Portfolio report

UBS Australian Small Companies Fund
Australia Equity Small Cap
Client report from 01.01.2024 to 31.03.2024

Performance comments

After fees and expenses, the Portfolio increased by 7.01% during the quarter, underperforming its benchmark by 54 bps.

The largest positive contributors were Megaport, Netwealth and Imdex. Our overweight position in Megaport outperformed following the release of its quarterly result. Similarly, Netwealth's outperformance was supported by the release of the 1H24 result which reported a 27.2% increase in EBITDA with margin expansion to 47.6%. Imdex also outperformed following stronger than expected 1H24 results.

The largest detractors during the period were Nanosonics, Kelsian and Gold Road Resources. Nanosonics underperformed during the period following a disappointing update as they continue to experience ongoing uncertainty associated with the timing of capital unit sales due to hospital capital budgetary pressures. Kelsian was a negative contributor during the period following its 1H24 result as strong revenue outcomes were partially offset by elevated D&A expenses. Gold Road Resources underperformed during the month following a weak update on production at the company's 50% owned Gruyere operation.

% Return (Net)	Fund[1]	Benchmark*	Difference
3 months	7.01	7.55	(0.54)
1 year	13.76	13.83	(0.07)
3 years	5.73	2.71	3.02
5 years	10.72	5.42	5.30
Calendar Year to Date	7.01	7.55	(0.54)
Since inception (03/04)	11.82	5.78	6.04

[1] Performance figures are net of ongoing fees and expenses.

* S&P/ASX Small Ordinaries Accumulation Index

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
Megaport	62.93	1.23	OW
Netwealth Group	38.13	0.92	OW
Ilmdex	24.46	0.51	OW
Select Harvests	53.45	0.46	OW
Cooper Energy	69.23	0.38	OW
Total of top 5 Contributors		**3.50**	
Collins Foods	(14.36)	(0.51)	OW
Sims	(18.25)	(0.66)	OW
Gold Road Resources	(19.05)	(0.68)	OW
Kelsian	(16.28)	(0.83)	OW
Nanosonics	(37.50)	(1.06)	OW
Total of top 5 detractors		**(3.74)**	

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	
Transportation	5.64	Consumer Discretionary Distribution & Retail	(6.97)
Health Care Equipment & Services	4.75	Energy	(6.60)
Financial Services	3.62	Materials	(5.49)
Insurance	3.13	Pharmaceuticals, Biotechnology & Life Sciences	(3.25)
Media & Entertainment	3.11	Telecommunication Services	(2.78)

Active Positions by Stock (%)

Top 5 Overweights		Top 5 Underweights	
SPI 200 FUTURES Jun24	3.84	CSR	(1.56)
Pinnacle Investment Management	3.50	Paladin Energy	(1.51)
Imdex	3.29	Viva Energy	(1.48)
Netwealth	3.26	Telix Pharmaceuticals	(1.33)
Auckland International Airport	3.16	HUB24	(1.28)

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

Market Review

The Australian small caps market strengthened during the first quarter of 2024.

The S&P/ASX Small Ordinaries Index returned +7.6% return for the quarter, taking its 12-month return to +13.8%. As a comparison, the broader S&P/ASX 300 Accumulation Index generated a +5.4% return, and globally, the MSCI World Index jumped by 8.5%.

Consumer Discretionary (+12.4%) was the main sector contributor with Lovisa Holdings (LOV, +38.6%) contributing to the outperformance. The jewellery chain recorded an 18.2% sales lift (to $373m) upon entering the Chinese and Vietnamese markets. Harvey Norman Holdings (HVN, 22.6%) was a significant contributor over the quarter following the release of its 1H24 results. Although the retailer reported lower earnings per share compared to last year, this still beat market consensus. Other notable contributors were Premier Investments (PMV, +21.6%), Light & Wonder (LNW, +32.3%) and Webjet (WEB, +20.3%).

The Information Technology (+21.2%) sector rallied during the period, with Life 360 (360, +73.2%) and Megaport (MP1, +62.9%) leading the gains. Both stocks saw positive performance following the release of 1H24 results, with Life 360 reporting an increase in revenue of 33% while Megaport reported an increase of 785% in EBITDA and a return to profit.

In contrast, Communication Services (-1.9%) was the worst performing sector. TPG Telecom (TPG, -11.2%) was the main detractor as the telecommunications firm reported a decrease in annual net profit. Other negative contributors to performance included Seven West Media (SWM, -27.8%) and Aussie Broadband (ABB, -8.2%).

Outlook & Strategy

The Australian equity market returned a very solid 3.3% in March, completing a 5.3% gain for the March quarter – the strongest March quarter since 2019. In concert with the rally of late 2023 the ASX200 has delivered a six-month annualised return of 14%. Despite the strong performance in large caps, small capitalisation stocks outperformed, returning 4.8% in March and 7.5% for the quarter. The standouts in the month were REITS which have returned 9.2% in March and 16.6% CYTD and gold which returned 9.1% in March and 8.1% CYTD. The laggards in March were alternative assets and the Australian dollar.

Optimism continues to be driven by financial markets becoming increasingly convinced that central banks are now preparing to ease interest rates from mid-2024.

Good news on inflation has also been met with signs of economic resilience. Although Europe continues to toy with a technical recession, the strength of the recovery in Emerging Market industrial production bodes well for a recovery in European demand in 2024, and indeed survey evidence suggests a recovery in European demand has commenced. 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/positive rather than universally poor. We continue to expect China to deliver on a more meaningful infrastructure package in 2024 and further encourage credit expansion to the real economy which should underpin economic growth around 5% in 2024 – a target that the Chinese government also adopted in recent weeks. As such we expect China to begin to provide a more meaningful support to global economic growth as we move through 2024.

Turning to Australia's prospects despite a weak finish for economic growth in 2023 – expanding just 0.2%qoq and 1.5%yoy - 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 as high interest 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 disproportioned 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 2024 some additional factors are worth noting that support a more positive outlook into 2024 and beyond.

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 a change to the details of the Stage 3 income tax cuts, the package is equivalent to 1.0% of disposable income. In conjunction with the Federal Budget in surplus, the RBA rate cycle likely complete and an election looming in 2025 it 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 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.

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, there are signs it is accelerating.

Outlook & Strategy (Continue)

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 in large caps and 15% in small caps. We are most overweight stocks in the Financials, Industrials and Information Technology sectors, and are underweight Consumer Discretionary, Energy and Materials.

UBS Asset Management (Australia) Ltd

ubs.com

UBS