30 SEPTEMBER 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	-5.05	2.35	-1.42	5.02	7.99	7.97
S&P/ASX 200 – Total Return Index	-6.17	0.39	-7.69	2.67	6.76	6.50
Excess Return	1.12	1.96	6.27	2.35	1.23	1.47

*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.

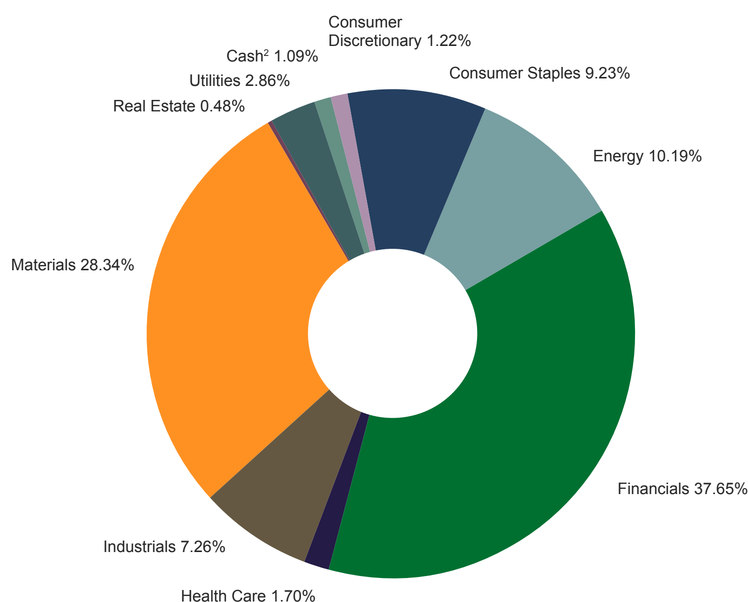
LEAD PORTFOLIO MANAGER

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	35
Portfolio Dividend Yield	5.64%
Fund Size (AUD)	$79M

TOP 10 POSITIONS	WEIGHT %
BHP Group Ltd.	15.24
National Australia Bank Ltd.	9.09
Woodside Energy Group Ltd.	6.56
Commonwealth Bank of Australia	6.50
Australia and New Zealand Banking	6.06
Macquarie Group Ltd.	4.40
QBE Insurance Group Ltd.	3.92
Santos Ltd.	3.63
Insurance Australia Group Ltd.	3.63
Rio Tinto Ltd.	3.62

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 fell over the quarter on concerns inflation will remain higher for longer and as central banks raise interest rates to choke off inflation, a deteriorating economic growth outlook with a heightened possibility of recession, and concerns of worse humanitarian outcomes from Russia's war on Ukraine. The MSCI World Net Total Return Index fell 6.19% (in USD) over the quarter. The S&P/ASX 200 Total Return Index however eked out 0.4%. The smaller decline in Australian equities was due to less exposure to Technology stocks which suffered heavy falls overseas, and greater exposure to Coal and Battery-material stocks that performed well.

Headline inflation remained elevated at 8.3% in the US in August 2022 yoy, and accelerated to 6.1% in Australia in the June quarter yoy, due to ongoing impacts from the Ukraine invasion and COVID overstimulation. The US Federal Reserve lifted their target rate by 150bp over the June quarter from 1.75% in June to 3.25% in September. The Reserve Bank of Australia (RBA) lifted rates 105bp over the quarter, plus another 25bp on 4 October, from 0.85% in June to 2.6% on 4 October. The US Fed's moves could be characterised as hawkish, but the RBA's 25bp increase on 4 October was less than the 50bp risk case as the Board appeared to favour a 'pause' given "The cash rate [had] been increased substantially in a short period of time". So, while the bond market futures now imply US rates peaking at ~4.4% (for April 2023), which is broadly in line with prior peak expectations, the domestic futures implied peak rate came back to ~3.5% (for May 2023), from a prior peak of ~4.0%.

Bloomberg contributing economists' US 2023 Real GDP growth expectations fell back to 0.8% from 1.9% in June, and they are now forecasting a 50% probability of a recession. The US 10-year government bond yield rose 82bps and the 2-to-10-year US yield curve flattened 51bp to become inverted by 45bp, which is an indicator of an impending recession. The situation is not as dire in Australia with the Bloomberg economists' 2023 Real GDP growth expectations still at 2.2%, versus 2.5% in June, and only a 25% probability of recession. The Australian 10-year rose 23bp and 2-year 68bp, so although the curve here also flattened 46bp, the curve remains positive by 58bp.

The Bloomberg Commodity Total Return Index declined by 4.1% (in USD). Thermal coal rose 12.37% (in USD) as Europe removed restrictions on coal fired electricity generation. Spodumene jumped 24.22% (in USD) on continued strong demand, particularly from Chinese auto manufacturing. Brent weakened 23.39% (in USD) as China and India bought Russia's oil exports. Iron Ore fell 18% (in USD)% on slower demand from China.

Energy was the strongest sector of the S&P/ASX 200 Total Return Index[1] rising 5.9% on the back of the stronger oil price. Banks rose 3.77% on an improved Net Interest Margin outlook helped by higher rates. Materials were largely in line, but with Battery-material stocks driving strong positive performance within the sector on the back of higher Spodumene. Staples, Industrials, REITS and Utilities underperformed due to a deteriorating earnings outlook and/or as their valuations were negatively impacted by higher rates due to the long-dated nature of their cashflows. On corporate activity, BHP bid for OZ Minerals, and private equity bid for Genex Power, while Atlas Arteria and Ramsay Health Care takeover offers were withdrawn.

PERFORMANCE

The Paradice Australian Equities Fund outperformed by 196bp over the quarter against the S&P ASX 200 Total Return Index.

Contributors/Detractors

Positives

Pilbara Minerals and Allkem (PLS and AKE) Overweight

Pilbara and Allkem outperformed on strong Lithium and Spodumene demand and pricing.

IGO (IGO) Overweight

IGO outperformed on strong Lithium and Nickel demand and pricing.

Transurban (TCL) Not Owned

Transurban's valuation was negatively impacted by higher rates and disappointing FY23 distribution guidance.

Qantas (QAN) Overweight

Qantas outperformed on a solid result boosted by strong demand, and an improved balance sheet and share buyback.

Negatives

CSL (CSL) Underweight

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

Whitehaven (WHC) Not owned

Whitehaven rose on the stronger coal price and significant free cash flow generation.

Westpac (WBC) Not owned

Westpac outperformed on an improved Net Interest Margin outlook helped by higher rates, and as it stuck by previous cost guidance which appears tough to attain.

Origin Energy (ORG) Overweight

Origin underperformed on a disappointing earnings result that was negatively impacted by higher coal fuel costs for its Energy Markets (electricity generation) business.

Mineral Resources (MIN) Not owned

Mineral Resources benefited also from strong Lithium and Spodumene demand and pricing, and the possibility of a rerating should they spin off their Lithium business.

PORTFOLIO CHANGES

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

Purchases

ANZ and Commonwealth Bank (ANZ and CBA)

ANZ and CBA were increased on improved Net Interest Margins (NIM) outlooks due to higher rates, and on expectations loan losses will take longer to materialise. ANZ's valuation was also particularly attractive.

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.

Resmed (RMD)

Resmed was purchased on a strong backlog for CPAP devices and earnings upside medium term from Phillip's recall.

Sales

Pilbara (PLS) and Allkem (AKE)

Pilbara and Allkem overweight positions were reduced following share price outperformance, and as the stocks moved ahead of their Lithium and Spodumene commodity price indexes.

Computershare (CPU)

Computershare was sold after the August results revealed less leverage (beta) to higher interest rates than expected.

IGO (IGO)

IGO overweight was reduced following share price outperformance, and as the stock moved ahead of its Nickel commodity price index.

Lynas Rare Earths (LYC)

Lynas overweight was reduced following share price outperformance, and as the stock moved ahead of its Rare Earth commodity price index.

Environmental, Social, Governance Issues (ESG)

The quarter was a one dominated by the actions of central banks around the world raising interest rates in an attempt to supress inflationary pressures. Internally, this gave rise to a multitude of conversations around the inputs of such inflation which led us to again highlight the importance of understanding the "S" in ESG. Talking to corporates over the quarter regularly saw labour market tightness and associated price increases quoted as a headwind to business performance across a range of sectors including consumer staples, travel and resources.

[1] Australian sector returns refers to the S&P/ASX 200 Total Return Index unless stated otherwise.

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A pertinent data point for labour inflationary pressures which we are monitoring is in Australia's enterprise bargaining agreement (EBA) deferrals, a building bubble that looks to be coming home to roost and locking in increased compensation for many. Whilst impacting a broad range of industries and business sizes, it is of particular importance to the Big 4 banks and the supermarkets.

The proportion of the Australian workforce on an EBA has been decreasing as a percentage of total workforce (from ~20% in 2012 to ~12% in 2022)[Source: Credit Suisse Research], however, the pressures of group bargaining, and the time sensitive nature of these agreements being struck would seem to provide near term wage pressure above and beyond the natural reactive increase. An example of this would be National Australia Bank's (NAB) offer at the beginning of September of a 5% increase in pay with an extra week of annual leave (~7% in totality).

Alongside the ongoing Russia-Ukraine war contributing to the current havoc in energy markets, nuclear continues to create friction in the global ESG landscape. One week after receiving final approval to be considered 'green' under the EU Taxonomy regulation, we saw new research by the Commonwealth Scientific and Industrial Research Organisation (CSIRO) concluding that nuclear was too expensive to be included as an option in Australia's energy transition – a position also voiced by Australian Energy Market Operator (AEMO) and Clean Energy Finance Corporation (CEFC) at the Morgan Stanley conference earlier this year. Clearly cost is not the only issue when determining a global grid and given global energy issues and the need for low carbon baseload supply, we see it as very likely that nuclear generation will have a significant part to play in reaching net zero.

The regulatory news flow around the gaming sector has recently been monopolised by operators Star Entertainment Group and Crown Resorts as they work through issues raised in recent inquiries. However, problem gamblers are back in the limelight as we continue to see ongoing regulatory pressure around the electronic gaming machines (pokies). The Tasmanian Government has recently announced a regime which includes mandatory cashless gaming pre-commitment cards and daily loss limits which can only be overridden if the individual can prove they have the financial means to bet more. New South Wales is to follow Victoria in introducing caps where transactions over $1,000 must be electronic and players can only transact up to $1,000 in cash per day.

ENGAGEMENT

During the quarter, we undertook a total of 29 engagements in which we explicitly discussed ESG matters with 23 companies relevant to the strategy. Of these, 89% 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, labour issues and stakeholder relations.

With the Commonwealth Bank (CBA) releasing its first standalone Climate Report in the period, the new carbon financing and climate targets were discussed in two meetings, one with the Chair and one with internal subject matter experts. We encouraged CBA to strengthen the previously set Sustainable Financing target given such significant progress had been already, and also encouraged clarity in the Bank's Environmental and Social Framework and Policy document to clarify Paris-aligned fossil fuel financing in the context of CBA's stated 1.5°C warming ambition. Overall, we were pleased with the progress evidenced in the disclosures, and the clear timeframe of when additional sector-based decarbonisation pathways will be set.

We also engaged at both Board and Executive level with Origin Energy, with a significant focus in discussions on the energy transition including Origin's Climate Transition Action Plan (which was published prior to the Beetaloo divestment announcement) and associated capex.
We also discussed Paris-aligned industry association lobbying and implementing Just Transition-related initiatives for Eraring workers. Additionally, we sought further detail on certain aspects relevant to the shareholder resolutions being put to the upcoming AGM.

OUTLOOK AND POSITIONING

We anticipate elevated inflation and increasing interest rates to continue medium term, albeit expectations are peaking. A recession in the US and Europe is a possibility, and economic growth will slow in Australia. The prospect of a humanitarian crisis in Europe over winter and war is real.

Material US higher inflation surprises are now likely behind us. Headline US inflation should ease over the next 3 to 6 months as Goods demand (relative to Services) normalises, although core inflation still faces headwinds from higher shelter and services costs.
There are signs though that the US Federal Reserve's rate rises so far are having the desired effect. The September 2022 Institute of Supply Management (ISM) reading fell back to 50.9, where 50 indicates neutral. Parcel service operator, Fedex said mid-September that volumes are declining in every region globally. On Employment, there was a ~10% reduction in US job openings in August 2022 MoM. Technology companies, Google and Meta are now showing restraint in new hiring. Economists' forecast the US Federal Reserve likely needs to raise the Fed Funds rate to circa 4.0% to 4.5% to choke off these inflation problems, which has remained broadly stable. The Fed still has a narrow path to walk to achieve a slowdown without tipping the economy into a recession. Economists' forecast the possibility of a US recession at 50%.

Europe and the UK however appear more vulnerable to a hard landing given double digit inflation exacerbated by the energy crisis, prompting an aggressive rate hiking responses from the Bank of England. The significant depreciation of the EUR and GBP has resulted in headwinds for companies with exposures to these regions.

In Australia, the challenge so far doesn't appear as great as wage growth has been a more acceptable 2.6%. However, Australia now faces increased inflationary risks as the Fair Work Commission decision on Minimum Wages has filtered through to other sectors with the Financial Services Union, for example, asking for 5% plus an extra week of holiday, equating to 7% in total; and as other price increases continue, for example, the supermarkets are now on their third round of increases. The RBA chose to 'pause' in making the decision to increase only 25bp on 4 October, and not the more aggressive 50bp alternative, which may risk elongating this cycle. 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. Economists forecast the possibility of a recession in Australia at 25%.

Growth expectations have 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 in Australia 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.

The portfolio is overweight Commodities, including fertilisers, where supply/demand fundamentals are attractive, due to a likely medium-term shift away from Russian supply, lifting cash flow generation and valuation support. Exposure to battery material stocks has been reduced following share price outperformance, and as the stocks moved ahead of their commodity price indexes; however, an overweight has been maintained due to the sector's long-term strategic outlook.

Within Energy, the portfolio is overweight Oil and Gas stocks on an increased Brent oil price medium term outlook that has strengthened their cash flow generation and valuation support. Further, 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.

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The portfolio is now 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 still exposed to Insurance companies, which are now benefiting from increasing their pricing.

Within Consumer, the portfolio is positioned in air travel where we see pent up demand. The portfolio is overweight defensive Consumer Staples. Within Industrials overall, the portfolio is only exposed to stocks with pricing power to take advantage of the inflationary environment. We see margin 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.

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