Fund Update - 30 June 2019

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 (%)	1 Month	3 Months	1 Year	Since Inception* p.a.
Australian Mid Cap Fund - Class B	2.85	2.88	-2.01	7.53
Mid Cap Composite Benchmark	2.04	4.60	3.21	9.76
Excess Return	**0.81**	**-1.72**	**-5.22**	**-2.23**

* Inception date - 15 May 2017

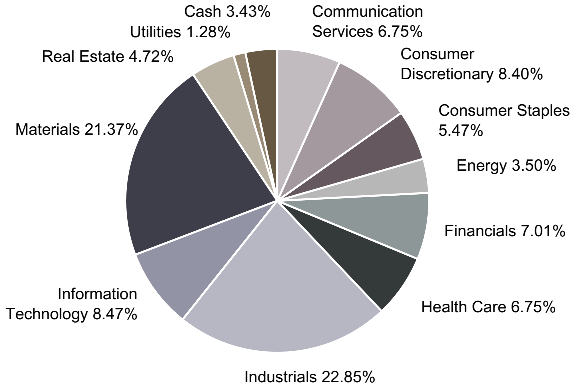
Fund Details

APIR Code	ETL8772AU
Fund Size (AUD m)	$79
Fund Base Currency	AUD
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	58
Portfolio Dividend Yield	2.82%
Stock Range	Typically 40-60
Industry Range	Unconstrained
Cash Range	0-10%

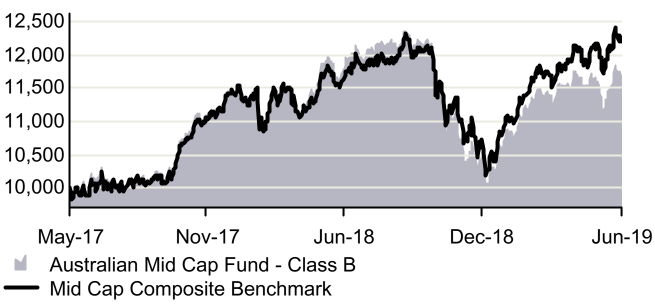
Sector Allocation (%)



Top 10 Positions (%)

	Fund
Atlas Arteria	4.31
Cleanaway Waste Management Ltd.	4.04
Resmed Inc	4.03
Charter Hall Group	3.77
Orora Ltd.	3.42
Downer EDI Ltd.	3.35
Northern Star Resources Ltd.	3.32
a2 Milk Company Ltd.	2.94
Xero Ltd.	2.50
Tabcorp Holdings Ltd.	2.47

Growth of AUD 10,000



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Commentary

MARKET REVIEW

For the purpose of comparison, commentary is quoted in AUD terms except where stated otherwise.

The June 2019 quarter continued the strong turnaround from the March 2019 quarter. The S&P/ASX Mid Cap 50 Total Return Index returned +4.9% in the June quarter. Despite this strength it underperformed the S&P/ASX 200 Total Return Index which rose 8.0%, to all-time highs, driven by strength in iron ore stocks (Fortescue), interest rate sensitive stocks (Mirvac, Goodman Group, Transurban) and a rebound in the major banks. Globally markets were largely up again, with the S&P 500 Index up 3.8%, the Nasdaq up 3.6% and the DAX Index up 7.6% (price indices denoted in USD and EUR).

Many of the issues grabbing the headlines during the last year continued through into the June 19 quarter. Trade talks between China and the US looked set for a resolution in May only to see Trump raise tariffs on the second round of goods ($200bn) from 10% to 25%. Following the recent G20 meeting a truce has been reached in respect to the final $300bn of Chinese exports but it is far too early to call a victory. Meanwhile, Trump also threatened tariffs on Mexico in relation to their border dispute (despite a new NAFTA agreement having already been reached) and threats remain on European autos as well as additional new countries like Vietnam. The war of words with Iran also escalated with military action being narrowly avoided. Brexit claimed another scalp with Theresa May falling on her sword. At the time of writing the UK is in the final stages of the election of a new Tory leader. Both candidates are committed to delivering Brexit and hence the threat of a hard Brexit seems more of a possibility. Despite all the bad news, the market continued being focussed more on central banks shifting to more accommodative monetary policy. In fact, the last 6 months have seen the strongest cross-asset rally in a decade.

The above-mentioned factors have seen the global economy entering a period of weakening economic growth with the Global PMI measure falling to 49.8 in June 2019, its lowest level since February 2016, driving the more accommodative monetary policy. Domestically this saw the RBA reduce the cash rate in June for the first time in 34 months (down 25bp) and then cut by another 25bp in July to 1.00%, a record low. The market is anticipating further cuts from here (although the RBA has flagged they will pause for the time being) and this also coincides with the recent easing of lending standards by APRA. This environment also saw bonds rally strongly for a second consecutive quarter with the US 10 year bond yield falling 40bps to 2.01% and the AU 10 year bond yield falling 45bps to 1.32%, touching a record low in June. The Australian 10 year bond has fallen 100bp since the EOCY18 demonstrating just how quickly sentiment has turned.

Despite the strong performance in equities, the Australian economy remains challenged with mixed economic data. Employment continues to be strong however wage growth remains soft, forward employment indicators (like the Seek job index) are weakening and house prices and retail sales remain under pressure. This has translated into a high number of profit downgrades across a number of sectors including building materials (Adelaide Brighton, Reliance), discretionary (Caltex, Costa, Metcash, Star Group), financials (Challenger, Link, Pendal) and even healthcare (Mayne Pharma, Regis). We have also seen a high level of secondary raisings in the market, particularly amongst property trusts that have taken advantage of recent strength in their sector with Charter Hall Long WALE, Cromwell, Dexus, GPT and Mirvac amongst those raising. Excess liquidity in the market is also seeing solid levels of corporate activity with recent takeover offers for Dulux, Automotive Holdings and GBST. However, as we've said in previous reports, an offer does not necessarily guarantee success with Vocus having seen two failed bids in a short timeframe.

Commodities were mixed in the quarter following a strong March quarter. Iron ore continued its strong rally post the Vale tragedy in Brazil, closing the quarter at USD $115.50. Gold also rallied from USD $1,295 to USD $1,409 during the quarter on political uncertainty. Oil and base metals prices drifted on trade war uncertainty and generally weaker demand.

PERFORMANCE

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

Challenger Limited (CGF) - Underweight / not owned Held an Investor Day where the new CEO reset expectations around the business resulting in FY20 earnings downgrades.

Unibail-Rodamco (URW) – Underweight / not owned Negative sentiment continues around retail REITs. The company also held an Investor Day in June that sent conflicting signals regarding its outlook.

Washington H. Soul Pattinson (SOL) - Underweight / not owned The company recently entered the ASX Mid Cap index from the Small Ordinaries. It was trading a significant and unjustified premium to its sum of the parts valuation.

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

Link Administration Holdings (LNK) – Overweight The company issued a profit downgrade and is also exposed to the Woodford funds management debacle through its Funds Administration business in the UK.

Reliance Worldwide Corp (RWC) – Overweight RWC issued a profit downgrade in May due to more difficult trading conditions including lower client restocking.

Downer EDI (DOW) – Overweight Impacted by the insolvency of a partner in a solar project they have been constructing. Whilst the potential liability hasn't been quantified the share price move seems an over-reaction.

OUTLOOK

As we mentioned in the Market Review the more dovish stance taken by central banks globally has seen the strongest cross-asset rally since 2009/10. The 2009/10 period coincided with the post-Lehman error of quantitative easing and an economic and investment recovery from a very low base. This contrasts to the current environment where we are coming off much higher levels, are witnessing slowing growth and are victim to significant global economic and political uncertainty. Further, we are seeing a tendency for markets to price in a very best case scenario – e.g. the market rallied on rate cuts designed to offset a negative trade outcome but then rallied further on the potential for resolution to the conflict. Against this backdrop we are trying to maintain a healthy level of caution and objectivity and we feel that the political uncertainties and backflips in the market will remain the status quo for the time being.

Domestically, we saw cyclicals rally in May post the surprise election result. They then gave up some of these gains in June on the realisation that conditions remain tough and following a number of profit downgrades in the sector. In the coming weeks, as parliament returns, it will be interesting to see the Government's ability to harness the support of the minor parties to put through some of their stimulatory policies, especially tax cuts. Their success in achieving this will likely set the tone for sentiment following a dour number of years of policy inertia and infighting. It will also be interesting to see the relative success of interest rate cuts and APRA loosening in boosting house prices and consumer confidence. Even if these initiatives are moderately successful the US experience post GFC has conditioned us not to expect a V-shaped demand recovery.

The difficult cyclical environment and accompanying profit disappointments for many industrial stocks, aided by low interest rates, has seen many investors flock to the newly named "hyper-growth" stocks. These stocks are predominantly in the tech and biotech sectors and their strong outperformance has continued even whilst many of the traditional growth stocks have languished. Whilst such stocks have done well in overseas markets their performance in Australia has been world leading, so much so that we are even seeing offshore based companies with only a tenuous link to this country choosing Australia for their primary listing. We maintain a constant coverage of these stocks but remain sceptical and find that many of them are incompatible with our valuation-based, cash flow focused investment style. Supporters of these stocks point to their high growth rates (which are often acquisition-led) and laud the margins and potential share they might achieve in the future of their Total Addressable Market “TAM”. Whilst we are conscious that lower interest rates (and by implication, discount rates) allow investors to look further into the future when estimating equity values, valuation methodologies and growth measures being deployed in these sectors are becoming increasingly creative, and often ignore discrepancies between accounting and cash profit/losses. An increasing number of the companies in this space are actually cash flow consumers and rely on the ongoing support of their shareholders to keep the doors open. Having survived the last tech boom we are conscious that in downturns a lack of cash flow and valuation support means there is little backstop to protect such share prices when markets become disorderly.

Our next key focus area is the June 2019 period end reporting season which will largely take place in August. We have seen a lot of profit downgrades ahead of this and suspect there could be further disappointment to come and that some of the expectations for F20 and beyond seem too optimistic. We remain focused on companies with resilient earnings that are trading at a reasonable price, mispriced stocks; and the portfolio maintains a healthy exposure to offshore earners that operate in more solid end markets.