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	-9.88	-15.03	-8.97	6.01	6.51	6.64
Mid Cap Composite Benchmark	-11.16	-16.44	-11.97	5.45	7.26	7.21
Excess Return	1.28	1.41	3.00	0.56	-0.75	-0.57

*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).

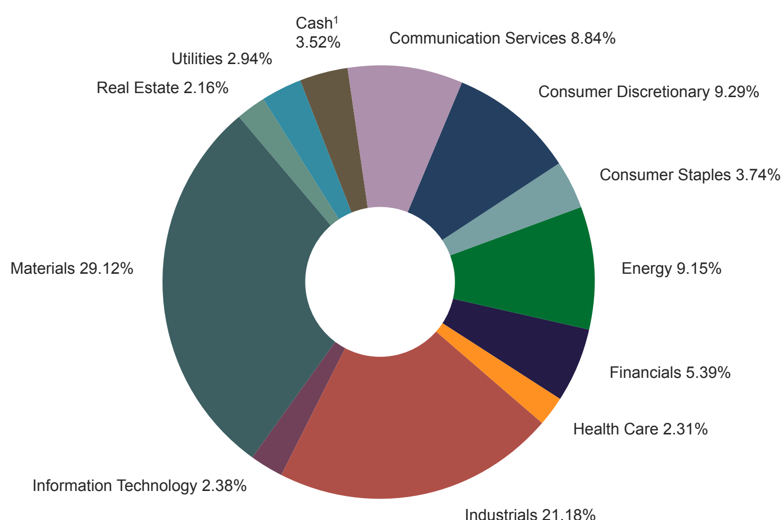
LEAD PORTFOLIO MANAGER

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	50
Portfolio Dividend Yield	3.12%
Fund Size (AUD)	$81M

TOP 10 POSITIONS	WEIGHT %
Ampol Ltd.	4.96
ALS Ltd.	3.92
Cleanaway Waste Management Ltd.	3.45
Lynas Rare Earths Ltd.	3.44
Orica Ltd.	3.43
IGO Ltd.	3.11
Aurizon Holdings Ltd.	3.07
Worley Ltd.	2.84
Qube Holdings Ltd.	2.84
Atlas Arteria	2.81

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.

Inflation came to the fore in the June 2022 quarter with the USA printing a headline figure of 8.6% and Australia 5.1% (with Governor Phillip Lowe saying that he expects this to reach 7% by year end). These generational high inflation figures have forced the hand of Central Banks globally who in hindsight had been far too slow to act. In the US the Fed lifted by an additional 50bp in May and 75bp in June to 175bp. In Australia the RBA lifted rates inaugurally by 25bp in May and 50bp in each of June and July to 135bp. The futures here imply a further 175bp of tightening this year to 3.1%, although this has come back by ~70bp. These actions marked a significant about face from both players given the Fed first raised by just 25bp in Mid-March and the RBA only signalled a change in tack towards tightening after the end of the March quarter. Both central banks have since embarked on the most aggressive rate rises since 1994. Even in Europe, despite the economic fallout from the War in Ukraine, the ECB has telegraphed pending rate rises. Globally over 80 central banks have now raised rates. The pressures of inflation are now also combining with a shortage of workers leading to pressure on wages which runs the risk of an ongoing negative feedback loop.

The central bank moves had a significant impact on financial markets. For example, 10 year bond yields in the US during the quarter rose from 2.3% to a high of almost 3.5% and in Australia from 2.8% to a high of 4.2%. The central banks messaging is that they are completely committed to taming inflation and hence there is further tightening to come from here. This has seen concerns start to rise over the potential for a policy induced recession. These concerns have actually seen 10 year bond yields drift back from their highs. At the time of writing USA 10 years have come back to 2.8% and in Australia they have fallen back to 3.4%. Many commentators are now arguing that we have seen peak long bond yields for this cycle and that we are likely to see yield curves invert in the coming weeks/months. In this regard market-based measures of inflation are off their highs and Fed expectations have been easing.

Concerns over a potential recession in the Western World have also combined with ongoing COVID lockdown pressures in China. Whilst COVID has taken a back seat in most parts of the world it continues to pose a real threat within China. It had previously been speculated that China might take an easier stance on containing COVID however it now appears that this will not be the case for a number of reasons. Firstly, the CCP's strict handling of COVID to date has been seen as an endorsement of the political system (although this has proved more difficult with the more infectious Omicron strain). Secondly, lower vaccination levels, especially amongst the elderly, combined with an inadequate hospital system, would mean that allowing a more widespread transmission of the disease could prove very problematic.

Fears of a potential recession combined with ongoing weakness in China took a toll on commodity prices. During the quarter the iron ore price peeled back from USD $157.50 to $123.50per tonne, copper fell from USD $4.70 to $3.74 per lb and nickel fell from USD $14.56 to $10.27 per lb. The AUD/USD also fell from $0.75 to $0.69 during this time. Interestingly the Russian Ukraine crisis is also having varied impacts on commodity prices and supply chains that were perhaps not anticipated at the outset of the conflict. Whilst we have seen ongoing pressure in the energy complex in the June quarter with the Brent oil price rising 15.4% (although as of the time of writing this has eased back), spodumene prices rising 73.7% and thermal coal rising by 62.0% (with European gas prices and Refining margins also strong), in other areas we saw many less scrupulous countries still willing to purchase Russian commodities, often at significant discount to the prevailing market price. In the case of commodities such as steel scrap and fertilisers we have even seen this put additional pressure on market pricing. Any sustained pullback in commodity prices will clearly help contain inflation moving forwards.

As mentioned in the March quarterly report capital management has remained strong with a high ongoing level of buybacks as utilising excess capital options are relatively limited for some given elevated asset prices. There has also been continuing corporate activity with Ramsay receiving a takeover offer from KKR, an agreed bid for Uniti Wireless, the completion of the Crown takeover by Blackstone and the IFM Global Infrastructure Fund taking a strategic stake in Atlas Arteria. The IPO market remains largely non-existent and capital raises remain light, with Carsales.Com raising funds to buy out the 51% balance of Trader Interactive that it did not own.

Heading into Q3 of 2022, we expect continuing volatility which will also hopefully provide opportunity. Q322 will also mark the Jun 22 period reporting season. These factors will be discussed in more detail in the Outlook Section.

PERFORMANCE

The environment described above led to significant volatility in equity markets globally during the June quarter with the MSCI World Net Total Return Index falling 16.2%, the S&P 500 Net Total Return Index falling 16.20% and the tech heavy NASDAQ 100 Total Return Index falling 22.30% (all in US Dollar terms). The Australian market outperformed these indices, with the S&P ASX 200 Total Return Index falling by 11.9%.

The Mid Cap composite index fell by 16.4% in the June quarter. Performance was driven predominantly by ongoing weak returns in interest rate sensitive sectors such as Information Technology, Consumer Discretionary and REITs. The materials sector also underperformed on weaker commodity prices and a potentially more difficult outlook for building materials stocks. Mining stocks were also not helped by strong cost inflation in the sector squeezing margins. We saw relative strength in the more earnings resilient sectors such as Utilities and Consumer staples and Energy also outperformed driven by stronger oil and LNG prices.

The Paradice Mid Cap portfolio delivered a positive relative return for the quarter outperforming by 1.41%. This continues the Fund's track record of relative capital preservation in more trying markets.

Positives

Ampol Limited (ALD) – Overweight

Experiencing a recovery in fuel demand post COVID combined with very strong refining margins due to an extended period of global under investment.

Orora Limited (ORA) – Overweight

The market reacted positively to ORA's investor day with the company seeing solid results, particularly out of its US operations.

Worley Limited (WOR) – Overweight

The market also reacted positively to WOR's investor day with solid demand for the company's services in both traditional and renewable energy markets.

JB Hi-Fi (JBH) – Underweight (not held)

Concerns over a weakening consumer environment.

GQG Partners (GQG) – Overweight

Continues to generate strong relative performance and generate inflows in a difficult equity market.

Negatives

Aurizon Holdings (AZJ) – Underweight

Benefiting from a resilient earnings stream in a period of economic uncertainty.

Vicinity Centres (VCX) – Underweight (not held)

Seeing a recovery in foot traffic and trading at their centres post Covid and have showcased a potential enhanced development pipeline.

Steadfast Group (SDF) – Underweight (not held)

Benefiting from a strong insurance pricing cycle.

IGO Limited (IGO) – Overweight

General weakness in resources names and is also exposed to Nickel which pulled back strongly from its March peak.

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Charter Hall (CHC) – Overweight

Expectation of rates rising impacted the broader property sector.

PORTFOLIO CHANGES

Purchases

Orica Limited (ORI)

H1 22 result exceeded expectations and the company is likely to have a multi-year tailwind from repricing explosives contracts.

Aurizon Holdings (AZJ)

Benefiting from a resilient earnings stream in a period of economic uncertainty and a pending reset on its regulated below rail assets.

Atlas Arteria (ALX)

Seeing traffic returning post Covid and benefits from inflation linked pricing on its toll roads. Since the portfolios purchase of the stock the IFM Global Infrastructure Fund has taken a strategic stake in the company continuing a run of corporate interest in infrastructure assets.

Ampol Limited (ALD)

Fuel demand recovering post Covid combined with very strong refining margins due to an extended period of global under investment.

AGL Energy (AGL)

Added AGL as it moves into a period of stronger earnings on higher electricity prices and potential corporate interest.

Sales

Crown Resorts (CWN)

Takeover by Blackstone completed during the quarter.

Nine Entertainment (NEC)

Concerns over a deteriorating advertising environment and the outlook for their Stan and Domain holdings.

Alumina (AWC)

Rising costs and a falling headline commodity price.

Reece Limited (REH)

Expensive US building materials play.

Virgin Money UK (VUK)

UK economy looking increasingly difficult.

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 17 engagements in which we explicitly discussed ESG matters with 10 companies relevant to the strategy. Of these, 82% 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 physical climate impacts.

One company of focus during the quarter was IGO Ltd (IGO). We met with the Board to discuss developments in the company's ESG materiality assessment and sustainability framework, as well as performance on certain ESG matters. We were pleased to see a focus on cultural heritage management and fostering stronger relationships with Traditional Owners, which included recent cultural awareness training and an increased indigenous employment rate. Additionally, IGO has enhanced training and procedures in relation to combatting sexual harassment, a matter we've previously raised with the company. We also discussed the inclusion of relevant KPIs in both short and long-term remuneration structures.

OUTLOOK

We feel that central banks actions will continue to dictate market movements in the short term. It is imperative for central banks to quash inflation given the damaging effects that it has on purchasing power and real asset prices. Unfortunately, monetary policy is a blunt tool and, especially given early policy errors, it may prove difficult to achieve these aims and avert a recession. Equity markets will also feel the dual pressure of the removal of excess liquidity in the market and the removal of the long standing "Fed Put". On a Global basis, attempts by China to contain COVID and the ongoing conflict in Ukraine will continue to impact with both looking like more enduring factors than was initially hoped.

Economically most of the data we receive tends to be a lagging indicator. At this stage the data largely continues to show strength with strong consumer spending, very low unemployment and accelerating wages. That being said early signs of caution are beginning to appear with house prices now declining in ANZ (though not the USA at this stage), consumer sentiment weakening, multiple US retailers reporting excess inventories and commodity prices flagging in some areas.

Corporate Australia is about to enter the June 22 period reporting season. We expect results to be quite resilient at this stage. We do feel that some companies will be impacted by inflation and supply chain issues and have already seen profit warnings on this front from the likes of Boral, ARB and GUD (the latter two impacted by the auto supply chain). Whilst we are not hearing of significant issues on the demand side thus far, we expect companies to be cautious in their outlook statements given the coming economic uncertainties and we would anticipate that the coming 6 months will see us enter a period of net profit downgrades.

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A lot of companies will also see increasing interest burdens after benefiting from a multi-year tailwind in this regard. From a valuation perspective, whilst at this stage we have seen the market multiples decline over the last 6 months, we believe that this has taken place in advance of a weakening earnings pulse.

In this environment the portfolio has looked to positions in companies that are resilient in more difficult economic cycles and have strong pricing power.

In the short-term equity markets are likely to remain volatile and as we all know nothing tends to move in a straight line. Looking to the medium-term equity markets will bottom before earnings do and should provide attractive returns to patient capital. In this regard decisive action from the world's central banks to tackle inflation, whilst potentially painful in the short term, will ultimately prove beneficial in the medium term.

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