31 DECEMBER 2023

AUSTRALIAN MID CAP FUND – CLASS B

PARADICE
INVESTMENT MANAGEMENT

PERFORMANCE NET (%)	1 MONTH	3 MONTH	1 YEAR	3 YEAR	5 YEAR	SI* P.A.
Australian Mid Cap Fund – Class B	7.00	6.64	7.28	5.20	9.15	7.30
Mid Cap Composite Benchmark[1]	6.99	5.90	7.81	5.20	10.20	8.44
Excess Return	0.01	0.74	-0.53	-	-1.05	-1.14
*Since Inception date (SI) – 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).

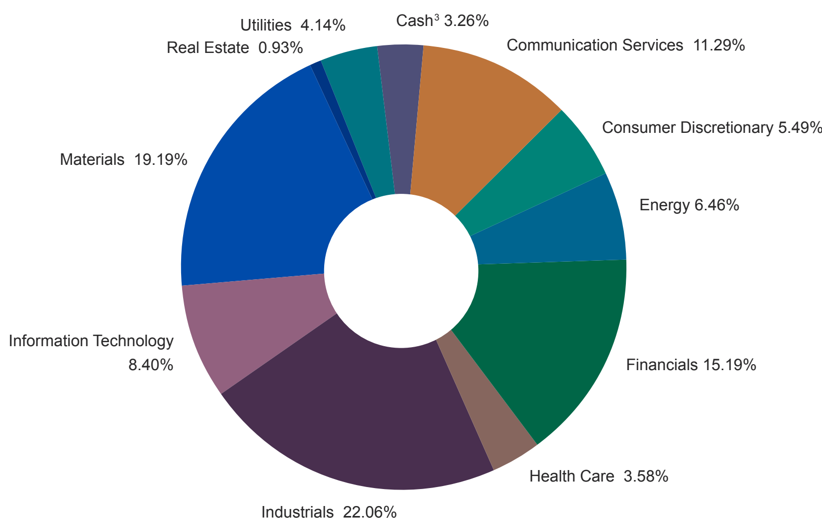
LEAD PORTFOLIO MANAGER

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	48
Portfolio Dividend Yield	2.31%
Fund Size (AUD)	$79M

TOP 10 POSITIONS	WEIGHT %
CAR Group Ltd.	6.36
Seven Group Holdings Ltd.	4.66
Orica Ltd.	4.33
REA Group Ltd.	3.47
Qube Holdings Ltd.	3.36
Cleanaway Waste Management Ltd.	3.26
ALS Ltd.	3.04
Ampol Ltd.	2.97
Steadfast Group Ltd.	2.93
Lynas Rare Earths Ltd.	2.88

FUND DETAILS	
APIR Code	ETL8772AU
Distribution Frequency	Semi-Annually
Management Fee	1.10% p.a.
Performance Fee[2]	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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AUSTRALIAN MID CAP FUND – CLASS B

PARADICE
INVESTMENT MANAGEMENT

Performance in AUD unless otherwise noted.

MARKET REVIEW

The December quarter capped off a volatile year for global equity markets. Going into 2023, market expectations were broadly for a first-half downturn, followed by second-half recovery, as well as a strong China reopening. What transpired was quite different, with a surprisingly resilient global advanced economy and a disappointing China reopening. The Fed's rate path was the primary focus for the year. The market wrestled with several potential scenarios, from 'hard landing' to 'no landing', each with its own growth, inflation and interest rate outcomes.

Along this vein, good news was good news, and then it was bad news. Relative to fears of a first-half US recession, stronger earnings in the second quarter drove equity markets higher. Soon after, the US economy resilience manifested in concern that further rate hikes were required to combat inflation. Stronger US data in the third quarter was bad news. Equity markets sold off in September and October as bond markets priced in higher rates, with US 10-year Treasury yields rallying to over 5.0%.

Softer-than-expected inflation figures in November sparked a sharp decline in bond yields and a rally in equity markets. With a more resilient economy and inflation trending in the right direction, the market looked forward to the peaking of the tightening cycle and the prospect of a 'soft landing'. The optimistic scenario was quickly priced in by the market. After a volatile year, the US 10-year ended at 3.88%, around where it started. As we look forward, the market is now pricing in several interest rate cuts by mid-2024. China, after having disappointed in 2023, is once again in vogue as stimulus comes into the fore.

The bifurcation of the US market between the 'Magnificent Seven'[1] and the rest of the market was also a key feature of the year. At a headline level, the S&P 500 Total Return Index was up 11.7% (in USD) for the year to 31 December 2023. Most of the heavy lifting can be attributed to the Magnificent Seven, up 107% for the same year. Indeed, this largely explains the outperformance of the S&P 500 relative to our ASX200 as IT now makes up circa 30% of the S&P500. Over 2023 Artificial Intelligence (AI) was a key thematic which may have explained the performance of the Magnificent Seven. AI has emerged as a crucial new secular trend, potentially touching all parts of the economy as both an opportunity and a threat.

While most advanced economy central banks left policy unchanged during the quarter, there was a more hawkish tone domestically. The Reserve Bank of Australia raised the cash rate by 25 basis points to 4.35% in November. The new Reserve Bank Governor, Michelle Bullock, commented that while inflation in Australia was trending in the right direction, it remains higher than other countries and is increasingly being driven by domestic demand. This relative hawkishness was reflected in the late rally of the AUD versus USD toward the end of the year, up 5.9% for the quarter.

Regardless, the Australian equity market broadly followed the strong US trend during the year and particularly in the December quarter. The S&P/ASX 200 Total Return Index (ASX 200) was up 8.4% during the quarter and the S&P/ASX Small Ords Total Return Index (Small Ords Index) increased 8.5% for the quarter. Typically, when investor sentiment turns more positive on the economy small caps outperform large caps due to their higher risk profile and higher reliance on market liquidity. During November and December, the Small Ords Index regained some of its relative underperformance rallying 14.8%, outperforming the ASX 200 by 2.0%. Again, this was a trend seen in the US with the Russell 2000 Total Return index rallying 22.4% (in USD) in November and December versus the S&P 500 Total Return Index up 14.1% (in USD).

The drop in bond yields triggered a sharp rotation during the quarter, with interest rate-sensitive names outperforming strongly. Locally, Materials (which includes Gold (+18.1%)) (+13.35%) and Real Estate (+15.8%) were the best performing industries and sectors. Energy (-9.1%) and Utilities (-2.1%) were the worst performing sectors in the S&P/ASX 200.

On the commodities front, battery materials companies underperformed due to the weakness in the spodumene price which declined by 48.5% (in USD) over the quarter. The cost curve discovery phase continues and there has been limited reports of miners cutting production or delaying mine expansion. Oil and Gas declined with the brent crude oil price down 19.2% (in USD). Demand eased in-line with slower global growth and amid signs that the Hamas-Israel Conflict was not spreading more widely across the region. Iron ore rallied 17.0% (in USD) over the quarter supported by positive information about the Chinese economy outside the property sector. Thermal coal was down 8.6% (in USD) for the quarter while Coking Coal was up 15.3%.

PERFORMANCE

The Fund delivered a positive return for the quarter of 6.64%, outperforming the Mid Cap Composite Benchmark by 0.74%. Outperformance was largely driven by stock-specific attribution rather than sectoral or factor tilts. The sharp decline in rates during the quarter drove a strong reversal in the REIT sector's recent underperformance. This negatively impacted the Fund given its underweight position.

A turnaround in market sentiment drove a flurry of corporate activity before the Christmas holidays. Notable takeover offers late in December included under-performers Link Administration Holdings and Adbri Limited. Several companies raised equity to expand operations including Karoon Energy, Treasury Wines, Steadfast and Evolution Mining. Orica Limited used its strong balance sheet to further expand into digital solutions with the acquisition of Terra Insights. After breaching its debt covenants, Covid beneficiary, Healius raised fresh equity to restructure its balance sheet. Finally, after being touted as one of the top IPO candidates for years, Chemist Warehouse announced its foray into listed markets via a merger with Sigma Healthcare.

Positives

Block (SQ2) – Overweight

Block shares outperformed after it reported a strong third quarter and upgraded its full year guidance. FY24 guidance was provided for the first time, significantly ahead of market expectations. Block has committed to achieving the 'rule of 40' (a revenue growth rate plus profit margin exceeding 40%) by 2026.

Liontown Resources (LTR) – Nil Holding

Liontown shares underperformed following Albemarle's withdrawal of its takeover proposal, its heavily dilutive capital raise and weakness in the spodumene price.

Neuren Pharmaceuticals (NEU) – Overweight

Acadia Pharmaceuticals, the distributor for NEU's first drug DAYBUE (trofinetide), reported a strong first full quarter of sales and raised sales guidance for Q4. In addition, NEU announced positive top line results of its Phase 2 study experimental drug NNZ-2591 in Phelan-McDermid Syndrome (PMS).

Seven Group (SVW) – Overweight

Seven Group outperformed following its full year guidance upgrade. SVW highlighted ongoing outperformance of Industrial Services and a very strong start to the year for WesTrac with increasing demand for mining

[1]Bloomberg Magnificent 7 Total Return Index consists of a group of seven of the mega-cap tech growth stocks including Amazon.com, Apple, Google parent Alphabet, Meta Platforms, Microsoft, Nvidia and Tesla.

support activity and strong new machine order book. SVW are seeing strength in infrastructure and construction, while Boral is reportedly executing strongly on cost and efficiency gains.

Champion Iron (CIA) - Overweight

Champion Iron shares outperformed following the release of its strong quarterly results and in line with the increase in iron ore prices.

Negatives

AGL Limited (AGL) – Overweight

Weaker electricity forward prices, and potentially some fallout from the rejection of the Origin deal, which in our view is impacting sentiment and driving weakness in the AGL share price.

Charter Hall (CHC) – Underweight

CHC rallied during the quarter alongside the broader REIT sector as bond yields declined.

Vicinity Centres (VCX) – Nil Holding

VCX rallied during the quarter alongside the broader REIT sector as bond yields declined.

AUB Group (AUB) – Overweight

AUB shares underperformed in sympathy with the broader insurance and diversified financial services sector. There was no stock specific news during the quarter.

Karoon Energy (KAR) – Overweight

KAR declined in sympathy with the oil price and as the market digested the recent equity raising.

PORTFOLIO CHANGES

Purchases

Block (SQ2)

We added to our position during the quarter. Block sold off with rate sensitive companies and was trading at an attractive valuation with strong growth prospects. Discipline around operating expenses and a timeline for achieving the 'Rule of 40' gives us confidence that management are executing on their strategy.

Steadfast (SDF)

We added to our holding in Steadfast following weakness in the share price and as we gained comfort around a more measured US expansion.

Qube (QUB)

Share price weakness around macro concerns provided an opportunity to add to our holding. QUB's diversified end market exposure should support future earnings growth. Issues with QUB's closest competitor should also provide an opportunity for increased market share.

Cleanaway (CWY)

We increased our position in Cleanaway during the quarter as we gained confidence around management's ability to execute on its turnaround strategy.

Promedicus (PME)

PME's best-in-class software combined with structural thematics including AI and hospitals' shift to cloud-based systems provide PME with the ability to continue winning contracts and increasing market share from less than 10% today.

Sales

Orora (ORA)

As premium brands around the world were reporting de-stocking trends, we exited our position in ORA.

IGO Limited (IGO)

Reduced our exposure to lithium as the outlook for the commodity remains weak.

Fisher and Paykel (FPH)

Low confidence around FPH's ability to achieve its Gross Profit and EBIT Margin targets over the medium term combined with limited valuation upside led us to exit our position.

IDP Education (IEL)

Uncertainty around a new entrant in India and the potential for share losses as a result of this increased competition. IEL also announced the retirement of its long-standing CFO, which follows the resignation of its CEO. In our opinion, the valuation did not reflect these risks.

Metcash (MTS)

During the quarter we exited our position in MTS. Increasing cost pressures combined with slowing revenue growth is expected to put pressure on supermarket margins. The hardware division is also expected to be under pressure as the housing backlog shrinks towards the middle of the year.

ENVIRONMENTAL, SOCIAL, GOVERNANCE ISSUES (ESG)

The major annual United Nations climate change conference COP28 concluded in Dubai in December, with a number of agreements made by member states while negotiations on a key sticking point (Article 6) failed. The conference also saw a 'Global Stocktake' undertaken, which was required under the 2015 Paris Agreement, in effect assessing countries' efforts to-date and determining gaps to meet the agreed goals.

Member states agreed to "[transition] away from fossil fuels in energy systems", the first explicit mention of fossil fuels more broadly rather than singling out coal, although some countries had sought stronger wording such as "phase out" or "phase down". Nevertheless, it is notable that oil and gas have now been brought into scope.

Countries reiterated their commitment to the stretch goal of the Paris Agreement – pursuing efforts to limit warming to 1.5°C. The text acknowledged the need for deep, rapid and sustained emissions reductions to meet such a goal, and called for member states to contribute to these efforts with consideration given to national circumstances.

Another notable development at the conference was a new declaration regarding nuclear energy. More than 20 countries committed to work together to advance an aspiration goal to triple nuclear energy capacity by 2050. While Australia did not sign, globally significant countries such as the US, Britain, France and Canada did. We anticipate policy support and greater acceptance of nuclear as a climate solution to become more widespread in the medium term.

Renewable energy and energy efficiency were the focus of a new pledge signed by around 130 countries, seeking to drive installed capacity and double the annual rate of energy efficiency improvements by 2030.

Disappointingly, we are no closer to a global carbon market with negotiations on Article 6 of the Paris Agreement postponed to next year's conference. This included a framework for carbon trading between countries and operationalising a UN supervisory body to administer a carbon trading mechanism for credits created by both the public and private sector.

AUSTRALIAN MID CAP FUND – CLASS B

PARADICE
INVESTMENT MANAGEMENT

Clarity on Article 6 had been hoped to help standardise and restore integrity to voluntary carbon markets, as well as provide a means through which countries could trade carbon in a manner which counts towards their nationally determined contributions. For now, national or regional level regulations and market initiatives will remain most influential in shaping carbon markets.

ENGAGEMENT

During the quarter, we undertook a total of 21 engagements in which we explicitly discussed ESG matters with 17 companies relevant to the strategy. A majority (86%) 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 discussed topics were climate transition, executive pay and other governance matters.

As an example of such discussions, in two meetings with Orica (ORI) we discussed the company's new climate plan, one with the CEO and one with the sustainability team. We sought clarification of a few points such as Orica's intention to not pursue Science-based Targets Initiative (SBTi) validation and the role of carbon credits in the achievement of emissions reduction targets. We provided feedback on some minor areas for improvement, including with respect to the board skills matrix. We voted in favour of the 'Say on Climate' vote put to the company's December AGM.

OUTLOOK

Turning to 2024, the equity market is once again optimistic about the outlook for the year ahead. A soft-landing scenario is being priced in as inflation has trended lower and the US economy has remained resilient. The big economic story in 2024 is likely to be the path of interest rates with several interest rate cuts priced in. Forecasters are predicting a 50% chance of a US recession, a coin flip. As we have experienced over 2023, markets have been quick to price in the end of the rate hiking cycle, well before the inflation targets have been met leading to disappointment.

While we keep abreast of macro activity and economic forecasts, we acknowledge accurately forecasting future market direction is near impossible. Macro sentiment can change quickly, sometimes in matter of days, as we experienced in early November. During periods of high volatility, rather than becoming too caught up trying to 'read the macro tea leaves', we gravitate to on-the-ground information-gathering, analysis, and meeting with companies we own and follow.

We expect inflation will continue to have varying impacts on companies resulting in a wide range of share price returns. Price increase fatigue appears to have set in for many sectors, including retailers and building materials. The cost-of-living pressures are impacting cohorts differently, with the most impacted being the 25-39 age range. Despite retailers reporting strong sales during Black Friday, it is likely there has been a pull-forward of Christmas demand as consumers increasingly search for value.

While wages growth is expected to ease, the labour market in Australia remains tight. For companies with limited flexibility in their cost base, it is likely that wage pressure will continue to impact profit margins. The Wage Price Index recorded its highest quarterly growth rate for September 2023 since it commenced in the late 1990s, reflecting the implementation of the Fair Work Commission's decision to significantly increase minimum and award wages. This will flow through to earnings in 2024 for companies with wages linked to awards including retailers and traditional healthcare services. We remain positive on companies that can continue to push through price increases, often reflecting rational industry structure and the importance of their product. This includes Orica, which has repriced a significant portion of its customer contracts, Seven Group and the insurance brokers.

After disappointing in 2023, stimulus in China is expected to support the economy, amid signs of rising deflationary pressures. Limited additions to supply in 2024 and low steel inventories are supporting the iron ore price. This combined with the global decarbonisation trend is positive for portfolio holding Champion Iron. Conversely, lithium producers continue to struggle as the demand/supply mismatch continues to weigh on inventory. We remain underweight lithium and believe prices are still in the cost discovery phase and are looking for cuts to production and mine expansions to provide a floor in prices.

It is also worth touching on the outlook for rate-sensitive names into 2024, notably REITs and Healthcare, which rallied strongly into the end of 2023. The market has been quick to price in the valuation benefit for rate sensitive sectors. However, these sectors have, and will continue to see negative earnings revisions. The risk/reward of chasing these sectors now, to us, does not look compelling.

We expect 2024 to be rich with opportunities. The real economy in such a dynamic state as the consumer and businesses at home and abroad digest four years of extraordinary monetary and fiscal stimulus and contraction, geopolitical uncertainty and ongoing inflationary challenges. While the macro-outlook for the year ahead is murky, we are focused on finding compelling opportunities that the market has overlooked, unfairly punished or misunderstood, and avoiding the inverse.