30 SEPTEMBER 2024

AUSTRALIAN MID CAP FUND – CLASS B

PARADICE
INVESTMENT MANAGEMENT

PERFORMANCE NET (%)	1 MONTH	3 MONTHS	1 YEAR	3 YEARS	5 YEARS	7 YEARS	SI* P.A.
Australian Mid Cap Fund - Class B	1.94	5.34	18.12	3.27	8.26	8.15	8.02
Mid Cap Composite Benchmark[1]	3.66	8.59	18.74	4.42	8.80	9.52	9.23
Excess Return	-1.72	-3.25	-0.62	-1.15	-0.54	-1.37	-1.21

*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).

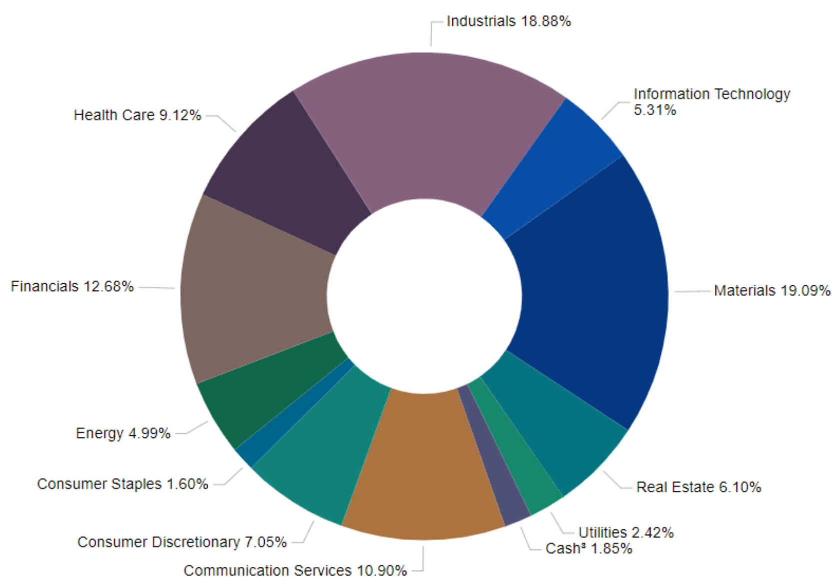
LEAD PORTFOLIO MANAGER

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	49
Portfolio Dividend Yield	2.08%
Fund Size (AUD)	$ 64M

TOP 10 POSITIONS	WEIGHT %
CAR Group Ltd.	5.92
Seven Group Holdings Ltd.	4.70
ALS Ltd.	3.92
Vicinity Centres	3.88
Orica Ltd.	3.66
REA Group Ltd	3.64
Cleanaway Waste Management Ltd.	3.35
Worley Ltd.	3.31
Qube Holdings Ltd.	3.15
Block, Inc.	2.91

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

Global markets experienced some volatility during the quarter following the short-term fall in the Nikkei and the unwind on the carry trade in early August. This was quickly brushed off by markets and saw a return to positive returns across the board. The MSCI World Total Return Index delivered 6.6% (in USD), which was driven by the ongoing strength in the US market with the S&P 500 Total Return Index delivering 5.9% (in USD) for the September quarter. US small caps weren't excluded from the gains in the US with the Russell 2000 Total Return Index gaining 9.3% (in USD). Elsewhere across the globe, markets also joined in on the rally with the FTSE 100 Total Return Index up 8.1% (in USD) and the DAX Total Return Index delivering 10.3% (in USD).

In the US, inflation continued to cool, which drove further discussion around a potential soft landing. This coincided with a 50bps rate cut late in the quarter as well as the normalisation of the yield curve, following months of inversion. Moving into the final quarter of the year, markets will be watching the US presidential election closely and what this could mean for global trade.

Turning to Australia, inflation remains a little stickier. With inflation continuing to hover around 3.9%, the RBA would like to see a further decline before pulling the trigger on any rate cut in Australia. Unemployment remained steady over the quarter, at 4.2% in August. Given the window remains open for a soft landing in Australia, the S&P/ ASX 200 Total Return Index rallied 7.8% for the quarter. This was helped with the ongoing strength of the S&P/ASX Midcap 50 Total Return Index (Midcap Index) which delivered 9.5% for the quarter. This brings the calendar year to date total return performance for the Midcap Index to 13.2%. The small cap end of the market also participated in the gains for the quarter, albeit underperforming the ASX 200 and Midcaps, with the S&P/ASX Small Ords Total Return Index (Small Ordinaries) returning 6.5%.

During August, many companies across the Australian market delivered their financial results for either the full year or half year. Looking at performance across the ASX, Midcaps delivered the strongest returns with the ASX Midcap 50 Total return up 2.0% during August. This compared to 0.5% for the S&P/ASX 50 Total Return Index and -2.0% for the Small Ordinaries.

One of the key themes coming out of reporting season was the strong performance of companies where expectations were low. Within this camp was Wisetech, Orora, JB Hi-Fi, AGL Energy, Charter Hall and Downer where we saw positive performance from +12% to +25%. There was an expectation for the forward EPS revisions in FY25 to be downgraded which didn't eventuate and drove a strong re-rating as well as EPS upgrades into FY25.

On the flip side, those companies that performed the worst over August were concentrated to resources with Mineral Resources, Arcadium Lithium, Paladin Energy and Whitehaven Coal all featuring in the bottom 10 performing companies across the ASX 100. Unsurprisingly, these moves were largely driven by the weakness in commodity prices. Some of the losses were reversed towards the end of the quarter following the stimulus measures announced in China.

The ongoing strength of the consumer was another theme during reporting season. Overall trading updates from retailers pointed to an improving sales environment. Feedback from retailers has been that consumers remain value conscious and big sales events including Black Friday are key trading periods. In real estate, the cap rate expansion period looks to be coming to an end as valuers get more comfort that we are approaching the end of a rate hiking cycle. Businesses with strong structural tailwinds, such as Netwealth, HUB24, Carsales and REA Group continue to prove their ability to deliver strong earnings resilience irrespective of what the economic cycle is doing.

After a volatile period, Commodities finished the quarter strong. Gold rallied 13.2% (in USD) during the period driven by geopolitical tensions and global uncertainty. Iron ore and copper saw a strong rebound following Chinese stimulus measures being announced, with iron ore ending the quarter +3.3% and copper +3% (both in USD). The ongoing excess supply in spodumene and uncertain demand outlook continued to weigh on the lithium sector with spodumene down 30.2% (in USD) for the quarter. Oil also felt the pain over the period, finishing the quarter down 16.9% (in USD) with demand continuing to be weaker and the threat of supply return from OPEC.

PERFORMANCE

The Fund was up 5.34% for the September Quarter, underperforming the Mid Cap Composite Benchmark by 3.25%. The underperformance for the quarter was largely around the underweights in Charter Hall and JB Hifi following better than expected results and the inflection point in interest rate expectations. The overweight position in Light and Wonder was also a detractor to performance after it was announced they had seen an injunction from a large competitor around one of their fastest growing games.

Contributors/ Detractors

Positives

Vicinity Centres (VCX) – Overweight
Vicinity centres saw strong outperformance over the quarter with an inflection point in interest rates being forecast by the market.

Northern Star Resources (NST) – Overweight
Northern Star outperformance continued on the back of ongoing gold price strength and the continued execution of production growth over the next few years.

Steadfast Group (SDF) – Nil Holding
Steadfast Group sold off on the back of media reports around conflicts of interest within the Strata insurance industry and the potential implications for Steadfast, as one of the biggest brokers and agencies in the industry.

NIB Holdings (NHF) – Nil Holding
The NIB FY24 result was weaker than expected with the Australian Residents Health Insurance (ARHI) segment showing a worse than guided policy growth and higher claims inflation compared to the industry.

Negatives

Light and Wonder (LNW) – Overweight
Following the notice of injunction from the US District Court of Nevada regarding Light and Wonder's Dragon Train game, the market has cast doubt over the growth profile for the company going forward.

Charter Hall (CHC) – Underweight
Earnings expectations for Charter Hall into FY25 were relatively low given the decline in FUM driven by negative valuations. Charter Hall guided to EPS growth into FY25 which caught the market by surprise and saw a strong rebound in the share price.

JB Hifi (JBH) – Underweight
JB Hifi was another company that exceeded low expectations at their FY24 result. Although the earnings were down for the period, it wasn't as bad as feared.

Nexgen (NXG) – Overweight
With a lack of contracting over the period and a weaker uranium price, Nexgen sold off in line with the commodity.

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PARADICE
INVESTMENT MANAGEMENT

PORTFOLIO CHANGES

Purchases

JB Hifi (JBH)
JBH has proven its ability to outperform irrespective of market conditions. JBH continues to grow and gain share in goods which are increasingly less cyclical including replacement cycle goods and technology. Operating leverage is expected to return as trading conditions improve.

Charter Hall Group (CHC)
As we approach the end of cap rate expansion, earning appear to have troughed. A combination of increased investor activity and stabilisation of valuations is expected to drive FUM growth.

Washington H. Soul Pattinson (SOL)
SOL is increasingly repositioning the portfolio and diversifying into private equity and private credit where they're generating double digit returns.

Sales

Ampol (ALD)
An increase in global refining capacity outstripping demand has driven weakness in refining margins.

Wisetech (WTC)
Wisetech has migrated to the top 50 now and have become a non-index position.

Contact Energy (CEN)
Reduced future dividend payments due to higher-than-expected capex requirements on replacing existing capacity.

ENGAGEMENT

During the quarter, we undertook a total of 33 engagements in which we explicitly discussed ESG matters with 29 companies relevant to the strategy. A majority (97%) were held at either board or executive level. The engagements covered a range of issues with most covering multiple ESG matters. In this period, the most discussed topics were the climate transition, environmental management and conduct.

We met with Cleanaway Waste Management (CWY) twice in the quarter, with the CEO and Chair in separate meetings. We discussed opportunities in the circular economy and environmental management, such as waste-to-energy and the management of PFAS (forever chemicals). We also covered safety, both in terms of the workforce and fire events caused at facilities primarily due to lithium batteries. Labour and industrial relations was another notable issue, with Cleanaway seeking to proactively negotiate with employees to avoid industrial action or multi-employer bargaining mandates.

TRIP TAKEAWAYS

Alongside our normal company visitation program, during the quarter the team conducted a trip to the US. Covering a large span of the country, we explored ideas across data centres and AI, IT and technology, industrials, energy and consumer.

Starting with the topical AI. Speaking to several companies and experts looking at AI, it remains unclear just how it will be properly monetised. What is clear though is that many do not want to miss out and be the laggard in the industry. As a result, there is a wave of activity and capital being thrown at the problem to keep up with the pace of innovation. Over the medium to longer term this could create a façade of demand that isn't as strong as originally thought. This will take some time to play out as we remain in the infancy of the technology and something we will be monitoring and keep in mind as the AI bubble builds momentum.

A natural extension of the AI thematic is the rollout of Data Centres (DC). Common feedback from our meetings was the difficulty in getting power to the sites and the large number of power reservations currently being requested from the utility companies. Given the overwhelming level of demand for power, utility companies are beginning to put more stringent measures around DC developers' ability to reserve power, e.g. developers must prove they have contracted volumes before they are able to reserve power. This is proving to be the biggest bottleneck in developing and building DCs now, which is not dissimilar to Australia.

We attended both the Orica and Incitec Pivot (Dyno Nobel) investor days in Atlanta and Salt Lake City. The key takeaway across the North American explosives market was that the demand profile is anticipated to be largely driven by the Quarry and Construction segment but offset by the ongoing structural decline in the Thermal Coal market. This means when looking at the market in aggregate it is expected to be largely flat to slightly down over the medium term, with the growth for Orica and Dyno Nobel to come from penetration of their higher value add products and technology innovation. Given the North American market is more concentrated in Quarry and Construction activity, this value proposition is a little more difficult given the scale of a quarry operation compared to a major mining operation in Australia. On this basis we walked away a little more cautious on both names' ability to continue to drive strong earnings growth over the medium term.

The team spent some time in Houston meeting with large scale engineering firms across the energy sector as well as analysts focussed on the oil and gas sector. Consistent feedback from our time in the US was the hesitation from large scale energy asset owners to spend capex leading up to the US election. This has created a short-term air pocket in terms of major project announcements. This is expected to reverse as we reach the other side of the US election in November as uncertainty fades and policy settings become clearer.

On refineries, we have seen ongoing weakness across cracking spreads globally. This has impacted Ampol and Viva Energy in Australia. Over the coming 6-12 months, further refining capacity is expected into the market from Mexico and Nigeria. Demand for refined fuels has disappointed expectation since the start of the year.

Finally, looking at the consumer, it remains a similar story in the US to Australia. The low-end consumer was touted as being most impacted from rate rises with the other demographics continuing to show resilience There are some signs of stress but overall the market continues to hold up, supported by the most recent jobs report.

OUTLOOK

The near-term outlook for the Australian economy appears cautiously optimistic. With rates close to peaking and unemployment continuing to remain low, the narrow path to a soft landing doesn't look to be out of reach just yet. Albeit, inflation remains too high with the risk of another rate hike not out of question just yet, however this isn't our base case moving forward. With tax cuts still to work through the economy, corporates now having some level of certainty around their cost of debt as interest rates top out and unemployment well below 5%, the outlook for the equity market looks relatively positive. As always though, we continue to keep our ears close to the ground as we engage with companies and monitor the data for any cracks appearing beneath the surface.

Looking at one of the sectors most sensitive to interest rates, real estate, reporting season presented some valuable insights into where exactly we are in the valuation cycle. One of the key questions on investors' minds has been when "will we see the end of cap rate expansion, and when will valuers fully reflect the change in interest rates into the underlying asset values?". The August reporting season would suggest we are now largely through this process. Retail and industrial assets are both best positioned

from this perspective, however certain pockets of the office sector could still have some pain to work through.

Looking across industrials, Australia has several long-term trends. Whether this be the structural housing shortage or underinvestment in infrastructure given population growth expectations, we believe this should be supportive for businesses exposed to these thematics. With recent cost inflation and contractors going bankrupt in the residential market, the housing shortage has only been extended which looks as if it will be a short-term issue. With developers in the multi-family segment of the market still unable to generate a development profit on projects, the lack of supply will likely see prices continue to move higher until it incentivises developers to start building product again. During the month of July, we saw private sector house approvals up 8.4% YoY , however approvals of other dwellings, including apartments, continue to lag for the reason mentioned above, which we believe will be short lived.

During our reporting season meetings with company management, there has been a clear shift in in the conversation around inflation and their ability to manage it. As the data has shown, inflation has continued to cool which has been consistent with our conversations with management. If we were to rewind to 18-24 months ago, it was clear that companies were struggling to keep up with the cost pressures coming through the business, whether this be across labour or raw material inputs. Reflecting on reporting season, most companies talk to inflation being less of a risk to the business and focus on operational efficiencies as they have exited covid and returned to a more normalised environment.

On the geopolitical front, uncertainty continues to be a factor and could potentially ramp up further, specifically in the Middle East and the potential implications from the US election. With the Middle East conflict ongoing and potential escalation with Iran now fully engaged, the key risk remains the oil price and the potential supply disruptions from here. In the US, Trump has been clear that he would look to impose 60% tariffs on goods from China and introduce further tariffs on other goods imported into the US. Given the implications this could have for those companies producing goods for import into the US, it remains a risk that will be watched with a keen eye.

As always, there continues to be several uncertainties in the world which will push markets to react in the short term. Over the quarter, we have been busy working through reporting season, travelling internationally and domestically, seeing companies, competitors and industry experts to come up with new ideas as well as test our existing views. The portfolio continues to be made up of companies where we believe there are strong structural tailwinds to drive ongoing strong earnings growth as well as take advantage of short-term mispricing in the market. Coming out of reporting season, we feel confident in the construction of the portfolio, without having a major tilt towards a particular style and focussing on the bottom up.

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