UBS Microcap Fund

February 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.

Active security positions

Overweight	Underweight
Monash IVF Group Ltd	Technology One Limited
Lycopodium Limited	Seven Group Holdings Limited
Ridley Corporation Limited	NIB Holdings Ltd
XRF Scientific Limited	Chorus Limited
Supply Network Limited	Charter Hall Long WALE REIT

Active industry positions

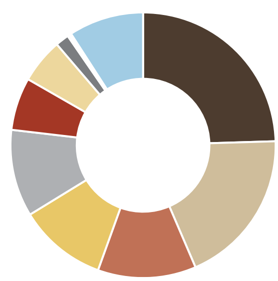
Overweight	Underweight
Capital Goods	Materials
Software & Services	Real Estate
Health Care Equipment & Services	Energy
Food Beverage & Tobacco	Diversified Financials
Transportation	Telecommunication Services

Fund information^

Inception date	12 August 2014
Fund size	$ 60.5m
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.

Fund positioning (%)



Industrials	24.52
Information Technology	19.01
Materials	11.99
Consumer Discretionary	10.74
Health Care	10.60
Financials	6.42
Consumer Staples	5.45
Real Estate	1.65
Energy	0.25
Communication Services	0.23

Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	0.76	1.15	(9.78)	10.12	9.90	12.45
Benchmark**	(3.70)	(1.21)	(7.97)	4.24	3.56	6.14
Added Value	**4.46**	**2.36**	**(1.81)**	**5.88**	**6.34**	**6.31**

* 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 0.76% during the month, outperforming its benchmark by 446 bps.

The largest positive contributors were Lycopodium, Ridley Corporation and XRF Scientific. Lycopodium provided a strong 1H23 update, increasing full year guidance across both revenue and NPAT reflecting a robust portfolio of projects and studies currently in delivery. Importantly, the business continues to be awarded new projects given high demand for base metal projects in support of the energy transition. Ridley Corporation posted a strong result, with EBITDA up 13% (y/y) to and NPAT up 20% (y/y). Management highlighted that despite challenging conditions they expect earnings growth in all business segments and improved asset utilisation. XRF Scientific continued to perform, driven by strength in the mining and industrial sectors. Sales revenue was up 46% on the pcp and NPAT was up 34%.

The largest negative contributors were Pacific Smiles, Mincor Resources, and Top Shelf International. Pacific Smiles traded lower after updating guidance to be at the bottom end of the previously advised range. Mincor Resources was sold off on the back of a weaker underlying Nickel price, in addition to a poor 1H23 result which flagged a slow ramp up of the Kambalda operation. Top Shelf International completed a capital raise to help fund the completion of their agave distillery, conducted at a 13% discount to the last traded price.

Market review

The S&P/ASX Small Ordinaries Index returned -3.7% for the month, with all sectors delivering negative returns, taking its 12-month return to -8.0%. The broader ASX300 (-2.6%) also produced negative returns for the month, as did global indices (MSCI World Index, -2.4%).

Industrials (-0.1%) was one of the better performing sectors in February, with Transportation stocks delivering positive 1H22 results reflecting better sales and margins, led by Kelsian (KLS, +12.5%) and Auckland international (+3.6%).

Information Technology (-1.0%) was also a better performing sector during the period. Despite the extreme market volatility in the technology sector there were outperformers, with notable stocks being Infomedia (IFM, +26.7%), Link Administration (LNK, +19.3%) and Tyro (TYR, +11.1%).

Insurance (+4.2%) was a top performing sub-sector during the month within the Financials (-1.3%) sector, which outperformed on the back of strong 1H22 results reflecting higher interest rates and, for the insurance broking sector, strong premium rate growth. A notable stock was AUB Group (AUB, +17.4%).

Conversely, the largest lagging sector was Materials (-8.2%), with Metals & Mining (-9.9%) being the poorest performer. With gold prices declining by 5% to US$1,817/oz at month end, the producers took a hit, in particular Regis Resources (RRL, -18.7%) and Red 5 (RED, -38.1%).

Outlook

As we near the end of the March quarter, some of the initial enthusiasm for risk has started to fade on the combination of stronger than consensus expectations data in the US and the US Fed raising the prospect of returning to 50bp hikes, after stepping down to a 25bp increment in January. This combination of events has seen bond yields rise in an environment where earnings revisions remain in downward revision mode, resulting in a relatively sharp decline in equity risk premia and leaving the equity market somewhat more vulnerable from a valuation perspective.

On balance, the better data in the US in early 2023 can be mostly attributed to unusually warm weather and we still believe the US and Europe remain near recession-like economic growth conditions in 1H23 and inflation dynamics will change sufficiently for policy makers to conclude that the monetary policy is sufficiently restrictive to halt the tightening cycle in coming months.

We continue to argue that Australia presents as a safe haven from both the perspective of more robust growth relative to the G7 peer group and as having good leverage to signs of a trough in the economic cycle in China. Although both the RBA and we expect economic activity to slow significantly in 2023 to average just 1.5%, we believe Australia should be able to avoid a technical recession due to four key reasons:

1) Australia has been a net beneficiary of global commodity shortages. This surge in commodity prices saw Australia's export prices in A$ terms move to their highest levels since the 1880s in 1H2022 and even though commodity prices are now off their peaks they remain very elevated from a historical perspective. The consequence has been strong national income growth, profits growth and an improving underlying fiscal position. Indeed, the Commonwealth Budget will likely be close to surplus for the 2023 financial year.

2) The household sector continues to hold a significant buffer of over $270bn of excess savings relative to pre-COVID levels. Although we expect the impact of higher interest rates and higher living expenses will curtail consumer spending, we do expect the combination of rising wage growth and a run down in the level of savings to continue to support consumption spending. Albeit we remain particularly cautious on discretionary retail spending, given most of the excess savings can be traced to older and wealthier households.

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 10x by 2030 and Australia has the world's 2nd largest copper resource. LNG is an important energy transition fuel, and currently accounting for 23% of global electricity generation. Australia just happens to be the world's equal largest exporter of LNG. Iron ore obviously remains Australia's biggest export and China the dominant customer. However, we expect the global energy transition to be steel intensive, opening up new customers.

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 appears likely in coming months, ensuring that Australia's population growth will be close to 2% in 2023.

While the RBA has been later than most other developed nations in tightening policy, tighter financial conditions in 2022 have come via both significantly higher cash rates, higher government bond yields and wider corporate bond spreads. Following the February and March rate hikes of 25 bps, we believe financial conditions are now in the restrictive zone and the RBA is now close to the finish of the tightening cycle. Importantly, it is clear the RBA is now openly considering pausing the hiking cycle. 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. Interest rate hikes in Australia will remain a month-to-month proposition for the next six months, however, our bias is that the last hike has likely been delivered this cycle.

The A$/US$ has been under downward pressure as markets grappled with a seemingly more hawkish Fed and a relatively more dovish RBA. Nevertheless, both central banks are in the concluding phases of the tightening cycle. 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 aggressive hiking strategy, we expect the A$/US$ will appreciate to the mid-70s through 2H 2023.

Client Services

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