THE DRIVE YOU DEMAND

UBAM - 30 GLOBAL LEADERS EQUITY

Quarterly Comment | Q4 2018

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

Market Comment

- All major equity markets ended the year in red with the MSCI AC World TR USD dropping -13% over the last quarter of 2018. The MSCI North America recorded the leading loss over Q4 2018 (-14.6%), followed by the MSCI Europe (-11.7%) and the MSCI Emerging Markets (-7.8%). On a full year basis, the figures are also negative with the MSCI AC World TR closing 2018 down 10%.

- Over the fourth quarter of 2018, the only sector posting positive performance was Utilities while Information Technology erased Q3 gains and dragged the MSCI AC World down -2.7%. Financials were also a big detractor to performance, costing Q4 -2.1% in returns. Over the full year 2018, only Healthcare and Utilities ended the year on a positive note as investors pursued defensive names.

- October and December brought significant losses and important swings in major stock markets and sparked fears that the deep corrections marked the beginning of a bear market. Uncertainty factors for investors mounted towards the end of 2018 around global growth slowdown, Trade War fallouts and revealed vulnerabilities along with a rate hike and a less dovish outlook delivered by the Fed in December. Further political pressure was also sensed by the market after a partial government shutdown over disagreements concerning a package of bills and the US-Mexican border wall budget.

- In terms of economic growth indicators, manufacturing indices also gave mixed signals. Over the last quarter of the year, the US, China, Germany and France saw their PMI levels deteriorating with the US ISM PMI dropping to 54.1, the lowest level in two years, however still holding up above the 50 level, i.e. in expansionary territory. Japan, Brazil and Russia continue to post low but stable PMI levels.

- Late 2018, earning revisions ratios turned negative in all major regions. While US earnings expectations for Q4 2018 remained positive at 16% growth year-on-year – in line with historical patterns – Q1 2019 estimates started reflecting lower trends (10% growth year-on-year) linked to the fading effect of corporate tax cuts on earnings and rising costs. 12-month forward P/Es dropped to multi-year lows for most global equity markets – pricing in an even more significant slowdown in earnings in 2019. In December 2018, consensus 2019 profit estimates were cut for more than half of the S&P 500 companies.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Performance Review

- UBAM - 30 Global Leaders Equity returned -11.7% over the fourth quarter, outperforming the MSCI AC World NR index by 103bps and ending 2018 with a solid outperformance of 8.7% versus the benchmark.
- As usual, most of the relative performance came from stock selection (138bps). Sector allocation was slightly negative over Q4 (-24bps), as the fund did not have any exposure to the Utilities and Real Estate sectors which outperformed the global markets.
- In terms of stock selection, McDonald’s (+58bps), Abbott (+38bps) and our absence from Apple (+41bps) were the best contributors to performance. McDonald’s delivered impressive growth numbers with their Q3 2018 results (bar the US) showing that the significant investments in store remodeling as well as technology to improve customer accessibility are starting to pay off. Abbott, the fund’s top holding at 4%, has been one of the best performing stocks over 2018, returning close to 28% and contributing 100bps of relative performance to the fund over the full year. .Apple suffered from weakness in China and lower iPhone replacement activity.
- The main detractors over Q4 2018 were Raytheon (-36bps), United Technologies (-36bps) and Amazon (-29bps). Along with the whole Aerospace and Defense segment, Raytheon dropped 25% over Q4 2018 linked to US budget concerns. United Technologies announced the completion of the Rockwell Collins acquisition and the three way split of the company at the end of November, raising questions regarding the process for the break up and valuations of the individual businesses. Amazon reported a significant sales slowdown of its online retail stores for Q3 which outweighed the achieved margin improvements. Over the full year however, Amazon remained the best performer in the fund with a return of close to 28%, delivering 123bps of positive relative performance contribution.

Portfolio Activity

- During the quarter, two positions were exited and two new ones were initiated. Facebook and Schlumberger were sold while Ecolab and Johnson & Johnson were bought.

- After five years of CFROI expansion driven by top line growth and operating margin expansion, Facebook is facing multiple challenges that the team believes will stress test its business model. The combined effects of tougher regulation around consumer data usage, higher security requirements against cyber-attacks and the need to better control the quality of information could negatively affect the company’s operating margin. Consequently, the group’s CFROI could decline by more than 10% in the next five years (from 25% in 2017), pushing Facebook out of the “beat the fade” stock list. Schlumberger’s operating cash flow never benefitted from the oil price rally that started more than a year ago: while the WTI surged above USD 70 at the end of September, cash flows stagnated/decreased on lower operating results and growing working capital needs. Schlumberger regularly blames a soft pricing environment and rising project costs and wages to justify disappointing results. The team does not expect a quick recovery as valuation remains rich (34x 2018 PE) and earnings continue to be revised downwards. Ecolab has long been considered one of the great American companies, specializing in cleaning and sanitizing products for use in several industries, including the food, energy, healthcare, industrial and hospitality markets. Ecolab’s business model and CFROI are extremely resilient, characterized by sticky customer contracts and recurring revenues. The team expects the current CFROI-level (18%) to gradually expand beyond the 20% threshold first reached in 2015. Johnson & Johnson is a mature diversified healthcare company that derives 50% of its revenues from its Pharmaceuticals unit, 32% from Medical Devices and 18% from Consumer Products. Potential upside surprises could either come from a successful restructuring of the Medical Devices division to boost its competitiveness (2022 plan) or a spin-off of this underperforming division in the mid- to long-term. The group's CFROI is forecasted to hold at around 15% in the next five years and beyond.

Outlook

- In terms of sources of risk, the delayed vote on the Brexit deal in January, Trade War escalation fears, Yellow Vest protests in France, as well as more marked signs of a global growth slowdown continue to be the main global headlines to watch for the new year.
- There has been an expectation that growth will slow down in 2019 globally. Note however the reference to slower growth, but growth is still expected in 2019. Earnings growth expectations have been revised down for all major equity markets but are still at 8% for the MSCI AC World for 2019. It would not be surprising to see this number being revised down further, after what may turn out to be a difficult fourth quarter and in view of the high base that needs to be overcome in the first half of the year. However, the second half of 2019 is likely to be more benign in terms of the comparable base and companies may again be able to show healthy earnings growth, provided that the macro-economic back drop remains supportive.
- This volatile environment continues to be favourable for the UBAM 30 Global Leaders fund which focuses on companies generating high and stable levels of CFROIs. Companies which consistently generate high and stable CFROIs tend to perform better in relative terms than other more growth, or restructuring-oriented companies in periods of market uncertainty. The portfolio is overweight the United States and Switzerland – the two markets with the highest aggregate CFROI profiles globally – and has no exposure to Emerging Markets and Japan. The main sector overweights are in Consumer Discretionary and Healthcare. The Financials sector remains underweight and the fund currently doesn't have any exposure to the Energy, Utilities, Real Estate and Telecoms sectors.

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