UBS Microcap Fund

July 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

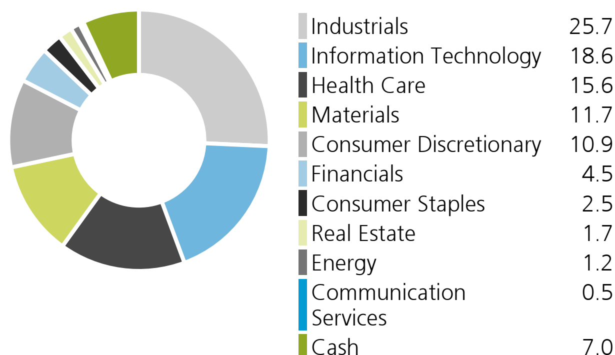
The Fund aims to outperform (after management costs) the S&P/ASX Small Ordinaries Accumulation Index over rolling five year periods.

Fund information^

Inception date	12 August 2014
Fund size	$ 55.1m
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 (%)



Sector	%
Industrials	25.7
Information Technology	18.6
Health Care	15.6
Materials	11.7
Consumer Discretionary	10.9
Financials	4.5
Consumer Staples	2.5
Real Estate	1.7
Energy	1.2
Communication Services	0.5
Cash	7.0

Active security positions

Overweight	Underweight
Monash IVF Group Ltd	Liontown Resources Limited
Lycopodium Limited	Flight Centre Travel Group Limited
XRF Scientific Limited	Chorus Limited
SmartPay Holdings Limited	Pro Medicus Limited
Supply Network Limited	Sandfire Resources Ltd

Active industry positions

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

Investment performance

Fund	1 month %	3 months %	1 year %	2 years % pa	3 years % pa	5 years % pa	Since inception* % pa
Total return	2.23	3.00	3.50	(2.45)	13.65	9.57	12.43
Benchmark**	3.54	0.20	0.77	(5.26)	5.89	3.18	6.11
Added Value	**(1.31)**	**2.80**	**2.73**	**2.81**	**7.76**	**6.39**	**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 increased by 2.23% during the month, underperforming its benchmark by 131 bps.

The largest positive contributors were Energy One, XRF Scientific and Murray Cod Australia. Energy One confirmed FY23 guidance will be met, with total revenue expected to be $44.5m and EBITDA of $12.3m. XRF Scientific reached new all-time highs, driven by strength in the mining and industrial sectors. Murray Cod Australia rallied after reiterating growth plan to achieve 10k tonnes of fish in 2030 and the successful recapture of escapee fish despite a provision of $2.6m previously made.

The largest negative contributors were NextEd, Lycopodium and Smartpay. Tertiary education provider NextEd updated the market with FY23 guidance which was slightly below expectations. The miss was largely a result of growing pains, where short-term classroom leases were booked as operating expenditure rather than being amortised. Lycopodium traded lower despite no stock specific news. Payment solution provider SmartPay reached all-time highs during the month but finished lower on fears of slower transacting volumes in the more challenging economic environment.

Market review

The Australian equities market started FY24 in a positive tone, with almost every sector gaining as of month-end.

The S&P/ASX Small Ordinaries Index returned +3.5% for the month following a flat fiscal year-end, taking its 12-month return to +0.8%. By comparison, the broader S&P/ASX 300 returned +2.9% and, globally, the MSCI World Index rose by +3.4%.

Consumer Staples (+9.5%) rallied during the month, with Costa Group (CGC, +21.7%) delivering a substantial gain for the sector on the back of it being in receipt of a $1.4bn takeover offer. All companies within the Packaged Foods & Meats sub-sector were in positive territory, with Bega Cheese (BGA, +14.0%) and United Malt (UMG, +9.6%) the main contributors.

Similarly, Consumer Discretionary (+8.6%) also rebounded from recent months of weak performance. The majority of the positive contributions stemmed from the Hotels Restaurants & Leisure sub-sector. Flight Centre (FLT, +22.7%) and Corporate Travel (CTD, +16.9%) outperformed following earnings upgrades and strong outlook commentary.

In contrast, Materials (-0.4%) was the only sector to have closed in the red for July after a mixed performance across the sector. Core Lithium (CXO, -28.9%) was a source of underperformance, after releasing quarterly results which foreshadowed challenging production due to capacity constraints in its lithium processing plant. Other notable stocks during the month were Liontown Resources (LTR, -5.0%) as the Lithium price slipped, and Sandfire Resources (SFR, +14.2%) on the back of its quarterly update.

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.

As a consequence, interest rate futures have been quick to price 125 bps of easing in the US through 2024, albeit interest rate futures in most other major economies have merely removed multiple rate hike expectations and adopted a flatter profile through 2024 around current levels rather than actively embedding interest rate reductions.

Moreover, the pessimistic tone of the economic activity data in the US that threatened a technical recession has given way to slightly more update 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.

While negative EPS revisions are likely to persist for several more months, a levelling out in economic momentum and an end to the interest rate tightening cycle will likely provide a shift from bearish equity positioning. Rising 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 0.3% q/q growth in the March quarter, with much of this growth able to be traced merely 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 fall 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, government demand growth is waning even faster than private demand growth.

Nevertheless, the good news is that after a pause in the tightening cycle in July, The Reserve Bank of Australia (RBA) remained on hold in August 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.

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 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% 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 for the next six months, our bias is that the RBA should have concluded its hiking cycle. 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 early 2024, we expect the A$/US$ will appreciate to the mid-70s towards mid-2024.

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