UBS Australian Small Companies Fund

July 2020

**Fund description**

The Fund is an actively managed fund investing in a portfolio of 30–60 Australian small company equity securities across a range of industry sectors.

**Investment strategy**

The Portfolio Manager’s overarching strategy is to identify those small company shares that are believed to be undervalued by the market. Normally the Fund will hold between 30–60 stocks in companies. Companies are selected for inclusion in the portfolio after a rigorous investment process.

**Investment return 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**

<table>
<thead>
<tr>
<th>Overweight</th>
<th>Underweight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlas Arteria</td>
<td>Appen</td>
</tr>
<tr>
<td>SeaLink Travel</td>
<td>Steadfast</td>
</tr>
<tr>
<td>Pinnacle Investment Management</td>
<td>Metcash</td>
</tr>
<tr>
<td>Healius</td>
<td>Harvey Norman</td>
</tr>
<tr>
<td>EQT Holdings</td>
<td>Breville</td>
</tr>
</tbody>
</table>

**Active industry positions**

<table>
<thead>
<tr>
<th>Overweight</th>
<th>Underweight</th>
</tr>
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<tbody>
<tr>
<td>Health Care Equipment &amp; Services</td>
<td>Real Estate</td>
</tr>
<tr>
<td>Transportation</td>
<td>Retailing</td>
</tr>
<tr>
<td>Diversified Financials</td>
<td>Pharmaceuticals Biotechnology &amp; Life Sciences</td>
</tr>
<tr>
<td>Consumer Services</td>
<td>Capital Goods</td>
</tr>
<tr>
<td>Insurance</td>
<td>Software &amp; Services</td>
</tr>
</tbody>
</table>

**Fund positioning (%)**

- Materials: 21.1%
- Financials: 17.8%
- Health Care: 14.4%
- Consumer Discretionary: 11.0%
- Industrials: 10.7%
- Information Technology: 6.4%
- Consumer Staples: 5.6%
- Real Estate: 4.3%
- Communication Services: 4.2%
- Cash: 2.4%
- Energy: 2.0%

**Top 5 stocks (%)**

- Mineral Resources: 5.1%
- Healius: 4.3%
- SeaLink Travel: 3.8%
- Elders: 3.8%
- Pinnacle Investment Management: 3.8%

**Investment performance**

<table>
<thead>
<tr>
<th>Fund</th>
<th>1 month</th>
<th>3 months</th>
<th>1 year</th>
<th>3 years</th>
<th>5 years</th>
<th>Since inception*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>% pa</td>
<td>% pa</td>
<td>% pa</td>
</tr>
<tr>
<td>Total return</td>
<td>2.01</td>
<td>13.27</td>
<td>(1.18)</td>
<td>11.59</td>
<td>10.97</td>
<td>11.90</td>
</tr>
<tr>
<td>Benchmark**</td>
<td>1.39</td>
<td>9.94</td>
<td>(8.49)</td>
<td>6.47</td>
<td>7.85</td>
<td>5.35</td>
</tr>
<tr>
<td>Added Value</td>
<td>0.62</td>
<td>3.33</td>
<td>7.31</td>
<td>5.12</td>
<td>3.12</td>
<td>6.55</td>
</tr>
</tbody>
</table>

*Inception date: 31 March 2004. **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 review

After fees and expenses, the portfolio increased by 2.01% over the month, outperforming its benchmark by 62bps. Positive contributors were Pinnacle Investment Management, Mineral Resources and Imdex. Pinnacle provided a better-than-expected market update with its larger affiliates – Hyperion, Palisade, Coolabah, Metrics and Firetrail – generating FY20 performance fees of $25.8mn, well above consensus forecasts and +69% y/y. Mineral Resources delivered a strong 4Q20 result, with quarterly iron ore production up 22% q/q to a record 4.2mn tonnes, with a realised price of $US84/t (+12%). Imdex outperformed alongside the higher gold price (+11% to $US1,965 per ounce) and after its $8.5mn acquisition of AusSpec International.

Negative contributors were AUB Group, Nanosonics and Bingo Industries. AUB Group partially retraced recent outperformance despite delivering a strong market update. Management increased FY20 guidance towards the top end of $52-53mn and reported 4Q20 premium rate increases of +6.8% (following +6.7% in 3Q20). Nanosonics underperformed without any material news, while Bingo Industries faced pressure over concerns of challenging market conditions across its Commercial & Industrial and Construction & Demolition waste streams amid the COVID-19 disruption.

Market Review

Australian small companies generated a modest return in July as strong performances from gold miners, retailers and consumer finance companies offset weakness from Health Care and Energy.

The S&P/ASX Small Ordinaries Accumulation Index increased by +1.4% in the month, taking its 12-month return to -8.5%. In comparison, the broader S&P/ASX 300 Index returned +0.6% for the month and -9.7% for the year. Globally, equities generated a solid return (S&P 500 +5.6%) supported by large cap tech stocks.

Gold (+10.3%) was among the top performers as the gold price rose 11.1% to a record high of $US1,965/oz. Top performers included Silver Lake Resources (SLR, +15.0%) and Perseus Mining (PRU, +17.2%).

Elsewhere, Consumer Finance (+15.2%) and Specialty Retail (+8.4%) outperformed amid stronger activity, with retail trade data bouncing 16.9% in May (and 2.4% in June based on preliminary data). In the former Zip Co. (ZIP, +13.8%) delivered a solid update, while in the latter Super Retail Group (SUL, +10.3%) announced better-than-expected trading.

Conversely, Health Care (-3.5%) saw declines from Avita Therapeutics (AVH, -32.6%), with its product sales impacted by COVID-19 in the US, Polynovo (PNV, -13.8%) and Nanosonics (NAN, -9.2%). In Energy (-2.9%), weaker demand for petrol following Victorian lockdown restrictions weighed on Viva Energy Group (VEA, -11.5%).

Outlook

Since early March our view has been that Australian economic data and financial markets would demonstrate a small-v shaped recovery, supported by the developed world’s 2nd largest fiscal stimulus, excess global liquidity and Australia’s likely better COVID-19 health outcomes. Australia’s economy has responded significantly to stimulus, shown through recovering retail sales and business confidence levels (back to pre-COVID levels or above), strong employment growth (210,000 jobs added in June represented the largest monthly rise on record) and resilient asset prices, with house prices declining just 2% relative to pre-COVID levels and the Small Ords recovering to 14% below the February peak.

Importantly, the Government announced it will extend key fiscal stimulus programs beyond September, and has announced it is considering pulling forward the scheduled income tax cuts from 2022–23 to 2020–21. Our estimates suggest household income is likely to remain positive through 2020 and early 2021.

Nevertheless, the Victorian outbreak and tighter lockdown measures represent a significant risk to the outlook and will taper the national recovery in 3Q and 4Q20. While the future will be constrained by businesses closed that will never return, increased debt loads and fiscal drag acting as a headwind over the next decade, we remain of the view that Australia’s economy will decline by 5% in 2020 and expand by 6% in calendar 2021.

Smaller companies have been particularly impacted by the Government-directed restrictions. The challenges of 1H20 of operational survival, liquidity and capital management have given way to which companies will be capable of capturing the operational leverage through the recovery phase and which companies have pricing power to withstand the disinflationary threats of global excess capacity. For small companies, the risks vs reward within the macro backdrop is somewhat binary. Active management has perhaps never been more important in navigating the minefield.

We see significant value in certain sectors but believe others to be overvalued based on our earnings and cash flow expectations. We are currently most overweight stocks within the Financials, Health Care and Industrials sectors, while we are most underweight Real Estate, Consumer Discretionary and Information technology.
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