UBS

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All data as at 30 June 2023

UBS Australian Small Companies Fund

June 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

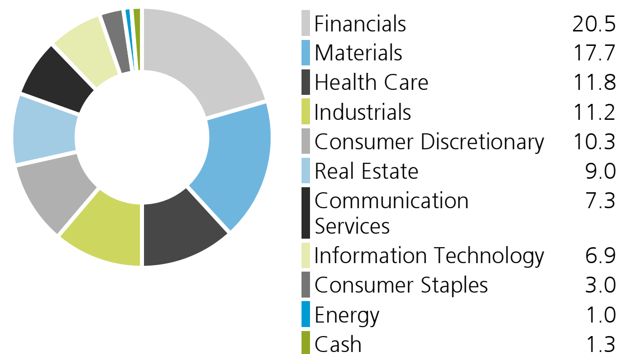
The Fund aims to outperform (after management costs) the S&P/ASX Small Ordinaries Accumulation Index over rolling five year periods.

Fund information^

Inception date	31 March 2004
Fund size	$ 124.4m
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 (%)
Pinnacle Investment Management Group Limited	4.36
Kelsian Group Limited	4.09
Auckland International Airport Limited	4.09
Netwealth Group Ltd.	4.06
Flight Centre Travel Group Limited	3.83

Active security positions

Overweight	Underweight
Pinnacle Investment Management Group Limited	Chorus Limited
Netwealth Group Ltd.	Pro Medicus Limited
Kelsian Group Limited	National Storage REIT
Auckland International Airport Limited	Perpetual Limited
Collins Foods Limited	Telix Pharmaceuticals Ltd.

Active industry positions

Overweight	Underweight
Health Care Equipment & Services	Materials
Transportation	Energy
Financial Services	Consumer Discretionary Distribution & Retail
Insurance	Pharmaceuticals Biotechnology & Life Sciences
Media & Entertainment	Equity Real Estate Investment Trusts (REITs)

Investment performance

Fund	1 month %	3 months %	1 year %	2 years % pa	3 years % pa	5 years % pa	Since inception* % pa
Total return	0.90	1.30	14.45	(1.68)	10.58	7.78	11.64
Benchmark**	0.03	(0.54)	8.45	(6.58)	5.16	2.25	5.27
Added Value	**0.87**	**1.84**	**6.00**	**4.90**	**5.42**	**5.53**	**6.37**

* 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 increased by 0.90% during the month, outperforming its benchmark by 87 bps.

The largest positive contributors were Collins Food, AUB Group and Pinnacle Investment Management. Restaurant operator Collins Food outperformed during the period after providing a stronger-than-expected result, in particular in Europe, and outlook commentary that indicated an improving outlook. Our positive view toward its Australian and European KFC businesses is supported by significant new store growth potential, defensive existing store sales growth and margin expansion from depressed levels as cost headwinds moderate. AUB continued to outperform due to upgrades to guidance, positive premium growth trends, and solid execution on the Tysers acquisition. The company also raised $150m during the period to retain its Tysers UK Retail business (which was to be sold) and increase capacity for M&A. We retain our positive view, with AUB remaining a key overweight. Pinnacle Investment Management outperformed during the period, in part supported by stronger than expected inflows of +$1.9bn during the first three months of 2023. Going forward, we believe revenue growth will accelerate, with material longer term growth potential as market conditions normalise from depressed levels, inflows re-accelerate across its diverse range of products and via international distribution, performance fees increase from near zero and new products mature.

The largest negative contributors were Gold Road Resources, TPG Telecom and Flight Centre. Our overweight position in gold producer Gold Roads Resources underperformed as gold prices declined 3% to close at US$1,908/oz at month-end. Additionally, the company downgraded full year production guidance due to flooding and mechanical issues at Gruyere mine during June. We continue to favour Gold Roads, with its Gruyere gold mine project (50% owned) a high-quality and low-cost operation, supported by a JV partner with deep operating expertise, while its 19.9% stake in fellow small-cap gold miner De Grey Mining offering significant strategic value and access to the very large Mallina gold mine development opportunity. TPG Telecom underperformed during the period, after the telecommunications company saw its proposed network sharing agreement (MOCN) rejected by the Australian Competition Tribunal. The decision leaves TPG without a partner for regional network access, resulting in network coverage that remains behind that of peers Telstra and Optus. Flight Centre underperformed during the period, partly reducing the level of outperformance over the last 12 months. While there were some expectations of an earnings upgrade at its June investor day (which did not materialize), it should be noted that earnings guidance was already upgraded at the start of May and, more importantly, the outlook remains positive as travel demand continues to increase.

Market review

Australian small caps were flat through the month of June (S&P/ASX Small Ordinaries Accumulation Index) while the 12-month return stands at +8.5%.

By comparison, the broader S&P/ASX 300 Accumulation Index gained +1.7% for the month and, globally, the MSCI World Index delivered a solid gain of +6.1%.

Higher interest rates were a feature during the month, with the Australian 10-year government bond yield rising to 4.0% and the cash rate increasing a further 25 bps to 4.1%.

The best performing sector during the month was Financials (+6.5%), with AUB Group (AUB, +16.3%) a key contributor reflecting upgrades to guidance and positive premium growth trends. Magellan Financial (MFG, +20.3%) was another strong mover in the index.

Energy (+4.8%) also contributed positively to returns, largely driven by Paladin Energy (PDN, +33.9%) after the uranium miner rebounded from the previous month's drop in performance on the back of expectations that Namibian government could nationalise its uranium mines.

Conversely, the Materials (-2.0%) sector was among the weakest performers for the month, with gold being the lagging sub-sector. Notable stocks were Lake Resources (LKE, -43.4%) which announced a worse-than-expected update on its Argentinian Kachi Lithium project, and Gold Road Resources (GOR, -15.6%) which traded lower alongside a ~3% decline in gold prices towards month-end.

Outlook

We have been of the view that the June quarter 2023 will mark the top of the interest cycle for most of the developed world, however, global central banks are seemingly prepared to continue hiking interest rates despite evidence inflation is moderating, lending availability tightening and economic growth faltering. With respect to the latter, we have received confirmation that the Euro Area entered recession and the Federal Reserve staff have retained their forecast that a modest recession in the US is likely. Nevertheless, it seems the appetite for policy makers to persist with the tightening cycle into Q3 has remained, with central bankers seemingly perplexed at why services inflation has yet to ease and why the labour market has yet to ease appreciably. It is possible that a pause in the hiking cycle in June by the Fed will set the scene for a pause across most of the developed world, however, the risk of overtightening and even weaker economic activity is now a real prospect. We believe the US labour market is set to post more modest employment gains from mid-23 which in concert with improving labour supply will continue to moderate wage growth and help underwrite the commencement of a gradual easing cycle in the US by the end of 2023. However, we have to acknowledge that the message from most central banks is that further hikes may be required and an interest rate easing cycle is not in prospect.

This weak economic growth narrative in concert with enthusiasm over the potential impacts from AI has seen large cap ‘growth’ stocks drive a narrow but strong equity market rally. This has largely hidden from view an ongoing negative earnings revision cycle which in concert with rising bond yields is leaving aggregate market valuations looking more challenging.

Economic growth has also slowed in Australia, recording just 0.3%qoq growth in the March quarter and much of this growth can merely be traced to strong population growth and ongoing engineering construction projects. It is clear the prior tightening of monetary policy is having a material impact on the interest rate sensitive parts of the economy. Nominal retail sales have slowed to 0% six - month annualised, following on from declining volumes in recent quarters. Building approvals continue to decline and are likely to decline further in coming months as declining housing affordability outweighs the impact of an under supplied housing market. Moreover, it is also clear that despite the Federal Budget forecast to return to surplus, that government demand growth is waning even faster than private demand growth.

Nevertheless, after describing the May decision to increase interest rates as finally balanced, the Reserve Bank of Australia (RBA) followed up with a further hike in June and a pause in July, but has flagged that further tightening may be required. The RBA has clearly shifted its focus to worrying about weak productivity growth and high unit labour costs as the main reason for fearing inflation may be higher than it forecasts. We think this ignores the fact that average compensation per hour has not risen sharply, and the main reason for high unit labour costs is a surge in hours worked and employment as the influx in immigration is absorbed into a slowing economy.

While this shift in the RBA’s focus risks a further hike in August, in our view the RBA would have been better served to pause after the May rate hike, rather than risking a harder economic landing.

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. Commodity prices are now off their peaks, and although they remain very elevated from a historical perspective, the impact of moving through the peak will be for nominal GDP growth will slow quickly over the next 6 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 for Australia 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 2nd largest copper resource. LNG is an important energy transition fuel, and currently accounts for 23% of global electricity generation. 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% 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. From our perspective, the RBA’s focus on global growth, trends in household spending and the outlook for inflation and labour markets in informing their future decisions suggest that multiple additional hikes are unlikely to be required. While interest rate hikes in Australia will remain a month-to-month proposition for the next six months, our bias is that the RBA should have concluded its hiking cycle, yet an ever-shifting RBA framework suggest they may hike again in August. It is unlikely that policy easing will be delivered in 2023, however, we do expect that the RBA will commence a modest easing cycle in 1H24.

The A$/US$ had been under downward pressure as markets grappled with a seemingly more hawkish Fed and a relatively more dovish RBA. However, the RBA has

recently sounded more hawkish than the Fed the A$ has started to appreciate. 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 persist as the Fed pivots from its hiking strategy to an easing cycle in 2023, we expect the A$/US$ will appreciate to the mid-70s towards the end of 2023.

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

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