30 June 2021

Australian Mid Cap Fund - Class B

PARADICE INVESTMENT MANAGEMENT

Performance Net (%)	1 Month	3 Month	1 Year	3 Year p.a.	Since Inception* p.a.
Australian Mid Cap Fund - Class B	2.60	9.14	31.13	8.65	10.80
Mid Cap Composite Benchmark	3.48	9.65	34.97	11.19	12.46
Excess Return	**-0.88**	**-0.51**	**-3.84**	**-2.54**	**-1.66**

* 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).

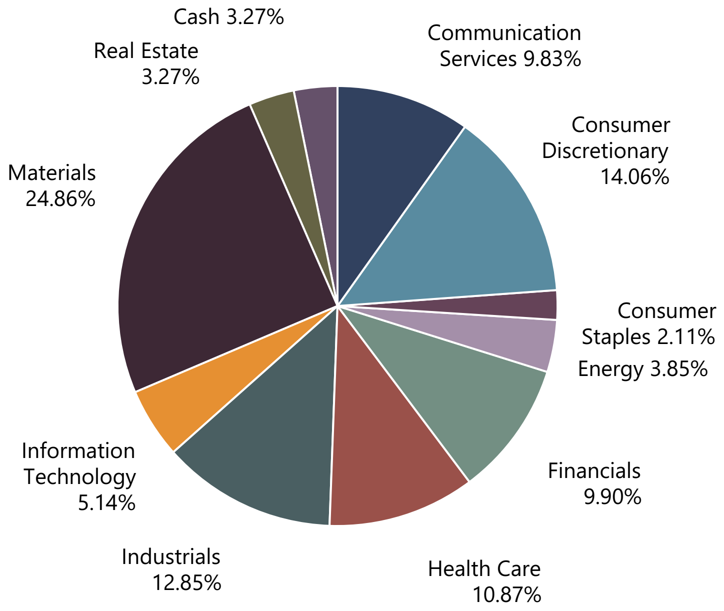
Lead Portfolio Managers

John Lake & Matthew Riordan

Fund Overview

Investing in stocks that are outside the S&P ASX50, this fund uses a detailed fundamental research process to construct a diversified portfolio of stocks. The highly experienced team have a focus on downside protection and are proven to generate consistent outcomes.

Sector Allocation



Key Details

Number of Holdings	55
Portfolio Dividend Yield	1.53%
Fund Size (AUD)	$96M

Top 10 Positions	Weight %
ResMed Inc.	4.97
Bluescope Steel Ltd.	3.40
Tabcorp Holdings Ltd.	3.32
Seek Ltd.	3.31
Charter Hall Group	3.27
Bank of Queensland Ltd.	3.14
Mineral Resources Ltd.	3.09
Ansell Ltd.	2.96
Domino's Pizza Enterprises Ltd.	2.95
ALS Ltd.	2.81

Fund Details

APIR Code	ETL8772AU
Distribution Frequency	Semi-Annually
Management Fee[1]	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.

Whilst the ASX broke into new record highs in the June 2021 quarter, market exuberance was dampened from the COVID-19 Delta strain leading to fresh lockdowns and prompting greater urgency for the vaccine roll-out. With the UK and USA opening up their domestic economies, the hope is that we could see similar relaxations in Australia towards the end of the year / early 2022 provided the vaccination rate gets into the 70%'s.

Outside of COVID the key topics were the likely impact of inflationary pressures, when will monetary tapering be implemented, the value versus growth debate and the likelihood of rate hikes. From an economic perspective, governments are still being relatively accommodative. However, there are increasing suggestions of various levels of tightening in the quarters ahead should growth continue its current trajectory with inflation being transitory or not being a major discussion point. We discuss this further in this quarterly. Last quarter the 'American Rescue Plan Act' was passed that will see close to US$2T of direct stimulus delivered into the US economy, with additional infrastructure spending measures to follow. In Europe the ECB maintained PEPP (Pandemic Emergency Purchase Program) size at Euro1.85T, despite 2021 Euro growth area forecast being lifted from 4% to 4.6%. Notwithstanding this unprecedented level of fiscal support globally in the face of more evidence of solid economic growth, central banks, including the US Federal Reserve, continue to signal no change in policy settings until evidence of a sustained growth recovery and more structural inflation is forthcoming.

The data points for the AU economy continue to be encouraging. The labour market is tight with indications unemployment could drop below 5% in coming months. Housing approvals for detached dwellings remain elevated although the May data, whilst up 53% YoY, was down 5% MoM which might be a sign of the Homebuilder subsidy curtailment. The current lockdowns may disrupt the data points in the short term but directionally are positive.

The debate around inflationary pressures has been fuelled by supply disruptions, large increases in commodity prices and liquidity driven demand growth. Australian companies were big beneficiaries from rising iron ore, coal, steel and copper prices to name a few. With commodities being such an important part of the AU economic landscape, it would have been expected that ancillary businesses in the likes of the mining services space would have been major beneficiaries. This was not the case as due to border closures and COVID restrictions, a shortage of labour meant an inability to deliver. In some areas price spikes have moderated as supply has worked its way back, lumber being a case in point (very relevant for housing construction). Over the quarter, the lumber index spiked 60% but ended the period 57% off its highs.

Following a number of poor performing IPO's it does look like the fading IPO market is being rapidly replaced with a very vibrant M&A market. A number of significant bids were lodged, many of them highly conditional and indicative. Autodesk bid for Altium, Star Casino put a merger proposal forward to Crown Casino after Crown received a few opportunistic bids, Tabcorp received bids for its wagering business and Seven Group continued its gradual creep on the Boral register. Boral also divested a large part of its USA operations for a healthy $2.9b. More deals are expected.

Performance

The Paradice Mid Cap portfolio performed broadly in line with the index. The Australian market performance was driven by strong performances in technology and discretionary. Strength in the USA was driven by the Nasdaq Composite Index returning +9.7% and the S&P500 returning +8.5% (in US Dollar terms). Bond yields drifted lower over the period (AU 10 years yield -14% and USA -16%) after a rapid rise in the March quarter. This apparent disconnect with inflation can be put down to a mix of factors including excess liquidity, Fed bond issuance weaker than normal and / or a sense that inflation pressures might be transitory. In Australia thematically the market was more mixed with standout under and over performance largely being driven by stock specific news flow.

The top relative contributors to performance for the quarter are as follows:

Resmed (RMD) – Overweight Ongoing strong performance in sleep apnoea business with key competitor Phillips having to recall a significant number of products in market due to health risks.

ALS Ltd (ALQ) – Overweight ALS reported a very strong result and is a world leading provider of services in GeoChem and Life Sciences.

AMP Ltd. (AMP) – Underweight (not held) Extended period of poor earnings performance coupled with significant cultural and leadership challenges.

The top relative detractors from performance for the quarter are as follows:

Reece Plumbing (REH) – Underweight (not held) Reasonable earnings result, supported by resilient housing and construction markets. Market has been buying for US growth however at 50x PE we believe this is more than reflected in the price.

Altium (ALU) – Underweight (not held) Altium received a takeover offer from USA listed Autodesk at a significant premium. This has been turned down by ALU.

Challenger Limited (CGF) –Underweight We owned CGF as it looked oversold based on the earnings outlook provided by the company at their interim result. However, they downgraded unexpectedly as the returns they are generating off the asset base are lower than what was anticipated.

ESG

Modern Slavery continues to be an excellent example of how the management of ESG associated risks can impact a company's earnings. During the quarter we saw the ramifications of the US Customs and Border Protection (CBP) directive to seize disposable gloves produced by Top Glove Corporation Bhd. in Malaysia. This action highlights the importance of having an informed view of the risk and the significance of external regulatory bodies in quantifying the impact of Modern Slavery. We see the potential ramifications of this increased scrutiny resulting in incremental cost if not managed correctly. As part of our ongoing engagement efforts on Modern Slavery, Paradice Investment Management joined the Investors Against Slavery and Trafficking (IAST) as a support investor to Ansell. We continue to look for additional engagement opportunities across the group.

Climate Change is continuing its dominance of global ESG news flow. Europe is at the forefront with Shell facing a recent court order to cut its carbon emissions by 45% by 2030 and shareholder activism increasing with both Exxon and Chevron under pressure. The Biden administration continues to act on its campaign promises with its new target of a 50-52% reduction from 2005 levels – this comes close to doubling the previous commitment under President Obama. At an organisational level we continue to improve our group-wide climate change analytics tool. During the period we trialed MSCI, continued our conversation with Risk Frontiers and met with Emmi.

In addition to our involvement with the IAST, and in keeping with our plans to increase alignment with relevant industry bodies, Paradice is now a member of the Responsible Investment Association Australasia (RIAA). This membership will allow us access to a broader range of collaborative working groups and engagement opportunities that we intend to utilise moving forward.

Internally, Paradice implemented its overarching Responsible Investment Policy. As a part of this we formalised our desire to avoid certain sub-industries in our investment universe, such as tobacco and controversial weapons. In line with our commitment not to invest in tobacco growers or manufacturers, we have signed the Tobacco-free Portfolio Pledge. In addition, in alignment with Paradice's support of the Paris Agreement, and our belief that thermal coal is facing long-term structural headwinds, we will not become a substantial shareholder (defined as owning more than 5% of the company) in companies whose primary business generates over 25% of revenues from mining or transportation of thermal coal. We believe that this step represents a clear signal of our beliefs and facilitates our teams to continue engagement efforts to drive best practice in the sector. Our internal compliance and ESG teams monitor the portfolios to ensure that these exclusions are upheld, and Paradice the Sustainability Committee has responsibility for oversight of this process. The list of exclusions and limits is monitored on a continuous basis through portfolio restrictions, reviewed annually and updated as appropriate.

Outlook

We are constructive on the domestic outlook with the current/recent lock-downs being a necessary hurry-on for vaccinations toward herd immunity. In this regard we are watching the likes of the US and UK closely as they fully reopen their domestic economies post their successful vaccination rollouts, to assess how life goes "living with COVID". Whilst there has been much discussion about the government delivering longer dated infrastructure work, this is not apparent as yet. Whilst the so-called accelerator effect caused by the massive monetary and fiscal stimulus seen to date drives the shorter-term cycles in housing and the consumer, there is not a real need as present to push the infrastructure button. At some point over the next year or so, we would expect policy makers to look at diversifying the growth mix and normalising the mismatch with rates and growth duration (current growth dynamics are shorter duration in nature versus central banks wanting to lower rate expectations in longer term).

The US economy looks solid. US households are well positioned given the strong labour market, excess liquidity (record savings) and the fast-growing millennial cohort (>50% of US population under 40 years old). In addition, the likes of Biden's stimulatory infrastructure bill and pressure from within the Democrats for further stimulus for those below the poverty line will add to the strength. China growth has not benefitted from the same level of stimulus as the likes of many developed nation economies but they have enjoyed very strong exports, fulfilling the consumption demands of those developed market nations. If the global economy does weaken off in the future as stimulus wanes, China has the capacity to turn up their domestic economic drivers.

With obvious supply disruptions globally, rising prices be they energy, wages, housing accommodation or raw materials, shortages of the likes of computer chips or lumber, the inflation warning signals have become very evident. Before any monetary tightening is triggered there will be a wait to assess to what extent this is transitory or longer dated. Inventory restocking has a part to answer for as has the incredible liquidity pumped into the economies driving demand. As businesses restock and we start to cycle some of the huge liquidity injections, the true extent of inflationary pressures should become more apparent in the first half of 2022. Over the next few quarters there might well be some higher inflation prints from inputs as mentioned above however we do expect the central banks to sit back and not rush into monetary tightening at the risk of shutting down the growth we are seeing come though.

The RBA has indicated that they are going to be patient before lifting the OCR (official cash rate), with sustained inflation of between 2% and 3% being their "target". In the interim we expect some signs of tapering with regard the support for bonds however the overall tone is one of continued monetary support until higher employment and higher inflation targets are reached. This sets a positive underlying support base for asset pricing.

In late July reporting season commences and given the current lockdowns and broader border closures, many companies are going to be hesitant to provide outlook statements given the uncertainty that still prevails. On aggregate though, we do expect a solid reporting season. Banks have been beneficiaries of a better than anticipated housing market, resource companies have enjoyed high commodity prices, domestic companies (excluding likes of travel) have enjoyed a strong consumer and there has not been much of a capital squeeze. We expect ongoing heightened M&A activity with strong management and boards coming to the fore as we transition through what we expect to be the closing quarters of broader COVID restrictions.