

UBS Microcap Fund

May 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	Liontown Resources Limited
Lycopodium Limited	Flight Centre Travel Group Limited
SmartPay Holdings Limited	Chorus Limited
Supply Network Limited	National Storage REIT
XRF Scientific Limited	Pro Medicus Limited

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
Insurance	Energy

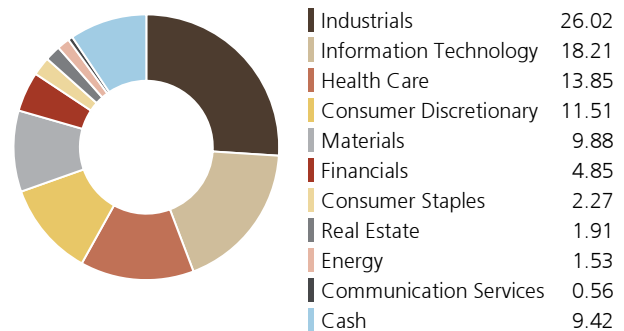
Fund information[^]

Inception date	12 August 2014
Fund size	\$ 52.7m
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 (%)



Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	(1.40)	0.43	(2.98)	14.14	9.69	12.13
Benchmark**	(3.26)	(1.29)	(5.77)	4.46	2.46	5.81
Added Value	1.86	1.72	2.79	9.68	7.23	6.32

* 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 decreased by 1.40% during the month, outperforming its benchmark by 186 bps.

The largest positive contributors were MaxiPARTS, SmartPay and Supply Network. MaxiPARTS announced and completed the acquisition of 80% of workshop consumables distributor Forch Australia which is expected to provide immediate incremental improvement to profit margins. Payment solution provider SmartPay outperformed after announcing its FY23 result which highlighted a 62% increase in revenue and 81% increase in EBITDA. Supply Network upgraded its FY23 guidance during May, highlighting that industry conditions remain very supportive.

The largest negative contributors were Lunnon Metals, Top Shelf International and XRF Scientific. Lunnon Metals traded lower, levered to the underlying Nickel price which traded around \$20,430 USD/T down from monthly highs of over \$24,950 USD/T. Top Shelf International fell after announcing it seeks to raise \$40m at a 19% discount to the 10-day volume weighted average price. The funds will be used to reduce debt while supporting the launch of their agave spirit. XRF Scientific retraced after reaching all-time highs, driven by strength in mining and industrial sectors.

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.

Client Services

Telephone: (03) 9046 4041 **Freecall:** 1800 572 018 **Email:** ubs@unitregistry.com.au www.ubs.com/am-australia

Any financial product advice in this document is general advice only and has been prepared without taking into account your personal objectives, financial situation or particular needs. Therefore, before acting on any advice, you should consider the appropriateness of the advice in light of your own or your client's objectives, financial situation or needs. Investors should consider the Product Disclosure Statement (PDS) and seek professional financial and taxation advice before deciding whether the product is appropriate for them and whether to acquire, or to continue to hold the investment. Your investment in the Fund does not represent deposits or other liabilities of UBS AG or any member company of the UBS Group including UBS Asset Management (Australia) Ltd (ABN 31 003 146 290) (AFS Licence No. 222605), the issuer and responsible entity of the Fund. Your investment is subject to investment risk, including possible delays in repayment and loss of income and capital invested. The repayment of capital or income is not guaranteed by any company in the UBS Group. Offers of interests in the Fund including the details of the management fee received by the responsible entity are contained in the PDS dated 28 September 2022. The responsible entity has also issued a target market determination (TMD) that describes the class of consumers that comprises the target market for the Fund and matters relevant to its distribution and review. A copy of the PDS (including the PDS additional information booklet) and TMD are available on our website at <https://www.ubs.com/au/en/asset-management.html> or by calling (03) 9046 4041 or 1800 572 018.

The PDS and application form is only available to persons receiving it (electronically or otherwise) while physically in Australia, unless expressly authorised by us in writing. The offer does not constitute an offer or invitation in any place in which, or to any person to whom, it would be unlawful to make such an offer or invitation. The Fund (or the PDS) has not been registered under the laws of any jurisdiction outside Australia. The Fund may not be offered or sold in the United States of America or to 'U.S. Persons' (as defined in 'Regulation S' of the Securities Act of 1933, as amended).

This document may not be reproduced or copies circulated without prior written authority from UBS Asset Management (Australia) Ltd.

Yarra Funds Management Limited (ABN 63 005 885 567, AFSL 230 251) is the portfolio manager of the Fund. The information set out has been prepared in good faith and while Yarra Funds Management Limited and its related bodies corporate (together, the "Yarra Capital Management Group") reasonably believe the investment information and opinions to be current, accurate, or reasonably held at the time of publication, to the maximum extent permitted by law, the Yarra Capital Management Group: (a) makes no warranty as to the content's accuracy or reliability; and (b) accepts no liability for any direct or indirect loss or damage arising from any errors, omissions, or information that is not up to date.

Yarra Funds Management Limited manages the Fund and will receive a fee that is paid from the fee received by the responsible entity and described in the PDS. To the extent that any content set out in this presentation discusses market activity, macroeconomic views, industry or sector trends, such statements should be construed as general advice only. Any references to specific securities are not intended to be a recommendation to buy, sell, or hold such securities. Holdings may change by the time you receive this report. Future portfolio holdings may not be profitable. Past performance is not an indication of, and does not guarantee, future performance.

References to indices, benchmarks or other measures of relative market performance over a specified period of time are provided for your information only and do not imply that the portfolio will achieve similar results. The index composition may not reflect the manner in which a portfolio is constructed. Portfolio characteristics take into account risk and return features which will distinguish them from those of the benchmark.

