

UBS Australian Small Companies Fund

September 2023

Fund description

The Fund is an actively managed fund investing in a portfolio of 30–60 Australian small company equity securities across a range of industry sectors.

Target market

The Target Market Determination (TMD) for the Fund sets out the class of consumers for whom the product, including its key attributes, would likely be consistent with their likely objectives, financial situation and needs. To access to the TMD and other Fund documentation visit our website.

Investment strategy

The Portfolio Manager's overarching strategy is to identify those small company shares that are believed to be undervalued by the market. Normally the Fund will hold between 30–60 stocks in companies. Companies are selected for inclusion in the portfolio after a rigorous investment process.

Investment objective

The Fund aims to outperform (after management costs) the S&P/ASX Small Ordinaries Accumulation Index over rolling five year periods.

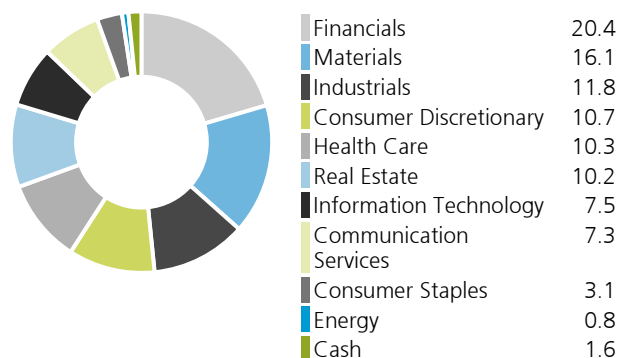
Fund information[^]

Inception date	31 March 2004
Fund size	\$ 137.0m
Management fee	0.85% pa
Performance fee*	Yes
Minimum initial investment	\$ 50,000
Typical number of holdings	30 to 60
Distributions	Quarterly
Buy/sell spread	+/- 0.45%
APIR code	UBS0004AU

[^] The UBS Yarra Australian Small Companies Fund has been renamed the UBS Australian Small Companies Fund, effective as at 9 November 2022.

* The performance fee equals 20% of the amount by which the Fund outperforms the S&P/ASX Small Ordinaries Accumulation Index.

Sector allocation (%)



Top 5 stocks

Name	Portfolio Weight (%)
Netwealth Group Ltd.	4.40
Flight Centre Travel Group Limited	4.16
Pinnacle Investment Management Group Limited	4.00
Sandfire Resources Ltd	3.95
Auckland International Airport Limited	3.88

Active security positions

Overweight	Underweight
Netwealth Group Ltd.	Pro Medicus Limited
Pinnacle Investment Management Group Limited	Paladin Energy Ltd
Collins Foods Limited	New Hope Corporation Limited
Kelsian Group Limited	Viva Energy Group Ltd.
Auckland International Airport Limited	Telix Pharmaceuticals Ltd.

Active industry positions

Overweight	Underweight
Financial Services	Energy
Transportation	Materials
Health Care Equipment & Services	Consumer Discretionary Distribution & Retail
Insurance	Pharmaceuticals Biotechnology & Life Sciences
Media & Entertainment	Commercial & Professional Services

Investment performance

Fund	1 month %	3 months %	1 year %	2 years % pa	3 years % pa	5 years % pa	Since inception* % pa
Total return	(3.76)	(0.91)	11.42	(5.23)	7.22	7.09	11.43
Benchmark**	(4.04)	(1.94)	6.85	(9.04)	2.57	1.63	5.10
Added Value	0.28	1.03	4.57	3.81	4.65	5.46	6.33

* Inception date: 31 March 2004.

** S&P/ASX Small Ordinaries Accumulation Index.

Performance figures are net of ongoing fees and expenses. The performance figures quoted are historical, calculated using end of month redemption prices, and do not allow for the effects of income tax or inflation. Total returns assume the reinvestment of all distributions. Performance can be volatile and future returns can vary from past returns.

Portfolio performance

After fees and expenses, the Portfolio declined by 3.76% during the month, outperforming its benchmark by 28 bps.

The largest contributors were Leo Lithium, Star Entertainment and Auckland Airport. Our underweight to Leo Lithium and Star Entertainment was a contributor to overperformance. Lithium company LLL underperformed during the month and went into a trading halt following correspondence from the Malian Junta government over a new mining code. Casino operator SGR underperformed following its announcement of a \$750m capital raising at a 20% discount to de-lever the balance sheet following a \$2.8b impairment, restrictions on operations and ~\$600m in provision for regulatory compliance (including fines). Auckland Airport outperformed during the month despite no major company news.

The largest negative contributors were Paladin Energy, Pro Medicus and Healius. Our underweight to Paladin Energy was a source of underperformance as the uranium miner benefitted from a rising uranium price. Similarly, our underweight to Pro Medicus was another source of underperformance as the health imaging company outperformed during the month following an announcement of a 10-year \$140m contract with Baylor Scott & White Heath. Healius continued to weaken following concerns raised by the ACCC over its potential merger with Australian Clinical Labs (ACL).

Market review

Australian small caps retracted further in the month of September with most sectors closing in negative territory.

The S&P/ASX Small Ordinaries Accumulation Index returned -4.0% taking its 12-month return to +6.9%. The broader S&P/ASX 300 Accumulation Index also declined and reported a return of -2.9% for the month and, globally, the MSCI World Index fell by 4.3%.

The best performing sector during the month was Energy (+15.1%) as companies within the Coal and Consumable Fuels sub-sector rallied. Paladin Energy (PDN, +30.2%) was a main source of outperformance as the uranium miner benefitted from a rising commodity price (uranium price was US\$70/lb at month-end). Other notable stocks were Boss Energy (BOE, +39.8%), New Hope Corporation (NHC, +12.8%) and Deep Yellow (DYL, +48.6%).

The Industrials sector (+0.1%) was broadly flat for the month. The Capital Goods sub-sector contributed positively, with Ventia Services (VNT, +3.7%) one of the main contributors following a solid FY23 result. Silex Systems (SLX, +9.4%) also outperformed, as the uranium enrichment technology company enjoyed the upside of a rising uranium price.

By contrast, the Real Estate (-8.1%) sector was among the weakest performers for the month. The Office and Retail REITs sub-sectors were largely impacted as high interest rates are expected to persist. Notable stock detractors include Charter Hall Retail (CHC, -10.0%), BWP Trust (BWP -9.5%) and National Storage REIT (NSR, -6.0%).

Outlook

With the major central banks declaring that further interest rates are now data dependent and as evidence continues to accumulate that inflation continues to moderate, our long-held view that mid-2023 would mark the top of the interest rate cycle appears to be broadly on track. Crucially, both labour markets and core services inflation have eased in recent months and forward indicators suggest further progress should be made through the rest of 2023.

Moreover, the pessimistic tone of the economic activity data in the US that threatened a technical recession has given way to slightly more upbeat data in recent weeks encouraging the belief that the US will escape a technical recession in 2023. Indeed, some leading indicators are suggesting that a broader turn in the global industrial cycle is at hand, which should encourage a rotation from a narrow mega-cap tech led equity market rally to broader participation in 2023.

Indeed, our leading indicators suggest the negative earnings per share revisions trend has now largely run its course which when combined with a levelling out in economic momentum and an end to the interest rate tightening cycle will likely provide greater confidence in underlying valuations and a shift from bearish equity positioning. Bond yields continue to provide the more significant challenge to equity market valuations, albeit the lift in bond yields into mid-2023 can mostly be attributed to a significant lift in the supply of US bonds as the US budget deficit continues to increase sharply, thereby providing a counter cyclical boost to economic growth.

Economic growth has also slowed in Australia, recording just 0.4%q/q growth in the June quarter, repeating the same languid growth recorded in the March quarter. Indeed, with population growth running at a 2.5% annualised pace in the six-months to June and economic growth expanding at an annualised 1.8% pace over the same period, Australia has recorded its first per capita recession since mid-2006 (excluding the COVID lockdown period). It is clear the prior tightening of monetary policy is having a material impact on the interest rate sensitive parts of the economy. For instance, discretionary consumption volumes have declined 0.6% (six-month annualised) as non-discretionary household expenses and interest costs soared by 16%yoy – the fastest annual increase since 1989. Building approvals continue to decline – now down 45% from the 2021 peak - and are likely to fall further in coming months as declining housing affordability outweighs the impact of an under supplied housing market.

Nevertheless, the good news is that after a pause in the tightening cycle in July, The Reserve Bank of Australia (RBA) has remained on hold and flagged that future monetary policy adjustments will be data dependent. To be clear, the RBA retains a tightening bias, however an update of their inflation forecasts now has inflation returning to inside the target band in 2025, providing a signal that absent any unexpected inflation shocks the RBA's rate tightening cycle is complete. The RBA also revised down economic growth modestly to just 1.0% in 2023, acknowledging that local economic growth had faltered. It is of note that the RBA's forecasts for domestic growth are now below our own for the first time since 2019.

Australia should still be able to avoid a technical recession due to four key reasons:

1. Australia has been a net beneficiary of global commodity shortages and the prior surge in commodity prices. Although commodity prices remain elevated from a historical perspective, they are now off their peaks. The impact of moving through the peak will be for nominal GDP growth to slow quickly over the next six months, removing some of the cushion that has protected corporate profits, tax receipts and wage growth.
2. The household sector continues to hold a significant buffer of excess savings which can be used to smooth consumption growth amid acute cost of living pressures. Nevertheless, our analysis suggests that the residual of the savings buffer skews to older households, leaving younger and more indebted households exposed. As such, we remain particularly cautious on discretionary retail spending.
3. Australia remains incredibly well placed to benefit from the global energy transition. Lithium is already a A\$10bn export industry domestically and Australia is the world's dominant producer. Electric Vehicle sales are forecast to increase 10 times by 2030 and Australia has the world's second largest copper resource. LNG is an important energy transition fuel – it currently accounts for 23% of global electricity generation – and Australia just happens to be the world's equal largest exporter of LNG. The limiting factor nearer term is that escalating costs and project delays risk pushing out the economic benefits.
4. Net migration into Australia contracted in 2021 for the first time since 1945. However, a very strong recovery was recorded through 2022 and a record level of net migration has occurred in recent months, ensuring that Australia's population growth will exceed 2.5% in 2023. This will be the primary mechanism keeping Australia out of recession, yet it comes with the complication of exacerbating the rental shortage evident across all capital cities.

While the RBA has been later than most other developed nations, we believe financial conditions are now firmly in the restrictive zone. While interest rate hikes in Australia will remain a month-to-month proposition, our analysis suggests that the RBA should have concluded its hiking cycle. Moreover, we do expect that the RBA will commence a modest easing cycle in 1H24, most likely commencing in May 2024.

The A\$/US\$ had been under downward pressure as markets grappled with a seemingly more hawkish Fed relative to the RBA and poor sentiment on the economic outlook for China. However, with Australia's external accounts remaining in excellent health, our expectation that Australia's economic growth will prove more robust, and the prospect the US\$ down trend will re-emerge as the Fed pivots from its hiking strategy to an easing cycle in early 2024, we expect the A\$/US\$ will appreciate to the low-70s towards mid-2024.

We are most overweight stocks within the Financials, Industrials and Health Care sectors and are underweight Energy, Materials and Consumer Discretionary.

Client Services

www.ubs.com/am-australia

Telephone: (03) 9046 4041

Freecall: 1800 572 018

Email: ubs@unitregistry.com.au

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