finds the highest quality companies.

- In terms of least preferred sectors, the portfolio continues to have no exposure to Utilities or Energy. From a relative perspective, the largest underweight sectors remain Real Estate (6.9% underweight) and Financials (6.0% underweight).
- From a regional/country perspective, the largest allocation remained to North America with the US at 50.7% and Canada at 10.4%. The allocation to Europe remained diversified with the largest allocations being 7.8% to the UK and 7.5% to Denmark, which increased. The Asia-Pacific region is a smaller part of the benchmark; our portfolio holds just a single position in battery power tool manufacturer Techtronic Industries.
- At the end of September, the portfolio's top 5 positions were Ritchie Bros. Auctioneer's (3.3%), Booz Allen Hamilton (3.0%), Euronext (2.9%) plus Deutsche Boerse and Electronic Arts (each at 2.8%).

Outlook

- In the near term, the investment team expects market volatility to remain slightly elevated given the multitude of concerns around the Delta variant, inflation, moderating economic growth, energy prices and difficulties among Chinese property developers. The team suspects that management commentary in the upcoming Q3 earnings season will be a little more subdued than Q1 & Q2, as companies look to manage expectations going in to 2022.
- From the investment team's perspective, they remain optimistic that global earnings should grow strongly in 2022 and continue to underpin a strong period of equity returns. The recent drawdown in the market, as investors began to price in a more moderate recovery, is providing many opportunities for active stock pickers.
- As far as valuations are concerned, the team would argue some of the valuation risk in markets has abated as growth stocks have pulled back a little. The manager does not feel that developed market equities are particularly expensive as the MSCI World SMID Cap Index trades on a 12m forward P/E at 19x, which is in line with the average observed over the last five years. From these levels, the team sees good risk-adjusted upside in the Fund going forward.

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