Q1 2023

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

- 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 ECB also raised rates by 50bps citing inflation concerns.
- 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, with the Eurozone yearly inflation trend also slowing down to 6.9% for March.
- The US Manufacturing PMI came in slightly higher in March at 49.2 vs. 47.3, with sentiment increasing on production and employment. The Eurozone Manufacturing PMI came in slightly lower for March at 47.3 vs. 48.5 for the prior print, but better than the 47.1 expected, with sentiment decreasing on production, new orders, and exports.
- Looking at small and mid-caps (‘SMID’) more specifically, the MSCI World SMID Cap Index was up +4.4% over Q1. Most sectors of the index were in positive territory at the end of the quarter, led by Information Technology, Communication Services, Consumer Discretionary and Industrials. On the other hand, Energy, Financials and Real Estate were negative contributors for the quarter.
- Global SMID cap valuations remain very attractive with the MSCI World SMID Cap Index trading at a P/E of 15.1x at the end of March (on a 12-month forward basis). This represents a 37% discount to the MSCI World Growth Index and a 7% discount to the MSCI World Index.
- Earnings growth expectations for global SMID caps stand at approximately 2% for 2023e, which remains above their all-caps counterparts. 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’ SMID 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 Global SMID Cap Equity offers this “Quality at a Reasonable Price” potential throughout this cycle.

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Performance Review

- UBAM - Bell Global SMID Cap Equity returned an excellent +6.39% during the first quarter of the year (Class IC USD, net of fees); it materially outperformed the MSCI World SMID Cap Index, which returned +4.39% over Q1. March was a particularly good month where the Fund rose by 2.8%, protecting capital in a declining environment that saw the benchmark decline by 1.7%. Since its inception in February 2021, our Fund has outperformed the MSCI World SMID Cap Index by a significant +798bps 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. The strategy benefitted from a lack of exposure to Financials (6% underweight), Energy (4% underweight) and Real Estate (6% underweight), which more than offset the negative impact of being overweight in Health Care (8% overweight). More specifically, the total lack of exposure to Banks helped, as the industry lagged the broader market by more than 12% in the wake of the SVB and US regional bank crisis. Regional allocation was a small positive, primarily due to the overweight to Europe.
- The position that contributed the most to portfolio returns in the first quarter was Arista Networks, which rallied nearly 40% (+91bps 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; however, there is still excellent opportunity for upside over the long term and it remains one of the largest positions in the portfolio.
- Other strong contributors included airline and travel related IT distribution platform Amadeus (+61bps contribution), handheld asset tracking computer maker Zebra Technologies (+60bps contribution), vehicle and bicycle suspension manufacturer Fox Factory Holdings (+46bps contribution), and remote patient monitoring company Masimo (+42bps contribution).

- Due to the strong performance of the portfolio, there were only a few companies that declined over the quarter. The biggest detractor was Japanese business broker Nihon M&A that reported lacklustre results and declined 39% (-89bps contribution). The investment team has recently spoken to management to gain a better understanding of what initiatives they are putting in place to accelerate the number of deals they participate in. Although execution of these strategies has room for improvement, the secular tailwinds in the industry remain strong. The only other weak significantly weak performer was Jack Henry & Associates that provides software platforms for banks. It fell 14% in the quarter (-24bps contribution) due to concern that there may be further pressure on smaller regional and community banks given the recent issues in the industry. The team added to the position on weakness since Jack Henry has an extremely diversified client base of banks and credit unions, and there is no customer concentration risk. Although there is some risk that customers reduce investment, which may slow Jack Henry's revenue growth, at present the backlog of business remains solid. This gives the team confidence that there is good revenue visibility and good upside in the stock when investor sentiment normalises.
- In terms of ESG credentials, the UBAM - Bell Global SMID Cap Equity portfolio remained AAA rated by MSCI ESG Research at the end of March. Its 9.1 ESG Quality Score remains comfortably above the SMID Cap Index at 7.9. Looking at environmental risk more specifically, our strategy was showing 88% less carbon risk than its benchmark at the end of the quarter (in tonnes CO_2e/USD million sales).

Portfolio Activity

- After the strong rally, cash level increased over the period. The portfolio began the period with a relatively low level of cash at 1.6%. At the end of March, the cash position had increased to 3.1%.
- Besides the increase in cash, the key change to sector allocation was a 1.8% reduction in Industrials (ending at 23%), which was similar to the reduction in the previous quarter. 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. At a regional level, after a strong performance in the US, exposure was reduced; however, at around 53% of the portfolio, it remains the largest exposure.
- At a stock level, the investment team has been opportunistic from a trading perspective and introduced three new positions whose share prices had drifted lower: Advanced Drainage Systems, Neste and SGS. Neste is a highly innovative Finnish based energy company focused on the growing renewable fuels market. It has an extensive network of feedstock suppliers from which they buy animal fats, used cooking oils and other inputs to refine into renewable diesel. Neste has recently opened new refining capacity in Singapore from where they will supply SAF (sustainable aviation fuel) to the many airlines that have signed up to use their product, which should help reduce carbon emissions. Neste is a leader in this rapidly growing market, helping them achieve strong margins, plus they have a track record of disciplined capital allocation. The shares currently trade on a very attractive 12-month forward price/earnings ratio of 14.5x, and the investment team sees strong upside over the medium and long term.
- 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.

- Looking at sector allocation, the portfolio remains diversified and fairly conservatively placed, with the most preferred sector being Industrials (23%), which is an array of predictable business that are much less cyclical than what might typically be expected in this sector. Health Care (17%) also remains a significant exposure.
- In terms of least preferred sectors, the largest underweights remain Real Estate (6% underweight) and Financials (6% underweight). The portfolio continues to have very low exposure to the Energy sector (4% underweight) and no exposure to the Utilities sector (5% underweight). These sectors are generally leveraged and have low returns, therefore are not attractive given the team's 'Quality' investment style.
- From a regional/country perspective, the largest allocation remains North America at 57% with the US at 51% and Canada just over 6%. The allocation to Europe increased slightly over the period ending at 30%. Allocation to the Asia-Pacific region is just under 8%.
- At the end of March, Broadridge Financial Solutions (3.2%), Kroger (3.1%), AmerisourceBergen (3.1%) and ICON (2.9%) were the portfolio's largest positions. The investment team has maintained a consistent portfolio construction methodology through this volatile period as this assists in the goal of generating a diversified contribution to overall portfolio returns.

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 global equity markets is exactly in line with the 10-year average of 16.4x. Given the fed funds rate currently sits at 4.83%, after a prolonged period of sub 1% interest rates, expensive valuations should need to rebase lower. Having said that, the Global SMID Cap cohort remains an anomaly, in that the current P/E of the MSCI World SMID Cap index sits at 15.1x, which is a 16% discount to its 10-year average and a 37% discount to the MSCI World Growth Index.
- 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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