30 SEPTEMBER 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	-7.50	0.80	-12.65	5.66	6.54	6.47
Mid Cap Composite Benchmark[1]	-8.62	3.48	-12.24	5.52	7.82	7.55
Excess Return	1.12	-2.68	-0.41	0.14	-1.28	-1.08

*Inception date – 15 May 2017

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).

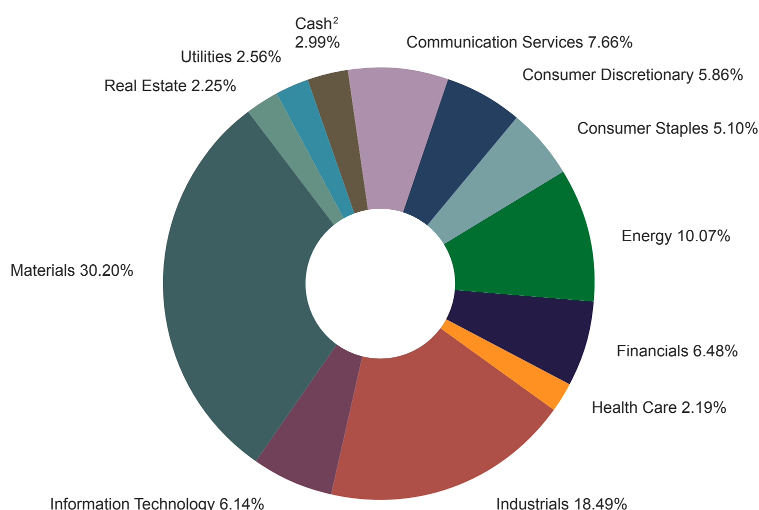
LEAD PORTFOLIO MANAGER

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	50
Portfolio Dividend Yield	2.98%
Fund Size (AUD)	$76M

TOP 10 POSITIONS	WEIGHT %
Ampol Ltd.	4.11
Pilbara Minerals Ltd.	4.07
IGO Ltd.	3.90
ALS Ltd.	3.72
OZ Minerals Ltd.	3.61
Carsales.Com Ltd.	3.46
Allkem Ltd.	3.44
Cleanaway Waste Management Ltd.	3.19
Orica Ltd.	3.16
Wisetech Global Ltd.	3.10

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

Inflation and interest rates continued to dominate markets in the September quarter with Australia having a solid August reporting season thrown into the mix. On the back of persistently strong inflation and very strong jobs markets, in the USA the Federal reserve lifted rates from an upper bound of 1.75% to 3.25% over the quarter via two 75bps hikes. Australia's Reserve Bank also hiked 150bps, but over three raises of 50bps each, from 0.85% to 2.35% and the Bank of England also joined the party, despite a weaker economy, lifting rates twice at 50bps each from 1.25% to 2.25%.

Inflation in the USA hit a recent high of 9.1% in June, with July and August data drifting down to 8.5% and 8.3% respectively. However, Core Inflation (which excludes more volatile fuel and food costs) rose from 5.9% to 6.3% from July to August, spoiling any thoughts of an "end of inflation" party. Australia's June quarterly CPI reading was 6.1% with the RBA expecting headline inflation to peak at around 7.75% by year end. In the USA, whilst non-Farm Payrolls signalled a slow-down in new jobs in July and more recently in August, the data was stronger than market expectations. In Australia the unemployment rate is expected to finish the year at a very low 3.25%.

The bond market has continued its roller coaster run, particularly in the USA. US 10-year treasuries dropped to 2.6% at the start of August before running back up to be just shy of 3.9% as at time of writing. With the yield curve remaining inverted, expectations still sit firmly in the camp of further hikes to tame inflation.

The August reporting season in Australia was reasonably strong. Inflationary impacts were relatively muted but high on the discussion agenda. There will be far bigger challenges ahead in passing on costs and holding onto margins. New Enterprise Bargaining Agreements will also have some impact and will need to be managed. Whilst energy supply and price has been a growing area of concern for some time, it has accelerated to be an area of major concern post the Russian / Ukrainian conflict. It is not only the direct impact from higher commodity pricing in the likes of coal and LNG, but the secondary derivative impact on industries such as fertiliser, refining and building materials. In the building industry bricks and plasterboard are both large users of gas. As gas contracts roll off, price increases of up to 25% could be required to offset the cost input increase.

The consumer has been extremely resilient over the quarter. Except for some pure online plays such as Kogan, results were very strong. With interest rate increases always impacting on a lagged basis and the economy at full employment, the slowdown is probably more of a 2H FY23 event and the market's lacklustre reaction to these solid results reflected this. Housing also held up well as the market struggles to build out the backlog caused by COVID and the unusually wet weather. Again, the lagged impact of building material price increases and rising rates is starting to feed through and would be expected to impact demand in the quarters ahead.

On the commodity front coal and Lithium were the standouts. With Spodumene and Hydroxide prices firming over the quarter and positive news flow regarding pent up battery related demand, the Lithium producers were well supported. Coal continued to rally hard (+20.8% in the Q), with Newcastle thermal breaking through US$450/T in September! Gold has been the real laggard in this inflationary environment, falling over the quarter from US$1,807 to US$1,660/oz on higher real rates. A partial offset to this for the AU gold producers has been the spot AUD: USD exchange rate continuing its fall, from US69c to US64c.

Market corporate activity picked up in the September quarter. On the M&A front there was reasonable news flow, albeit all not positive. A non-binding indicative bid was made for Oz Minerals by BHP, Perpetual successfully bid for Pendal, whilst Link looks to have lost their potential acquirer Dye and Durham (for the entire business anyway). Cleanaway and Orica both made smallish acquisitions and both over-raised. For Orica it was not exactly clear why, and for Cleanaway it was to facilitate further potential growth options. Perhaps one to go down as worst infrastructure deal of the year was Atlas Arteria's acquisition of Chicago Skyway Toll Road. Paying a big price for concession life was not well received with the stock trading at discount to the 12.1% discount to TERP raising price.

PERFORMANCE

The Fund delivered a positive absolute return for the quarter of 0.80%, which was 2.68% below the index. Main contributors to this were being underweight coal, and a number of the strong performers from the June quarter giving up some of their gains.

With higher bond yields and concerns about economic growth driven by rampant inflation and higher interest rates, it would seem odd that the top 7 performing Mid Cap holdings over the quarter were a mix of tech and resource stocks. There were no broad discernible trends outside of lithium and coal. Performance was very much stock specific and driven predominantly by results and management commentary.

There was continued volatility in global equity markets during the June quarter with the MSCI World Net Total Return Index falling 6.19%, the S&P 500 Total Return Index falling 4.9% and the tech heavy NASDAQ 100 Total Return Index falling 4.42% (all in US Dollar terms). The Australian market outperformed these indices, with the S&P ASX 200 Total Return Index rising by 0.4%. A number of stocks generated in-line results but after strong runs into reporting season, were sold off if there was no quantifiable upgrade to expectations (e.g. Orora, Qube). The market also marked down stocks that made poor acquisitions and / or over-raised (e.g. Atlas Arteria, Orica).

Positives

Oz Minerals (OZL) – Overweight

OZL received a non-binding bid from BHP at $25/share.

IGO limited (IGO) – Overweight

A very strong Lithium market has led to elevated pricing.

Allkem (AKE) – Overweight

A very strong Lithium market has led to elevated pricing.

Pilbara Minerals (PLS) – Overweight

A very strong Lithium market has led to elevated pricing.

Domino's (DMP) – Underweight

DMP's earnings are under pressure as the European market struggles economically.

Negatives

Whitehaven Coal (WC) – Underweight

Demand for high calorific coal has been extremely strong particularly post the start of the Ukraine war.

Ampol (ALD) – Overweight

With rates rising, fuel volumes are under the spotlight.

Orora (ORA) – Overweight

Market concerns about ORA's exposure to a slowing USA market.

Orica (ORI) – Overweight

After over-raising for a relatively small acquisition, there were concerns about the underlying strength of the operations in what should be a strong market.

ALS Ltd (ALQ) – Overweight

Some market concerns about the level of capital raisings amongst the gold miner juniors to fund exploration spend.

PORTFOLIO CHANGES

Purchases

A2 Milk (A2M)

A2M delivered a very clean result with improvements shown in the crucial Chinese market for Infant formula growth. With borders reopening, some improvement is expected in the Daigou channels with an extension of the Chinese regulatory approval still a key risk to be cognisant of.

Downer (DOW)

DOW has a strong balance sheet and a relatively clean book of work going forward, trading at a below trend multiple.

Pilbara Minerals (PLS)

We increased our position is PLS as we exited MIN to maintain a reasonable Lithium exposure.

Steadfast Group (SDF)

The general insurance broker continues to show solid growth through organic and acquisitive channels, with positive premium growth across the sector.

Wisetech (WTC)

WTC continues to offer the go to technology solutions for the broader global freight forwarding industry. They generated a very strong FY22 result.

Sales

Bendigo Bank (BEN)

Concerns about mortgage competition as housing market tightens with cost inflation.

Dominoes (DMP)

DMP has significant exposure to the European market (Germany, France, Netherlands) and the economies and currencies are weak.

Mineral resources (MIN)

MIN went into the ASX50 towards the end of June. We maintained a strong Lithium exposure through adding to PLS (see above).

Reliance Worldwide (RWC)

RWC has a large exposure to the weak UK market through John Guest plus there are concerns about the USA rates impact on the future strength of the Repair and Remodel market.

Aurizon (AZJ)

We reduced the position in AZJ as the sale of East Coast Rail post the One Rail acquisition looks to be a tough proposition to realise any meaningful outcome for shareholders.

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.

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 27 engagements in which we explicitly discussed ESG matters with 21 companies relevant to the strategy. 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 period, the most commonly discussed topics were climate transition, labour issues and environmental management.

One company of focus during the quarter was AGL Energy Ltd (AGL). In the period we held two meetings, including with both Executive and Board representatives. While the Climate Transition Action Plan and decarbonisation capex dominated the conversation, we also discussed several other ESG matters. We sought information on board renewal and director independence, talent attraction and retention given the current business challenges, including for the CEO. We tested the Chair's thinking on the Say on Climate vote and what additional disclosures or commitments could be made in advance of the AGM to shore up shareholder support.

OUTLOOK

As we said in the last quarterly report, we feel that central banks actions will continue to dictate market movements in the short term. The next Federal Reserve meeting is on 2nd November. Market expectations are for another 75bps to take the upper bound of the range to 4% given the strong jobs market and persistent inflationary pressures. Once that is "out of the way", focus and discussion will be on the level of further hikes in mid-December at the last meeting of the year. Whilst the bulls might want to jump onto any hint of the rates cycle topping out, the earnings cycle is yet to reflect the real impact of the tightening cycle, and this could take a while to wash out.

From an earnings perspective, the October USA quarterly reports and commentary in Australia out of the AGM's will give some colour on where expectations sit looking forward through the end of CY22. Whilst the June financial year reporting season in Australia was very good, there was muted commentary about the outlook given the issues at hand. These issues, including the Ukrainian war and its impact on goods availability, energy prices, inflation and rising interest rates, have all not abated. Whilst market multiples have re-rated and reflect some of these concerns, the earnings forecasts of analysts are notoriously late in adjusting to a potential downturn and this is what we are cautious about.

Other issues to be alert to going forward is the Chinese market and FX. The 19th Central Committee of the CPC opened in Beijing on Sunday 9th October. This is followed by the 20th National Congress of the Chinese Communist Party which opens on the 16th October and any changes in approach to their zero COVID policy and economic intentions should hopefully become clearer. The Australian Dollar was trading at US64c as at the end of September, close to 15% lower than its average for FY22. This will be a positive for offshore earners however, will be a source of imported inflation.

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Whilst to date in Australia the economic data has been strong given the environment (jobs, consumer spending, housing approvals, wage growth etc), this is all backward looking and there are signs of a few cracks appearing. Some companies are talking redundancies, there are some excess inventory issues, costs of debt is becoming an issue for those corporates with high debt ratios and limited hedging, plus the impact of rising input costs is still feeding through into higher prices. Couple this with very low rental vacancies, house prices starting to noticeably roll over and building costs indicatively being anything between 15% and 30% higher than 2020, we believe caution is the better discretion today. The USA is well ahead of Australia on the rates curve and there have been earnings downgrades from the likes of Fedex, Nike and Apple which gives cause this broader caution.

With ongoing high volatility in the equity markets over the next quarter at least, the best indicators are from industry themselves. We have a raft of conferences, AGM updates and a constructive visitation schedule for PIM Mid-Caps over the next 2 months. We also welcome Jordan Woods to our team. He starts on the 14th November and has strong experience on the buy side and will be a great asset to the team.

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