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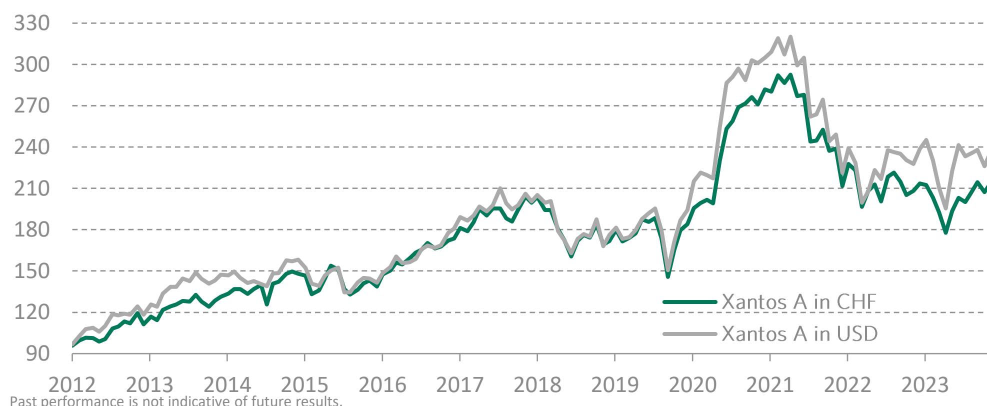
HALF-YEARLY REPORT 2024

- Positive semi-annual return on small and mid caps despite lacklustre start
- Continuing euphoria surrounding artificial intelligence
- Large caps and "AI" stocks driving market growth
- Decreasing inflationary pressure, but increasing growth problems in Europe; US growth still strong
- Good corporate profit statements and a better-than-expected outlook buoying particular stocks
- Xantos share class A generated a return of +4.0% (CHF) or -2.6% (USD) in the first half of the year, driven by the information technology, industrials and finance sectors
- Portfolio – no strategic adjustments
- Easing inflationary pressure is increasing the prospect of a loosening of monetary policy and creating favourable conditions for a rally in small and mid caps
- Profit recovery following industrial recession and easing pressure on margins are increasing the potential for a rally in small and mid caps
- Attractive valuation of global small and mid caps is offering good entry opportunities

Performance of Xantos A in CHF



Past performance is not indicative of future results.

Lacklustre start to the year for small and mid caps

Small and mid caps got off to a lacklustre start in the new year. Inflation and interest are continuing to dominate the discussion and market events. The US economy also demonstrated strong growth in the first half of the year, while China and Europe faced weak economic growth or a recession. The slowdown has been particularly evident in the real estate market, industrials and small

and mid caps. Despite the tough environment, many companies have been managing to remain profitable. The majority of companies will remain reticent for the next few months. Due to the uncertain prospects of sales and profit, the shares of many companies are under pressure. The effects of the sharp increase in interest rates are becoming ever more apparent.

Inflationary pressure easing in Europe, with growth problems taking centre stage

US growth remains surprisingly high. However, more and more clouds are forming in the economic sky and economic indicators appear to be cooling. China is stuck in a deflationary spiral, while Germany – the beating heart of the European economy – is undergoing a recession. Inflation is continuing to ease, albeit not as quickly as hoped. There is increasing scope for central banks to intervene in response to any economic weaknesses. In a surprise move in March, the SNB announced a turnaround in interest rates by bringing in its first rate cut. Europe also took initial measures with regards to interest in June while the US appears poised to follow suit.

Strong annual financial statements and better than expected outlooks help Xantos achieve positive returns in the first quarter

Following the previous year's year-end rally, profit-taking was reported in the first few weeks of 2024. In February and March, Xantos profited from rising share prices, driven by strong annual financial statements and better than expected outlooks (Coherent, Fortnox, Pegasystem) for this year. The positive return in the first quarter is mostly attributable to investments in the defence industry and the information technology sector.
Last year's affairs continued to dominate the performance of certain sectors. In the case of the technology sector, this was artificial intelligence (AI); in the healthcare sector, it was GLP-1 weight loss injections, while in the industrials sector, it was the defence industry.

Stubbornly high inflation and strong employment figures in the US cast doubt on interest rates falling any time soon and depressed markets at the start of the second quarter

As the saying goes, "good news becomes bad news". Sure enough, strong US economic data and higher commodity prices at the start of the second quarter cast doubt on the speed of the loosening of monetary policy. If, at the start of the year, the market was still predicting six base rate cuts of 0.25 percentage points each, expectations have since been revised down to just one or two rate cuts. Stock markets have been reacting negatively to the subsequent rise in interest rates. Even Xantos has been unable to resist the selling pressure. On top of this, geopolitical risks (Ukraine, Middle East, Taiwan) have been consistently weighing down the markets. After the European elections, European

markets were depressed by political power shifts and uncertainty in addition and in particular.

Better than expected Q1 corporate profit figures and uninterrupted AI hype buoy stock markets

A strong US reporting season for the first quarter and the uninterrupted hype surrounding artificial intelligence (AI) catapulted the major US indices to new all-time highs, more than making up for April and May's losses. Xantos, too, climbed to a new annual high. There was great hope that this year would see profits recover, especially as the overall market's profit increase was attributable to a small number of mega caps. However, the results of the Q1 earnings season sent mixed signals, above all from the retail sector. The surplus savings accrued during the pandemic seemed to have been used up. The macroeconomic data points were showing signs of a slowdown in some parts of the US economy, increasing the probability that the Fed would cut interest rates sooner rather than later. While the US was showing signs of an economic cooldown, Europe was showing signs of a cyclical upturn.

Portfolio

Information technology and defence industry as main performance drivers

The half-year performance is relatively broad-based, but chiefly driven by the information technology, industrials and finance sectors. Within the information technology sector, Coherent (optical communication, US) is the top performer, followed by CyberArk Software (software company in the area of internet security) and MKS Instruments (US semiconductor). Pegasystems (US software) and QT Group (Finnish software company) also delivered above-average returns. Within the industrials sector, the biggest positive contribution to returns resulted once again from defence companies (Saab AB, Rheinmetall and AeroVironment), which are continuing to profit from geopolitical insecurity and increased defence spending among the NATO allies. VAT also performed well as a supplier to the semiconductor industry. Among financial stocks, Nordnet (Swedish digital bank) and Mapfre (Spanish property and casualty insurance) contributed to the positive return performance in the first half of the year.
Once again, the healthcare sector delivered a disappointing performance in the first half of the year. This sector made the largest negative contribution to returns, with companies such as Quanterix (US diagnostics), Surgical Science (Swedish provider of medical simulation training and software solutions) and Alphatec (US medical technology) in particular, under constant price pressure. The consumer staples and materials sectors also made negative contributions to returns.
The biggest positive contributions to returns on the stock level came from Coherent, Saab AB, Rheinmetall, AeroVironment and CyberArk Software. On the

negative side, Quanterix, Sinch, Ocado Group, Alfen and Temenos weighed down returns the most.

Portfolio structure and adjustments

Xantos kicked off this year with a cash ratio of almost 10%. In sector terms, Xantos had invested almost 40% in information technology, 16% in the healthcare sector and 11% in industrials as of the start of the year. In geographical terms, 49% of assets were invested in Europe and 39% in the US.

In the first half of the year, we cut back somewhat on certain positions, especially in the area of information technology. In particular, this applied to the area of cybersecurity (CyberArk Software, Qualys), but also to other software companies such as Fortnox and SPS Commerce, as well as semiconductor companies (BE Semiconductor, Advanced Energy Industries) and optical communication (Coherent, Universal Display). We also severed ties with Sinch, Temenos, Silicon Laboratories and Lattice Semiconductor, reducing the sector weighting from 40% to 37%.

In the healthcare sector, we sold Exact Sciences (diagnostics) and Inmode (medical technology), while establishing a small position in Biotage (Swedish life sciences company). The weighting of the healthcare sector was reduced by 2% net.

In the area of defence, we have severed ties with Rheinmetall due to its market capitalisation of over EUR 20 billion. We had purchased the shares in January 2022 due to their cheap valuation. 4–5% of our investments are still in the defence industry, with the companies Saab (Sweden), AeroVironment (US) and Hensoldt (German defence corporation/defence and security electronics).

In view of falling interest rates, we established a small position in UK home builders (Cairn Homes, Persimmon, Berkeley). Towards the end of the second quarter, a position was also opened in the Swedish real estate market (Catena, NP3 Fastigheter, Nyfosa). We have also slightly intensified investments in industrials in Europe (Jungheinrich, Sdiptech, Kardex), where we are anticipating a profit recovery after the industrial recession. Expensive technology stocks were reduced further and replaced with attractively valued companies with good prospects for improving margins and increasing profits.

As of the end of the first half of the year, the cash ratio is 10%. 41% of assets are invested in the US and 47% in Europe.

Xantos sector and country breakdown at the end of June 2024

Sectors in %

- Information Technology 37.2%
- Health Care 14.0%
- Industrials 12.3%
- Consumer Discretionary 8.0%
- Financials 7.3%
- Other sectors 11.0%
- Cash 10.2%

Countries in %

- USA 40.0%
- Sweden 13.9%
- Germany 6.6%
- Norway 4.3%
- Denmark 3.2%
- Other countries 21.9%
- Cash 10.2%

Outlook

Interest rates – the decisive factor

As expected, the ECB lowered the base rate in June. The forthcoming inflation and labour market data will now show how soon further rate cuts will follow in Europe. Pressure on the ECB to support the ailing economy in Germany and other Central and Northern European countries may rise. Under no circumstances will the cycle of rate cuts in Europe be as aggressive as the cycle of rate hikes; on the contrary, the reduction of the base rate will be gradual. However, in the second half of the year, the shift in monetary policy may elevate the economic outlook in Europe.

The question now is when the Fed will begin to lower interest rates. Since the start of the year, we have witnessed enormous shifts in expected interest rates. Initially, market participants were expecting six base rate cuts in the US; now the prediction is one or two rate cuts. In terms of potential rate cuts, the question is not when but why rates will (have to) be cut. If the economy slows sharply or even slides into a recession – of which there is currently no indication – central banks could be forced to loosen monetary policy significantly. The great risk remains the future course of interest rates, if inflation fails to come down further as hoped.

Lower interest rates work in favour of small and mid caps

Small and mid caps may benefit more than average from rate cuts. Lower interest rates will breathe life into the economy. In particular, real estate, consumption and investments may be stimulated by lower interest rates.

Small and mid caps have more debt on average than large companies. Lower interest expenses will relieve the burden from small companies and free up liquidity for other areas.

The main beneficiaries of lower interest rates would be bond-proxy sectors such as the utilities, consumer staples, healthcare, and telecommunications sectors and, to a certain extent, the real estate sector. These are defensive sectors that generate relatively stable profits even in weak economic phases. Small and mid caps should respond much faster and more dramatically to an economic recovery due to falling interest rates.

AI euphoria continues

The euphoria surrounding artificial intelligence (AI) continued into the first half of the year. Large tech corporations have been investing heavily in the computer intelligence megatrend, from which Nvidia has been profiting in particular, as its processors are essential for training generative AI that generates language and images. There is currently a real race among big tech corporations as per the motto “the winner takes it all”. As for whether the high level of investments will pay off for everyone, only time will tell. As it stands, the beneficiaries are primarily companies that provide the infrastructure for generative AI and are therefore profiting from the investment cycle. These include chip manufacturer Nvidia and cloud service providers Amazon, Microsoft and Alphabet.

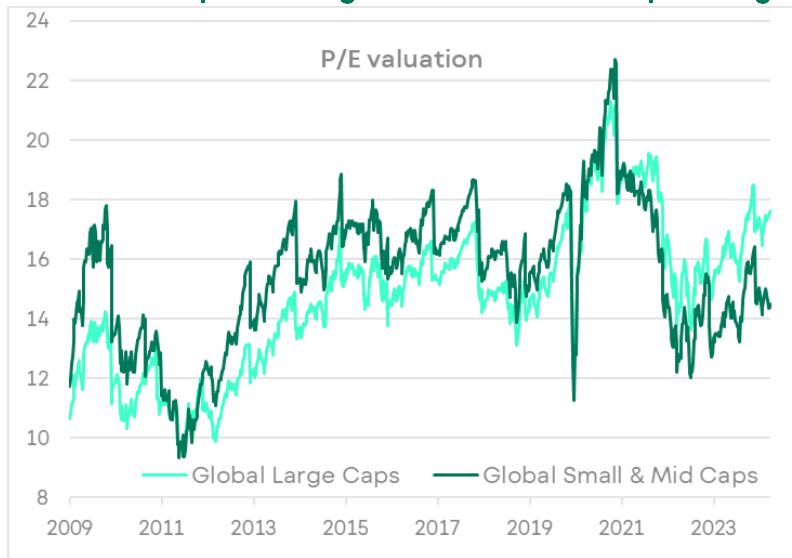
For the time being, small and mid caps may not benefit as much from the AI hype. They will benefit in the second round if they manage to increase their productivity and thus their profitability by using AI. In the next one to two years, the first AI-based productivity advances may become apparent. In light of the weak productivity growth over the last few years, this would be very good news.

It can be assumed that AI hype will remain the dominant investment topic in the second half of the year. This might also be the case if and when the first rate cut in the US or further rate cuts in Europe manifest. However, it is possible that those profiting from AI will see a shift away from the providers of computing power to applications (software) and users.

Global small and mid caps with a valuation discount of almost 20% compared to large caps

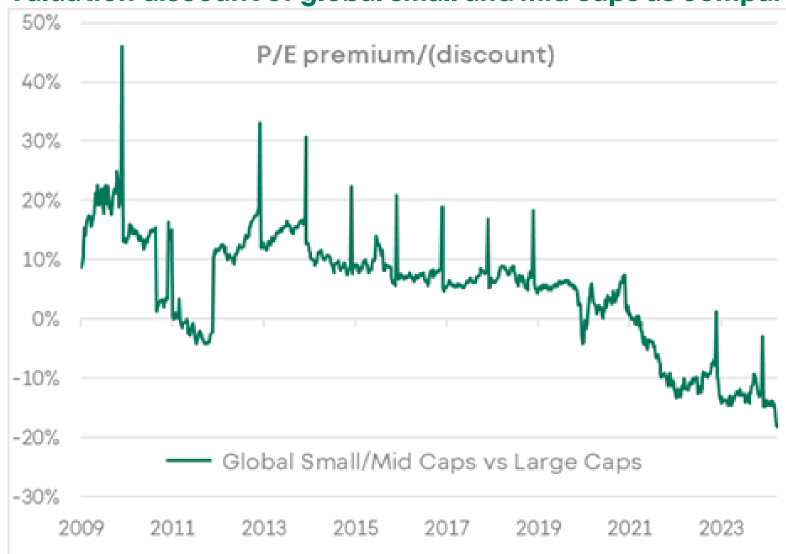
The valuation of large caps and in particular mega caps has become more demanding and leaves no room for nasty surprises in terms of sales and profit trends. Small and mid caps, on the other hand, are attractively valued, including from a historical perspective. Global small and mid caps are currently trading at a discount of almost 20% compared to large caps, whereas over the last 15 years they have traded at a premium of 5–10%.

Valuation comparison of global small and mid caps vs large caps



The following valuation chart makes the impressive trend apparent. In boom phases, small and mid caps trade with a 20% premium as compared to large caps. In the last 10 years, the premium has consistently declined and, since 2021, small and mid caps have even been trading at a discount as compared to large caps. This year, the valuation discount of small and mid caps has increased significantly yet again. The reversal from valuation premium to valuation discount demonstrates the impressive potential of small and mid caps.

Valuation discount of global small and mid caps as compared to large caps



Great potential waiting to be harnessed

The first half of the year was very challenging for small and medium-sized enterprises. It was characterised by pressure on margins, interest rates,

geopolitics and a dominating area of investment among a small number of "super companies". In spite of this, it has been possible to generate a modest positive return.
Going forward, enormous potential is building for many companies, in particular small and medium-sized enterprises. The valuations are attractive, especially compared to large companies, and expectations are conservative. The possibilities of AI will open up new opportunities for growth in many companies. For suppliers, for providers of innovative solutions in niche areas and for users, AI will open up new prospects for countless companies.
We predict that some of the price potential will be triggered in the next few months. It is difficult to say whether the effects of interest rates and the state of the economy or technological drivers will take hold first. Rate cuts may have a temporary effect, while technological changes would more likely produce effects in the medium term. The lower valuation may then ease as well. Investment opportunities in small and medium-sized enterprises are exceptional and show great promise.