30 SEPTEMBER 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	-4.81	-2.03	6.74	6.77	4.10	6.52
Mid Cap Composite Benchmark[1]	-4.44	-1.75	9.26	8.44	5.88	7.81
Excess Return	-0.37	-0.28	-2.52	-1.67	-1.78	-1.29
						*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).

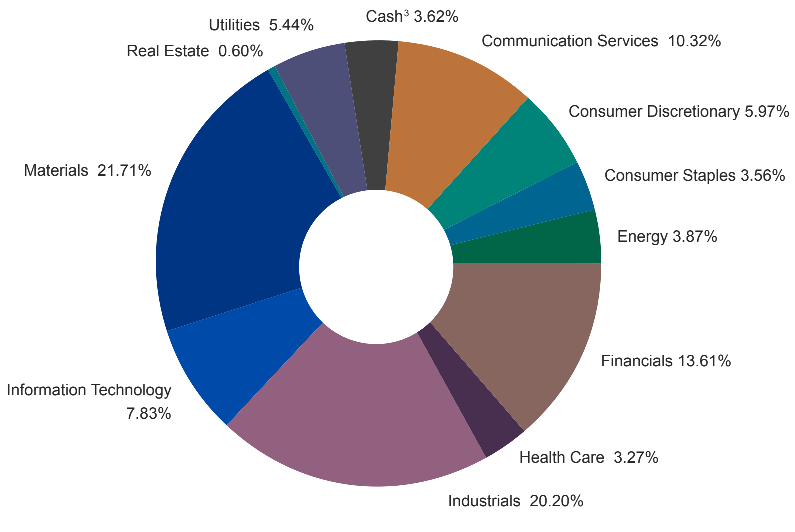
LEAD PORTFOLIO MANAGER

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	51
Portfolio Dividend Yield	2.83%
Fund Size (AUD)	$75M

TOP 10 POSITIONS	WEIGHT %
Carsales.Com Ltd.	6.09
Seven Group Holdings Ltd.	4.20
Orica Ltd.	4.10
AGL Energy Ltd.	3.47
Aurizon Holdings Ltd.	3.33
Ampol Ltd.	2.96
Orora Ltd.	2.91
ALS Ltd.	2.86
Worley Ltd.	2.85
IGO Ltd.	2.78

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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Performance in AUD unless otherwise noted.

MARKET REVIEW

The Australian market saw a mixed quarter of performance. Heading into reporting season, the S&P/ASX 200 Total Return Index was up 3% in July. This was followed by declines in August and September which resulted in the S&P/ASX 200 Total Return Index ending the quarter down 0.8%. The S&P/ASX Mid Cap 50 declines were more pronounced, finishing the quarter down 1.7%. The S&P/ASX Small Ords Total Return Index also posted a decline of 1.9% for the quarter. The negative equity market returns extended beyond Australia with both the S&P 500 Total Return Index and NASDAQ Total Return Index down 3.3% and 3.9% respectively for the quarter (in USD).

Equity and fixed income markets continue to paint conflicting pictures. While reporting season held up relatively well compared to consensus expectations, the fixed income market continues to price in higher rates for longer. The long end of the yield curve in both Australia and the US continue to move higher as inflation continues to remain persistent, albeit moving in the right direction. As we moved into the back end of the quarter and into October, the continued increase in the long end of the yield curve has started to weigh on equity market valuations as we saw equity markets start to come unstuck. The S&P/ASX 200 Total Return Index has fallen 2.8% in September, and a further 2% at the time of writing (as of 4th October).

In equity markets, the big event during the quarter was reporting season. Companies results proved better than feared with more beats than misses. However, consistent with what we have seen during the year, the market continued to downgrade the outlook. FY24 consensus earnings saw further mild downgrades through the month of August.

Looking across the S&P/ASX 50 Mid Cap and S&P/ASX Small Ordinaries universe, sector returns were differentiated during August. Communication Services, Consumer Discretionary and the Energy sector were among the top performing sectors over August. Utilities, Healthcare and Real Estate, however, were the bottom performing sectors over the same period.

Looking at the strength of the Consumer Discretionary sector, it appears expectations heading into reporting season were relatively low. Broadly speaking, the trading updates provided were negative, but not to the same degree as that factored into consensus expectations for 1H24. Given its still relatively early in the new financial year it's likely too early to call a soft landing for a lot of the retailers as they try to improve on strong comparable periods from previous cycles and as rate hikes bite into consumers' disposable income. Some of the biggest detractors within the Consumer Discretionary sector for the month of August were the travel names, Flight Centre, Webjet and Corporate Travel.

Across other sectors, Real Estate was down 4.95% for the month of August as ongoing interest rate rises not only impact valuations but also the growth in interest expense. One of the common themes seen across reporting season was the continued underestimation of interest expense growth. It appears consensus continues to lag when it comes to forecasting the impact of the increase in interest rates on future years earnings. This has been a driver of the earnings downgrades coming out of reporting season.

On the commodities front, battery materials companies underperformed, driven by the weakness in the spodumene price which declined by 44% (in USD) over the quarter. The Gold sector was largely flat over the quarter with the gold price down slightly (-3.7%) (in USD). Oil and Gas saw strong gains with the brent crude oil price up 27% (in USD) as well as thermal coal which was up 25% (in USD) for the quarter.

PERFORMANCE

The Fund delivered a negative return for the quarter of -1.99%, which was in line with/slightly lower than the Mid Cap Composite Benchmark of -1.75%. The main contributor to this was more stock specific than from a sector perspective which is evident in the positives and negatives from an attribution perspective.

Corporate activity was fairly muted. Orora's announced the acquisition of Saverglass in France, and there were further rumours around the sale of Incitec Pivot's Fertilisers business, although nothing announced.

Positives

Seven Group (SVW) – Overweight

A strong result with the earnings outlook remaining strong and potential upside to guidance.

Carsales.com (CAR) – Overweight

International segments continue to outperform and FY24 guidance drove upgrades to consensus.

Alumina (AWC) – Underweight

Current commodity pricing and ongoing elevated costs are driving negative free cash flow.

Chalice Mining (CHN) – Underweight

Post the release of the Gonneville scoping study, Chalice has sold off aggressively as lower metallurgical recoveries, higher operating costs and higher capital costs were all worse than expectations for the project.

Orica (ORI) - Overweight

Orica didn't release earnings over the period given they have a September year end. However ongoing earnings upgrades and the stock trading at a discount to longer term averages saw outperformance during the quarter.

Negatives

Illuka resources (ILU) – Overweight

Weak cash flow result on inventory build up due to weaker zircon demand and negative free cash flow in the first half.

Incitec Pivot (IPL) – Underweight

Further rumours around the potential sale of the Fertilisers business for $1.5bn.

Block (SQ2) – Overweight

The stock sold off aggressively post their 2Q23 result as the rule of 40 look more difficult to achieve and gross profit growth was forecast to be slower in 3Q.

Altium (ALU) – Underweight

A strong result driven by higher-than-expected subscription performance and long term aspirational target of $500m revenue reaffirmed.

NIB Holdings (NHF) – Overweight

Uncertainty around the full release of the remaining Deferred Claims Liability and further customers trends distorted the underlying result and made the future margins a little unclear.

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PORTFOLIO CHANGES

Purchases

Domino's Pizza (DMP)
Added post the result given same store sales growth is improving, cost out is starting to kick in and European margins looked to have troughed.

Light and Wonder (LNW)
The company has provided a FY25 EBITDA target of $1.4bn which the market is not forecasting and we believe is very achievable.

Altium (ALU)
Increased our exposure following the very strong result with annual recurring revenue being better than expected.

CSR Limited (CSR)
Increased our exposure ahead of the 1H25 result. CSR continues to demonstrate strong pricing power and its volumes are being supported by the backlog of work. Australia's housing undersupply and recent Government plans to increase housing construction are supportive of medium-term earnings.

Resmed (RMD)
RMD's share price has significantly declined on the threat of GLP-1's on sleep apnea demand. With its competitor Phillips still out of the market we believe demand for RMD's products continue to be strong and are positive on the inherent operating leverage.

Sales

Iluka Resources (ILU)
Concerns around the lack of free cash flow, inflated costs and zircon demand outlook.

Steadfast (SDF)
Trading at a premium to AUB Group and some questions around their entry into the US market.

Wisetech Global (WTC)
Reducing some of our exposure after a strong run and some concerns around margins in FY24 as acquisitions are integrated.

Atlas Arteria (ALX)
With uncertainty around French tax concessions in the next 12 months, we have exited our position.

Allkem (AKE)
Reducing our exposure to lithium and the outlook for the commodity remains weak.

ENVIRONMENTAL, SOCIAL, GOVERNANCE ISSUES (ESG)

This past quarter saw the majority of ASX-listed companies post either half year or full year financial results during the August 'reporting season'. While the focus in the related investor briefings continues to be financial performance, the trend in recent years of including more ESG content has continued.

Pleasingly, we have also seen the release of more 'integrated' annual reports – combining both key regulatory filings with material ESG information – and for those companies which produce a separate ESG or sustainability report, the publication of these at the same time as the annual report and as part of the full reporting suite. In the past, in many cases there has been a significant delay in the publication of such reports. Further, sustainability reports were often not formally included in the annual reporting suite published to the ASX.

The reporting season saw a number of updates on companies' decarbonisation efforts, including progress against established targets. We also saw two companies – Rio Tinto (RIO) and Boral (BLD) – highlight the near term challenges in decarbonising, both with rising costs and project delivery issues. Rio Tinto admitted its 2025 emissions target was at risk unless the company purchased carbon offsets, while Boral revised down its interim 2025 reduction target citing regulatory approval delays. Pleasingly, of the remaining 34 ASX200 companies which have an interim 2025 target, the majority are on track, with some even having met the target ahead of schedule.

Reported safety performance was mixed, which tragically included an uptick in the number of worker fatalities, with our research indicating over 19 fatalities have occurred in the past 12 months across both large and small caps. This has occurred in the context of tight labour markets, increased use of contractors by some, and some continued issues arising from operational re-starts post COVID. Sectors which generally saw Total Recordable Injury Frequency Rates (TRIFR) improve included Materials, Chemicals and Energy. Companies across Consumer Discretionary and Mining had mixed performance.

An emerging theme this reporting season was Artificial Intelligence (AI), which added to the growing focus on cyber, data management and digital capabilities seen in recent years. Many companies were keen to highlight how they have been or are in the early stages of applying AI across areas such as unlocking operational efficiencies, reducing costs, improving safety and customer experience. A number had already documented productivity gains, while others also called out efforts to develop internal guidelines around the responsible use of AI.

ENGAGEMENT

During the quarter, we undertook a total of 23 engagements in which we explicitly discussed ESG matters with 21 companies relevant to the strategy. All 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 workplace health and safety.

In the period we met with the CEO of JB Hi-Fi Ltd (JBH) after the FY23 results were released. We used the opportunity to also discuss cyber resilience and data management after the company reported it had made one notification of an incident to the regulator after a former supplier's IT systems had been breached and some customer data (not sensitive) was accessed. This supplier had informed JB Hi-Fi that data had been deleted, despite this being inaccurate. In response, the company has strengthened its requirements of suppliers with respect to data destruction and generally enhancing supplier due diligence.

OUTLOOK

As we look past reporting season, it would appear there remains a level of uncertainty as inflation continues to remain persistent and the RBA guides to more rate hikes if needed. With unemployment remaining stubbornly low, wage inflation continues to be a driver of services inflation which is proving tough to control. Not only is wage inflation putting pressure on margins, but also the availability of labour which looks to have peaked, albeit continuing to be a theme in the last few reporting seasons. Those businesses that can pass through cost pressures and protect margins should provide a higher level of earnings certainty and outperform in this environment. Given the higher interest rates, it's also important to monitor debt levels as well as hedging profiles to ensure there are no earnings surprises moving forward from higher interest costs than expected.

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China remains an important player in terms of both Australia's and global growth. The relationship between the USA and China continues to remain fractured and the reopening of China post Covid has underwhelmed. The structural issues around high youth unemployment, aging population, slowing birth rate, slowing population growth and increasing debt burden continue to drive China GDP downgrades. There was an expectation early to mid-way through the year that China would announce some large-scale stimulus measures to drive economic growth and provide support for the property developers, however this has failed to come through and we would expect to see ongoing weakness in property investment for the remainder of the year. On the flip side, electric vehicles sales continue to grow rapidly and meet forecasts, but lithium supply is placing downward pressure on pricing across spodumene, carbonate and hydroxide as the market looks to have moved into a surplus from high-cost producers placing product in the market. This surplus looks as if it will continue as we move into the next year, however as always with the lithium market, supply chain inventories need to be monitored closely.

As we now turn our attention to FY24 and beyond (for most companies), we continue to favour those companies where we have a strong degree of confidence around earnings growth, such as Seven Group, AUB and Orica. With the rapid rise in interest rate, both at the short and long end of the curve, we remain cautious on consumer discretionary names and real estate. Although we saw retailers outperform during reporting season, since the end of August they have retracted just over 6%. We believe the short-term performance of these names could be short lived as we move through the year with revenue growth remaining under pressure and inflation driving growth in costs. Real estate valuations still don't look appealing enough in our view. Given the large move in the long end of the yield curve and lack of earnings growth across a lot of the sector, the real estate sector would appear to have an extremely low embedded risk premium, especially when compared to several fixed income alternatives.