31 March 2022

Australian Mid Cap Fund - Class B

PARADICE
INVESTMENT MANAGEMENT

Performance Net (%)	1 Month	3 Month	1 Year	3 Year p.a.	Since Inception* p.a.
Australian Mid Cap Fund - Class B	7.36	-2.14	16.91	12.99	10.62
Mid Cap Composite Benchmark	6.52	-3.03	15.51	13.64	11.63
Excess Return	**0.84**	**0.89**	**1.40**	**-0.65**	**-1.01**

* Inception date - 15 May 2017

Investment Objective

The Fund aims to outperform the composite benchmark of 70% of the S&P/ASX Mid Cap 50 Total Return Index and 30% of the S&P/ASX Small Ordinaries Total Return Index over a three to five year period (after management costs and before tax).

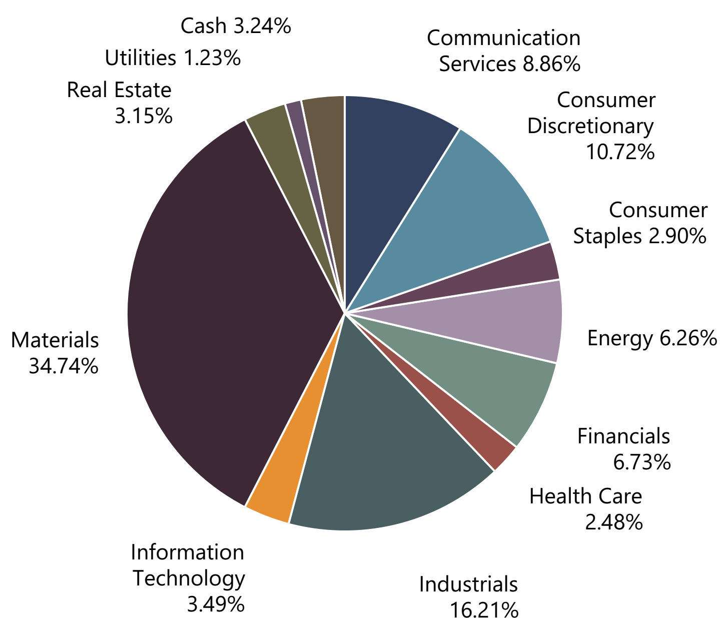
Lead Portfolio Managers

John Lake & Matthew Riordan

Fund Overview

Investing in stocks that are outside the S&P ASX50, this fund uses a detailed fundamental research process to construct a diversified portfolio of stocks. The highly experienced team have a focus on downside protection and are proven to generate consistent outcomes.

Sector Allocation



Key Details

Number of Holdings	51
Portfolio Dividend Yield	2.29%
Fund Size (AUD)	$167M

Top 10 Positions	Weight %
IGO Ltd.	3.86
Cleanaway Waste Management Ltd.	3.59
ALS Ltd.	3.47
Lynas Rare Earths Ltd.	3.46
Ampol Ltd.	3.17
OZ Minerals Ltd.	3.16
Charter Hall Group	3.15
Incitec Pivot Ltd.	2.79
Allkem Ltd.	2.75
Iluka Resources Ltd.	2.66

Fund Details

APIR Code	ETL8772AU
Distribution Frequency	Semi-Annually
Management Fee	1.10% p.a.
Performance Fee	15% p.a.
Buy Sell Spread	+/-0.25%
Minimum Investment	$20,000
Stock Range	Typically 40-60
Cash Range	0-10%

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Market Review

For the purpose of comparison, commentary is quoted in AUD terms except where stated otherwise.

The March 2022 quarter is one that will be remembered for a number of things, unfortunately the most prominent of these being the Russian invasion of Ukraine on the 24th February. Of greatest significance is the social impact this conflict is having on so many lives and we can only all strongly support the necessary actions needed to bring this to an end. From a market perspective, pre the invasion the debate was still live about inflation being transitory or longer dated. With both Ukraine and Russia being key suppliers in various commodities plus the effect of sanctions that have been imposed, this has firmly pushed the view towards the latter whilst the appetite for Central Banks to "normalise" rates and repair balance sheets has not abated.

COVID has been the standout topic since February 2020. The supply chain problems that were caused by COVID was one of the key drivers of inflation concerns. Inflation then became the key issue for markets, especially from the second half of CY2021. As mentioned above, the Ukraine conflict has added more fuel to the inflation fire. Outside of China, COVID has de-escalated to largely being a secondary issue compared to inflation, rates and Ukraine. China still targets net zero COVID as their home-grown vaccinations did not seemingly work and there are still major concerns on the capabilities of their healthcare system to handle a mass outbreak, even if predominantly of the Omicron variant. Over the past two years the liquidity pumped into the market has been (in hindsight) excessive. This has led to excess consumption of hardgoods, also due to social activities such as leisure and business travel curtailed. Human capital flows being compromised has also led to major labour shortage issues in many markets. Again, this is proving to be inflationary.

With the rise in demand for hardgoods, the growth in demand for cleaner environmental solutions (e.g. EV's) and the more recent concerns on certain hard and soft commodity supply due to the Ukrainian war, commodity prices have continued to rally, in particular Lithium (battery material). With no strong evidence that supply will catch up to demand in many instances in the short to medium term, we are seeing more capital being committed to projects, both green and brownfields. This is not limited to Lithium. We expect an increase in capital expenditure across the commodity set and over reporting season, many resource companies focused on their expansion opportunities.

Rates globally have been a major focus with Central Banks reacting to the inflation data coming through. Our neighbours in New Zealand lifted their cash rate for the 4th time in February to take it to 100bps and in the USA, the Fed raised rates by 25bps in mid-March, signalling the potential for more aggressive tightening to come. Whilst in Australia the Official Cash Rate remained at the low of 10bps, expectations of future rate expectations were reflected in banks hiking their fixed term mortgage rates, in some cases to be approximately double the rate they were in November 2020. In recent days, the Reserve Bank of Australia has taken a change of tack, signalling a rate hike could be sooner than previously indicated, potentially in June this year.
Capital management has remained strong with a record number of companies embarking on buybacks as utilising excess capital options are relatively limited for some given elevated asset prices. Despite this there were a number of approaches made including an offer for Uniti Group (broadband fibre) and for AGL Energy. Capital raises were few and far between, however one notable raise was Air New Zealand doing a deeply discounted rights issue as the recovery in air travel just did not come back soon enough.

As at the close of the quarter, bond yields had rallied well off their 2021 year-end levels. For example, 10 year bond yields in the USA rose from 1.5% to 2.3% and in Australia, from 1.7% to 2.8%. This steepening of the curve led to a selloff in duration assets and hence the NASDAQ Composite Index ended down 9.1% (in US Dollar terms) for the quarter. Australia's economic indicators remain supportive with unemployment as at Feb reading 4.0% with underemployment continuing to drop. Wage pressures are building with corporates not reporting significant impact in their February results, but highlighting it as an issue to deal with going forward. In the January 2022 inflation figures to end December, inflation was up to 3.5% and rising. Non-discretionary annual inflation is higher than the CPI and more than twice the rate of Discretionary inflation. Non-discretionary inflation includes goods and services that households are less likely to reduce their consumption of, such as food, automotive fuel, housing and health costs.

Heading into Q2 of 2022, there are many risks and volatility to be navigated ahead and with that comes opportunity. We cover these off in more detail in the Outlook Section.

Performance

The Paradice Mid Cap portfolio delivered a positive relative return for the quarter, generating -1.89% as compared to the Mid Cap composite index return of -3.03%, outperforming by 1.14%. The March quarter opening and closing months were polar opposites, highlighting the volatility of markets: the benchmark was down 8.77% in January and up 6.52% in March, following what was an overall very positive reporting season. The Australian market outperformed all major global indices given our weighting to Resources and Banks, with the NASDAQ Composite Index, for example, down 9.1% (in US Dollar terms) and the Dow Jones Industrial Average down 4.6% (in US Dollar terms).

The February reporting season was strong from a results perspective and the portfolio was generally favourably positioned. Overall "value" stocks outperformed relative to consensus and "expensive" stocks underperformed. Approximately 36% of companies saw consensus upgrades which is well above the long-term average.

The Mid Cap composite index performance was driven predominantly by strong returns across the Materials sector and, to a lesser extent, Regional Banks. Standout from an unexpected perspective was a very strong result from JB HiFi which continued its strong run despite coming up against a comparatives historic period that was positively impacted by lockdown buying. Offsetting this strength were sell-offs in IT names and other areas such as stocks exposed to interest rate hikes. USA exposed stocks such as Reliance Worldwide and Reece were sold off on expectations that the rates cycle will have a significant negative impact on housing facing earners.

The top relative contributors to performance for the quarter are as follows:

Sims (SGM) – Overweight With strong demand and underlying commodity pricing Sims produced a very strong result with the outlook positive for the Scrap merchant.

Fisher & Paykel (FPH) – Underweight (not held) FPH was a big beneficiary of COVID related volumes in the respiratory market and is now selling off as volumes wind back.

IGO Limited (IGO) – Overweight With both Nickel and Lithium markets very strong, IGO has good positions in both areas.

The top relative detractors from performance for the quarter are as follows:

Charter Hall (CHC) – Overweight The market was concerned about CHC buying into equities funds management plus the expectation of rates rising impacted the broader property sector.

Carsales (CAR) – Overweight Tech names in general sold off and CAR was impacted in particular on perceptions about car shortages impacting earnings.

AGL Energy (AGL) – Underweight AGL received an unsolicited bid plus rising energy prices on the back of coal input costs are expected to feed through to stronger earnings in 2024 as contracts roll off.

ESG

Australian corporates continue to increase their focus on ESG, as evidenced in the February reporting season. Dozens of companies featured ESG-related content more prominently in their results presentations than previous years, with many sharing progress on ESG-related performance or highlighting new sustainability initiatives commenced.

A trend we continue to monitor is that many corporate climate plans, especially those of companies with harder-to-abate emissions, intend to purchase carbon offsets to achieve net zero emissions. As such, we continue to follow the Australian carbon market and corporate use of offsets. To unlock more Australian Carbon Credit Units (ACCU), in early March the Federal Government announced a change to the ACCU regime allowing farmers and project owners to pay the government the original price for fixed delivery, they can then sell the credits on the voluntary market and pocket the difference earned. After hitting $55 a tonne in early 2022, by 31st March the spot price was $30.50. This disruption to the market came at the same time as the former chairman of a key carbon market oversight committee, Professor Andrew Macintosh, came forward with claims that some carbon abatement projects generating ACCUs lack integrity. The Greens have referred the matter to the Auditor-General, while Labor says they will establish an inquiry if they win office. With both price volatility and increasing scrutiny of the integrity of credits coming to the fore, we continue to prefer company climate plans that prioritise actual emissions reduction over offsetting.

Globally, there were two notable ESG-related developments which have longer term implications for companies. The first was the publication of the draft disclosure framework of the Taskforce on Nature-related Financial Disclosures' (TNFD) which is now in a consultation phase as the taskforce moves to finalise its recommendations. The TNFD is striving to solicit decision-useful information out of companies regarding their exposure to and management of nature-related risks and opportunities such as biodiversity loss and deforestation.

The second development came from the United Nations (UN) where member states have approved a landmark agreement to create a legally binding global plastic pollution treaty. A UN Environment Assembly spokesperson said it's "the most significant environmental deal since the Paris accord". The aim is to agree a treaty by 2024 which would cover the entire plastics value chain to address pollution.

Engagement

During the quarter, we undertook a total of 15 engagements in which we explicitly discussed ESG matters with 14 companies relevant to the strategy. Of these, 80% 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, environmental management and human capital management.

One company of focus during the quarter was Worley Ltd (WOR). We met with the sustainability team to discuss a number of workplace related matters. We encouraged the company to enhance its response to addressing potential sexual harassment, in line with our broader engagement on the topic. We discussed actions underway to improve diversity and inclusion, in particular how WOR is providing additional support for people leaders. We also spoke about how WOR is up/reskilling its workforce to better support its customers' sustainability needs, as well as how it is handling talent attraction in the context of strong competition for talent with sustainability expertise.

Outlook

Much of the western world is seeking to move on from COVID. In the absence of a more deadly (as opposed to infectious) strain emerging, we expect governments to continue shifting to an endemic response as they manage to hospital capacity rather than case counts. As economies continue to open up and human movement normalises, we anticipate spending patterns to shift from the extremes seen over the past two years with significant implications for corporate earnings and equity valuations; some of which markets are reflecting already.

The tragic events in Eastern Europe are only further exacerbating these inflationary supply side pressures, noting Russia produces a slate of commodities and primary compounds (e.g. fertiliser) that are now facing sanctions; whilst Ukraine is a major source of high-end manufacturing and natural resources utilised by global technology and automotive companies. Whilst a (hopefully swift) resolution to the conflict may serve to calm nerves and thereby prices in the short term, these events seem likely to drive a reshaping of global supply lines and trading partners that will take some years to navigate and bed down. Should the conflict prove a more elongated affair, these impacts will be magnified further.

Given the above, the task for Central Banks has become even more precarious. It is a virtual certainty that central bank policy rates are moving higher, though bankers have been keen to highlight their focus on more structural sources of inflation. Their challenge, which investors are starting to understand, is managing inflation down without stamping out the economic recovery, particularly when it is not clear what, if any, demand destruction may result from the spike in commodity prices.

It is not surprising therefore that markets remain short-sighted, prone to over-shooting and relatively volatile. It is an environment we have become accustomed to, though note that there are some discernible underlying trends; principally that the cost of risky capital is going up, and is already driving a shift towards quality/profitable operators at the expense of more speculative investments. Further, we expect this volatile environment will continue to provide opportunities to enter new positions into the portfolio at more attractive entry prices – a dynamic we have already been taking advantage of.

As for Corporate Australia, most groups we met with during reporting season seemed relatively upbeat about their own outlooks, although noted that managing their operations through COVID isolation protocols remains challenging, and labour shortages are pressuring their cost bases. There is some hope that the recent reopening of our borders will alleviate this pressure. We would observe that, by and large, listed corporates are very well funded having raised significant amounts of capital early in the pandemic, and a number are articulating plans to invest both organically and via M&A. As an aside, we remain cognisant of the pending Federal Election in Australia, though lead-in policy announcements to-date have focused on a 'khaki election' and significant spending programs, suggesting there is potentially a lower than average risk of adverse policy changes as far as the Australian equity market is concerned

Although the portfolio does not have any sector / trend biases, we do see "expensive" stocks as trading above long term historical levels whilst "value" stocks remain relatively cheap. We continue to find valuation distortions and have positioned the portfolio accordingly. Navigating the impacts of inflation and rising rates will also be critical.