31 DECEMBER 2022

AUSTRALIAN MID CAP FUND – CLASS B

PARADICE
INVESTMENT MANAGEMENT

PERFORMANCE NET (%)	1 MONTH	3 MONTH	1 YEAR	3 YEAR P.A.	5 YEAR P.A.	SINCE INCEPTION* P.A.
Australian Mid Cap Fund – Class B	-3.72	6.10	-11.06	6.54	5.39	7.30
Mid Cap Composite Benchmark[1]	-4.36	7.32	-10.01	7.39	6.82	8.55
Excess Return	0.64	-1.22	-1.05	-0.85	-1.43	-1.25
						*Inception date – 15 May 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 Mid Cap Composite Benchmark[1] 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).

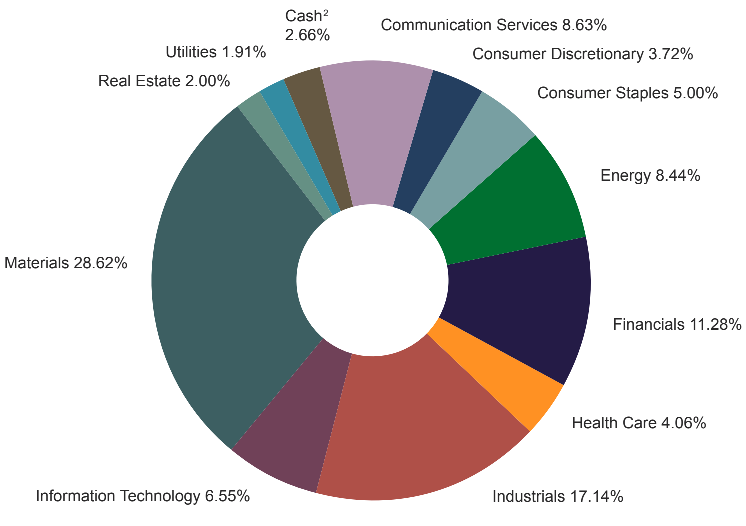
LEAD PORTFOLIO MANAGER

John Lake & Matthew Riordan

FUND OVERVIEW

The highly experienced team have a focus on downside protection and aim to generate strong, long term risk-adjusted returns.

SECTOR ALLOCATION



KEY DETAILS	
Number of Holdings	49
Portfolio Dividend Yield	2.85%
Fund Size (AUD)	$79M

TOP 10 POSITIONS	WEIGHT %
ALS Ltd.	4.23
Carsales.Com Ltd.	3.79
OZ Minerals Ltd.	3.68
Orica Ltd.	3.67
Ampol Ltd.	3.33
Steadfast Group Ltd.	3.27
Challenger Ltd.	3.08
Cleanaway Waste Management Ltd.	2.98
IGO Ltd.	2.95
Lynas Rare Earths Ltd.	2.93

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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Performance in AUD unless otherwise noted.

MARKET REVIEW

The Australian market put aside fears of an economic slowdown heading into 2023, with the S&P/ASX 200 Total Return Index finishing up 9.4% for the December quarter. This was on the back of the RBA continuing to increase the cash rate, albeit at a slower rate. The RBA moved from 50bps rate hikes every month since June through to September, to 25bps hikes for October, November and December. The US Fed was similar in that they also continued their path of raising rates, with the Fed Funds rate moving from 3.25% to 4.5% for the December quarter in order to combat inflation.

As we head into the new calendar year, the RBA has continued to highlight the levels of uncertainty Australia is facing for 2023 and beyond. In the most recent RBA minutes, they spoke to putting all options on the table, including pausing rate rises if the economic data were to soften significantly. This seems unlikely in the early part of the calendar year in our view, given inflationary pressures are expected to continue into the new year. The RBA recently spoke to the upside risks to inflation that have been experienced by other countries and inflation becoming entrenched in the economy for a longer period, which would be an undesirable outcome.

One of the biggest changes over the quarter was the change in the COVID stance from the Chinese government and their move away from the ‘COVID zero policy’ and began relaxing restrictions. Following several protests and frustration from civilians, the loosening of COVID restrictions across the country continued to play out in the back half of the quarter. On top of relaxing of restrictions, there has also been the announcement of further stimulus measures aimed at boosting growth. These have predominantly been aimed at the property and infrastructure sectors, as well as small and medium sized businesses. For example, during November the People’s Bank of China (PBOC) announced RMB200bn of interest free loans to be provided to six commercial banks in order to fund troubled housing projects. Other measures also include supporting developers and guaranteeing development loans. However, the COVID situation continues to be volatile in China and seems to be two steps forward, one step back. Therefore, it’s not expected to be a smooth path out of COVID restrictions but is heading in the right direction.

The reopening of China has provided support for many commodities. Given several stimulus measures are focussed on the property and infrastructure sectors, this provided a positive backdrop for iron ore. For the December quarter, iron ore was up 21%. Copper was also a beneficiary of the China reopening story, finishing the quarter up 9.7%. On the other hand, spodumene prices pulled back in December from their recent highs on the tempering of EV sales expectations in China later in the quarter. Over the quarter, spodumene prices were still up 7.5% One of the biggest outliers during the quarter was the strength in the nickel price, which was up 42%. This was supported by Russian nickel producer, Nornickel, announcing production cuts in 2023 amid weakening demand due to sanctions from their customers. Gold prices have been on a general incline since the beginning of November as market turbulence, rising recession expectations and more gold purchases from central banks underpinned demand. Gold finished the quarter up 9.8%

Looking at the consumer in Australia, this has arguably surprised to the upside as we are yet to see any major signs of weakness, and feedback regarding the Christmas trading period suggesting it was relatively strong. Although we have already seen a significant de-rate in the consumer discretionary names, it is expected that the cost-of-living pressures will begin to take a stronger hold in the 2023 calendar year. For example, a significant number of fixed rate mortgages will begin to revert to variable rate mortgages from April 2023 onwards. CBA estimates are suggesting the average loan rate for a borrower rolling off a fixed rate loan over the next 18 months is ~2.25%, with new standard variable home loans expected to attract interest rates of 5-5.5%. This is expected to place significant pressure on the disposable income of the consumer as we progress through the 2023 calendar year. This is on top of the already strong inflationary pressures the consumer is currently experiencing.

There seems to be a high level of uncertainty based on the broad number of company meetings we conducted during the quarter. Feedback from consumer facing companies and several of the industrials suggest that they have a reasonable level of confidence in earnings up to December, however the second half of the Financial Year 2023 carries a high level of uncertainty. Resource companies expect commodity prices to remain elevated as the Russia/Ukraine conflict continues and China continues to reopen. The banks still remain confident on consumers and businesses, however, do expect 2023 to be more challenging than 2022.

PERFORMANCE

The Paradice Australian Mid Cap Fund (the Fund) delivered a positive absolute return for the quarter of 6.10% , which was 1.22% below the Mid Cap Composite Benchmark. Main contributors to this were being underweight real estate and overweight the materials sectors. The Mid Cap resources sector has a significant weighting to lithium stocks which gave up some of the strong gains that they have achieved over the last year.

With heightened uncertainty and caution persisting over the quarter, the top performing stocks within the Fund were a mix of industrials that have a greater level of earnings certainty, as well as iron ore names with the reopening of China. Outside of these key themes, performance was very much stock specific and driven predominantly by trading updates and management commentary.

There was continued volatility in global equity markets during the December quarter with the MSCI World Net Total Return Index increasing 9.8%, the S&P 500 Total Return Index increasing 7.42% and the tech heavy NASDAQ 100 Total Return Index fell 0.29% (all in US Dollar terms). The S&P ASX 200 Total Return Index increased 9.4%. The biggest driver of this was the reopening of China which supported several commodities, as well as the long end of the Aussie bond curve coming down, which saw the outperformance of long duration sectors such as real estate and utilities.

Positives

EBOS (EBO) – Overweight

Positive trading update at the AGM for the first three months of the year

ALS (ALQ) – Overweight

Strength in the gold price during the quarter

Challenger (CGF) – Overweight

Challenger announced the sale of its Bank during the quarter which was a large overhang for the stock.

Seven Group Holdings (SVW) – Overweight

Strong AGM trading update regarding WesTrac and Coates.

A2 Milk Company (A2M) – Overweight

FDA approval for entry in the US market as well as the reopening of China.

Negatives

APM Human Services International (APM) – Overweight

The company’s earnings appear to be more variable than the market had previously factored.

Evolution Mining (EVN) – Underweight

Strength in the gold price during the quarter saw the outperformance of EVN.

Ampol (ALD) – Overweight

With rates rising, fuel volumes are under the spotlight.

Downer Group (DOW) – Overweight

Downer downgrade guidance off the back of ongoing weather related issues, as well as an accounting issue in one of their contracts.

Domino’s Pizza (DMP) – Underweight

With the bond yield moving lower in the quarter, a risk on environment saw the outperformance of DMP.

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PORTFOLIO CHANGES

Purchases

Virgin Money UK (VUK)

Increased the position following a very strong result. Strong NIM expectations and cost to income ratio continuing to move lower with the stock valuation well below the industry average and the expectation of ongoing capital returns.

Champion Iron (CIA)

With China reopening and the ongoing stimulus being provided to the property and infrastructure sectors, Champion Iron should be a beneficiary as this continues to play out through 2023.

Sandfire Resources (SFR)

Following the takeover of Oz Minerals by BHP, Sandfire is a high-quality copper producer. The company raised equity during the period which strengthened the balance sheet as the company continues to build out its operations at the Motheo and MATSA assets. The appointment of a new CEO has also been taken positively by the market.

Fisher & Paykel Healthcare (FPH)

Following the 1H23 result, the worst now looks to be behind the company with the outlook commentary suggesting a strong rebound with customers already working their way through the covid inventory overhang.

Bendigo and Adelaide Bank (BEN)

Following a strong trading update for the first 5 months of the year, NIM expectations continue to move higher, and the deterioration of credit quality seems benign at this stage.

Sales

Pilbara Minerals (PLS)

Following a strong run in lithium pricing and the potential short-term risks around EV sales, we exited the position in Pilbara.

Allkem (AKE)

Following a strong run in lithium pricing and the potential short-term risks around EV sales, we reduced the position in Allkem.

APM Human Services International (APM)

The company's earnings appear to be more variable than the market had previously factored.

Aurizon (AZJ)

Following the sale of the One-Rail business, the stock now lacks any major catalysts to see a solid re-rate.

Elders (ELD)

Following several strong years in the agriculture sector after higher-than-average rainfall, we believe the end of the cycle is near for Elders.

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, available in the ESG section of our website 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 20 engagements in which we explicitly discussed ESG matters with 15 companies relevant to the strategy. Of these, 70% 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 physical climate risk.

One company of focus during the quarter was IGO Ltd (IGO). In the period we held two meetings, including with both Executive and Board representatives. We held an engagement on executive pay in advance of the AGM and had a separate meeting with the Head of Safety. We sought to gain a deeper understanding of how the company fosters a safety-focused culture and tracks performance, as well as to follow up on how the company is addressing the issue of sexual harassment in mining. We were pleased to see this integrated within its broader safety program, with close collaboration with the human resources team and enhancements to training.

OUTLOOK

With the surge of inflation across the globe being a key theme during 2022, it is expected that this will continue into 2023, particularly the first half. Looking at the US, the most recent US payrolls print was stronger than expected and was a reminder for policy makers of the stickiness of inflation. The Fed Chair Powell recently emphasised the need to see a slowing labour market in order to combat the inflation story. The Fed seems to have been consistent in stating that an elongated period of high inflation would be a worse outcome than a recession. Therefore, it would seem unlikely at this stage for the Fed to deviate from its current stance on monetary policy tightening, or even slow the pace of rate rises.

As we approach reporting season in the US, we do believe that the outlook commentary should be marginally weaker. Looking at the consumer in the US, companies such as Target, Walmart, Best Buy and Macy's etc. have all been consistent in their outlook commentary from recent trading updates. This includes sales expectations weaker, excess levels of inventory, higher than expected discounting and prolonged promotional periods. Interestingly this contrasts with Australia where we are yet to see any major profit warnings from the consumer discretionary names (other than a few standouts). That's not to say we don't expect to see earnings downgrades flow through, it's just a timing difference between rate rises and the flow through to the consumer. With many mortgages reverting back to variable rates from April 2023 onwards, at an additional ~300bps higher, we believe this will put added pressure on the disposable income on the consumer.

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Looking at the next 12 months earnings estimates for the ASX200, consensus currently forecasts 3% EPS growth. Given the macro backdrop above, this seems optimistic at this stage and we would expect the aggregated market earnings expectations to come down as we work through the 2023 calendar year. With the February reporting season just around the corner, we expect the outlook commentary to be either more downbeat than the previous reporting season or continue to talk to elevated levels of uncertainty that we saw in the last half of 2022.

Protecting the Australian market to some degree will be the continued reopening of China and the flow through this will have on commodity prices. Iron ore is expected to be one of the more obvious beneficiaries, with property and infrastructure stimulus announced by China to play out over the next 12 months. Coal is also expected to remain elevated as there still seems to be no sign of the Russia/Ukraine conflict reaching a resolution, global energy shortages continuing to boost demand for coal, and China even mentioning more recently that they could potentially lift tariffs on Australian coal exports.

As we begin the new year a little more cautious, we will be monitoring the volatility very closely as this always provide a great opportunity to pick-up high-quality names that will deliver alpha over time. Reporting season will be an important time in catching up with companies and gauging exactly how early 2023 is playing out.