31 MARCH 2023

AUSTRALIAN EQUITIES FUND

PARADICE
INVESTMENT MANAGEMENT

PERFORMANCE NET (%)	1 MONTH	3 MONTH	1 YEAR	3 YEAR	5 YEAR	SI* P.A.
Australian Equities Fund	-1.34	1.51	1.45	19.78	9.09	9.42
S&P/ASX 200 – Total Return Index	-0.16	3.46	0.10	16.52	8.69	8.25
Excess Return	-1.18	-1.95	1.35	3.26	0.40	1.17
						*Since Inception date (SI) – 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.

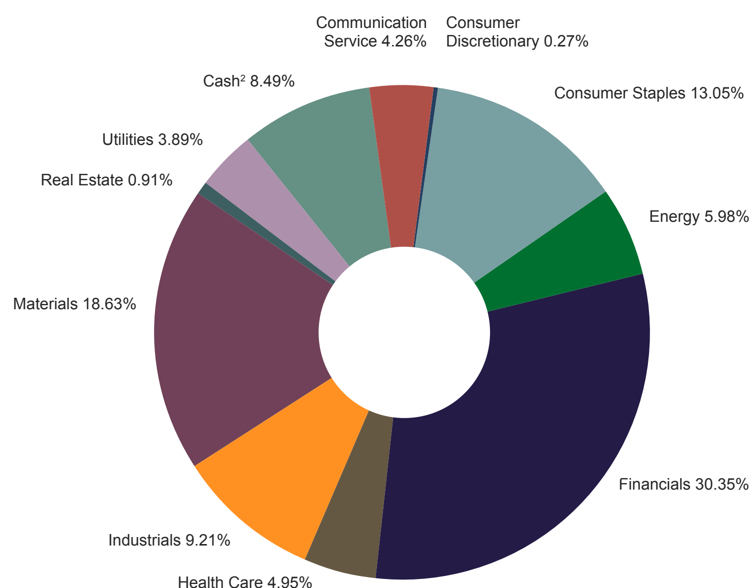
LEAD PORTFOLIO MANAGER

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 employs a long term 'bottom up' approach to investment.

SECTOR ALLOCATION



KEY DETAILS	
Number of Holdings	37
Portfolio Dividend Yield	4.59%
Fund Size (AUD)	$91M

TOP 10 POSITIONS	WEIGHT %
BHP Group Ltd	12.83
National Australia Bank Limited	6.24
Commonwealth Bank of Australia	6.00
Woolworths Group Ltd	4.83
Woodside Energy Group Ltd	4.48
ANZ Group Holdings Limited	4.35
Telstra Group Limited	4.11
Macquarie Group, Ltd.	4.07
Qantas Airways Limited	4.02
Coles Group Ltd.	3.82

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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Performance in AUD unless otherwise noted.

MARKET REVIEW

Global equity markets rebounded in the quarter on reduced inflationary pressures and lower interest rates, and a belief that the collapse of Silicon Valley Bank (SVB) and Credit Suisse are idiosyncratic. The MSCI World Net Total Return Index rose 7.3% (in USD)[1] versus the December 2022 quarter. The S&P/ASX 200 Total Return Index (the Index) improved 3.5%. Australia underperformed global markets due to weak Bank sector performance, which makes up 21% of the Index versus 4% in the S&P500. Growth sectors outperformed Value in Australia and globally. The Technology laden NASDAQ rose 17.0% (in USD).

Australian Banks' mark-to-market the value of bonds they hold for liquidity, which makes an SVB event here less likely. However increased credit spreads because of these events will impact on our Bank funding costs, which will be particularly impactful given the need to refinance ~$200b COVID Term Funding Facilities shortly. Further, CBA in their February outlook warned that increasing housing lending competition has removed the possibility of any further future Net Interest Margin (NIM) upside, which contrasted with expectations. The S&P/ASX200 Bank sector fell 5.6% over the quarter.

US Core Inflation reduced to 5.5% in February from a peak of 6.6% in September 2022, and has remained in the range from 5.5% to 6.6% for 12 months, giving comfort that inflation is being tamed.

However, the prospect of a recession is now a key concern. The US 2-to-10-year yield curve inversion is now back to 56bp, which is well down from its 108bp peak in early March. A reduction in the magnitude of the inversion historically has a successful track record of indicating a recession is imminent. Bloomberg contributing economists' US 2023 Real GDP growth expectations fell to just 1.0% from 1.3% previously, and they are now forecasting a 65% probability of a recession.

The economic outlook for Australia remains solid but did weaken over the quarter due to global pressures. The RBA paused rate hikes in April. The Australian 2-to-10-year yield curve remains positive at 34bp, but is down 31bp over the quarter. Bloomberg contributing economists' Australian 2023 Real GDP growth expectations sit at 1.7%, which is largely flat; but they are now forecasting a 40% probability of a recession, which is up from 30% last quarter.

The Bloomberg Commodity Total Return Index (in USD) declined 5.4%. Gold rose 8.0% (in USD) on financial market risks following SVB and Credit Suisse's demise. Iron Ore advanced 9.0%, and Copper 6.5% (in USD), on China's reopening. Spodumene fell 23.3% (in USD) on deteriorating end market demand and excess inventory. Brent eased 7.1% (in USD) on weaker demand fears.

Consumer Discretionary was the strongest sector of the S&P/ASX 200 Total Return Index rising 11.4% on solid February earnings updates and expectations lower rates will help consumers. Materials advanced 7.7% on higher commodity prices. REITS (+0.5%) underperformed on concerns around gearing levels in the sector globally. Energy (-1.0%) underperformed on weaker Brent prices.

Brookfield formally bid for Origin Energy, Albemarle made an offer for Liontown Resources and Newmont Gold for Newcrest Mining.

PERFORMANCE

The portfolio underperformed by 176bp over the quarter. The rally in bond yields early in the quarter saw long duration and growth stocks outperform where the portfolio is underweight. Good stock selection saw the portfolio miss most of the disappointing results over the February reporting period. The overweight positioning in Banks were a detractor due to the events at SVB and Credit Suisse and CBA warned that increasing housing lending competition removed NIM upside.

Contributors/Detractors

Positives

Westpac (WBC) Underweight

Westpac fell on a weaker industry Net Interest Margin outlook and international sector concerns.

Woolworths (WOW) Overweight

Woolworths outperformed on a solid February earnings result with improving margins.

Qantas (QAN) Overweight

Qantas outperformed on a strong earnings result and balance sheet boosted by solid demand.

Brambles (BXB) Overweight

Brambles outperformed on solid earnings on better margins and strong pricing power.

QBE Insurance (QBE) Overweight

QBE outperformed on decent earnings aided by an insurance pricing 'hardening' cycle.

Negatives

National Australia Bank (NAB) Overweight

NAB fell on a weaker industry Net Interest Margin outlook and international sector concerns.

Incitec Pivot (IPL) Overweight

IPL underperformed on a weaker price outlook for its produced commodities.

Newcrest Mining (NCM) Not Owned

Newcrest outperformed on an offer from Newmont Gold and a higher gold price.

Challenger (CGF) Overweight

Challenger underperformed on higher credit spreads.

Wesfarmers (WES) Not Owned

Wesfarmers outperformed on a positive earnings surprise on ongoing solid demand.

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

Telstra (TLS)

Telstra was added on strong mobile pricing power driving a better earnings outlook and cash flows.

A2 Milk (A2M)

A2 Milk was added as China's reopening created a potential demand inflection and facility approvals.

Amcor (AMC)

Amcor was added on lower commodities resulting in a better margin outlook.

CSL (CSL)

CSL underweight was reduced on an update suggesting more stable earnings than expected.

Mirvac (MGR)

Mirvac was added as they benefit from ongoing apartment building activity and valuation support.

Sales

ANZ (ANZ) and NAB (NAB)

ANZ and NAB were reduced on weaker domestic Net Interest Margin prospects on increased housing lending competition, and global sector concerns which will increase funding costs.

Santos (STO)

Santos was reduced in growing government and regulatory headwinds that have raised the prospect of higher taxes and project delays, and a weaker oil demand and price outlook reducing valuation support.

Rio Tinto (RIO) and BHP (BHP)

Rio and BHP were reduced following share price outperformance, as the stocks moved ahead of their commodity price indexes, and due to a deteriorating commodity outlook reducing valuation support.

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)

Since taking government in 2022 the Labor Party has sought to deliver on the climate agenda it took to the Federal Election, the cornerstone of which has been a commitment to reform the safeguard mechanism. The Government published its initial proposed changes to the Coalition-era policy in January before consulting with business and other stakeholders. As the Coalition ruled out supporting the required legislation through Parliament, it became apparent that Labor would instead need the Greens support which initially cast some doubt on whether a deal could be struck given the Greens stance on new fossil fuel projects. This was despite the proposed changes being broadly supported by business and investors.

After weeks of negotiations, in late March it was announced that Labor had ensured the Greens support in return for a number of concessions to the plan. While exact detail remains to be published, it is clear that the deal will now require higher hurdles that current and new heavy emitting facilities covered under the mechanism must pass. The deal also has ensured greater funding to support harder-to-abate sectors such as steel to decarbonise, while limiting public funds being directed to coal and gas projects.

We have commenced a number of discussions with companies which operate safeguard facilities and will need to comply with the mandated emissions reductions out to 2030, whether these are achieved through operational efficiencies or in part by carbon offsets. While we wait for the publication of the more detailed Amendment Rules, we are testing companies' early understanding of potential costs to their business to upgrade infrastructure, invest in new decarbonisation initiatives or secure carbon credits. For any company which will need to initially rely on credits to comply, we are seeking to understand how it is managing this cost which we see as likely to increase over time.

ENGAGEMENT

During the quarter, we undertook a total of 27 engagements in which we explicitly discussed ESG matters with 18 companies relevant to the portfolio. 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 quarter, the most commonly discussed topics were climate transition, conduct and stakeholder relations, and human capital management.

In the quarter we had a dedicated meeting on cyber resilience with the Commonwealth Bank of Australia (CBA). We sought to better understand internal capabilities, the extent of outsourcing and how due diligence is undertaken, as well as the testing and response planning in place. We encouraged sufficient attention be given to communications strategies in the event of an incident as part of the broader response planning. Overall, we were reassured by the controls in place, especially around working from home protocols, and the demonstration of robust board oversight.

We also went on a site visit to the IGO Ltd (IGO) nickel operation at Nova in Western Australia and also met with company executives. Areas of focus in meetings were the site rehabilitation program, workplace culture (including safety and sexual harassment), cultural heritage management and relations with Traditional Owners.

OUTLOOK AND POSITIONING

The portfolio is positioned defensively on expectations of slowing economic growth with risks skewed to the downside. The risk of a recession in the US is more likely than not, and the risks to Australia have increased on greater headwinds from offshore. Company earnings expectations in the US and Australia still appear too high, especially for Industrials, Technology and Consumer Discretionary.

The probability of a US recession is forecast by Economists at 65%. The US 2-to-10-year yield curve inversion is now back to 56bp, which is well down from its 108bp peak. A reduction in the magnitude of the inversion historically has a successful track record of indicating a recession is imminent. The March 2023 US Institute of Supply Management (ISM) fell back to 46.3, its lowest level since May 2020. The recent crisis around SVB regional bank funding appears to have been managed via the Fed's emergency repo facility, with collateral valued at par, making it appear idiosyncratic. However, not all regional banks have sufficient quality collateral to use this facility, so a repeat of a SVB type situation could happen again in the US. The Credit Suisse resolution strategy to dilute losses by forcing a merger also faces repeatability challenges. We see potential vulnerability in US Commercial Real Estate (CRE) and Private Equity (PE) lending, given a reluctance to mark-to-market assets lower in the now higher interest rate environment, and especially given that regional banks are responsible for roughly 40% of CRE lending. As a result, we see some potential for these problems to become more 'systemic' risks.

In Australia, the possibility of a recession has increased to an estimated 40% by economists based on the greater US and global risks discussed above. Australia also seems to now be facing the possibility of increased government and regulatory headwinds, for example higher energy taxes and project delays. Increased global credit spreads will impact on our bank funding costs, which will be particularly impactful given the need to refinance ~$200b COVID Term Funding Facilities shortly.

The portfolio is overweight Financials overall, but underweight Banks on weaker domestic Net Interest Margin prospects on increased housing lending competition and global sector concerns that will increase funding costs. The portfolio is overweight Insurance, which is benefiting from increasing pricing and better investment yields, and overweight Medibank, Challenger and Macquarie Bank.

Materials positioning is underweight as global growth slows. The portfolio is overweight BHP, which has supportive valuation. It is also overweight commodities (including fertilisers, nickel and rare earths) where supply/demand fundamentals are attractive due to China's reopening and a likely medium-term shift away from Russian supply. The portfolio also owns Amcor on a better margin outlook from lower commodity price inputs.

Energy is around benchmark weight as growing government and regulatory headwinds have raised the prospect of higher taxes and project delays, and a weaker oil demand outlook due to recessionary concerns have reduced price assumptions, cash flow forecasts and valuation upside support.

Within Consumer, the portfolio is overweight defensive Staples, which will be food inflation beneficiaries and COVID costs drop out. The portfolio owns stocks that will benefit as China reopens and travels abroad. The portfolio owns Telstra on mobile pricing power driving solid earnings growth.

Within Industrials the portfolio is exposed to stocks with pricing power to take advantage of the inflationary environment. The portfolio is positioned in air travel where we see pent up demand continuing. But the portfolio is underweight Industrials more broadly as we see margin and earnings expectations generally too high. The portfolio is underweight IT, Healthcare, Infrastructure, and Utilities.