Fund Update - 31 December 2018

Global Small Cap Fund

PARADICE
INVESTMENT MANAGEMENT

Fund Objective

The Fund aims to outperform the S&P Global BMI (US$1bn - $5bn Market Cap Range) Net Total Return Index ex Australia and New Zealand in AUD over a three to five year period (after management costs and before tax).

Performance Net (%) p.a.	1 Month	3 Months	1 Year	3 Years	5 Years	Since Inception*
Global Small Cap Fund	-3.94	-11.54	-8.88	5.52	7.74	13.93
Benchmark**	-4.04	-12.35	-5.03	6.63	8.45	13.56
Excess Return	**0.10**	**0.81**	**-3.85**	**-1.11**	**-0.71**	**0.37**

* Inception date - 18/01/13

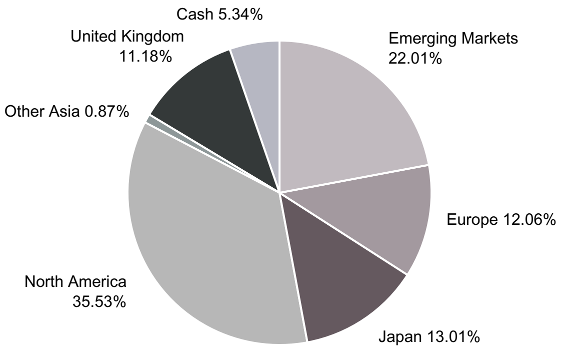
Fund Details

APIR Code	ETL0365AU
Fund Size (AUD m)	$733
Number of Stocks	70
Average Market Capitalization (AUD)	2,279
Application Price	$1.9369
Redemption Price	$1.9253
Distribution Frequency	Semi-Annually
Management Fee	1.25% p.a.
Performance Fee	15% p.a.
Buy Sell Spread	+/-0.30%
Minimum Investment (AUD)	$20,000

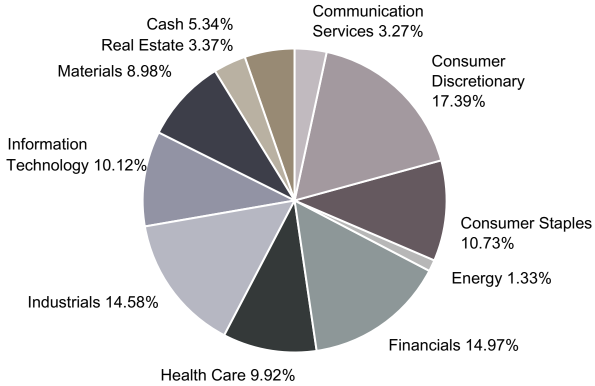
Top 10 Positions (%)

	Fund
Kansai Paint Co., Ltd.	2.90
Nihon Kohden Corporation	2.85
Mandom Corporation	2.55
International Speedway Corporation Class A	2.53
Tata Global Beverages Ltd.	2.40
ITT, Inc.	2.37
Axis Capital Holdings Ltd.	2.35
Equiniti Group Plc	2.35
Lear Corporation	2.24
CNO Financial Group, Inc.	2.19

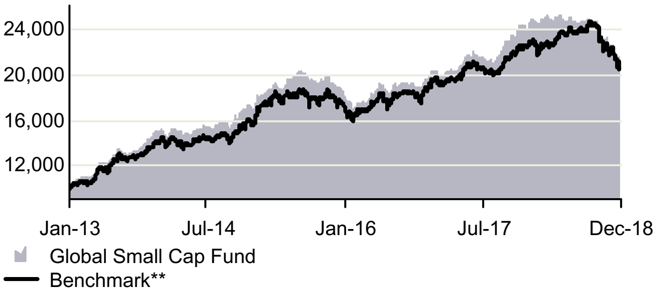
Region Allocation (%)



Sector Allocation (%)



Growth of AUD 10,000



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** S&P Global BMI (US$1bn- $5bn Market Cap Range) Net Total Return Index ex Australia & New Zealand in AUD effective from 5 November 2018. Prior to this date the benchmark was S&P Global BMI (US$1bn-$5bn Market Cap Range) Net Total Return Index in AUD effective from 1 October 2015 to 4 November 2018 inclusive and S&P Global BMI (US$1bn-$5bn Market Cap Range) Index in AUD prior to 1 October 2015.

Commentary

MARKET REVIEW

For the purpose of comparison, commentary herein is quoted in USD terms, except under the ‘Performance’ heading which is quoted in AUD currency.

Global small caps fell 14.7%, 12.3% in AUD, (S&P Global BMI (US $1bn - $5bn Market Cap Range) Net Total Return Index) in Q4 2018, led by Energy stocks that plunged in sympathy with crude oil. Safe haven Utilities were the only sector generating a positive AUD return. Geographically, the US declined the most, reversing its outperformance from the prior quarter as investors began fretting about the pace and impact of Fed tightening. The UK and Europe fared nearly as poorly, however, with Brexit anxiety, a negative GDP print in Germany, and French protests over fuel tax hikes all weighing on sentiment. Rather unusually for a risk-off period, Emerging Markets dramatically outperformed, thanks to strong trading in Brazil and India.

Owing to a combination of underweighting and stock selection, we outperformed in the US. The same can be said for our relative performance in Japan. These bright spots more than offset our poor showing in the UK, where a major valuation discount versus other developed markets has encouraged us to maintain an overweight position.

PERFORMANCE

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

Federal Bank (India) Federal Bank grew strongly while maintaining asset quality, beating low expectations upon reporting quarterly results. The shares have re-rated to a less depressed multiple following a period of concern regarding non-performing assets. The fall in oil prices is also supportive for Indian economic growth generally, as it eases inflation and interest rate pressures.

Semen Indonesia (Indonesia) Semen Indonesia, the country’s top cement producer, acquired control of the #3 player from struggling LafargeHolcim in a move that consolidates a market that has been suffering from excessive price competition. Investors bid up the shares sharply following the announcement.

Kansai Paint (Japan) Kansai Paint, currently suffering from the impact of FX translation in its Emerging Markets-facing coatings business, is a beneficiary of lower oil prices, given that crude-derived naphtha is a key input. The collapse in crude should help ease the margin squeeze this well-managed company faced in 2018.

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

Ferroglobe (UK) Silicon metal producer Ferroglobe reported a terrible quarter that dramatically missed expectations, owing to a combination of weaker pricing/volumes and significant inflationary cost pressures. The company is doing its part to restore balance to the market through capacity closures, but this will take time. While the company has some breathing room with regard to its debt burden, the balance sheet is now stretched. We had drawn comfort from the asset value of the company’s hydro plants, but the company’s ongoing inability to monetise these assets has challenged our initial thesis on the pro-forma leverage profile. This investment, now much diminished after a collapse in the share price, has proved a costly reminder to stick to quality franchises with clean balance sheets.

Scapa Group (UK) Contract manufacturer Scapa Group, a long-term star performer for us, failed to impress investors with its latest acquisition and the stock de-rated from a premium multiple to a more pedestrian one. We believe the firm has an opportunity to illuminate the merits of the somewhat complex Systagenix transaction as it meets with investors, though the valuation may remain pressured as long as Brexit uncertainty hangs over UK small caps generally.

CNO Financial (US) Life insurer CNO Financial traded off sharply despite having ring-fenced its legacy long-term care exposure at the end of Q3. With that tail risk concern off the table, investors turned to worrying about the volatile equity market and its implications for the annuities business, which had just begun to show signs of life.

Portfolio changes over the quarter is as follows:

We sold out of three holdings during the quarter: auto aftermarket parts specialist Dorman Products (US), which reached fair value, merchant acquirer Global Payments (US), which has considerably outgrown our market cap mandate and has also stretched its balance sheet, and KLX Inc (US), an aircraft parts distributor that was acquired by Boeing. In conjunction with the KLX buyout, we received cash and shares of the spinoff KLX Energy Services (US).

We reduced our holdings in Nihon Kohden (Japan) on strength, International Speedway (US) in response to a take-private offer, and Ferroglobe (UK) upon recognition of a broken thesis as described earlier.

We established one new position in the quarter, purchasing shares of a US company struggling with market share losses and an unfocused portfolio following years of M&A-driven growth. With a new CEO at the helm, we believe the company will either fix its problems or get taken out by a strategic buyer should they fail to do so. The company trades at a steep discount to comparable firms globally.

We increased our stake in the afore-mentioned KLX Energy Services following the spinoff, took up the Avanos Medical (US) position we had sold down aggressively in the prior quarter at much higher prices, and added to several other holdings on weakness, such as video game retailer GameStop (US) and functional ingredients provider Corbion (Netherlands).

OUTLOOK

We suggested last quarter that the ‘Goldilocks’ economy in the US may be approaching its end. This seems to be playing out, albeit with suddenly much less inflationary pressure than we had been witnessing a short time ago. Wage growth is still perky, as is employment, but oil and other commodities have plunged on a lowered outlook for global growth. Communication by the Fed about the likely pace of interest rate hikes and balance sheet shrinkage has been a bit muddied, with the latest message being that there is no preset path for policy and that they will be ‘patient’ and responsive to market signals. At least for today, the market is interpreting this message as a signal that the Fed has its back.

This recent easing of inflation/interest rate pressure of course needs to be weighed against the deteriorating global growth outlook that has directly contributed to the Fed adopting this more dovish tone. It’s a delicate balance for the global equity markets to strike from here, as a little softening may keep rate hikes at bay and valuations elevated, whereas a sharper synchronised downturn featuring a marked uptick in credit stress would likely swamp any perceived benefit of “lower for longer” interest rates. While we try not to take too strong a view on future states of the world, we do suspect that as the market cycle plays out, we will eventually see more attractive valuations than have been prevalent in recent years.