Fund Update - 31 December 2018

Australian Mid Cap Fund - Class B

PARADICE
INVESTMENT MANAGEMENT

Fund 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).

Performance Net (%) p.a.	1 Month	3 Months	1 Year	Since Inception*
Australian Mid Cap Fund - Class B	-1.68	-15.86	-9.97	1.81
Mid Cap Composite Benchmark	-2.44	-13.29	-7.73	3.22
Excess Return	**0.76**	**-2.57**	**-2.24**	**-1.41**

* Inception date - 15/05/17

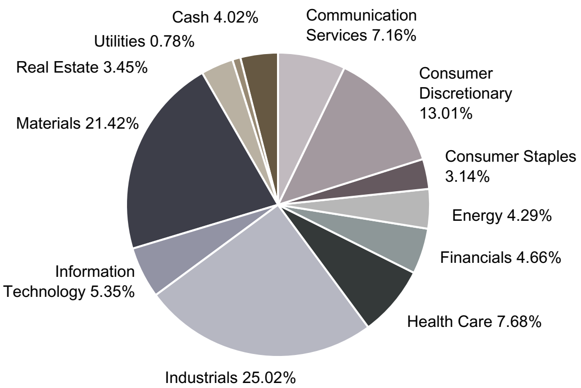
Fund Details

APIR Code	ETL8772AU
Fund Size (AUD m)	$285
Application Price	$0.9337
Redemption Price	$0.9291
Distribution Frequency	Semi-Annually
Management Fee	1.10% p.a.
Performance Fee	15% p.a.
Buy Sell Spread	+/-0.25%
Minimum Investment (AUD)	$20,000

Characteristics

Number of Stocks	53
Portfolio Dividend Yield	3.28%
Stock Range	Typically 40-60
Industry Range	Unconstrained
Cash Range	0-10%

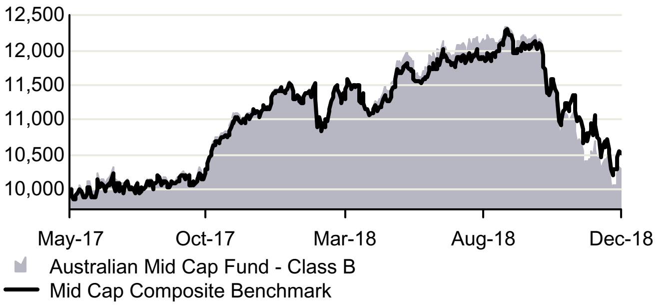
Sector Allocation (%)



Top 10 Positions (%)

	Fund
Resmed Inc	5.28
Downer EDI Ltd.	3.70
Atlas Arteria	3.68
Charter Hall Group	3.45
Cleanaway Waste Management Ltd.	3.36
Orora Ltd.	3.28
Northern Star Resources Ltd.	3.14
Tabcorp Holdings Ltd.	2.97
CIMIC Group Ltd.	2.93
Link Administration Holdings Ltd.	2.80

Growth of AUD 10,000



Contact

Phone: 02 8227 7400

Email: distribution@paradice.com

Website: www.paradice.com

MARKET REVIEW

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

The Australian equity market was caught up in the downturn across global markets, with the S&P/ASX 300 Total Return Index falling 8.4% for the December quarter. Within this, larger more defensive stocks held up relatively better, whilst the more growth oriented mid and small cap sectors underperformed, falling 13.1% (S&P/ASX Mid Cap 50 Total Return Index)and 13.7% (S&P/ASX Small Ordinaries Total Return Index) . The Australian market fared better than most developed markets, the MSCI World Net Total Return index declining 11.0%.

There were plenty of headlines during the quarter to make investors nervous about the future global economic outlook. Political uncertainty continues to plague a number of major economies, particularly in the UK where Prime Minister May had to see off a vote of no confidence, and the US which entered a partial Government shutdown late in the quarter due to disputes over Trump's border security policy. Trade tensions appear to have escalated more recently also, both in Europe as Brexit negotiations come to a head, as well as between the US and China who remain locked in a stalemate; all whilst markets are contemplating the progressive withdrawal of monetary stimulus as central banks seek to return policy to a more conventional footing.

Such exogenous issues are inherently difficult for market participants to forecast, particularly as the underlying motivations of key individuals are not always clear and the potential range of outcomes for any one factor are inextricably linked. However, it was evident from the sell-off of equities over the quarter, that there has been a rapid deterioration in the average investors' expectations for global growth; even though the underlying data is yet to fully validate these concerns.

In terms of the Australian market, performance largely followed the lead from overseas, with share price moves reflecting a similar macro-dominated mindset. Local investors are also having to consider a potential change in federal government mid-2019 and the major policy initiatives this is likely to bring (specifically changes in property taxation, treatment of franking credits, and initiatives aimed at increasing wage inflation), declines in property values across most major cities which are being exacerbated by tighter bank lending standards post the Financial Services Royal Commission, and softening consumer demand as this negative wealth effect coupled with lacklustre income growth fails to keep pace with escalating costs of living. Even in areas where growth has been strong, particularly construction across the eastern seaboard, cost blow-outs have led to profitability issues for a number of exposed listed companies.

Against this backdrop, share price performance was led by sector-wide views more than individual stock fundamentals, particularly as we headed into the end of year blackout period limiting news flow for investors to anchor their views. Energy was unsurprisingly the worst performing sector, as concerns around oversupply and potentially weaker global GDP drove Brent and WTI down 34% and 38% respectively. Materials and resources also fell although performance was more mixed: base metals fell reflecting the above growth concerns, led by nickel which was down 15.2% over the quarter, whilst iron ore and coal continued to rally on the back of strong steel production and anticipated stimulus measures in China. Gold rallied as investors sought out safe havens. Across other corners of the market, the consumer discretionary and IT sectors underperformed as investors sold economically exposed and high multiple growth stocks, whilst defensive sectors such as REITs and Utilities only fell modestly (down 1.9% and 3.1% respectively).

Australian economic data during the quarter was mixed, although arguably less negative than the performance of equities would suggest. Q3 GDP growth of 0.3% was somewhat weak as was inflation at 0.4%, both of which support the RBA's stance of retaining interest rates at their current low level (1.5%; unchanged for 26 months). Recent comments from the central bank also indicated some concerns around the property market should prices continue to fall materially from here, noting that the performance of lead indicators such as automotive sales suggests consumers are already tightening their wallets in response, and banks continue to reign in mortgage lending in the wake of the royal commission. That said, employment remains relatively robust with the unemployment rate holding largely steady at 5.1% despite an increase in the participation rate, and survey data suggests corporates continue to expect capex to increase in the coming 12 months. To that end, it is interesting to note the heightened level of M&A activity during the quarter, both from corporates and private equity funds looking to deploy capital into growth opportunities.

So as we head towards the February reporting season, the equity market appears to have moved ahead in anticipating some tougher times for Australian corporates, even more so than debt markets are currently indicating: investment grade and high yield bond spreads, whilst wider, have not expanded to the extent implied by the equity sell-off. As we discuss in the outlook section, this is opening up opportunities to invest in quality companies that have been sold off due to these broader concerns, but in our view should outperform from an earnings perspective. As these results are delivered, we would expect these stocks to anchor back to fundamentals and ultimately outperform.

PERFORMANCE

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

Spark New Zealand (SPK) – Overweight SPK is well positioned for the pending rollout of 5G in New Zealand, and the group's defensive earnings have been attractive to investors amidst the current market volatility.

St Barbara (SBM) – Overweight The group is benefiting from a strong AUD gold price.

Charter Hall Group (CHC) – Overweight The company continues to maintain a disciplined investment process throughout the property cycle.

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

Clydesdale PLC (CYB) – Overweight CYB has underperformed after providing disappointing NIM guidance for the merged Virgin Money/ Clydesdale business, as well as broader concerns around Brexit.

Worley Parsons (WOR) – Overweight Sentiment towards the company has been impacted by near-term oil price weakness, as well as drag from the substantial capital raising attached to the acquisition of Jacobs ECR.

Beach Energy (BPT) – Overweight The stock has reacted to the falling oil price, although underlying operational performance at the company remains strong.

OUTLOOK

Looking into 2019, it is easy to paint a pessimistic picture for prospective returns given the pervasive global political and economic uncertainty. Even in the absence of these concerns, the withdrawal or 'normalisation' of monetary policy is challenging for equity markets to digest, particularly given investors arguably have to hark back to the 1970s if not earlier to understand how the recovery from a financial led recession like that experienced last decade is likely to play out. Specifically in the US, debate is increasing about whether the current growth backdrop is strong enough to withstand the withdrawal of monetary stimulus and, perhaps of more concern, whether the Federal Reserve as sufficient policy firepower left should growth deteriorate. To this end, it is interesting to note that many commentators are pointing to the potential inversion of the treasury yield curve as a traditional indicator of an impending recession, even though other typical accompanying factors such as higher inflation, are yet to emerge, and recent underlying data in the US remains relatively robust; particularly vs. other large global economies.

Commentary

As for China, our recent trips on the ground support the view that the economy is slowing, though not entirely because of recent trade disputes. Whilst these are undoubtedly impacting and will likely continue doing so, the Central Government is seeking to transition the economy to a cleaner, more financially stable basis with consumption taking over from fixed asset investment as the key source of economic growth. This transition is unlikely to be perfectly smooth, and it remains to be seen how far policymakers will allow the economy to slow before they feel forced to resort to a more full-blown stimulus package as seen in 2015. The current trade dispute with the US only further muddies this picture, particularly as a growth slowdown will likely weaken China's negotiating position.

We have accordingly adjusted our positioning to reflect the uncertainties outlined above, largely by having reduced our overweight to resources earlier in the year notwithstanding valuations remain relatively attractive vs. other corners of the market (e.g. IT) that continue to command hefty premiums. We also remain cautious towards the domestic economy, particularly around the outlook for the consumer in the context of tighter lending standards and falling property prices, as well as the uncertainty that an elongated election cycle brings. However, as is often the case, equity markets have moved in anticipation of a potential slowdown in global growth, in this instance ahead of debt markets where spreads have widened only modestly, creating other opportunities to invest in stocks that have been sold off with the market, but should continue to grow their earnings irrespective of the macro backdrop. This is particularly the case where companies have material investment plans in place to grow into new end markets, which feature in the portfolio. We also retain our bias towards economies where growth, particularly on a relative basis, remains more robust, most notably the US.

As for broader equity valuations, multiples in Australia have retreated from recent highs, with the broader market trading at an 8% P/E discount to the five year average, and Industrials ex-financials back to 18.9x from a 2018 peak of 22.2x (Morgan Stanley). With interest rates still remaining low, the implied equity risk premium offers some protection for equity valuations vs. other asset classes. However, whilst trade and political concerns continue to distract investors, markets will likely remain volatile.