

UBS Microcap Fund

August 2023

Fund description

The Fund is an actively managed fund investing in a portfolio of 35 to 65 predominantly Australian Microcap equity securities across a range on 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 Microcap shares that are believed to be undervalued by the market, based on an assessment of the companies' future cash flows. Normally the Fund will hold between 35–65 stocks in companies with a market capitalisation of generally less than \$250m at the time of initial purchase. The Portfolio Manager searches for businesses that have exposure to growing markets or are benefiting from changes in market structure and are in a rapid growth phase of their life cycle.

Investment objective

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

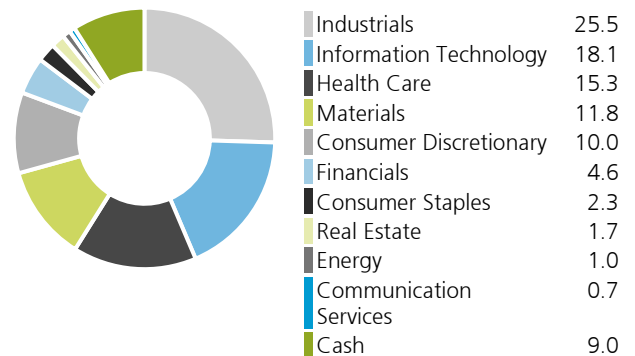
Fund information[^]

Inception date	12 August 2014
Fund size	\$ 58.0m
Management fee	1.20% pa
Performance fee*	Yes
Minimum initial investment	\$ 50,000
Typical number of holdings	35 to 65
Distributions	Semi-annually
Buy/sell spread	+/- 0.50%
APIR code	UBS0057AU

[^] The UBS Yarra Microcap Fund has been renamed the UBS Microcap 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. The performance fee equals 20% of the amount by which the Fund outperforms the S&P/ASX Small Ordinaries Accumulation Index

Sector allocation (%)



Active security positions

Overweight	Underweight
Monash IVF Group Ltd	Liontown Resources Limited
Lycopodium Limited	Pro Medicus Limited
Botanix Pharmaceuticals Limited	Flight Centre Travel Group Limited
GR Engineering Services Ltd	Chorus Limited
SmartPay Holdings Limited	Sandfire Resources Ltd

Active industry positions

Overweight	Underweight
Capital Goods	Materials
Software & Services	Equity Real Estate Investment Trusts (REITs)
Health Care Equipment & Services	Financial Services
Retailing	Consumer Discretionary Distribution & Retail
Pharmaceuticals Biotechnology & Life Sciences	Energy

Investment performance

Fund	1 month %	3 months %	1 year %	2 years % pa	3 years % pa	5 years % pa	Since inception* % pa
Total return	1.70	6.24	2.88	(3.52)	9.61	9.05	12.52
Benchmark**	(1.31)	2.22	(1.12)	(8.14)	3.00	2.40	5.90
Added Value	3.01	4.02	4.00	4.62	6.61	6.65	6.62

* Inception date: 12 August 2014.

** 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 1.70% during the month, outperforming its benchmark by 301 bps.

The largest positive contributors were Botanix Pharmaceuticals, Energy One and Laserbond. Botanix Pharmaceuticals traded higher as the targeted FDA approval date for their novel drug Sofpironium Bromide was reaffirmed for end of September 2023. Energy One received a non-binding indicative offer for their business at \$5.85/share being a 44% premium to its last traded price. Laserbond provided a strong FY23 result with revenue up 25.7% on pcp and net profit after tax up 31.1%.

The largest negative contributors were NextEd, XRF Scientific and PeopleIn. Tertiary education provider NextEd traded lower following a trading update highlighting the negative implications of the temporary COVID-19, 408 Visa on their business which has since ceased. XRF scientific traded lower after reaching all time highs. PeopleIn was sold off after missing their pre-announced EBITDA guidance range of \$62m-\$66m for FY23, generating \$60.9m.

Market review

The Australian small cap market performance retraced in the month of August following a volatile reporting season.

The S&P/ASX Small Ordinaries returned -1.3% for the month, taking its 12-month return to -1.1%. Whereas the broader S&P/ASX 300 generated a return of -0.8% for the period. On the global scale, the MSCI World Index declined by 2.4%.

The Energy (+4.6%) sector had a solid month, mainly enforced by positive performance of companies within the Coal & Consumable Fuels sub-sector. Paladin Energy (PDN, +15.0%) was the top contributor as it capitalised on the forward-looking demand growth of uranium as a commodity. Similarly, Deep Yellow (DYL, +37.2%) and Boss Energy (BOE, +19.2%) also benefitted from the positive outlook.

Consumer Discretionary (+3.0%) was another strong sector performer, led by Premier Investments (PMV, +16.1%) following a strategic review announcement. G.U.D Holdings (GUD, +24.0%) also outperformed on the back of a positive FY23 result. Other notable stocks within the sector were Eagers Automotive (APE, +8.4%), Breville Group (BRG, +9.0%) and ARB Corporation (ARB, +8.4%).

On the contrary, Health Care (-4.8%) was the worst performing sector. Mainly driven by Mesoblast (MSB, -55.5%), its share price plummeted after the US Food and Drug Administration (FDA) rejected a resubmission of MSB's Biologics License Application (BLA) for its novel drug candidate.

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 updated 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 EPS 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 largely 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, similar to the 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. 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 slow nominal GDP growth 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 and a relatively more dovish 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.

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