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ANNUAL REPORT 2023

- Volatile global equity markets
- Fears of inflation fade into the background while focus shifts to the general economic situation
- More restrictive lending conditions and fears of a recession weigh down small and mid caps; artificial intelligence euphoria fuels large cap tech stocks
- Global small and mid caps are suffering the second-largest underperformance relative to large caps since 1998
- Currencies, especially the US dollar, weigh on returns in CHF; in the long run, price fluctuations tend to balance out
- Xantos share class A achieves returns of +1.3% (CHF) and +11.3% (USD), driven by the information technology sector
- Portfolio: intensified focus on automation and digitalisation, cyclical components reduced
- Small and mid caps are likely to benefit more from interest rate cuts and the economic upturn
- Higher growth potential and attractive valuations increasingly support small and mid caps

Performance of Xantos A

Past performance is not indicative of future results.

A flying start to the year on the global stock markets

Contrary to many predictions, the year got off to a very promising start. The stock markets enjoyed a heartening rally in January. Last year's losers became this year's winners, none more so than the tech giants and stocks in the consumer cyclical sector. Xantos was no exception, posting a brilliant return of almost 9% (CHF).

Inflation has been falling for several months. In the same stroke, concerns about the economy have been growing. All major economies are witnessing declining levels of consumption and a lull in the construction of new properties.

Stubborn inflation and rising interest rates weigh down markets in February

Hopes of rapidly falling inflation figures, which boosted stock markets in January, were dashed in February. The data for the first two months showed that the drop in inflation was more sluggish than hoped. At the same time, the economy was stagnating. This left its mark on the markets and led to price declines. Xantos was able to escape the pressure to sell and recorded growth in February. There were a number of indications that companies' pricing power was eroding. The price increases implemented in all sectors started to have an effect on sales volumes. Fixed costs rose and reduced households' disposable income. Credit card debt in the US climbed sharply in the past year. Debt and the interest burden grew, putting particular strain on the budget of those with lower incomes.

US regional banking crisis

Rising interest rates began to take a toll. The collapse of California's Silicon Valley Bank in early March sparked the worst banking crisis since the 2008 financial crisis, triggered by the US Federal Reserve's sharp hike in key interest rates in the fight against high inflation. Many investors lost confidence and withdrew their money from a range of US regional banks. In the weeks that followed, other US regional banks fell like dominoes, such as Signature Bank or First Republic Bank, which was taken over by JP Morgan Chase. Various banks floundered, including Credit Suisse, which was acquired by UBS in a compulsory deal brokered by the Swiss government. The banking turmoil caused equity markets to slump by 7% to 10%. Following various government interventions, the markets calmed down in the second half of the month and equities were able to make some gains again.

More restrictive lending conditions and fears of a recession weigh down small and mid caps

As a result of the banking crises, lending conditions became more restrictive while money supply (M1) fell and interest rates were raised further. This deterioration was to have a negative impact on the real economy and lead to an economic slowdown. The mood became more cautious. The latest data showed that consumers were becoming more hesitant. A weakening of economic growth or even a recession seemed to be on the horizon. However, there were no signs of a recession in the relevant data and leading indicators at that stage. Full employment in the industrialised countries of the West continued to provide support.

The restrictive monetary policy and the resulting depressed economic sentiment took their greatest toll on smaller and mid-size companies. Small and mid-size companies suffered disproportionately under the restrictive monetary policy, as they are more heavily indebted on average than large cap companies and therefore feel the effects of higher interest rates and the tightening of credit more acutely. The situation was particularly difficult for companies with negative cash flow that rely on the capital market for their financing. Xantos already sold most loss-making companies in the previous year and focuses on companies with solid balance sheets. Nonetheless, Xantos did not come away unscathed from the pressure that shares in small and mid-size companies were under in April. In addition to the weak US dollar, the cyclically sensitive semiconductor companies had a particularly negative impact on the performance of returns. The generally very low demand coupled with the ongoing effects of reducing customer inventory levels already observed in the first quarter continued in the second quarter.

Artificial intelligence euphoria

In line with the stock market saying “sell in May and go away”, most markets slow down in May. As well as weaker economic figures, particularly in manufacturing in the US, Europe and above all in China, sentiment was also affected by concerns about the debt ceiling in the US. A handful of tech stocks escaped the general trend, fuelled by the artificial intelligence euphoria. Xantos posted a positive return in this month, largely due to our positioning in the technology sector (semiconductors, software). The AI euphoria made its mark.

Equity markets come under pressure from August due to rising interest rates

From August onwards, global equity markets came under heavy pressure due to rising interest rates. 10-year US government bonds reached new highs not seen since 2007. Meanwhile, rising interest rates were slowly eating away at the economic system. European economic figures in particular pointed to a slowdown and the situation in China remained fragile with its ailing real estate market. The US appeared to be in a slightly better position, but there, too, a weakening was becoming increasingly clear. In this uncertain environment, Western central banks decided not to raise interest rates further for the time being. We continue to focus heavily on automation and digitalisation and also always see economic slowdowns as a time to invest in productivity.

Escalation in the Middle East

Following an already difficult September, October brought new burdens for the equity markets. The sudden escalation in the Middle East in early October was unexpected and led to renewed turbulence that affected not only the energy and commodity markets, but also the equity markets. The geopolitical uncertainties were compounded by fears of a recession. Small and medium-sized companies came under even more pressure. A lot of money flocked to the few mega caps in the hope that they would be more resistant to the economic cycle. Given this environment and the uncertainty, many companies were not yet issuing any forecasts for 2024. Quarterly reports were dominated by disappointing figures and cut targets. Xantos had to accept price declines among semiconductor companies in the technology sector. The healthcare sector was not very defensive and remained the most significant area of concern. Constant pressure on prices, disappointments in product development and rising costs were restricting the incomes of medical and pharmaceutical companies. Equities were therefore under pressure and hardly made any price gains. This was also the case for the few companies in the field of alternative energy.

Brilliant end-of-year rally

Following the sell-off in the previous three months, the markets, and in particular small and medium-sized companies, recovered significantly in November. The recovery at Xantos was strongest in the technology sector, which remained the dominant sector. Equities in the healthcare industry also contributed to the positive monthly performance, despite the fact that, with a few exceptions, this sector was still under heavy pressure. Stockpicking has become key in healthcare in particular. Many companies experienced a veritable rally. Some Xantos stocks (Sinch, Alfen, Crisper Therapeutics, Bloom Energy, Surgical Science Sweden, AddLife) gained between 35% and 70% in November, showing how heavily the market was oversold. Fears of a conflagration in the Middle East subsided. Inflation continued to fall in most countries, while energy and metal prices generally declined in November. In Europe, there were growing signs of a recession and China was also struggling with a weak real estate market and low demand. Only the US still seemed to be experiencing robust growth, although more and more signs of a slowdown could be seen there too. Due to this global economic weakness, markets were speculating that central banks would cut interest rates again in the next year. Small and medium-sized companies particularly stand to benefit from potential interest rate reductions.

Portfolio

Performance drivers

In 2023, the information technology sector made by far the greatest positive contribution to returns. This area suffered particularly badly from the contraction in valuations in the previous year due to the rise in interest rates. Over the past year, fuelled by the euphoria surrounding artificial intelligence, software companies such as Qualys, CyberArk Software and SPS Commerce in particular, performed well. However, semiconductor companies such as BE Semiconductor Industries and Universal Display also generated above-average returns in this period.

In addition to the information technology sector, the consumer discretionary, industrial, consumer staples and financial sectors had a positive impact on the year's returns.

In the consumer discretionary sector, the portfolio particularly benefited from motorhome manufacturer Thor, where some pessimism seems to have been priced in. The limited supply of existing homes in the US also spurred interest in new builds, benefiting the two US homebuilders PulteGroup and Meritage Homes.

In the industrial sector, the defence companies Rheinmetall, SAAB and AeroVironment were once again the performance drivers. They continue to benefit from the rising arms spending of various NATO states, triggered by the war in Ukraine and increasingly by the war in Israel. VAT also performed very well as a supplier to the semiconductor industry, where the market already seems to be anticipating the next upturn.

The healthcare sector was disappointing in 2023, making the greatest negative contribution to returns, driven by companies such as Formycon (biosimilars) and Inmode (medical technology – manufacturer of minimally invasive beauty treatment devices). Negative contributions to returns also came from the cyclical materials and energy sectors.

Looking at the individual companies, BE Semiconductor (Dutch semiconductor supplier) had the greatest positive impact on returns in 2023. The market is already anticipating the next upturn in the semiconductor industry, from which BE Semiconductor is likely to benefit more than average due to its leading position in hybrid bonding. Hybrid bonding is a new and innovative technology in the field of advanced packaging – an area that is growing in importance in the semiconductor value chain as Moore's law will soon cease to apply. Apart from BE Semiconductor, Qualys (US software), Universal Display (US leader in OLED technology), CyberArk Software, SPS Commerce (US software), Rheinmetall (German defence company), VAT Group (CH semiconductor supplier), Thor Industries (US motorhome manufacturer), Salmar (Norwegian salmon farmer) and PulteGroup (US homebuilder) in particular, contributed to the positive performance.

Formycon (biosimilars) made the most substantial negative contribution to returns in 2023, followed by Inmode (medtech). The economic slowdown had a negative impact on sales figures in the third quarter and the company had to revise its profit forecast for the year. Companies in the alternative energy sector (wind/solar energy) also suffered above-average price declines, especially TPI Composite, a leading manufacturer of composite materials for the production of rotor blades for wind turbines. It was the sharp rise in interest rates and the insolvency of a customer that had a negative impact in this case.

Portfolio structure and adjustments

Xantos kicked off 2023 with a cash ratio of 17%. In sector terms, Xantos had invested almost 30% in information technology, 15% in industrial stocks and 13% in the healthcare sector as of the start of the year.

In January, we increased our position in US homebuilders (PulteGroup, Meritage Homes), which we opened in December 2022 due to their attractive valuation. Despite rising interest rates negatively impacting demand for home ownership, US homebuilders benefited from growing demand for new homes as the supply of existing homes had almost dried up. In the US, property purchases are primarily financed via 30-year fixed-rate mortgages. The sharp increase in interest rates is discouraging homeowners from moving, as the majority has mortgages that are well below the current market rate. Following a very good performance, we closed the positions again in September/October.

In January/February, we further increased our exposure to information technology to 35%, including a new position in Universal Display and MKS Instruments (semiconductors). Universal Display is a leader in the research, development and commercialization of OLED technologies and a prominent supplier of materials for OLED displays, and is expected to benefit from increasing penetration of OLED screens in the coming years, as well as a sales boost from the commercialization of its blue OLED material to supplement green and red. As a result, the cash share fell to 11% as of the end of January, which was the lowest point for the year.

In view of the increasing risk of recession, we began reducing cyclical stocks from February onwards. This included stocks from the energy (Patterson-UTI Energy, Uranium Energy), materials (Intrepid Potash) and industrial (Bossard, Bertrandt, Aumann) sectors, but also from alternative energies (Sunpower, SolarEdge, Siemens Energy). The sharp rise in interest rates makes financing projects, which are often worth billions, more expensive and puts pressure on returns. This is coupled with increased inventories following the boom years.

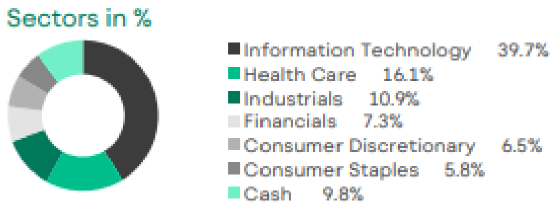
The bank run in the US and the demise of Credit Suisse made us cautious about banks (sale of Lakeland Financial, First BanCorp). The cash share at the end of April was 17% again as at the start of the year.

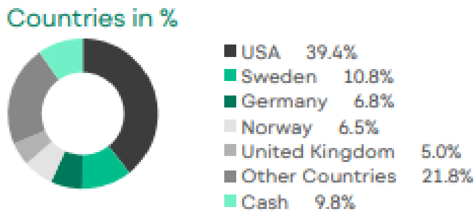
We made a few acquisitions in the healthcare sector in April, followed by more in May and June, including Demant (hearing aids), Exact Science (diagnostics – tests for the early detection and prevention of colorectal cancer), Veracyte (diagnostics – tests for the early detection of thyroid cancer, prostate cancer, breast cancer and bladder cancer), Quanterix (diagnostics – tests for the early detection of Alzheimer's) and AddLife (Swedish labtech and medtech company). This increased the weighting of the sector from 13% to 18% while reducing the cash share to 12%.

In the second half of the year, the alternative energies sector was further decreased, so that by the end of the year it had shrunk to 2% (8% at the start of the year). We also cut materials and some unprofitable companies in the healthcare sector. Conversely, we made a number of acquisitions in the consumer staples sector (Mowi, Aryzta).

As of the end of the year, Xantos has invested 40% in IT and 16% in healthcare. Geographically speaking, 39% of the assets are invested in the US and 49% in Europe. The cash ratio is just under 10%.

Xantos sector and country breakdown at the end of Dec 2023





Outlook

Growth concerns

Global industry has been in recession for several months. Pricing power in industrial and consumer goods has been eroded and prices for most goods have been falling again for a few months now. Major growth concerns are spreading in Europe and China, while industry in the US is also experiencing weak growth. This weak growth now seems to be expanding into the service sector. The labour market in Western countries is still very robust. However, consumers' purchasing power is reducing steadily, increasing their price sensitivity. The strengthening of the tourism sector and the price increases have presumably led to an overly positive view of growth. With around 10–12% of global economic output, tourism is the largest industrial sector alongside the construction industry. However, construction in particular is increasingly suffering from rising interest rates.

Interest rate turnaround

Concerns about growth have reached the central banks. At the Federal Open Market Committee (FOMC) meeting on 13 December, Jerome Powell signalled an interest rate turnaround. The Fed is promising interest rate cuts soon. This unexpected turnaround occurred within a few weeks. It seems that inflation is falling faster than expected or that the Fed fears that its excessively restrictive policy could stifle the economy (overtightening). In Europe, the European Central Bank (ECB) has also made a rhetorical U-turn. The question for the coming year is therefore no longer whether interest rates will fall, but when and by how much. The abrupt rhetorical U-turn and increasingly weak economic figures suggest that the first interest rate cuts will take place sooner than previously anticipated.

Profits

As a rule, company profits are extrapolated into the future based on the average of past years. A profit increase of around 12% is estimated for the US market, while no growth is expected for Europe. However, the lack of momentum is likely to cause many disappointments. As already pointed out, pricing power is eroding not only for industrial goods, but also for consumer goods and services. Nevertheless, any interest rate cuts are expected to brighten the outlook again. We are assuming that sectors in the consumer and service industry that recorded rising sales and profits in 2023 will be more likely to struggle with stagnation in the new year. At the other end of the scale, industrial companies in particular, should have bottomed out. It is difficult to estimate profit momentum in the healthcare sector. Cost pressure and a lack of new products are negatively affecting many companies' profit trends. By contrast, some companies repeatedly succeed in substantially increasing profits with innovations and new products (e.g. weight loss injections). As has long been the case with technology companies, the gulf between "losers" and "winners" is growing steadily in the healthcare sector.

Stockpicking

As in the previous year, uncertainty about profits is likely to bring stockpicking to the fore. Last year, a dozen mega caps dominated the large companies. This is set to continue in the coming year. The situation is similar for small and mid caps, which are expected to vary considerably once again. In case of doubt, falling interest rates will outweigh weaker profits. Markets are hoping that the interest rate cuts will boost the economy and that profits will rise again with a delay of a few months. However, this also means that the prices of companies with above-average debt are likely to benefit.

Preferred sectors

At present, government investment programmes in energy infrastructure, security of supply or strategic technologies dominate investment areas. Reshoring, which refers to the return of various production processes to Western spheres of influence, also remains an ongoing theme. In order to boost productivity and maintain margins, automation and digitalisation will continue to be popular. Given these programmes and priorities, we believe that the greatest opportunities will still be found in the technology segment. Following last year's industrial recession, many industrial companies are also likely to benefit more from these government measures.
New technologies/innovations remain an important driver on the equity markets. New technologies can create new markets. However, the implementation

of many new technologies is likely to start with existing companies in many cases. The use of artificial intelligence, automation and digitalisation is advancing. Artificial intelligence will remain a topic in the coming months. Companies like Surgical Science Sweden AB (Swedish manufacturer of VR simulators for laparoscopic and endoscopic training) and Autostore (Norwegian robotics and software company in the field of warehouse automation technology) will continue to be established or expanded.
The healthcare sector remains an area of concern. In the short term, many companies are facing increasing competition (expiring patents), growing cost pressure and substantial development times and costs. In the long term, the sector continues to offer great potential for innovation and above-average growth. AI will pave the way for new technologies, particularly in the field of diagnostics. Algorithms will also become increasingly important in development. Rising interest rates have severely reduced the provision of venture capital, making financing considerably more expensive and in many cases impossible. The interest rate turnaround is likely to ease this situation. The healthcare sector remains exciting, but also challenging and selective.

Global small and mid caps attractively valued

Global small and mid caps suffered the second-largest underperformance relative to large caps in 2023 since 1998. The strong underperformance has made small and mid caps more attractive in terms of valuation. Small and mid caps are currently trading at a discount of around 10% compared to large caps, whereas over the past 15 years they have traded at an average premium of around 10% due to their higher growth. Small and medium-sized companies may be hit harder by the effects of an economic slowdown than large companies, but this also opens up investment opportunities as the potential for recovery is greater. The higher growth potential combined with a more attractive valuation increasingly supports small and mid caps, particularly if the economic environment brightens up again and the interest rate situation eases.

Valuation comparison of global small and mid caps vs large caps