

# UBS Microcap Fund

September 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.

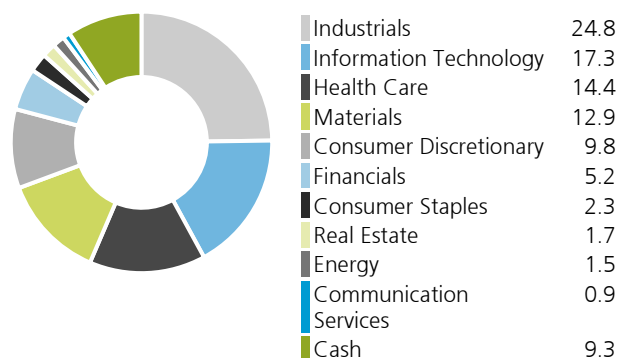
## Fund information<sup>^</sup>

Inception date	12 August 2014
Fund size	\$ 56.0m
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

<sup>^</sup> 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	Pro Medicus Limited
Lycopodium Limited	Flight Centre Travel Group Limited
Generation Development Group Limited	Paladin Energy Ltd
SmartPay Holdings Limited	New Hope Corporation Limited
Supply Network Limited	Viva Energy Group Ltd.

## Active industry positions

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

## Investment performance

Fund	1 month %	3 months %	1 year %	2 years % pa	3 years % pa	5 years % pa	Since inception* % pa
Total return	(4.14)	(0.34)	6.21	(5.31)	7.94	8.09	11.88
Benchmark**	(4.04)	(1.94)	6.85	(9.04)	2.57	1.63	5.37
<b>Added Value</b>	<b>(0.10)</b>	<b>1.60</b>	<b>(0.64)</b>	<b>3.73</b>	<b>5.37</b>	<b>6.46</b>	<b>6.51</b>

\* 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 declined by 4.14% during the month, underperforming its benchmark by 11 bps.

The largest positive contributors were Generation Development Group, Monash IVF and Leo Lithium (not held). Generation Development Group jumped on speculation that the business may be a takeover target given recent consolidation in the funds management industry. Monash IVF traded higher after the release of Medicare statistics for August which showed total cycle growth of 20.3% on the prior corresponding period. Leo Lithium (not held) was suspended from listing pending correspondence from the Mali government in relation to their Goulamina Lithium project.

The largest negative contributors were Botanix Pharmaceuticals, Paladin Energy (not held) and XRF Scientific. Botanix Pharmaceuticals traded lower as FDA approval for their novel drug Sofpironium Bromide was delayed pending additional information regarding patient use instructions. Paladin Energy (not held) traded higher on the back of a stronger underlying Uranium price. Lastly XRF Scientific was sold off despite no stock specific news.

## 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.

## Client Services

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