30 JUNE 2022

AUSTRALIAN EQUITIES FUND

PARADICE
INVESTMENT MANAGEMENT

PERFORMANCE NET (%)	1 MONTH	3 MONTH	1 YEAR	3 YEAR P.A.	SINCE INCEPTION* P.A.
Australian Equities Fund	-8.67	-11.57	-0.24	5.09	7.87
S&P/ASX 200 – Total Return Index	-8.77	-11.90	-6.47	3.34	6.76
Excess Return	0.10	0.33	6.23	1.75	1.11
					*Inception date – 2 August 2017

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.

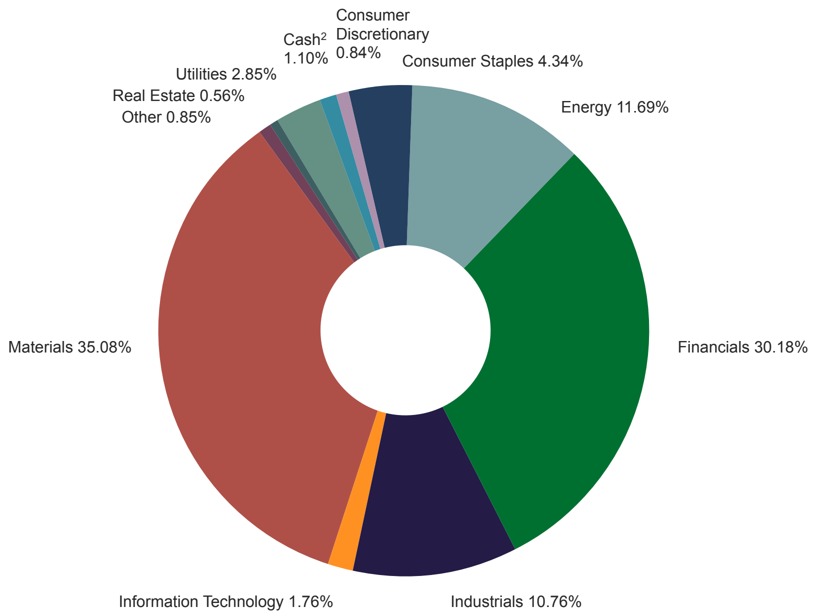
LEAD PORTFOLIO MANAGER

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	32
Portfolio Dividend Yield	5.25%
Fund Size (AUD)	$76M

TOP 10 POSITIONS	WEIGHT %
BHP Group Ltd.	16.95
National Australia Bank Ltd.	8.82
Woodside Energy Group Ltd.	7.40
Commonwealth Bank of Australia	4.88
Macquarie Group Ltd.	4.64
Santos Ltd.	4.29
QBE Insurance Group Ltd.	4.12
Insurance Australia Group Ltd.	3.29
Rio Tinto Ltd.	3.20
Australia and New Zealand Banking Group Ltd.	3.20

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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MARKET REVIEW

Global equity markets fell over the quarter on higher inflation surprises, central banks raising interest rates, and a deteriorating economic growth outlook with an increasing possibility of recession. The MSCI World Net Total Return Index fell 16.2% (in USD)[1] versus the March 2022 quarter. The S&P/ASX 200 Total Return Index fell 11.9%. The smaller decline in Australian equities was largely due to less exposure to Technology stocks, which suffered heavy falls overseas.

Headline inflation accelerated to 8.6% in the USA in May 2022 year on year (yoy), and 5.1% in Australia in the March quarter yoy, due to ongoing impacts from the Ukraine invasion and COVID overstimulation. The US Federal Reserve, after its inaugural rate rise for this cycle of 25bp in March 2022, lifted 50bp in May, and another 75bp in June, to 175bp. Chairman Jerome Powell said the Fed is 'strongly committed' on inflation and noted recession is a 'possibility'. The bond market futures in the USA are implying a further 150bp of tightening for the remainder of the year to 3.3%, although this has come back by ~30bp recently. The Reserve Bank of Australia lifted rates inaugurally by 25bp in May and 50bp in June to 85bp. The futures here imply a further 230bp of tightening this year to 3.1%, although this has come back by ~70bp.

Bloomberg contributing economists' US 2022 Real GDP growth expectations peaked at 4.3% back in September 2021 and has fallen to 2.5%, and Australian Real GDP forecasts peaked at 4.5% in March 2022 and now at 4.0%. The US 10-year yield rose 67bps and the US yield curve steepened 6bps. The Australian 10-year and 2-year both rose 82bps, so the steepness of the curve was maintained.

The Bloomberg Commodity Total Return Index rose 2.3% for the quarter. Thermal coal leapt 49.0% (in USD) as Europe removed restrictions on coal fired electricity generation. Spodumene rose 60.1% (in USD)on continued strong demand, particularly from Chinese auto manufacturing. Brent oil rose 6.4% (in USD) as the world, except China and India, shunned Russian oil exports. Iron Ore fell 21.6% (in USD) on slower demand from weaker Chinese economic growth.

Energy was one of only two sectors of the S&P/ASX 200 Total Return Index in the green this quarter, rising just 1.5% on the back of the stronger oil price. Utilities rose 1.7% on perceived stability in a deteriorating economic environment. Healthcare and Staples outperformed the average for the same reason. Technology was the weakest sector, falling 27.2%, relatively more negatively impacted by higher rates due to their long duration cash flows. Materials and Banks underperformed on lower commodity prices and a weaker economic growth outlook.

On corporate activity, BHP sold their Petroleum unit to Woodside in exchange for shares. Crown Resorts delisted following the Blackstone takeover. Atlas Arteria and Ramsay Health Care received takeover offers. AGL Energy withdrew from their proposed demerger of their retail and coal-focussed generation businesses due to the company not being able to secure the necessary support. The May 2022 Banks' earnings' season saw those companies step back from cost out guidance.

PERFORMANCE

The Fund outperformed by 33bps over the quarter.

Contributors/Detractors

Positives

Woodside (WDS) Overweight

Woodside rose as oil rallied and investors factored in the acquired BHP Petroleum assets.

QBE Insurance (QBE) Overweight

QBE rose on earnings leverage to higher interest rates via its investment book.

Block CDI (SQ2) Underweight

Block fell on higher interest rates, the prospect of greater bad debts, the possibility of regulation, new competition, and declining technology sector valuations.

Westpac Banking (WBC) Not Owned

Westpac fell on a weaker economic outlook, and poor operating momentum in its half yearly earnings release.

Treasury Wine Estates (TWE) Overweight

Treasury Wines outperformed due to stability of demand in a weaker economic environment.

Negatives

Transurban (TCL) Underweight

Transurban outperformed due to its perceived defensive and inflationary protection characteristics.

CSL (CSL) Underweight

CSL outperformed due to its perceived defensive characteristics as the equity market pulled back.

IGO (IGO) Overweight

IGO underperformed after the Nickel price weakened, having surged in the prior quarter on Russia's invasion of the Ukraine.

IDP Education (IEL) Overweight

IDP underperformed due to a valuation derating on higher US rates of long duration growth stocks.

Betmakers Technology (BET) Overweight

Betmakers underperformed due to a valuation derating on higher US rates of low profitability stocks.

PORTFOLIO CHANGES

Purchases

Woodside Energy (WDS)

Woodside was increased via the dividend received from BHP from the sale of their Petroleum unit.

Brambles (BXB)

Brambles was purchased on evidence of good pricing power, expectations lower lumber prices will reduce capex, and attractive valuation.

Insurance Australia Group (IAG)

IAG was added due to leverage to short duration rates, improving pricing and supportive valuation.

Qantas (QAN)

Qantas was increased on greater conviction of a demand and capacity recovery, cash generation and loyalty earnings growth.

National Australia Bank (NAB)

NAB was increased after a pull-back provided an attractive entry, and on strong momentum.

Sales

Goodman (GMG)

Goodman was reduced on slowing industrial development activity, driven by higher construction costs and interest rates, and tight availability of infill sites.

CSL (CSL)

CSL was reduced due to slowing organic growth, as high donor fees weigh on plasma margins, and the flu vaccination growth normalizes.

IDP Education (IEL)

IDP Education was sold due to valuation concerns in a rising bond yield environment and the unexpected departure of the CEO, despite it being a fast growing and quality company.

Australia and New Zealand Banking Group (ANZ)

ANZ was reduced to bring the Banking sector weight down on a weaker economic outlook, on concerns NIM expectations were too high, and due to ongoing ANZ slow loan processing issues.

BlueScope Steel (BSL)

BlueScope was exited on an expectation US steel prices would fall on slowing domestic demand and incremental new steel supply.

[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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Environmental, Social, Governance Issues (ESG)

The quarter's mini-AGM season was notable for the presence of non-binding, advisory resolutions put to meetings which ask for endorsement of the company's climate change report, dubbed 'Say on Climate' votes. While new to Australia, there have already been a number of Say on Climate votes overseas started thanks to a campaign in recent years to encourage Boards to voluntarily give shareholders a means through which they can endorse a company's climate response (or not).

BHP Group (BHP) was the first Australian company to hold such a vote last November, but this mini season saw three more votes put to the Rio Tinto (RIO), Santos (STO) and Woodside Energy (WDS) AGMs. Similarly to BHP, Rio Tinto received ~85% support for the climate report, while shareholders were less supportive of Santos and Woodside's climate plans (63% and 51% respectively). In our view these early results indicate the Say on Climate mechanism has strong potential to facilitate constructive shareholder feedback regarding corporate climate responses. All companies engaged a range of stakeholders on the plans, and we expect this to continue.

We also note the shift this could create with respect to climate-related shareholder-requisitioned resolutions, which may be less likely to receive less support in the future. Prior to the emergence of Say on Climate, support for resolutions on climate matters requisitioned by activist shareholders had been steadily growing. In the most recent mini-season, Woodside and Santos also received shareholder resolutions on Paris-aligned capital allocation and decommissioning. Support for these resolutions (c. 11-16%) was much lower than some of the results for other climate-related shareholder votes across the ASX which reached highs of nearly 50% support. It appears companies' broader shareholder base may be favouring the Say on Climate vote as the primary channel to provide a signal to the company.

We anticipate that to regain higher numbers of support, shareholder-requisitioned resolutions will need to become both more targeted and differentiated from the Say on Climate vote, which essentially asks shareholders "do you think our plan and targets are comprehensive, Paris-aligned, and achievable?". In our view, shareholder resolutions on specific areas such as climate lobbying will be seen as more supportable than emissions reduction target or capital allocation-related resolutions. Matters, which we believe, many investors now feel is best addressed through the Say on Climate vote.

While it may be too early for clear patterns to emerge, with more companies committed to a Say on Climate votes later in the year, this is an area we will be monitoring. In the medium term, we expect these types of votes to be a focus at the AGM's of larger or mid cap companies with elevated climate risk, rather than becoming the norm.

ENGAGEMENT

During the quarter, we undertook a total of 22 engagements in which we explicitly discussed ESG matters with 13 companies relevant to the strategy. Of these, 60% were held at either board or executive level, with much of the remainder with internal subject matter experts. The engagements covered a range of issues and most meetings discussed multiple ESG matters. In this period, the most discussed topics were climate transition, human rights and modern slavery, and executive pay.

Given the Say on Climate votes, discussed above, put to the AGMs of Woodside Energy (WDS) and Santos Ltd (STO), we held multiple engagement with both companies regarding their respective climate change reports. Not only did this help to inform our voting positions, it enabled us to convey our expectations around enhancements we believe each should make to their climate plans and disclosures. Additionally, we provided detailed letters to both Chairs to explain our voting position and summarise our expectations in a more formal manner.

We also had two notable engagements as part of our modern slavery engagement program with Qantas Airways (QAN) and Treasury Wine Estates (TWE). In both instances we encouraged certain enhancements to disclosures, in particular, pursuing opportunities to provide greater detail to shareholders with minimal effort by sharing more data points already collected internally. With respect to Qantas, advancements on planned activities to better address modern slavery risks was hampered by ongoing COVID-related disruptions last year. We were pleased to hear some initiatives have re-commenced this quarter and we expect progress will be evident in the next Modern Slavery Statement.

OUTLOOK

We anticipate elevated inflation, increasing interest rates and slowing economic growth.

Material US higher inflation surprises are now likely largely behind us. Headline US inflation should peak and ease over the next 3 to 6 months as demand for goods (relative to services) normalises post reopening. However, core US inflation faces headwinds from higher shelter and services costs. Further, given high wage growth of 4.5% in May 2022, the US now appears to have the problem of inflation and wages 'spiralling' higher together. Economists' forecast the US Federal Reserve likely needs to raise the Fed Funds rate to circa 3.5% to 4% to choke off these inflation problems. The challenge is difficult for them to navigate as the outcome partly depends on whether a reversal of the workforce participation rate decline that occurred over COVID happens, and the 'spiralling' issue may mean they need to move beyond the neutral rate to control the situation.

The challenge in Australia so far doesn't appear as great as wage growth here has been a more acceptable 2.5%. However, Australia now faces increased inflationary risks as the Fair Work Commission decision on minimum wages filters through to other sectors to drive increases of circa 5% across the board, and as utility and other price increases go through on 1 July. RBA Governor Philip Lowe said in a recent interview he expects inflation to get to 7% by year end. That all said, economists still conclude the challenge in Australia is less than in the US, and rates may not need to go as high.

Growth expectations have already come back to more normal levels as mentioned above. However, monetary authorities have not managed a slowdown of this magnitude in the past without it ultimately leading to a recession. That said, given the current strength of the economy, we don't see a recession as likely in the short-term. Employment is currently strong, and households and Small and Mid-sized Enterprises (SMEs) have considerable savings to buffer against higher mortgage rates and inflation for a period. There does not appear to be a systemic risk to the economy like there was in the lead-up to the Global Financial Crisis - so at this stage we see equity markets remaining orderly.

As such, the Fund is overweight Commodities where supply/demand fundamentals are attractive, due to some likely medium-term shift away from Russian supply, lifting cash flow generation potential and valuation support. The Fund remains exposed to fertiliser and battery material stocks.

The Fund is overweight Oil and Gas Energy stocks on an increased Brent oil price outlook that has strengthened their cash flow generation and valuation support. Further, proposed asset sales should be easier to complete, and previously marginal projects have justifiable economics. ESG issues remain a concern, but all companies owned largely produce LNG, which is a transition fuel.

The Financials exposure is via stocks that benefit from higher short-dated yields. Computershare will benefit via exposed cash balances, and Insurance companies via their investments in short-dated fixed income securities. The Fund is underweight Banks as lower economic activity will weaken credit growth, and a flatter yield curve negatively impact Net Interest Margins (NIM).

Within Consumer Staples, the Fund is positioned in air travel where we see pent up demand. The Fund is selectively exposed to defensive consumer staples. Within Industrials more broadly, the Fund is only exposed to stocks with pricing power as inflationary pressures build. We see margin expectations for Industrials generally too high. Strong demand over covid may be replaced by cost inflation next.

The Fund 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.