Insight into Swiss Equity market in 2023

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Signatory of:

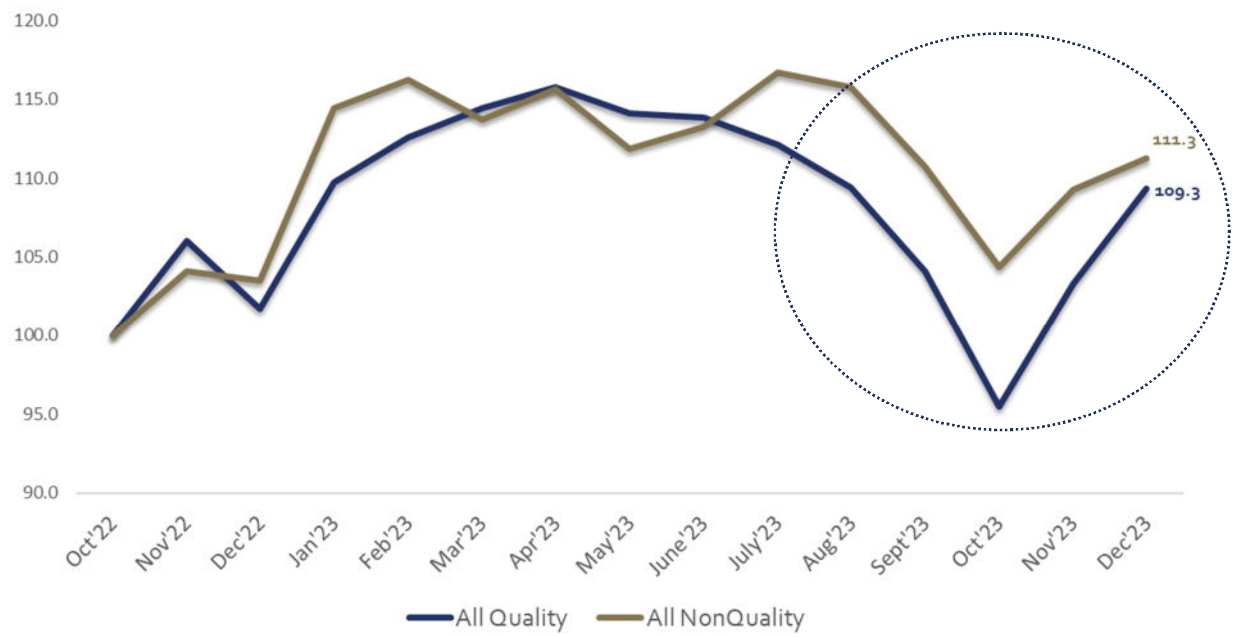
Principles for Responsible Investment

Contents

1. Rollercoaster year for Quality in Switzerland

Back in 2022, when all the hell broke loose in the equity markets, Quality in Switzerland, same as in other regions across the globe, has suffered substantial set-back performance wise. While country itself got somewhat sheltered from massive spike in inflation and interest rate hikes – although both items have experienced upward movement – Swiss companies, being global players, had to face consequences of a slowdown in economic growth and weak consumer sentiment. We have always argued that given the very nature of Quality companies, they would be sailing strong even if operational momentum goes through temporary phase of weakness. But as investors attempted to protect their worth by either fleeing into cash or Commodities that soared as a result of the war in Ukraine, sentiment was clearly set to overlook long-term picture in the face of immediate, short-term fears. Fundamental quality and durable business models – something that is well known to generate solid long-term shareholder returns – were largely ignored and therefore did not provide shelter to the investors during those turbulent times.

Figure 1: Indexed Total Return Performance (October 2022=100) of Quality and Non-Quality clusters, regardless of Valuation (Gross, in CHF) 30.10-2022-31.12.2023



Source: Hérens Quality AM, MSCI

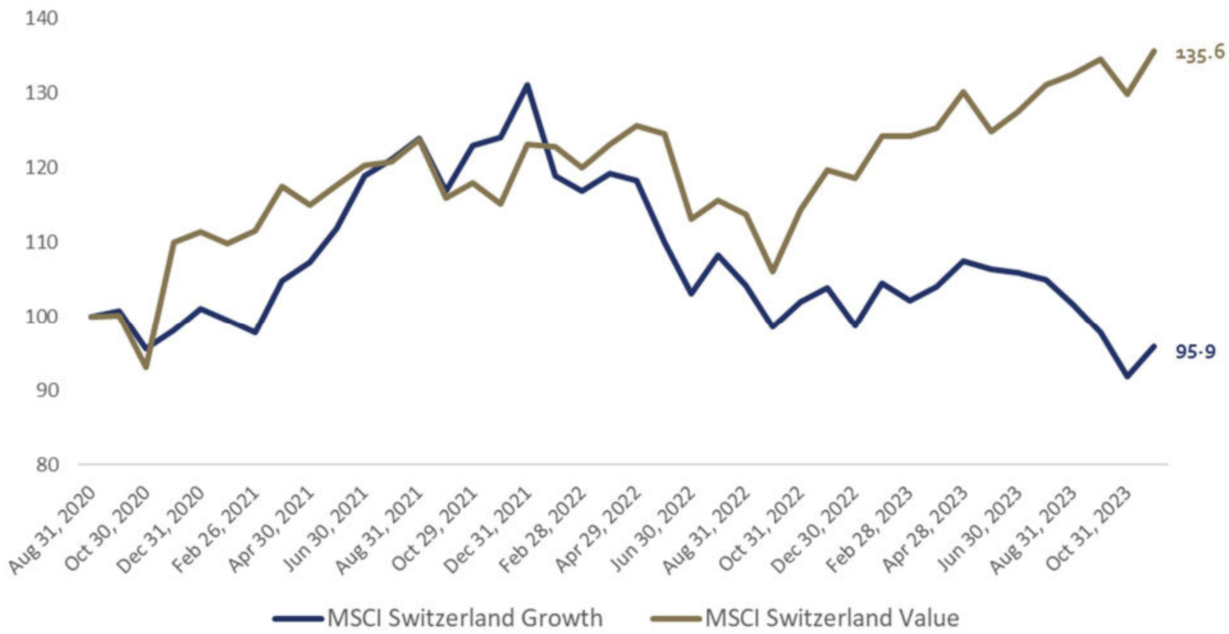
As fears subsided and dust settled, market was able to think rationally yet again. And, as one would expect, investors began picking up competitive and financially sound companies as 2023 entered the stage. All the points we have been relentlessly making back in 2022 – that Quality stocks are more than equipped to deal with exogenous shocks and input costs inflation because of the strong pricing power and well managed cost base – have finally come to be appreciated.

As a result, Quality in Switzerland came back strong in the beginning of 2023 and held up well right until the end of May, when tables turned and Non-Quality began taking up the pace, predominantly driven by companies from the Financial sector (Figure 1). While Swiss Quality has very limited exposure to this sector (4.5% weight), Financials have rather substantial weight in the broader benchmark (16% in MSCI Switzerland). Also, as reporting season unfolded during summer, selective Quality stocks fell out of favour as general sentiment over relevant industry turned sour or lack of guidance upgrade was perceived as a sign of weakness, despite operational performance remaining very solid.

As we were closing in on 2023, markets flipped once again, and rally of Quality was so strong in November that in just one month Switzerland Quality Fund managed to close the underperformance gap that it had accumulated throughout the year and even generate outperformance during December to finish 2023 on the positive relative note.

It is also important to highlight that, as opposed to USA, for instance, Growth never made a comeback in Switzerland even with the end-of-the year rally, and Value as a factor continues to prevail on the market since the beginning of 2022 (Figure 2). As such, MSCI Switzerland Growth has lost 0.4% as per December 31st, while MSCI Switzerland Value had shot up 16.5%. This is a staggering contrast to USA, where for the same period MSCI USA Value gained 8.4%, while respective MSCI USA Growth accumulated mind-blowing 46.5%, even despite the August- October sell-off. As Quality has a tilt towards growth – and this is a common denominator in all the regions- performance of Value created substantial headwind in Switzerland for the style.

Figure 2: Indexed Total Return Performance (August 2020=100) of Growth and Value factors in MSCI Switzerland (Net Performance in CHF) 31.08.2020-31.12.2023



Source: Hérens Quality AM, MSCI

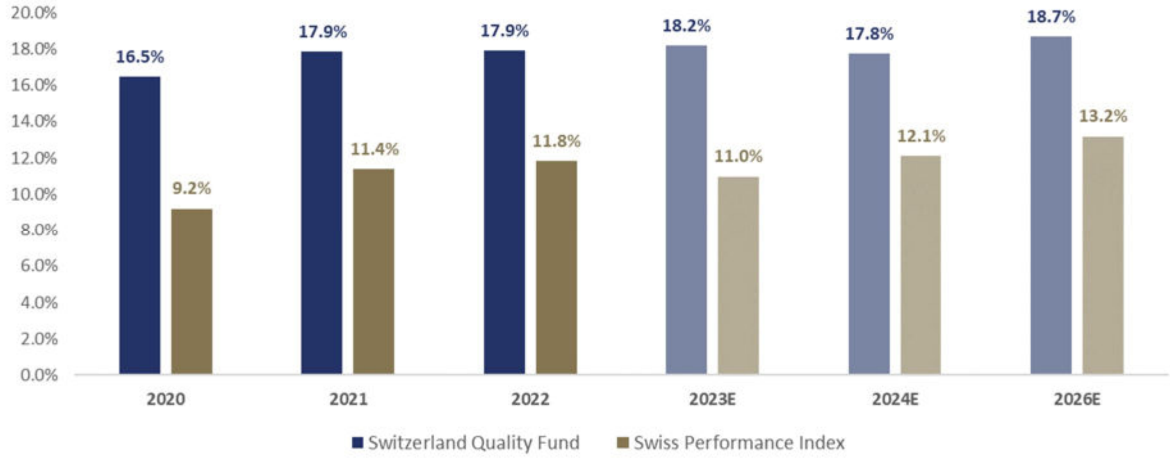
On the broader scale, unfortunately, Swiss market looks like a major laggard performance-wise in 2023, both in comparison to Europe and USA. As such, MSCI Switzerland (Gross, CHF) gained 6.3% year-to-date as per end of December, which is a sharp contrast to 27.1% gain in MSCI USA (Gross, USD) and substantially below 16.7% performance of MSCI Europe (Gross, EUR). However, if one looks deeper, it becomes apparent that half of the market gains in USA was delivered by IT sector, excluding which MSCI USA would have gained just 17.1%, which is comparable to the performance in Europe. Swiss market, in turn, has only nominal exposure to IT and did not benefit from AI frenzy that took over US counterparts in the first half of the year.

2. Mid & Long-term prospects of Quality remain intact

As we entered 2023, full-year reporting season has proven the point we tried to bring across all along – given strong pricing power, Quality companies would be less likely to suffer notable margin squeeze as they are able to pass on rising input costs to the customer, while broad geographic coverage and presence in growth pockets will allow them to maintain positive top-line dynamics. At the same time, healthy balance sheets and well-managed debt levels would prevent them from taking too much of an impact from higher interest rates.

Needless to say that Switzerland Quality Fund sustainably exhibits superior profitability to the benchmark (Figure 3). Moreover, in 2023, it is expected that Portfolio companies would deliver 30bps margin expansion despite inflationary headwinds, while median indicator in the SPI is expected to contract by 80bps.

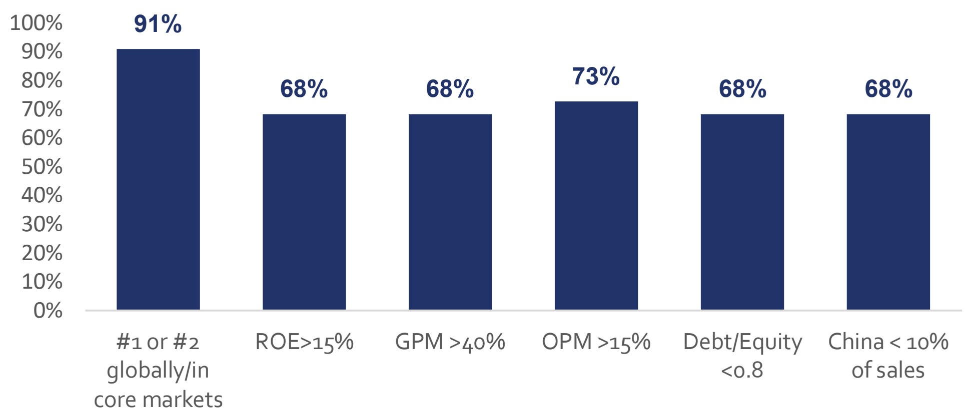
Figure 3: Historical and Estimated Operating Margins (median) of the Switzerland Quality Fund and respective benchmark (as of 31.12.2023)



Source: Hérens Quality AM, Reuters

It is important to highlight that 91% of companies within Switzerland Quality Fund are #1 or #2 in their respective markets (Figure 4). They are well-financed (68% have debt-to-equity ratio below 0.8) and have strong operational metrics (68% of companies have Return-on-Equity more than 15% and Gross Profit Margin above 40%). Importantly, only several stocks due to the nature of their business have substantial exposure to China, while majority (c70%) generate no more than 10 percent in the country. Among those, for whom China is an important market is Richemont (28%), Georg Fischer (25%), as well as Inficon and VAT (14% for each).

Figure 4: Share of Switzerland Quality Fund companies that meet specified characteristics (as of 31.12.2023)



Source: Hérens Quality AM, Reuters

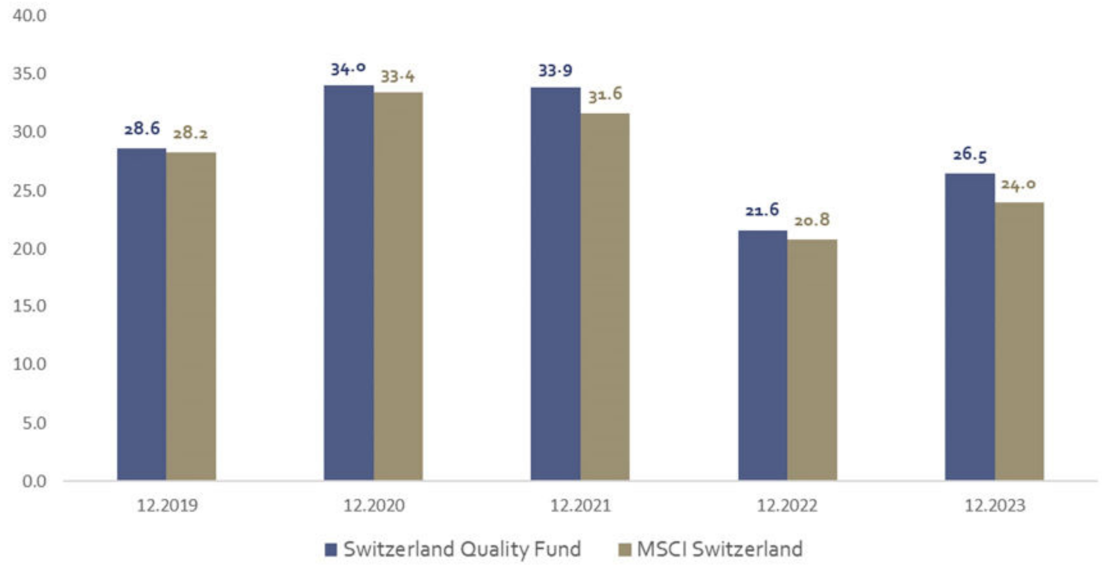
3. Valuation is attractive

During later days of the pandemic, t.i. in 2021, relative valuation of the Switzerland Quality Fund has seen substantial deviation from its historical premium versus broader market that hovered around 40-80bps range (Figure 5). Per end of December 2021, median P/E of Switzerland Quality Fund stood at 33.9 versus just 31.6 of MSCI Switzerland (hence, delta of 230bps). Such contrasting picture had a rather simple explanation – after initial sell-off triggered in Q1'2020, share prices of quality companies have seen very strong recovery and delivered above-market returns as it quickly became apparent that challenges posed by pandemic lock-downs, if any at all, would be transitory and short-lived for strong, competitive businesses that quality companies are.

This was especially true for businesses that by their nature are heavily exposed to physical locations, like dental implant maker Straumann or premium chocolatier Lindt & Sprüngli. As lockdowns put face-to-face contact on hold, dental practices performed much smaller number of procedures, resulting in lower revenues for Straumann. At the same time, people shifted to online purchases where Lindt is not well represented, while physical stores underperformed due to significantly lower traffic. Top-line headwinds for both companies translated into considerable reduction in the bottom line, which, in turn, triggered spike in valuation. Needless to say that as soon as COVID restrictions were lifted, both companies have caught up with pent-up demand and quickly improved fundamentals, as well as valuation, back to the usual levels. On the other hand, pandemic winners, like Lonza or Tecan, have also seen significant multiple expansion as operational performance had not yet managed to catch up with priced-in expectations.

Up until October end, Switzerland Quality Fund traded at lower level of its historical bandwidth (PE of 21.8) and at 70 bps delta verus MSCI Switzerland - also at the lower end of valuation premium in comparison to the broader market, representing attractive entry point. However, given substantial gains over November-December time frame, Switzerland Quality Fund finished 2023 on a more elevated level, which should see adjustment after reporting. From historical perspective, however, it is still trading at one of the lowest levels in five years.

Figure 5: 12M Trailing P/E per December 31st over 2019-2023 period



Source: Hérens Quality AM, Reuters

4. Over long-term, Quality offers strong track-record of consistent returns

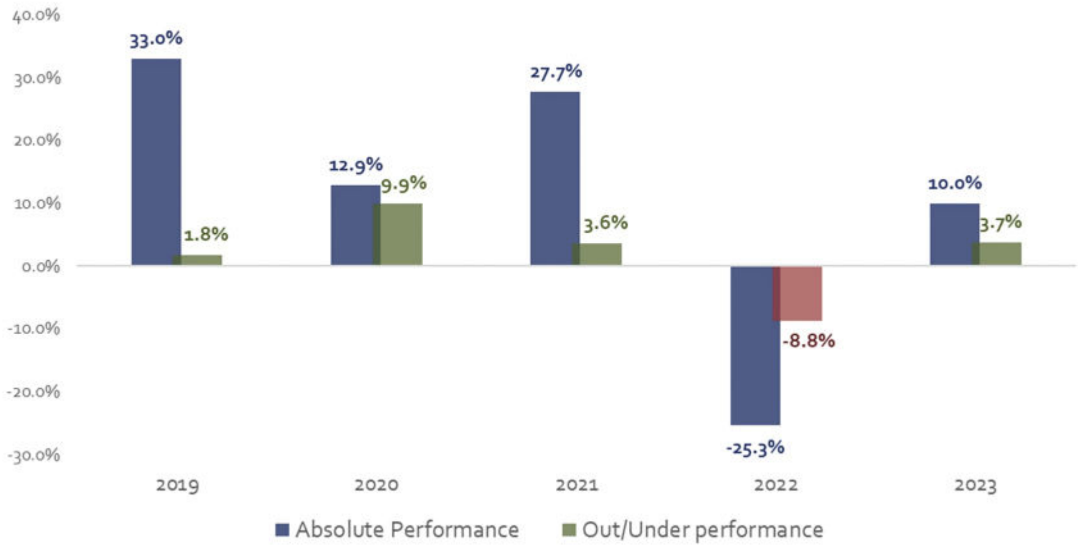
It would be fair to say that past four years, namely 2020-2023 period, have been exceptionally challenging for investors globally. Not only because they were packed with numerous shocks and crises going one after another and offering little room for taking a breather, but also because they created massive volatility on the equity markets with violent swings between extreme greed and extreme fear. Even most experienced market participants have seen their nerves and strategies tested multiple times over that timeframe. This is why long-term view matters as it diminishes the significance of short-term moves, however violent. Eventually, market resets and comes back the basics, with durable, high quality business models standing out and driving attraction. This concept is universal and Switzerland is no exception.

While incessant outperformance every single year, of any strategy, is improbable and unrealistic, it is more than possible to generate alpha over long-term if you follow Quality approach. Quality companies are well positioned to consistently grow, develop and capture new opportunities. They have strategic vision to expand into new markets and enough balance sheet flexibility to give them room for manoeuvre whatever the circumstances. Their products are always in need and are often of the essential nature, which gives such firms certain power over the market and ensures business continuity. As a result, quality companies are able to consistently generate value in the long run for all the stakeholders involved. And that, in itself, is something market finds attractive and always comes back to. Take Straumann or Lindt & Sprüngli, as two Quality examples with different tilts style-wise. Over last ten years (31.12.2013-31.12.2023), first generated 792.3% in Total Return, while second returned 187.5% (for participation certificate) versus 85.9% delivered by SPI.

5. Performance Overview of Switzerland Quality Fund

Although 2023 was in no way an easy year for quality in Switzerland, Switzerland Quality Fund managed to close 31.12.2022-31.12.2023 period with a 10% gain (Gross, Total Return), thus outperforming MSCI Switzerland by a hefty 3.7% and confirming strong track record over the last five years ex-2022 (Figure 6). Majority of the high-quality companies, like Partners Group, Straumann and VAT that were massively sold-off in 2022 have reversed their course in 2023 and delivered exceptionally strong performance (e.g., VAT was best performer in the portfolio with 70% gain).

Figure 6: Gross Annual Total Return Performance of Switzerland Quality Fund and relative performance versus MSCI Switzerland (2019-2023)



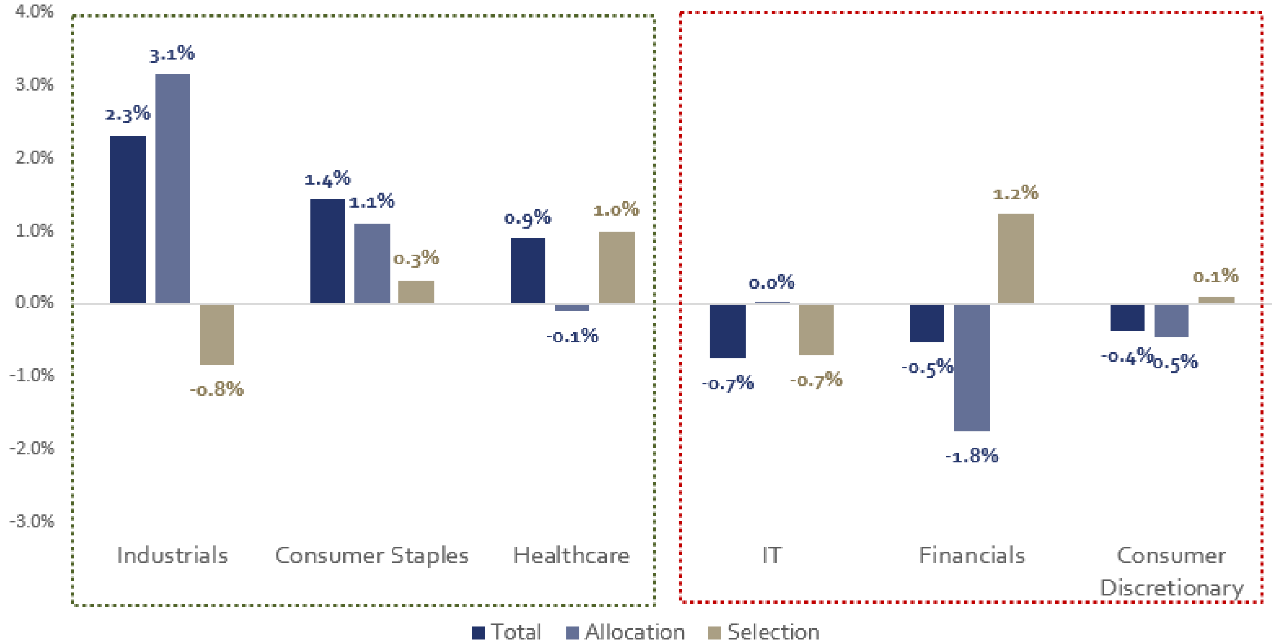
Source: Hérens Quality AM, Reuters

Performance-wise, biggest tailwind for Switzerland Quality Fund in relation to MSCI Switzerland came from Allocation effect (+2.6% attribution), although Selection effect was also positive at +1.1%.

Substantial overweight with cyclical Industrials (14% more exposure than in the benchmark) that was second best performer on the market after Information Technology, as well as underweight with Consumer Staples, that was the worst performing sector with a loss of 6%, were major highlights from Allocation perspective. Slight overweight with Materials that was third best performing sector on the market in 2023, was another positive. Within Consumer Staples, underweight with a heavyweight Nestle that lost 6.7% was one of the main drivers of outperformance within the sector. However, other holdings – Emmi (+18.1%) and Lindt & Sprüngli (8.2%) have also performed strong against a loss-making sector, thus contributing positively to the relative performance.

Selection effect, on the other hand, was the strongest in Healthcare and Financials, driven by the sole holding, Partners Group (+55.2%). Unfortunately, due to meaningful underweight of Switzerland Quality Fund with Financials in general (4.5% weight vs 16.4% weight in MSCI Switzerland), negative Allocation effect was strong enough to cancel out positive Selection effect and thus result in the overall negative attribution from the sector. In Healthcare, cumulative performance of Switzerland Quality Fund holdings was 1.2% versus 1.5% loss of the sector in the benchmark, mainly driven by gains in Sonova (+27.6%) and Straumann (+29.2%). At the same time, 7% underweight with Roche that lost 12.7% in 2023, was more than enough to compensate for negative impact from underweight with Novartis that outperformed both, the market and the respective sector.

Figure 7: Top 3 & Bottom 3 sectors within Total Attribution for Switzerland Quality Fund in 12/2022-12/2023



Source: Hérens Quality AM, Reuters

The biggest negative to relative performance, on the other hand, came from Selection in Information Technology, where we used to own Logitech up until mid-July. While being in portfolio, Logitech lost 4.1% versus positive performance of the broader sector, which was mainly driven by Temenos. Banking platform that falls into Non-Quality cluster, has soared 42.3% (in Total Return) in H1'2023, boosting sectoral gains in the benchmark. However, also timing of Logitech sale was somewhat unfortunate as since then, driven by the improved outlook for semiconductor industry and PC demand in particular, company's share price has seen good momentum and finished 2023 with a 42.2% gain.

Underweight with Financials, as mentioned above, has also put pressure on relative performance of Switzerland Quality Fund, while allocation within Consumer Discretionary has also been a point of weakness. This mainly has to do with the timing of entering the position with Cartier owner Cie Financiere Richemont. Luxury name started 2023 off the strong foot, but since March the sentiment towards the entire sector went sour as growth in North America slowed, while demand in China failed to meet expectations. As a result, performance of Richemont in Switzerland Quality Fund was double-digit negative in 2023 despite overall positive development across the business.

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