A closer look at Swiss small and mid-caps

From the eyes of a Swiss insurance company

Asset Management
For qualified investors only / For information purpose only

UBS

Are Swiss insurance companies missing an opportunity?

While many Swiss insurers tend to have a strong home bias towards Swiss large caps, investments in Swiss small and mid-cap companies are significantly underweighted. This is not intuitive, as this segment is the backbone of the Swiss economy. It consists of very successful and innovative companies which are often among the leaders in their global business sectors.

We believe it is worthwhile to start taking a closer look at Swiss small and mid-caps investments and take advantage of the opportunities they offer today.

Swiss small and mid-cap companies represent an important part of the Swiss economy and are largely responsible for the strong economic position and the prosperity of the national economy. Usually, these names not only hold a leading global position in niche markets, but are also characterized by high innovative strength, robust balance sheets and led by successful management teams with strong track records.

However, despite their strong long-term outperformance versus large cap companies[1], it is precisely these Swiss small and mid-cap names that remain underinvested in investors› portfolios.

The underlying paper focuses on the most important benefits of Swiss small and mid-caps and discusses the current market environment including present valuation levels.

Why to invest in Swiss small and mid-caps?

As of end December 2022, small and mid-cap companies accounted for 19.2% of the broad Swiss equity market (SPI®). Looking at the actual absolute number of small and mid-cap companies in the SPI® (the index currently comprises 220 stocks in total),

[1] Please note that past performance is not a reliable indicator of future results

the percentage weight of small and mid-cap names significantly increases.

We believe that the market of Swiss small and mid-caps is best represented by the SPI Extra® index. The index measures the development of the small and medium-sized Swiss equity market and consists of the SPI® without the components of the large and mega cap SMI® names. This universe gives investors an early access and benefit of investing in future winners. One of the latest examples of such a company that has evolved from the Swiss small and mid-cap universe to a new member of the SMI (from September 2022 onwards) is Sonova.

In addition to the high importance of small and mid-cap companies for the Swiss economy, the segment has clear advantages that should pay off in the long term when investing[2]:

– Less complex business compared to large caps

– Highly qualified management teams

– Above-average growth profile

– High degrees of flexibility

– Solid balance sheets

– Niche exposure

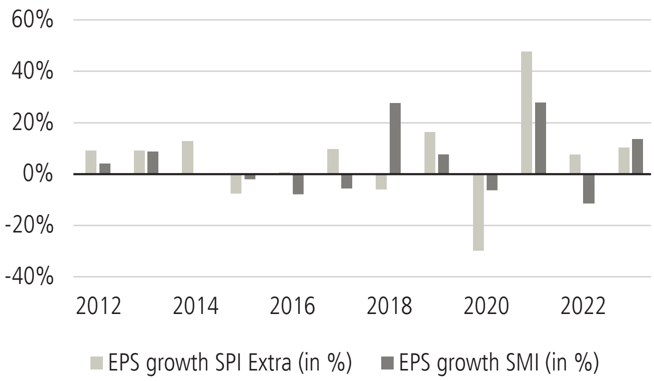
Even in times of increased uncertainty, small and mid-caps have a decisive advantage. Due to less complex businesses compared to large companies, leaner processes, and structures, they often react *more flexibly* to unforeseen influences than large caps. Especially in times of crisis, such as the recent COVID pandemic, a healthy financial position is also particularly helpful. Most Swiss small and mid-caps are characterized by *solid balance sheets*, which can represent a valuable competitive advantage versus international peers.

Additionally, the successful longer-term track record of most of the Swiss names highlights the companies' *highly qualified management teams* with necessary experience regarding different market phases over a full economic cycle. However, it is not only the management teams of Swiss small and mid-caps that stand out: the firms' access to a *talented workforce* is also an attractive advantage in Switzerland. The consistently good performance of Swiss universities in international comparisons underscores this point. Through cooperation with institutes such as Eidgenössische Technische Hochschule (ETH) Zurich, companies often secure direct access to the talent that will enter the labor market after successfully graduating at an early stage.

Historically, compared to large-cap companies, small and mid- caps showed *above-average growth dynamics*. This is impressively underlined by looking at historical growth rates in terms of EPS growth (in %) over the last ten years.

[2] This does not constitute a guarantee by UBS Asset Management

Figure 1: Historical EPS growth SPI Extra vs. SMI 2012 – 2023e



Source: UBS Asset Management, FactSet, data as of 23rd January 2023.
Past performance is no guarantee for future results.

As figure 1 shows, small and mid-caps experienced lower growth rates compared to the ones of large caps in only three of the ten years between 2012 and 2022. It is noteworthy that all these three years were characterized by increased market uncertainty in the short term (2014, 2018 and 2020). Conversely, during periods of positive market momentum as well as periods of economic recovery, the growth rates of small and mid-caps used to significantly exceed those of the large cap companies.

Another advantage of Swiss small and mid-caps lies in their corporate structure. These companies are often partially owned by anchor shareholders such as founders, the management, a family, or employees. Our experience shows that these companies are managed with entrepreneurial vision and thus often more successfully. Furthermore, the agile and entrepreneurially managed smaller companies typically grasp the new business areas emerging from structural trends like digitalization, demographics, climate change and urbanization faster than their large rivals.

Moreover, Swiss small and mid-caps possess high innovative strength and valuable know-how in *niche markets*. These characteristics represent important competitive advantages and provide the basis for a leading market position. Mainly responsible for the know-how built up over decades are two specifics of the Swiss market: the size of the country and the currency.

The limited domestic market pushes Swiss companies to expand internationally and differentiate themselves from the competition at an early stage. In addition, the strong Swiss franc forces companies based here to remain competitive through innovation leadership. The necessary investments in research and development usually lead to higher sales and profit growth in the long run.

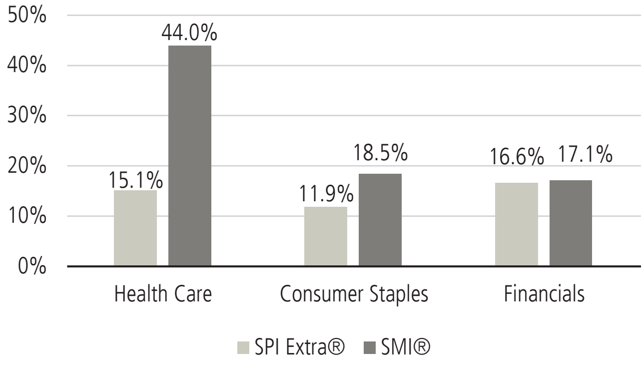
The specific risks of small and mid-caps must also be taken into account when making an investment. Typically, small and mid-caps have a lower trading volume compared to large and mega cap stocks. As a result, liquidity can be significantly lower than that of large and mega caps, especially in market phases characterized by high volatility and distress. In such a case, even comparatively small transactions can lead to noticeable movements in the share price.

Furthermore, history shows that small and mid-caps tend to have a higher cyclicality than their large cap peers. As a result, the swings can not only be stronger in the phase of an economic recovery, as described above, but can also be correspondingly more negative in the case of a deep recession.

Positive diversification effect

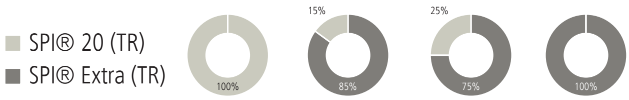
In addition to the advantageous characteristics of Swiss small and mid-caps, the diversification effect of such an investment should not be ignored. A look at the top three industry exposure (ICB classification) clearly shows how concentrated the SMI® is compared to the SPI Extra®.

Figure 2: Top 3 industry exposure SPI Extra vs. SMI



Source: UBS Asset Management, FactSet, data as of 30th December 2022. **Past performance is no guarantee for future results.**

Figure 3: Swiss small and mid-caps in a portfolio allocation



	Portfolio 1	Portfolio 2	Portfolio 3	Portfolio 4
Portfolio return (annual.)	7.28%	7.76%	8.06%	10.09%
Portfolio volatility (annual.)	12.75%	12.71%	12.77%	12.71%
Sharpe ratio	0.56	0.60	0.62	0.78

Sources: SPI 20® (TR) and SPI® Extra (TR),Sharpe ratio: Calculated with FTSE CHF 3M Eurodeposits as the risk-free rate Note: Data in CHF for the period 01.01.2003-31.12.2022
Assumption: Monthly rebalancing without transaction costs

In the SMI®, a total of 79.6% of the sector is attributable to the three largest sectors, Health Care, Consumer Staples, and Financials. For the same industries, the SPI Extra®, shows an exposure of just 43.6% as of end December 2022. Looking at the top 3 industry exposure of SPI Extra® (Industrials, Financials and Health Care), one also finds a lower concentration rate of 67.4%.

This diversification effect is also evident when looking at the different portfolio allocations in Figure 3. Adding Swiss small and mid-caps to a pure large cap portfolio significantly increased the portfolio return over the last 20 years. At the same time, it is remarkable that the risk of the portfolio measured by volatility did not change significantly. Accordingly, the Sharpe ratio also improves significantly after adding Swiss small and mid-caps.

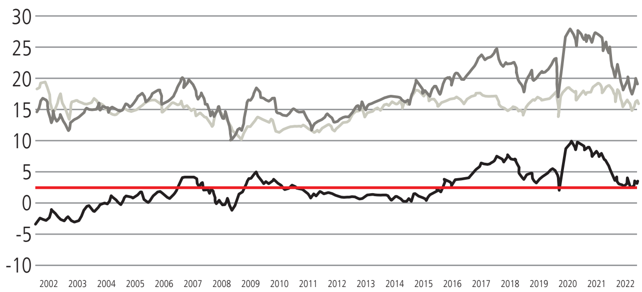
Market environment and valuation

After Swiss small and mid-caps posted attractive returns for three consecutive years between 2019 and 2021, the picture changed at the start of 2022. During 2022, small and mid-cap stocks in the Swiss market had lost around -24.0% (SPI Extra®), closing significantly lower than their large-cap counterparts (SMI® -14.3%).

In addition to the significant tightening of monetary policy worldwide, as well as concerns about declining economic momentum, geopolitical risks, primarily the war in Ukraine, weighed on the market. Although Swiss small and mid-caps have little direct exposure to Russia and Ukraine, they are nevertheless directly affected by higher commodity prices and bottlenecks in supply chains. The latter were further exacerbated by the temporary lockdowns in China. As of end December 2022, year-to-date, Utilities (+4.4%), Financials (-3.0%) and Telecommunications (-6.8%) performed best in the SPI Extra®. Conversely, Technology (-49.2%), Health Care (-33.6%) and Basic Materials (-29.3%) recorded the strongest correction.

The comparatively stronger correction of Swiss small and mid- caps is also reflected in the recent development of the valuation premium versus SPI large caps®. After this price-to-earnings premium between small & mid-caps (SPI Extra®) and large caps (SPI Large Caps®) reached its peak of the past 20 years at the end of 2020, it began to approach its long-term average again as early as 2021. This trend was further accelerated by the strong correction in the course of 2022, so that the premium has now nearly arrived at its long-term average of 2.5%.

Figure 4: Valuation premium CH SMID vs. CH Large Caps



Source: UBS Asset Management, FactSet, data as of 30th December 2022. Valuation premium SPI Extra vs. SPI Large Cap. P/E Switzerland SPI Large Cap (dark grey), P/E Switzerland SPI Extra (light grey), premium P/E SPI Extra vs. P/E SPI Large Cap (black), premium average over 20Y (red horizontal line).

Outlook
Following the year-to-date sell-off, investors ask themselves whether the worst is already over for Swiss small and mid-caps.

Based on the latest inflation data in Switzerland, there are at least initial signs that inflation may have peaked. A progressive normalization of economic momentum and more difficult year-on-year comparisons may cause inflation to stabilize or decrease over the remainder of the year. Nevertheless, this development remains difficult to forecast, as the situation surrounding commodity prices and potential new COVID outbreaks, including pressure on supply chains as key drivers, are unpredictable. However, compared to their European and US peers, Swiss small and mid-caps face less cost pressure due to the significantly lower inflation in Switzerland and the strong Swiss franc, which can become a real competitive advantage.

With accelerating tightening of central bank's monetary policy, we expect the focus of investors to shift back to companies' fundamentals and consequently, the normalization of equity valuations to continue.

Accordingly, it remains important to monitor how corporate results develop in Q4 2022 and the quarters beyond. The question of whether companies can achieve their issued guidance will determine how earnings revisions develop and if they could potentially become an additional source of increased volatility in the short term. While much of the prospective economic development is likely to be priced in already, we see the potential for negative revisions in the 2023 estimates short term.

Overall, in combination with the attractive characteristics of Swiss small and mid-cap companies, we see the year-to-date correction and valuation levels reached as an interesting opportunity for medium-to long-term investors to enter this market or to expand existing investments.

Conclusion
We are convinced that Swiss small and mid-caps should be considered in a diversified asset allocation. Many Swiss insurance companies are currently underinvested in the core of the Swiss economy. The benefits of Swiss small and mid- caps are clear:

– Attractive risk/return profile as well as lower sector concentration related to Swiss large caps

– High level of innovation and early access to future winners

– With stable balance sheets and above-average growth rates do Swiss small and mid-caps offer solid and sustainable returns.

Swiss insurance companies traditionally invest significantly in their home market. We believe it is worth extending these investments with a current focus on large caps to the small and mid-cap segment and taking advantage of the opportunities they offer.

More explanations of financial terms can be found at ubs.com/glossary

UBS Asset Management
Institutional Client Coverage Switzerland

Nino Colesanto
Head Insurance Coverage

+41-44-235 43 03
nino.colesanto@ubs.com

UBS