MIRABAUD Asset Management

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KNOWLEDGE-BASED INVESTING IN SWISS SMALL AND MID-CAP EQUITIES

An update on the Mirabaud – Equities Swiss Small and Mid Strategy

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European equities saw heightened volatility and substantial losses in the first quarter of 2020 as investors attempted to calculate the impact of the Covid-19 pandemic on business operations. Some European indices were particularly hard hit, with the Eurostoxx 600, for example, down around a quarter in the first three months of the year.

By comparison, Swiss stocks fared somewhat better. Over the same period, the Swiss Performance Index (SPI) lost half as much, at around 12.5%.[1] While we anticipate that the second quarter of the year is likely to be worse than the first, there have been signs that a slow market recovery is on the way. Since the third week of March, indices have started to make back some ground, although the recovery cycle remains extremely difficult to read. There is no clear trend in the market, which revolved around risk-on and risk-off.

Earnings estimates were still heading downwards, albeit softening in recent weeks. Traditionally, equity markets are around three months ahead, in terms of pricing in the bottoming of earnings revisions. But, in this market, each stock requires delicate scrutiny to weigh up whether these revisions have already been factored into the price.

Informed portfolio construction

We believe a barbell approach, with a slight tilt to value, will lead to better portfolio outcomes in the current climate. This blends better quality defensive companies with strong balance sheets alongside more growth-orientated names. In terms of sector allocation, we are now overweight Industrials, Information Technology, Materials and Consumer Discretionary stocks. We are underweight Consumer Staples and Financials.

We have no exposure to Real Estate as we believe the headwinds facing the sector are particularly strong. Retail rents are falling, and there has been a marked increase in the number of employees working from home. We believe that the valuations, even before the Covid-19 outbreak, were expensive when comparing the stock prices to the underlying net asset values.

Stock application

Turning to individual holdings, we have maintained several high conviction holdings, including Vifor Pharma, where we have already seen the share price recover some of its lost ground, and in specialty chemicals maker Clariant. We have built a substantial overweight in the latter. Clariant has continued its rationalisation programme to sell two of its business units. Based on current estimates we believe this sale will generate a $1 billion special dividend later this year, more than offsetting the company's strategy to scrap its regular dividend payments. We also believe that Clariant is less GDP correlated than some of its peers.

[1] Source: Bloomberg

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Another of our holdings is Schindler, the elevator maintenance business. The company has developed its business model to become more service-focussed, with between 70 and 80% of its profits now generated from these business activities.

While the fall in oil prices in recent weeks has weighed heavily on many related stocks, we have retained an active position in pump manufacturer Sulzer. The company's share price is highly correlated to oil, but its exposure to upstream operations are around 17-20% of its overall business operations. The remainder of its business is in Industrials and Health and Beauty. As a result, we believe the company has an attractive risk/reward profile. While the stock lost ground during the oil price decline, we believe there is much more value in the company.

Swiss appeal

Switzerland has a large pool of high quality mid- and small-cap companies across a diverse range of sectors such as Financials (24%), Industrials (22%), Healthcare (15%) and Information Technology (10%). And unlike other markets, the Financial sector in Switzerland tends to be less cyclical in nature given its exposure to insurance companies and Cantonal banks. Furthermore, Switzerland has the highest density of high-quality names in Europe, with many players that hold the number one, or number two spot in terms of market share, characterised by strong balance sheets and management, creating opportunities for long-term alpha generation. Food manufacturer Nestle, private equity specialist Partners Group, freight forwarder Kuehne & Nagel, and elevator servicing company Schindler are all examples.

We believe that outperformance will come from stock selection based on comprehensive research that identifies companies with robust business models, solid balance sheets and sound leadership teams.

What is coming?

In the immediate term, we believe that the daily volatility will persist in the weeks ahead, with markets continuing to witness risk on, risk off behaviours. At the same time, investors are waiting to deploy large volumes of cash, and are seeking a trigger.

With analysts already having downgraded earnings, we believe that a turning point is coming soon. We have conducted a stock-by-stock analysis, comparing the first and second quarter of 2019 with the current landscape. Our analysis suggests that a large dispersion of stock valuations could be a recipe for alpha, within our current portfolio positions.

At the current time, we believe investors are largely hiding in relative growth stocks, and that could be wrong. We have already seen lofty valuations in growth stocks, with investors unwilling to hold expensive defensives.

The question now is whether the uptick in markets, which started in the third week of March is the beginning of a rebound, or a slower, more sustained recovery. On that front, we have a positive and optimistic view. Inflexion points are important. If economic data sets, such as the global PMIs, are favourably received by investors, we could see a strong rebound in the summer months ahead. That may lead investor sentiment to make a substantial shift from growth to value stocks. Such a scenario may lead us to further increase our value bias within the portfolio.

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