31 DECEMBER 2022

AUSTRALIAN EQUITIES FUND

PARADICE
INVESTMENT MANAGEMENT

PERFORMANCE NET (%)	1 MONTH	3 MONTH	1 YEAR	3 YEAR P.A.	5 YEAR P.A.	SINCE INCEPTION* P.A.
Australian Equities Fund	-2.57	10.35	4.48	7.81	8.15	9.56
S&P/ASX 200 – Total Return Index	-3.21	9.40	-1.08	5.55	7.11	7.96
Excess Return	0.64	0.95	5.56	2.26	1.04	1.60
						*Inception date – 2 August 2017

Past performance of the Fund is not a reliable indicator of future performance. The value of an investment in the Fund may rise or fall. Returns are not guaranteed by any person. Fund returns are calculated before tax, after ongoing management costs and any accrued performance fees, and assumes the reinvestment of distributions. Returns greater than 1 year are annualised.

INVESTMENT OBJECTIVE

The Fund aims to outperform the S&P/ASX 200 Total Return Index (after fees and before taxes) over a rolling three to five year period.

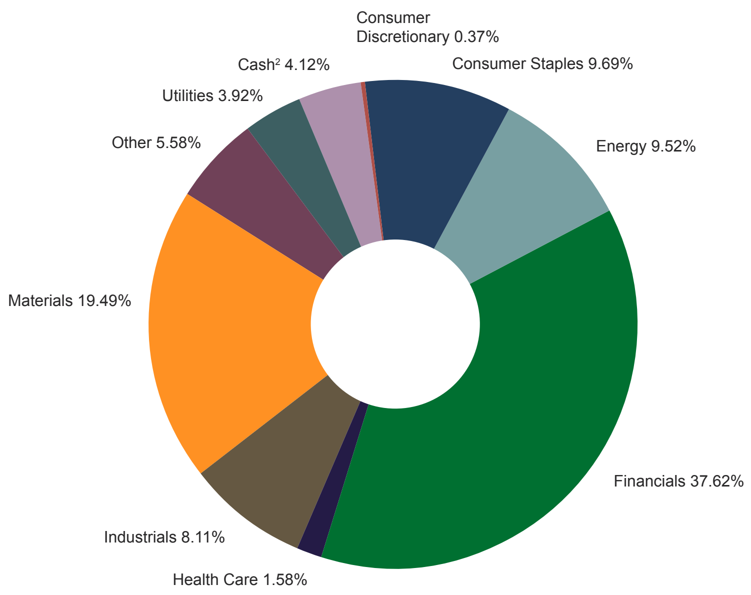
LEAD PORTFOLIO MANAGER

Troy Angus

FUND OVERVIEW

The highly experienced team use a detailed fundamental research process to find stocks that are growing faster with better outlooks over the next 3–5 years. The fund is agnostic of investment style and has a focus on capital preservation.

SECTOR ALLOCATION



KEY DETAILS	
Number of Holdings	30
Portfolio Dividend Yield	4.95%
Fund Size (AUD)	$91M

TOP 10 POSITIONS	WEIGHT %
BHP Group Ltd.	13.60
National Australia Bank Ltd.	8.63
ANZ Banking Group Ltd.	6.73
Commonwealth Bank of Australia	6.59
Woodside Energy Group Ltd.	5.94
Macquarie Group, Ltd.	4.04
Woolworths Group Ltd.	3.89
Origin Energy Ltd.	3.82
Qantas Airways Ltd.	3.71
QBE Insurance Group Ltd.	3.63

FUND DETAILS	
APIR Code	ETL8084AU
Distribution Frequency	Semi-Annually
Management Fee[1]	0.75% p.a.
Performance Fee	15% p.a.
Buy Sell Spread	+/- 0.20%
Minimum Investment	$20,000
Stock Range	Typically 30–50
Cash Range	0–10%

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PARADICE
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Performance in AUD unless otherwise noted.

MARKET REVIEW

Global equity markets rebounded over the quarter on reduced inflationary pressures, and interest rate expectations stabilising. China embarking on a reopening, and the Ukraine pushing back Russian forces helped. The MSCI World Net Total Return Index rose 9.8% (in USD)[1], and the S&P/ASX 200 Total Return Index improved 9.4%. Globally, only the Technology heavy NASDAQ disappointed as it fell 0.3% (in USD) on a declining earnings outlook.

US Core Inflation eased slightly to 6.0% in November from a peak of 6.6% in September, and (although still elevated) has now remained in a range from 5.5% to 6.6% for 12 months, giving some comfort that inflation isn't spiralling out of control. Although the US Federal Reserve lifted their target rate by 125bp to 4.50% in December, from 3.25% in September, this was largely in line with expectations and the US 10-year government bond yield rose just 4bp over the quarter. However, with interest rates still moving higher, US economic growth faces headwinds. Futures imply a 5.0% US Fed target rate by June 2023. The US 2-to-10-year yield curve remains inverted by 55bp, which is an indicator of an impending recession. Bloomberg contributing economists' US 2023 Real GDP growth expectations fell to just 0.3%, and they are now forecasting a 65% probability of a recession.

The economic situation in Australia is better than in the US due to the relative benefit of China reopening and lower wage pressures. Futures imply a 3.7% cash rate in June 2023, which is a 40bp reduction from September. The Australian 2-to-10-year yield curve is positive by 64bp, which is an 8bp improvement over the quarter. Bloomberg contributing economists' Australian 2023 Real GDP growth expectations sit at 1.8%, and they are forecasting a 30% probability of a recession.

The Bloomberg Commodity Total Return Index (in USD) gained 2.2%. Nickel bounced 42.2%, Iron Ore 20.9% and Copper 9.7% (all in USD) on more positive sentiment stemming from China's reopening. Spodumene rose 7.5% (in USD) over the quarter but was higher earlier on strong demand and then eased on deteriorating end market demand and excess inventory. Thermal coal eased 6.8% (in USD) on lower demand as Europe enjoyed a warmer autumn. Brent weakened 2.3% (in USD) as China and India bought Russia's oil exports.

Utilities were the strongest sector of the S&P/ASX 200 Total Return Index rising 28.0% on Brookfield's bid for Origin Energy. Materials (+15.2%) outperformed on a recovery in commodity prices driven by sentiment around China's reopening. REITS (+10.4%) outperformed as valuations bounced due to interest rate expectations easing. Financials (+10.5%) marginally outperformed largely as Banks rose on an improved Net Interest Margin (NIM) outlook. Consumer Discretionary and Information Technology underperformed due to deteriorating earnings outlook.

The Australian Government announced coal and gas energy price caps. BHP entered into a scheme to buy OZ Minerals. CSL and Newcrest CEO's both announced their departures. Woolworth's bought a 55% stake in Petspiration.

PERFORMANCE

The portfolio outperformed by 95bp over the quarter.

Contributors/Detractors

Positives

Origin Energy (ORG) Overweight

Origin jumped on a takeover offer from Brookfield.

CSL (CSL) Not owned

CSL underperformed on negative earnings revisions as the path to recovery continues to be delayed and the market likely remains unconvinced around its Vifor acquisition.

BHP (BHP) Overweight

BHP outperformed on a recovery in the iron ore price driven by sentiment around China's reopening.

Qantas (QAN) Overweight

Qantas outperformed on another profit and balance sheet upgrade driven by ongoing strong demand and customer ticket prepayments.

Challenger (CGF) Overweight

Challenger outperformed on an improving outlook for annuity sales due to higher interest rates and credit spreads.

Negatives

Westpac (WBC) Not owned

Westpac outperformed on an improved Net Interest Margin (NIM) outlook helped by higher rates.

Medibank Private (MPL) Overweight

Medibank fell on a cyber-attack and expected increased IT costs and possible litigation.

Santos (STO) Overweight

Santos underperformed on project delays due to a court ruling at Barossa and internal redesign at Dorado, and negative sentiment from the Australian government's East Coast gas price cap.

Resmed (RMD) Overweight

Resmed underperformed on a valuation derating due to higher rates.

Fortescue (FMG) Not owned

Fortescue outperformed on a recovery in the iron ore price due to China's reopening.

PORTFOLIO CHANGES

The portfolio was rotated toward more defensive positioning on increasing macro headwinds and a concern consensus earnings expectations are too high for many Industrials.

Purchases

ANZ and Westpac (ANZ and WBC)

ANZ was increased and Westpac added back into the portfolio on improved NIM outlooks due to higher rates, on expectations loan losses will take longer to materialise, and attractive valuation.

Coles (COL) and Woolworths (WOW)

Coles and Woolworths were increased post stock price weakness that improved valuation, and on expectations they will be food inflation beneficiaries and COVID costs drop out.

Brambles (BXB)

Brambles was increased on ongoing solid business momentum and pricing power evidence.

Sales

Rio Tinto (RIO), BHP (BHP) and South32 (S32)

Rio Tinto, BHP and South 32 were reduced following share price outperformance of their respective commodity price indices and due to a lower iron ore forecast on weaker Chinese property demand.

Woodside (WDS)

Woodside was reduced following outperformance and reduced valuation support, and as part of a switch into Santos which has underperformed.

Pilbara (PLS) and Allkem (AKE)

Pilbara and Allkem were sold following share price outperformance, as the stocks moved ahead of their Lithium and Spodumene commodity price indexes, and due to a deteriorating commodity outlook on weaker end market sales and inventory build.

[1] For the purposes of comparison commentary is quoted in Australian dollar terms and Australian sector returns refers to the S&P/ASX 200 Total Return Index unless stated otherwise.

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PARADICE
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ENVIRONMENTAL, SOCIAL, GOVERNANCE ISSUES (ESG)

Environmental, Social, Governance Issues (ESG)

A number of notable developments related to nature and natural capital occurred during the quarter. Firstly, the much-delayed UN Conference on Biodiversity, COP15, was able to achieve a landmark agreement with 196 countries signing up for the Kunming-Montreal Global Biodiversity Framework. A key commitment made was to protect 30% of the world's land and water by 2030. In Australia, the Federal Government released a Nature Positive Plan with significant reforms proposed including a new environmental protection agency (EPA) and increased protections for areas of national environmental significance. We anticipate that these developments will further drive the fast-emerging investor focus on natural capital and enhanced corporate reporting on management of nature-related risks and opportunities.

With two high profile cyber incidents in recent months and potential vulnerabilities exposed across corporate Australia, cyber resilience has become a key focus for companies and investors alike. While we understand that legal settings in Australia are likely to make customer class actions challenging, companies which fall victim can face other financial impacts such as fines and regulatory impost. So far, we have found that customer churn is lower than one might anticipate given negative media coverage. Additionally, in our view, cyber resilience needs to be approached in a holistic manner, well beyond a focus on IT systems and security and extend to human capital and customer management practices. For further thoughts on understanding the human side of cyber resilience to mitigate risk please see our recent article here.

Australia is one step closer to a mandatory climate-related disclosure regime which has the potential to change the landscape of reporting across ASX-listed entities. Recently the Treasurer announced a consultation on such a regime, seeking input from industry on items such as who should be required to report and to what extent should a local regime align with international standards. Australian efforts follow a similar endeavour commenced by the US Securities and Exchange Commission earlier in the year. MSCI research found that the proposal of climate-related reporting requirements through the consultation was enough to see a 67% uptick in US companies reporting Scope 3 emissions. Regardless of the exact shape of the Australian regime, in our view there will be a significant impetus for ASX companies to expand the climate-related disclosures provided to the market.

ENGAGEMENT

During the quarter, we undertook a total of 16 engagements in which we explicitly discussed ESG matters with 12 companies relevant to the strategy. Of these, 81% were held at either board or executive level. The engagements covered a range of issues and most meetings discussed multiple ESG matters. In this period, the most commonly discussed topics were climate transition, executive pay and cyber risk.

Cyber security dominated engagement in the period with Medibank Private (MPL). We held various meetings at executive and board-level, seeking to understand the incident, the impacts to customers and ultimately the potential for penalties or other liabilities. While the compromise of sensitive medical data for a significant portion of the Australian population is obviously a negative, we believe Medibank has responded to the incident responsibly by refusing to pay a ransom and has been transparent in its disclosure (made challenging by the rapidly evolving situation). We are of the view that policyholder churn in the short term and penalties under prevailing law is likely limited, but it is too early to conclude longer term ramifications.

We also held a meeting with Woolworths Group (WOW) dedicated to modern slavery. After learning that the company had confirmed modern slavery was found at a supplier in Malaysia, we sought to understand more about the incident itself as well as how the company was responding. Overall, we took comfort that Woolworth's approach was very thorough and the company had evidenced a strong commitment to transparency.

OUTLOOK AND POSITIONING

We anticipate ongoing elevated inflation and increasing interest rates, albeit expectations have likely peaked. 2023 GDP growth expectations have largely normalised. But the risk of a recession in the US and Europe is more likely than not. Australia though should avoid a recession, and the outlook for GDP growth may have troughed, as China now reopens. However, company earnings expectations in the US and Australia still appear too high, especially for Industrials, Technology and Consumer sectors.

Economists forecast the possibility of a US recession at 65%. Core inflation still faces headwinds from higher Shelter and Services costs. Economists forecast the US Federal Reserve needs to raise the Fed Funds rate to 4.7% (from 4.5%) to choke off inflation. The December 2022 Institute of Supply Management (ISM) reading fell back to 48.4, where 50 indicates neutral.

In Australia, the outlook is better. Economists forecast the possibility of a recession at 30%. Australia should benefit as China reopens, although the success of this does also pose a risk. The inflation challenge isn't as great here as in the US as wage growth has been a more acceptable 2.6% (vs 5.1%). Economists conclude rates may peak at just 3.55% (from 3.1% today).

However, recessionary risks remain globally as monetary authorities have not managed a slowdown of this magnitude previously without a recession. That said, households and Small and Mid-sized Enterprises have considerable savings to buffer higher mortgage rates and inflation. There does not appear to be a systemic risk to the economy like there was in the lead-up to the Global Financial Crisis.

The portfolio is defensively positioned and exposed to inflation beneficiaries. The portfolio is underweight Materials overall as global growth slows, and because lithium stocks were sold after they moved ahead of their commodity price indexes. The portfolio is overweight commodities (including fertilisers) where supply/demand fundamentals are attractive, due to China's reopening and a likely medium-term shift away from Russian supply, lifting cash flow generation, and valuation support. Although Lithium stocks have been sold, the portfolio is still exposed to other battery materials such as nickel and rare earths.

The portfolio is overweight Energy on an increased medium-term outlook for Brent oil and gas price that has strengthened their cash flow generation and valuation support. Proposed asset sales should be easier to complete, and previously marginal projects now have justifiable economics. ESG issues remain a concern, but all companies owned largely produce LNG, which is a transition fuel.

The portfolio is overweight Banks on an improved Net Interest Margins (NIM) outlook due to higher rates, and on expectations loan losses will take longer to materialise. The portfolio is exposed to Insurance companies, which are benefiting from increasing their pricing and higher investment yields. Challenger has been added due to an improving outlook for annuity sales on the back of higher interest rates and credit spreads.

Within Consumer Discretionary, the portfolio is positioned in air travel where we see pent up demand continuing. The portfolio is overweight defensive Consumer Staples, which will be food inflation beneficiaries and COVID costs drop out. Within Industrials overall, the portfolio is exposed to stocks with pricing power to take advantage of the inflationary environment. We see margin and earnings expectations for Industrials generally too high. Strong demand over COVID may be replaced by cost inflation next.

The portfolio is underweight IT, Healthcare, Infrastructure, Telcos and Utilities where valuations tend to be negatively impacted by rising rates due to the long-dated nature of their cash flows.