Fund Update - 31 December 2018

Australian Equities Fund

PARADICE
INVESTMENT MANAGEMENT

Fund Objective

The Fund aims to outperform the S&P/ASX 200 Total Return Index (after fees and before taxes) over a rolling three to five year period.

Performance Net (%) p.a.	1 Month	3 Months	1 Year	Since Inception*
Australian Equities Fund	-0.37	-12.98	-5.28	3.50
S&P/ASX 200 - Total Return	-0.12	-8.24	-2.84	3.06
Excess Return	**-0.25**	**-4.74**	**-2.44**	**0.44**

* Inception date - 02/08/17

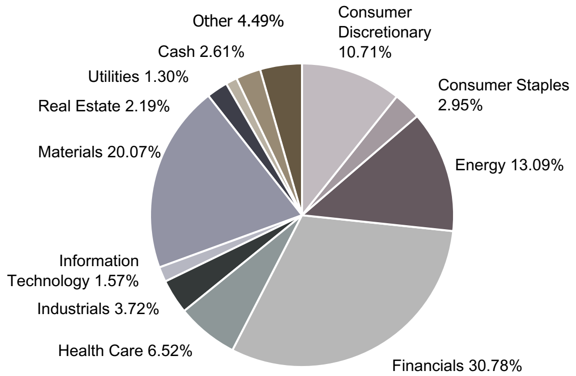
Fund Details

APIR Code	ETL8084AU
Fund Size (AUD m)	$34
Application Price	$1.0276
Redemption Price	$1.0234
Distribution Frequency	Semi-Annually
Management Fee	0.75% p.a.
Performance Fee	0.15% p.a.
Buy Sell Spread	+/- 0.20%
Minimum Investment (AUD)	$20,000

Characteristics

Number of Stocks	35
Portfolio Dividend Yield	4.22%
Stock Range	30 - 50
Industry Range	Unconstrained
Cash Range	0-10%

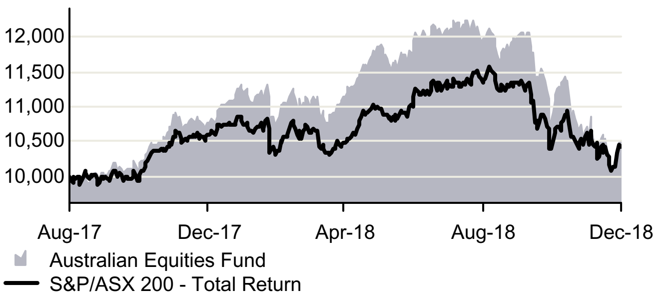
Sector Allocation (%)



Top 10 Positions (%)

	Fund
BHP Group Ltd.	7.81
Commonwealth Bank of Australia	7.07
Australia and New Zealand Banking Group Ltd	6.59
CSL Ltd.	6.52
Westpac Banking Corporation	5.63
Aristocrat Leisure Ltd.	5.46
Macquarie Group Ltd.	5.43
National Australia Bank Ltd.	5.33
Woodside Petroleum Ltd.	4.29
Origin Energy Ltd.	3.72

Growth of AUD 10,000



Contact

Phone: 02 8227 7400

Email: distribution@paradice.com

Website: www.paradice.com

Commentary

MARKET REVIEW

For the purpose of comparison, commentary is quoted in AUD terms and Australian sector returns refers to the S&P ASX 200 TR Index except where stated otherwise.

The Australian Equity market fell 8.2% over the quarter as the global macro environment turned sharply from contemplating synchronised growth to a weaker pace of growth, concerns over what economists are calling “Bondcano” (i.e. as central banks start removing monetary policy stimulus) and a sentiment driven market contraction over a US-China trade war concern. The MSCI AC World NTR Index decreased 12.8% in USD terms over the quarter. The US 10-year bond yield fell -37.7bp to 2.68% due to the fears of slowing global growth.

At the outset of the equity market weakness macro data was quite strong but this sentiment subsequently negatively rubbed off onto Purchasing Managers’ Indices (PMI’s) and sell-side broker earnings expectations globally. Globally, employment data, credit spreads and Producer Price Indices (PPI’s) generally remained solid. China’s macro data though deteriorated more than the rest of the world. The concern next though is that this negativity may also spill over into consumer sentiment globally and worsen the macro environment further.

Commodities endured a difficult quarter with the Bloomberg Commodities Index down 10.0%. Iron Ore rose 4.8% as Chinese steel production remained strong. Brent oil fell 34%, partly due to the weaker global demand outlook, but more as US President Trump seemingly ‘tricked’ OPEC by requesting a production expansion on a promise of Iranian sanctions but then reengaged by offering various waivers. Base Metals (-6.5%) declined, with all the key constituents Nickel (-15.2%), Aluminium (-9.0%) and Copper (-5.0%) losing ground. The LME Precious Metals Index moved up 7.0% with Gold up 7.5% as investors flocked to the safe haven metal.

The Australian macro environment remained solid. The RBA left rates unchanged at 1.5%. Third quarter GDP grew a sluggish 0.3% but the wage price index increased an acceptable 0.6% q/q and employment increased by 66k positions in Oct-Nov. The Westpac Consumer Confidence Index rose 2.9% over the quarter. The NAB Business Conditions Index fell 2 points between Oct-Nov but remains an acceptable +11. House prices are the biggest area of concern within the Australian economy. They fell 2.6% in the Australian capitals according to Corelogic.

In Australia, the defensive equity market sectors AREITS (-1.9%) and Utilities (-3.1%) performed best in this environment. Materials (-4.9%) also performed relatively well helped by BHP, RIO Tinto and Fortescue, which all conducted capital returns. The Energy sector (-21.3%) was the worst performer on the back of the oil price fall. Communication Services was the next worst performing sector (-14.7%) as the ACCC expressed concern that the TPG Telecom and Vodafone merger will substantially lessen competition. Consumer Discretionary (-14.1%) was weak due to several stock-specific profit warnings.

AMP’s ANZ unit was sold for just A$3.5b, missing expectations. Coles was spun out of Wesfarmers, with an initially subdued reaction. CBA sold its asset management business for A$4.1b, and Woolworths its Petrol business for A$1.7b, which should both lead to capital management. Three of the major four banks reported soft revenue growth, but there were signs of a lift in business lending.

The Banks were also schooled by the Royal Commission on remuneration, remediation, and responsible lending. In December APRA announced that from 1 January 2019 the cap on interest only (IO) lending will be removed.

PERFORMANCE

The portfolio underperformed due to its positioning for a better macro environment (beta above 1), a more stable oil price (long energy) and because of stock selection (Lendlease and Aristocrat fell on stock specific issues).

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

BHP Billiton (BHP) Overweight BHP’s capital management initiatives were well received, and they benefited from a strong Iron Ore price amid robust steel demand in China.

BlueScope Steel (BSL) Not held BlueScope underperformed as investors questioned the sustainability of high USA steel spreads.

Fortescue Metals (FMG) Overweight Fortescue benefited from a decrease in the discount they receive for their lower iron content ore, and a buyback.

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

LendLease (LLC) Overweight Lendlease fell on a profit warning from problem contracts within Engineering. The company flagged a full review of the segment.

Santos (STO) Overweight Santos weakened in line with the decrease in the oil price.

Aristocrat Leisure (ALL) Overweight Aristocrat fell on a weaker Digital outlook, as offshore comps weakened, and as broker forecasts were negatively revised.

OUTLOOK

We expect Australian equities to have a bounce short-term and over calendar 2019 from an oversold position currently due to an overreaction to the mid-cycle slowdown. The ASX 200 valuation on a simple P/E is now back to its long-term average.

Our base case is that trade tensions between the USA and China ease, and China may then stimulate their economy. The US Fed will likely pause tightening in reaction to the slowdown and limited inflation. This should see a weaker US$. This would be good for commodity prices and commodity equities, including Gold. The portfolio remains overweight Materials, with positions in BHP Billiton, Fortescue, Iluka, South 32, and Western Areas, which have supportive valuation and strong cash flows. We reduced exposure to the sector over the period via BHP Billiton and Rio Tinto and switched some exposure into Fortescue.

We expect oil prices to rise from the current oversold level. OPEC has removed capacity to balance the market. We still expect the theme of expanding Chinese LNG demand may accelerate over the next 12-24 months in a bid to curb pollution, but this thesis now also depends on what China-USA trade deal is done. The portfolio remains overweight Energy with positions in Santos, Beach Energy, Origin Energy, Oil Search and Woodside. However, we have reduced the sector exposure due to the weaker demand environment, and done this via Santos and BHP, which have both performed well.

The reduction in positions in Materials and Energy reduced the portfolio’s beta.

Less tightening will reduce the effect of the ‘Bondcano’. But the portfolio is still short bond proxies and long duration stocks, which we still see as expensive. REITs also face declining growth.

We have closed the Bank sector underweight and have gone slightly long, as relative valuation (NAB at 8% dividend yield) became attractive and with the Royal Commission news flow now likely to become less negative and APRA having removed the cap on interest only lending. House prices and a bank levy increase post the next Federal election remain concerns. The portfolio is long the business orientated banks – ANZ and NAB. We also added CYBG on valuation grounds. Computershare was reduced following performance and in reaction to the reduction in US Treasury yield rates.

Commentary

We are underweight the consumer sectors on concerns spending may be negatively impacted by weakening house prices. We are underweight Woolworths, but we added Wesfarmers again as valuation came back to attractive levels. We are also attracted to Wesfarmers without the competitive grocery unit Coles.

Within Industrials, Star Entertainment was added back into the portfolio on an improving VIP outlook, seemingly less mass disruption from construction, a reduced capex outlook and attractive valuation. Aristocrat remains an overweight, despite stock price weakness in the December quarter, due to the momentum in the core business and an attractive growth outlook in digital although execution in the latter is yet to be achieved. We added to our Treasury Wine overweight due to stock price performance and it should still benefit from robust Chinese demand and is yet to harness the benefits of restructuring US logistics.