

Portfolio report

UBS Microcap Fund

Australia Equity Micro Cap

Client report from 01.10.2023 to 31.12.2023



Performance Comments

After fees and expenses, the Portfolio increased by 1.37% during the quarter, underperforming its benchmark by 715 bps.

The largest positive contributors were Botanix Pharmaceutical, Lycopodium and Coventry Group. Botanix Pharmaceuticals traded higher as FDA approval for their novel drug Sofdra neared after completion of a human factor study with revised instructions for use. Engineering business Lycopodium traded higher after providing NPAT guidance for FY24 of \$46-\$50m, which was well ahead of market expectations. Coventry Group provided a positive trading update with forecasted EBITDA over the December quarter up 28.5% on the prior corresponding period.

The largest negative contributors were Panoramic Resources, Janison Education, and Energy One. Panoramic Resources entered voluntary administration and subsequently revalued to \$0 as the ongoing capital requirement to operate their Savannah nickel mine in a depressed pricing environment was too great. Janison Education traded lower after announcing the departure of their CEO in conjunction with a board reshuffle. Energy One traded lower after the non-binding indicative offer from STG to acquire the company was revised down from \$5.85 to \$5.15 and subsequently rejected by the board with discussions terminated.

% Return (Net)	Fund	Benchmark*	Difference
3 months	1.37	8.52	(7.15)
1 years	6.47	7.82	(1.35)
3 years	4.50	0.95	3.55
5 years	12.30	6.39	5.91
Calendar Year to Date	6.47	7.82	(1.35)
Since inception (08/14)	11.71	6.14	5.57

* 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.

Source: UBS Asset Management. These figures refer to the past. Past performance is not a reliable indicator of future results.

Stock Contributors & Detractors (%)

Company name	Return	Contribution	Over / underweight
Botanix Pharmaceuticals	55.95	0.68	OW
Lycopodium	27.04	0.66	OW
Coventry Group	38.10	0.42	OW
New Hope Corporation	(14.62)	0.30	UW
Matrix Composites & Engineering	27.78	0.30	OW
Total of top 5 contributors		2.36	
Lunnon Metals	(25.00)	(0.62)	OW
Neuren Pharmaceuticals	125.77	(0.68)	UW
Energy One	(23.93)	(0.76)	OW
Janison Education Group.	(37.80)	(0.77)	OW
Panoramic Resources	(100.00)	(1.45)	OW
Total of top 5 detractors		(4.28)	

Note: Position at quarter-end, which may be different to the position during the quarter.

Portfolio Positioning

Active Positions by Industry Group (%)

Top 5 Overweights		Top 5 Underweights	
Capital Goods	14.85	Equity Real Estate Investment Trusts (Reits)	(9.81)
Software & Services	8.06	Materials	(8.85)
Health Care Equipment & Services	4.84	Financial Services	(6.90)
Insurance	2.57	Energy	(5.11)
Pharmaceuticals, Biotechnology & Life Sciences	2.22	Consumer Services	(4.14)

Active Positions by Stock (%)

Top 5 Overweights		Top 5 Underweights	
Monash IVF	4.31	Pro Medicus	(2.00)
Lycopodium	4.30	Viva Energy	(1.51)
Generation Development	3.68	Flight Centre Travel	(1.45)
RPMGlobal Holdings	3.53	Sandfire Resources	(1.34)
Supply Network	3.47	Champion Iron	(1.30)

Note: Position at quarter-end, which may be different to the position during the quarter.

Market review

Australian small caps rallied during the December quarter, with Health Care being the top-performing sector and Energy being the weakest performer.

The S&P/ASX Small Ordinaries Index generated a +8.5% return for the quarter, taking its 12-month return to +7.8%. As a comparison, the broader S&P/ASX 300 Accumulation Index generated a +8.4% return, and globally, the MSCI World Index gained 11.1%.

The Health Care sector recorded the largest gain (+18.0%) during the quarter, primarily driven by Neuren Pharmaceuticals (NEU, +125.8%). The share price jump was attributable to US sales partner, Acadia reporting strong 3Q23 sales growth on its maiden drug, Daybue, and further propelled by solid results of its Phase 2 trial on NZ-2591 for Phelan-McDermid patients. Other notable contributors were Sigma Healthcare (SIG, +50.1%) and Imugene (IMU, +139.1%).

Consumer Staples (+13.9%) outperformed the Real Estate (+13.4%) sector for the quarter, led by Elders (ELD, +34.4%). The agribusiness group secured market confidence after CEO Mark Allison reinforced the company's resilience in a more challenging agricultural environment. Both food producers Bega Cheese (BGA, +40.5%) and Inghams Group (ING, +19.3%) also rebounded during the quarter, supporting the sector's return.

While other sectors managed to accumulate gains during the quarter, Energy (-5.3%) saw a challenging period and was the only sector to have closed in the red. Key negative contributors were New Hope (NHC, -14.6%), Karoon Energy (KAR, -22.4%) and Paladin Energy (PDN, -10.5%).

Outlook & strategy

Financial market's finished 2023 on a particularly strong note with the ASX200 returning 7.3% in the month of December and REITs returning an astounding 10%. For those awaiting a bond rally a 2.9% gain in December provided most of the 4.9% annual return in the final month. Optimism was driven primarily by financial markets becoming increasingly convinced that central banks are now finished tightening monetary policy in the major developed economies and the prospect for easing in interest rates is starting to come into view.

Good news on inflation has also been met with signs of economic resilience in the US and Japan. Although Europe will likely record a technical recession into the conclusion of 2023, the strength of the recovery in Emerging Market industrial production bodes well for a recovery in European demand in 2024. This strength in Emerging Market growth has largely been in spite of China rather than because of China. Nevertheless, the bout disinflation in China has largely run its course and economic data has become more mixed rather than universally poor. We continue to see China delivering on a more meaningful infrastructure package into 2024 and further encouraging credit expansion to the real economy which should underpin economic growth of around 5% in 2024. As such we expect China to begin to provide a more meaningful support to global economic growth next calendar year.

Turning to Australia's prospects we continue to suggest that not only will Australia avoid a recession it will likely accelerate sequentially through 2024 with the improving global backdrop acting as a tailwind. No one should be disputing that 2023 likely felt like a recession for many Australians. A per capita recession and a negative income shock for those with high debt and young families has cascaded into weak discretionary spending into 2024 and further rates coalesced with surging insurance, utilities, rates, education and food prices. Nevertheless, economic growth was held up by several unusual features this economic cycle vis-à-vis prior cycles;

1. Commodities. Prior commodity price strength continued to underwrite double digit nominal economic growth and profitability.
2. Backlogs. Much has been made of the backlog of work in housing construction that has nullified the typical cyclical shock that is transmitted via the housing construction sector during rate hiking cycles. Approvals and affordability are at very poor levels yet the level of home building has barely declined at all. The backlog in work yet to be done is now peaking at a very high level suggesting we shouldn't be looking at the housing sector as a source of new economic growth, but equally we shouldn't be expecting a precipitous collapse in 2024. That may come in 2025 if interest rates remain at current levels, but that is not our expectation. But less has been made of the backlogs in non-residential building (led by offices, warehouses, health and transport) which equates to 7% of GDP and the backlog of engineering construction (led by roads, railways, electricity and mining) which equates to 16% of GDP. This enormous backlog of work has kept upward pressure on the labour market and on input prices at a time when typically, a global slow down would have seen investment tumble between 10-15%.
3. Buffers and Asset prices. Newly indebted households without other forms of income producing assets feel the full force of rate hikes. However, the economy wide impact of interest rates is diluted the more that growth in income producing assets outstrip the growth in debt. The rising trend in net household assets as a share of income over time means that income from term deposits, financial assets and investment property ownership have all risen over time and all produce an income stream which even after 13 rate hikes this cycle is still in excess of the rise in interest payments on the outstanding debt. This explains the bifurcated nature of spending growth. Older asset rich households are largely impervious to the rate hikes and as such luxury spending categories remain strong whereas younger indebted households cashflow has turned negative and spending is being seriously challenged. In aggregate a rate hike pack less of punch compared to prior cycles but the young and indebted are taking a disproportionate beating.
4. Population pump priming. Net immigration has surged well through government projections taking population growth close to 2.5%yoy growth in 2H23. Quite simply, it is very hard to record a recession with that type of population growth at your back. We do expect net migration

to slow in 2024 as the government seeks to tighten up some education programs and entitlements, yet the risk remains that the flood of people entering Australia surprises on the upside until a more material rise in the unemployment rate is realised.

In the concluding weeks of 2023, some additional factors are worth noting that support a more positive outlook into 2024.

1. Commodity prices are rising again. A falling USD and stronger global demand has seen commodity prices rising in Q4 which will provide a fillip for profits, tax revenue and nominal economic growth.
2. Fiscal support and tax cuts. Despite pressure for change, Stage 3 income tax cuts remain an election commitment of the ALP. The cut is equivalent to 1.1% of disposable income and skews to higher income households which under our analysis suggests over 50% of the tax cuts will be saved. Nevertheless, with the Federal Budget in surplus, the RBA rate cycle likely complete and an election looming in 2025 is likely that addition fiscal support will be announced in 1H24 to support lower- and middle-income households.
3. Inflation moderation to drive rate cuts. We expect inflation to move into the top of the RBA target band before the end of 2024, setting up the prospect of the RBA easing in August and again in November 2024. While we are expecting a relatively shallow rate easing cycle it will likely come earlier than most expect and importantly the RBA has renewed firepower to drive a more powerful economic recovery should inflation surprise on the downside.
4. Capex intentions have lifted. We were pleasantly surprised to see that the ABS measure of investment intentions rose through 2H23 and now suggests business investment will rise 10% in 2023-24 – well above the RBA's 1-2% forecast. Indeed, not only has business investment been robust, but there are also signs it is accelerating.

As a consequence, we are relatively optimistic on the outlook for the Australian economy and constructive on the equity market outlook for 2024. We expect economic growth to average 2.25% v a consensus forecast of 1.5%, bond yields to finish the year at 4.0%, the \$A/\$US to reach 74c, and Australian equities to return 10% in large caps and 15% in small caps.

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