UBS

UBS Asset Management
For Professional / Qualified / Institutional Investors only
All data as at 31 May 2023

UBS Australian Small Companies Fund

May 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.

Active security positions

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

Active industry positions

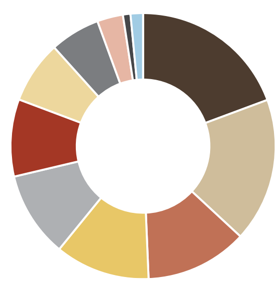
Overweight	Underweight
Health Care Equipment & Services	Materials
Transportation	Energy
Financial Services	Consumer Discretionary Distribution & Retail
Insurance	Pharmaceuticals Biotechnology & Life Sciences
Media & Entertainment	Equity Real Estate Investment Trusts (REITs)

Fund information^

Inception date	31 March 2004
Fund size	$ 123.2m
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.

Fund positioning (%)



Financials	19.35
Materials	17.52
Health Care	12.46
Industrials	11.56
Consumer Discretionary	10.42
Real Estate	9.39
Communication Services	7.60
Information Technology	6.10
Consumer Staples	3.15
Energy	0.92
Cash	1.52

Top 5 stocks

Name	Portfolio Weight (%)
Auckland International Airport Limited	4.28
Flight Centre Travel Group Limited	4.27
Kelsian Group Limited	4.13
Pinnacle Investment Management Group Limited	3.93
Netwealth Group Ltd.	3.76

Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	(3.03)	0.98	0.11	10.55	7.74	11.64
Benchmark**	(3.26)	(1.29)	(5.77)	4.46	2.46	5.29
Added Value	**0.23**	**2.27**	**5.88**	**6.09**	**5.28**	**6.35**

* 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 3.03% during the month, outperforming its benchmark by 23 bps.

The largest contributors were Kelsian Group (KLS), Pinnacle Investments (PNI), and Megaport (MP1). Kelsian outperformed during the period despite no material company specific news. We have a positive outlook for its three divisions spanning Australian buses, US buses and Australian tourism. Pinnacle Investments' outperformance in May was partly encouraged by stronger than expected inflows during 1Q23 (+$1.9bn). Going forward, revenue growth, inflows, performance fees and international distribution are expected to reaccelerate. Megaport also outperformed following the release of stronger than expected March quarterly results, with forward guidance for FY24 materially ahead of consensus expectations at both revenue and margin level, leading to material earnings upgrades and an improved balance sheet position.

The largest negative contributors were oOh!Media (OML), 29Metals (29M), and Nanosonics (NAN). OML was an underperformer during May reflecting short-term cyclical headwinds to revenue and higher than anticipated costs on contract renewals. 29Metals was a detractor to the portfolio as copper prices declined by 5% to close at US$3.68/lb at month-end. Disinfection medical device company Nanosonics underperformed during the period following significant outperformance in prior months, despite no specific company news.

Market review

The Australian small cap market performed poorly in the month of May, with nearly every sector delivering negative returns. The 10-year bond yield rose to 3.6% following the resumption of RBA cash rate hikes.

The S&P/ASX Small Ordinaries Accumulation Index recorded a return of -3.3% for the month, taking its 12-month return to -5.7%. Similarly, the S&P/ASX 300 Accumulation Index generated a -2.5% return for the month and globally, the MSCI World Index returned -0.9%.

Information Technology (+4.9%) was the top performer for the month, led by Life360 (360, +34.1%) reflecting the benefit of large price increases to revenue. Other notable stocks that also contributed to the sector's positive performance were Weebit Nano (WBT, +27.4%) and Megaport (MP1, +21.1%).

Industrials (+1.9%) also delivered a positive return for the index, with primary contributors including Kelsian (KLS, +11.5%) and Fletcher Building (FBU, +10.2%).

By contrast, Energy (-6.7%) delivered the worst performance during the month. New Hope (NHC, -13.2%) and Paladin Energy (PDN, -16.8%) were the biggest drivers of the sector's negative performance. Closely behind was Materials (-6.1%) as declines in commodity prices were observed across the board (Bloomberg Commodity Index fell by 6.1%).

The Consumer Discretionary (-5.7%) sector also reported negative returns for the month, driven by a number of retailers including Lovisa Holdings (LOV, -22.5%), Premier Investments (PMV, -13.9%) and Super Retail Group (SUL, -15.5%).

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 tightened and economic growth is 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 markets 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 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. This shift in the RBA's focus risks a further hike in July or August, however, 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. Surprisingly, the RBA cited the A$ and house prices as a catalyst for the May rate hike, neither of which had risen materially. 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 July or 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.

Client Services

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