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UBAM - EURO EQUITY INCOME

Quarterly Comment | Q4 2018

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Market Comment

- Q4 2018 will not be remembered warmly by equity investors, with the S&P recording its worst December return since 1931 and the MSCI Europe Net Return finished the month at -5.53%. Developed market equities in aggregate pulled back by 13.0%. Concerns of a slowing global economy in the midst of both inter and intra country political friction created a nervous climate for markets. Trade war news dominated the headlines for much of Q4, and it included the positive announcement of a 90 day pause between China and the US for further tariff hikes but also a significant negative when Huawei CFO Meng Wanzhou was arrested in Canada on. In December investors had to contend with further unwelcome US-related news as the US entered a new partial government shutdown over a standoff with President Trump and the Democratic-led House of Representatives on border-wall funding.
- Global economic growth concerns rose to the surface when statistics pointed to a slowdown in the retail and industrial sections of the Chinese economy, impacted in part by US tariffs. In Europe, Germany in particular continued a recent lower trend in business confidence.
- At the beginning of the quarter Jerome Powell, Federal Reserve chairman, commented that US policy was still a 'long way' from neutral and this led to the rate rise of 0.25% to the 2.25% to 2.50% range in December. But investors did not react well to Powell's more sanguine views of the US economy and indications of further rate increases at a time of apprehensions over global growth. He later softened his position. The change of sentiment in one quarter just goes to illustrate how uncertain and rapidly evolving consensus expectations can be in this period of monetary policy when the tide is ebbing. The European Central Bank also ended its quantitative easing programme, as signposted through 2018, and held the rates at 0%.
- European investors were appeased somewhat in December following the announcement that an agreement had been reached between the European Commission and the Italian government over its spending targets. The Lega-Five Star coalition agreed to a budget that would reduce the deficit/GDP ratio to 2.04 percent of GDP in 2019 from an earlier announced 2.4%. However, confusion over the likely path of negotiations for Brexit has weighed on sentiment throughout Q4 and looking forward we would expect Q1 to be no less tense.
- Looking at the latest Eurozone figures, the manufacturing PMI remained around the level of recent months, at 51.4 in December, while the services figure dipped from 53.40 to 51.20, dragged lower by Germany, while Spanish reading remained robust. Both measures continue to indicate growth in the EU, albeit slower than of late. Part of the slowdown appears attributable to lower demand from China but clearly the governmental tensions between Italy and the EU and the protests in France will have hindered growth. In France, Macron's idealistic reform agenda has been de-railed in a characteristically French fashion, leading to some hefty compromises. With Macron's most recent Kantar poll showing at 26% approval and sitting below the 18 month level for either Sarkozy or Hollande, we would expect the French president to be cornered into further concessions.

All performance figures are given net of fees unless stated otherwise.
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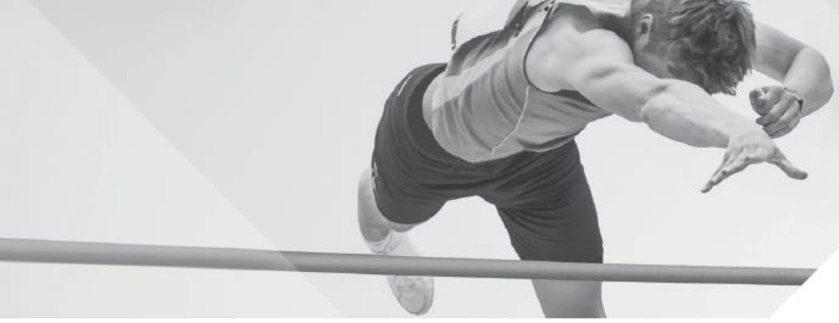

Performance Review

- The portfolio produced a -12.60% return after fees in the quarter, marginally beating the benchmark index which returned -12.73%.
- As detailed above, Q4 witnessed one of the more dramatic sell-offs in recent times with few areas of the market left unscathed. With around 50% of that fall coming in December alone, the portfolio proved relatively resilient, beating the benchmark by 0.76% over the month. Interestingly, the market moves did not conform to popular belief that any sell-off would hit hardest amongst growth-oriented stocks. Whilst some suffered, others held up relatively well. Understandably the cyclical vs. defensive trade was far more pronounced, with the best performing sectors being Utilities, Telecoms and Consumer Staples versus the likes of Autos, Banks and Energy on the negative side of the ledger.
- At a country level the portfolio sat broadly in line with the index for Germany. However, good stock selection resulted in out-performance. Conversely, the portfolio is materially underweight France but weak stock selection caused meaningful under-performance (Unibail Rodamco SE and Legrand SA being examples).
- At a sector level, the relative performance of the Financials segment of the fund was strong despite being materially overweight when the sector under-performed the index. Good stock picking via the likes of Munich Re and not owning BNP Paribas SA helped.
- Likewise in the Industrials space the fund was over-weight and out-performed despite the sector performing poorly against the benchmark. The was in part due good performances from Siemens & Lufthansa and in part due to a bias towards higher quality stocks such as Atlas Copco AB, Befesa SA and Kone AG.
- Lastly, the Telecoms sector was a notable out-performer over the period, with the fund having a strong over-weight position.
- Conversely on the negative side, being underweight the Utilities sector impacted the fund demonstrably via not owning the likes of Iberdrola SA and Enel Spa.
- Similarly, continued poor performance from the Auto sector (the component suppliers in particular) resulted in the Consumer Discretionary segment of the portfolio under-performing the benchmark. Notable detractors in terms of stock selection were Faurecia SA and Valeo SA on the back of lingering concerns around trade disruption and consumer demand, particularly in China. NB we exited the position in Valeo during the quarter in favour of Melrose, an off-benchmark position where we have greater conviction around the self-help story with the automotive and aerospace parts businesses.

Portfolio Activity

- Q4 was a notably active period for the portfolio as market moves facilitated the decision to increase exposure towards higher quality, high ROCE stocks across various sectors. Conversely the decision was taken to exit a number of positions where conviction was low and similar exposure could be found either through existing or new positions. There was no deliberate attempt to shift the portfolio towards a more defensive stance but merely to gain exposure to fast growing, compounding dividend streams in high quality franchises.

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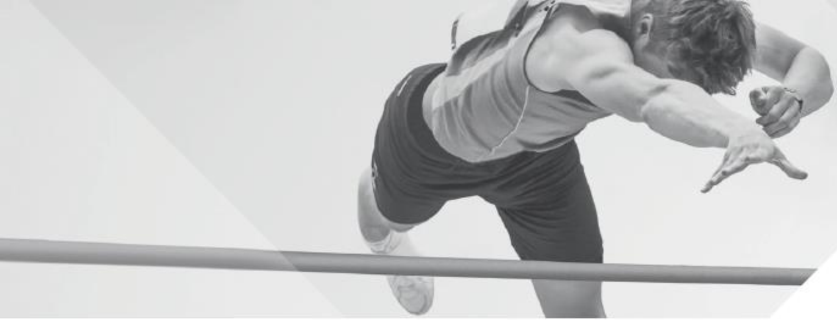
- During the quarter we have started new positions with: Kone AG, Amadeus IT Group SA, Heineken NV and L'oreal SA.
  - Regarding Kone, We like the company for its high quality characteristics, principally a leading position in a globally consolidated industry with high barriers to entry and excellent long-term growth prospects. Accompanying the high returns on capital is a strong balance sheet that offers the longer-term potential to tie-up with Thyssen Krupp's elevators business and realise significant synergies. An attractive and growing dividend yield also interests us.
  - For Amadeus, We started a position on the back of Q3 results, which were taken badly by the market (an incorrect conclusion in our view). We believe this to be one of the highest quality companies in the Eurozone universe, with a dominant market position in the provision of global airline software & IT services. The resultant high returns on capital and excellent growth in revenues, profits and free cash flow set it apart from the global and European peer group. We have used subsequent weakness in the shares to increase the position size.
  - Concerning Heineken, We believe the company to be one of the highest quality Consumer Staples names in the universe. Aside from its tremendous brand strength we find the management team to be highly competent in both how they run the operations and allocate capital. In addition to strong market positions in Vietnam, Mexico & Nigeria the recent entries into Brazil and China offer exciting growth prospects at sensible prices. The company has a dividend yield of c.2% with a 5 year track record of over 10% annual growth.
  - Lastly, for l'Oreal, the pullback in the share price early in the quarter offered a rare opportunity to start a position in what we believe to be one of the world's finest consumer franchises. Not only does the company possess some of the most globally recognisable brands (L'Oreal Paris, Maybelline, Vichy, Lancome, La Roche-Posay etc), it has a long track record of organic sales growth and high returns on capital. It also provides valuable exposure to burgeoning demand from the Chinese middle class. On the aforementioned setback the shares were yielding nearly 2% whilst having grown the dividend at a 9% CAGR over the prior 5 years. We think this company has all the hallmarks of a strong compounder of capital over time.
- During the quarter we have Sold with: Bayer AG, Credit Agricole SA, BASF SE, Banco Santander
  - Regarding Bayer AG, We attended the Capital Markets Day in early December and left unconvinced by the detail surrounding the turnaround program which requires, inter alia, a material cultural shift at the company. Whilst the potential for positive change appears interesting at first glance, we can find more advanced progress of shareholder-focused change in other (German) portfolio holdings such as Siemens. We find what Bayer is attempting to do neither unique nor ambitious and feel that the process is likely to take a number of years, with limited guarantee of success. In the interim, the legal overhang around glyphosate remains. We think Bayer is a well-invested business but prefers to invest in its spin-offs (Covestro) rather than the core.
  - For Credit Agricole SA, Having reviewed the Financials exposure of the portfolio we took the decision to lower the material sector overweight via closing the position in Credit Agricole. We can find many of the attributes of the company within other sector holdings and feel our conviction is stronger elsewhere.



- Concerning BASF SE, Having reviewed the Chemicals exposure within the portfolio the decision was taken to exit BASF on the basis that a faster growing, higher ROCE and free cash flow generative combination can be made via owning Covestro for its upstream chemical assets and Sika for its downstream assets. We believe the blend of the two businesses, together with a potential third candidate, makes for a superior combination yet is achieved by paying only a small price premium to BASF's current valuation (10-15% on 2019 EV/EBIT multiples). To be fair one does need to make a modest sacrifice in terms of dividend yield but we believe that is more than accounted for via stronger growth prospects.

- Laslty, Banco Santander's position in the fund was based, to an extent, on the exposure it provided to Emerging Markets (EM), as well as the discount investors paid for the domestic Spanish and UK operations. Following the underperformance of Heineken in recent months it is our belief that the company provides a more attractive way to gain EM exposure. Consequently, given the significant overweight in Financials and contrasting underweight in Consumer Staples it was decided to use Santander as a source of capital to fund the purchase of Heineken.

Outlook

- Since our last outlook comment we have witnessed a steep decline in markets. However, we have also witnessed a considerable change in the likely path of US interest rates. Fed Fund futures now indicate a small cut by the end of 2019 and a larger one into 2020.
- At the start of 2019 this has ushered in something of a relief rally based on the growing belief that the Quantitative Tightening phase is sensitive to change in the economy on the ground. The weakening of economic prospects in the US, China and Europe has certainly softened the tone of monetary policy makers. The chances of a recession in the US have grown, albeit a mild one.
- In light of this change and the steam that has been taken out of the valuation multiples of stock markets in Q4, the prospects for equities now look more stable. We would expect the investment backdrop to remain volatile with both sharp rises and sell offs as we navigate this period of normalisation in monetary backdrop.

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