Fund Manager Commentary

Quarter ended 30 June 2018

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Market Review

The S&P/ASX 300 Accumulation Index finished the June quarter with a gain of 8.4%, closing the financial year with a 13.2% return. Earnings growth has powered these gains, as the Royal Commission and a challenging environment has seen the banks de-rate, keeping the market's aggregate valuation rating steady. This is important, as ultimately we see earnings-driven market growth as more sustainable than valuation-driven returns. The market's return for the year was materially ahead of the +8.8% 12-month gain from the MSCI World (in local currency terms). In the US, the S&P 500 gained +12.2% and the NASDAQ +22.3%, while Japan's Nikkei was up +11.3%. European returns were muted, with the UK's FTSE 100 up by 4.4% over 12 months while Germany's DAX was down by 0.2%

Beneath the positive headline figure, volatility emerged over the quarter, albeit in a somewhat contained manner. During May we had the formation of a populist coalition government in Italy between the Lega Nord and the Five Star parties, which prompted a bout of market volatility towards the month end. Italian bond yields spiked, as did speculation over the potential for a parallel currency, presidential impeachment and a potential showdown between Italy and Germany over debt and fiscal discipline. However, in spite of all the concerns and uncertainty, the episode proved short-lived and most assets reverted towards their value at the start of the period. During June investor attention was diverted to the trade war issue between the US and China. Whilst it hasn't fully deterred investors from risky assets, the impending implementation of the 25% tariff on US$50b worth of goods on July 6 is going to be closely watched by the market, as China is expected to retaliate in kind. Any further escalation in trade tensions could see the global equity market react poorly. Nevertheless, market valuations remain supportive in Australia, largely attributable to a weak currency against the greenback, as well as patience displayed by the Reserve Bank of Australia (RBA) in prolonging its first interest rate hike.

All of the GICS sectors, except for Telecommunication Services (-13.3%) finished the quarter higher. In particular, most managed to record double-digit gains, including Energy (19.8%), Health Care (+15.9%), Consumer Staples (+12.0%), Materials (+11.4%), Information Technology (+11.0%), Consumer Discretionary (+10.6%) and Real Estate (+10.0%). Telstra (TLS, -16.6%) was the largest drag on index and sector performance. Its long-awaited investor day emphasised the challenges facing the mobile phone market in Australia, with competition intensifying as the largest player attempts to shift tack from being the disrupted to becoming the disruptor. Management flagged an additional $1b of costs that the company expects to cut over the next three years, on top of the existing $1.5b program, driven by job cuts and rationalisation of its phone plans from 1800 to 20 to simplify the business. However, dampening investor sentiment was management's guidance to a 17% fall in core underlying earnings for FY19. Following a 9% fall in the first half of FY18 and an expected 13% fall in the second half, this accelerating trend in earnings declines is the key challenge facing the business, and saw the stock sell off as a result.

On the positive side, Materials provided the backbone for the index's performance, with BHP (BHP, +20.2%) contributing the most. Despite some short-term oscillations, commodity prices remain elevated compared to a couple of years ago and hence, free cash flow generation has significantly improved at BHP. This, in conjunction with a better capital allocation discipline, has seen investors favour the diversified miner, particularly during a time where the banking sector has been kept at bay by the Royal Commission. Some of the gold miners, including Newcrest Mining (NCM, +11.5%), Northern Star Resources (NST, +15.6%) and Evolution Mining (EVN, +15.8%) also outperformed over the quarter. NST in particular saw its share price rise by more than 15% in June despite a subdued gold price, driven by a stronger US dollar. The miner updated the market with its production levels and is on track to exceed the top end of its FY18 production guidance, which was well received by the market.

Portfolio performance

The Pendal Australian Share Fund (formerly the BT Wholesale Core Australian Share Fund) returned 6.99% (post-fee, pre-tax) for the quarter, underperforming its benchmark by 1.38%.

Contributors

Overweight BHP

As mentioned earlier, commodity prices remain elevated compared to a couple of years ago, which has been supportive for BHP’s (BHP, +20.2%) free cash flow generation and its performance over the quarter.

We continue to favour BHP for three reasons: the Chinese supply-side discipline remains crucial and we see no sign of changes there; consensus expectations for the iron ore price remain well below the spot price, supporting the prospect for further earnings upgrades; and continued improvement in the company’s capital discipline/allocation.

Underweight National Australia Bank

National Australia Bank (NAB, - 0.3%) and ANZ (ANZ, +8.2%) released half-yearly results in May which were broadly in line with market expectations. While NAB has the most leverage to an improved corporate credit cycle, we do not expect this cycle to strengthen in the near term. Amongst its ‘Big Four’ peers, we still see ANZ’s greater focus on cost control - where they are guiding towards flat cost growth versus mid-single digit for its peers - as the key differentiator in an environment of muted revenue growth. It is therefore our preferred exposure within the sector.

Overweight Santos

The share price of Santos (STO, +23.7%) rebounded in June, recouping some of the losses incurred in May when it walked away from a takeover offer from Harbour Energy. The natural gas explorer announced further progress on the front end engineering and design (FEED) phase of the Barossa offshore project with the award of three major engineering contracts during June. In addition, the global oil price has been on the rise, which is partially attributable to the US’ upcoming ban of oil exports from Iran which could take place as soon as November. The elevated oil price level provides the backbone for STO’s free cash flow generation. Santos is now targeting a range of 10% to 30% payout of free cash flow as shareholder dividends.

Overweight Aristocrat

Gaming operator Aristocrat (ALL, +29.2%) released its first-half results in May, which saw earnings surpass market expectations. Management is now guiding towards double-digit growth in net profits (NPATA) for FY18. ALL remains one of our preferred growth names and its underlying earnings strength justifies the valuation multiple. Its core business has been strong and the prospects for continued growth are strong, considering the pipeline of new casinos and social apps. That said, we are conscious that the additional rolling out of apps and functionalities, whilst providing a platform for improved revenues, is also likely to compress margins.

Detractors

Overweight Metcash

Food/Grocery/Hardware wholesaler, Metcash (MTS, -16.6%) has come under pressure over the quarter after it first reported the loss of the supply contract for Drakes Supermarkets chain in South Australia in May, and released its full year result in June. In our view, the impact of the contract loss will be contained and the result is reasonable, given the competitive challenges in the supermarket sector.

The stock initially rallied post the result announcement, but then gave it back as the market latched onto two specific items. The first was the material decline in sales in some parts of Western Australia in response to new Aldi stores, with the market concerned that IGA's large share of the market may be under sustained threat. We see some parallels here with South Australia, where new Aldi stores initially dented IGA sales before management were able to respond with promotional programmes which ultimately arrested the decline. Sales growth has turned positive in South Australia during the most recent quarter and we expect management to replicate this approach in Western Australia. The second issue was the planned one-off $10m investment into the food and grocery business, which management have indicated will be put towards staffing and marketing, although the market appears to have assumed this will translate directly to price discounts and the bottom line.

We maintain our conviction in MTS despite the market's concern. In our view it is only half-way, at best, through the transition programme implemented to turn the company around. One key positive area is the removal of 6,000 low-value, low-turnover items and their replacement with 3,000 higher turnover units in their food and grocery business. This is in the early days of roll-out through IGA stores and there is evidence emerging of sales growth in those stores where it has taken place. Elsewhere, there are further gains to be made in hardware as the integration continues. MTS trades at a multiple of 12.15x consensus next 12 months earnings and a dividend yield of 5.7% and no debt. At this point, the implied valuation for food and groceries is only 2x earnings (EBITDA), once hardware and liquor are backed out, which we believe is far too low for a division where several positive program are in place to regain sales growth.

Overweight AMP

AMP (-28.7%) dominated news headlines in April after it was revealed in the Royal Commission that it charged clients for services that were never provided and management was criticised for the lack of transparency post this event. The company has fallen out of the S&P/ASX 20 index, which further weighed on stock performance.

While we acknowledge it will take time for AMP to rebuild trust with the market, regulators and the public, we also think the circa 35% fall in the share price (from its March peak) is out of proportion to the likely earnings and valuation impacts. Errors in the business were compounded with misrepresentations to the regulators; however, the overcharging related to only about $800,000 of revenue. There is no doubt that senior management and the board must be held accountable, and the likely outcomes we see from here are management and board changes in conjunction with fines and higher regulatory costs. Nevertheless, we expect the franchise risks around adviser and customer departures to likely recede as negative publicity subsides. Given where stock valuations are at the moment, we continue to hold AMP in the Fund.

Overweight Telstra

Telstra (TLS, -16.6%) held its long-awaited investor day in June, which emphasised the challenges facing the mobile phone market in Australia, with competition intensifying as the largest player attempts to shift tack from being the disrupted to the disruptor. Management flagged an additional $1b of costs that the company expects to cut over the next three years, on top of the existing $1.5b program, driven by job cuts and rationalisation of its phone plans from 1800 to 20, simplifying the business. We expect to see more detail as the new plans begin to emerge from July. We do not see the move to create a standalone infrastructure business within the company as significant for the moment, although it does provide some optionality for a sale once the NBN rollout has been completed.

However, the key feature was management's guidance to a 17% fall in core underlying earnings for FY19. Following a 9% fall in first half earnings and an expected 13% fall in the second half of FY18, this accelerating trend in earnings declines is the key challenge facing the business. While reporting is short on detail, we suspect the company's rapidly disappearing ability to charge for excess data is playing a significant role in this. It is possible that the company may go to unlimited data plans and drop prices, placing pressure on competitors who may struggle to match this in an attempt to regain share in the mobile phone market. Our view remains that we will ultimately see rationalisation and sustainable profitability among mobile phone providers. This should benefit TLS, which continues to grow its subscriber base. The company is signalling it will defend its market share; however, intense competition is likely to see the company endure some pain before consolidation occurs.

Overweight JB Hi-Fi

JB Hi-Fi (JBH, -6.7%) downgraded full-year guidance at the beginning of May due to weaker gross margins on white goods at Good Guys. Some have been quick to conclude that the downgrade is a sign of Amazon-induced stress and JBH is among the most-shorted stocks on the exchange at the moment. However, the downgrade was driven by a case of old-fashion competitive pressure from Harvey Norman (HVN) which has taken advantage of the fact that long-term buying contracts at Good Guys limit its flexibility to recoup price discounts from their suppliers. This forced the company to accept lower margins. This is one of the issues that we believe the franchise's new owners will be able to fix. We continue to believe the JB Hi-Fi team are among the most astute retailers in the country. Ultimately, we also believe that the pressure on price from HVN is a temporary issue. Good Guys represents about 20% of JBH's value and in our view the 8% fall is an overreaction, driven by broader fears about the effect of Amazon. The core JBH business continues to perform well, delivering sales growth on top of what was already a very strong prior year. We continue to maintain our conviction in the stock.

Strategy and outlook

Australian equities staged a strong quarter, with the S&P/ASX 300 up 8.4%. While resources outperformed (S&P/ASX 300 Resources +16.0%), Industrials and A-REITs also posted solid gains. The portfolio made absolute gains, helped by strong performance from Whitehaven Coal, CSL and Santos. However, the overweights in Metcash and JB Hi-Fi saw the Fund finish behind the Index for the quarter.

The Index returned 13.2% for the financial year, including dividends. At just under 16x, the next 12-month price/earnings ratio for the S&P/ASX 300 remains above its long term average, however not egregiously so given the low target interest rate of the Reserve Bank of Australia (RBA). While rates remain low we believe the market can maintain its current valuation and we do not expect imminent rate rises given the lack of inflation in the economy. This leaves earnings to drive stock markets. We think there is enough momentum in the economy to support mid-single digit earnings growth, helped by the pipeline of infrastructure spending and a pick-up in capital investment in corporate Australia. As a result we continue to expect Australian equities to return somewhere near high single-digit returns for the next year, once dividends are factored in.

The market's key feature in recent times remains the increase in stock dispersion. This is driven partly by the decline in previous thematic drivers, but the scale of disruptive challenges facing a large swathe of corporate Australia is paramount. This provides a fertile ground for active managers to add value.

Our key positions include BHP in resources. Chinese supply-side policy settings continue to support commodity prices and earnings growth, while the company's strategy of divesting its poorly-performing assets should lead to improved capital allocation and return on equity. We also maintain conviction in Metcash. We believe the market's reaction to the loss of the Drake contract in South Australia has been disproportionate, while we also believe the improving trends in supermarket sales are underestimated. At this point, the implied valuation for the IGA business is little more than two times earnings (EBITDA), which we believe is far too low given the programs in place to drive revenue growth.

Qantas dragged slightly over the quarter, however it also remains among our highest conviction positions. Disciplined pricing and capacity in the domestic market underpin continued earnings and cash flow. A pick up in corporate capital expenditure - not the least of which by the West Australian miners - is helping domestic demand growth. Trends in its international market have also turned positive for the first time in a while. At a multiple of 9.9x its next 12-month price/earnings ratio, we think Qantas continues to offer a compelling opportunity, despite its strong gains over the past five years.

Pendal Smaller Companies Fund

Market review

The S&P/ASX Small Ordinaries Accumulation Index finished the June quarter 7.7% higher, underperforming its large cap counterpart slightly by 0.7%. However, for the 2018 financial year the Index managed to record a double-digit gain of +24.2% with a significant contribution from small cap Resources (+49.0%), whereas small cap Industrials (+18.3%) lagged but still generated an attractive return.

Over the quarter, all of the industry sectors advanced with the exception of Financials (-1.0%). Alternative asset manager, Blue Sky Alternative Investments (BLA, -83.6%), was the largest detractor on the sector's performance. A research piece released by US hedge fund, Glaucus, questioned the way BLA values its alternative investment portfolios, which caused a downward spiral on investor sentiment and saw the CEO step down. Adding to BLA's staggering poor performance, sector heavyweight private health insurer NIB (NHF, -10.2%) also weighed on sector performance. The market continues to question the outlook for NIB given the structural headwinds it faces, such as the affordability of private health insurance. Partially offsetting some of these losses, insurance broker Steadfast (SDF, +12.0%), funds management business Navigator Global Investments (NGI, +43.9%) and wealth management platform Netwealth (NWL, +20.9%) all recorded double-digit gains. Navigator Global Investments provided the market with an update on the acquisition of Mesirow Financial's multi-manager hedge fund business in May. It expects circa $5.2b of assets under management to transition to its existing Lighthouse business. Although the operating margins are initially lower than Lighthouse's, management expect those to normalise over three years as the integration ticks along.

Energy (+26.6%) fared the best in absolute return terms amid a rising global oil price, which benefited from the upcoming ban by the US on Iran oil exports. Beach Energy (BPT, +44.4%) was the standout amongst peers over the quarter, as the company released a strong set of quarterly results, with sales revenue more than doubling compared to the prior year. Free cash flow generation improved and the surplus cash helped to reduce net gearing to 29%. Others stocks that also advanced with double-digit gains include Whitehaven Coal (WHC, +27.4%) and WorleyParsons (WOR, +21.8%).

Outside Energy, index heavy weight Consumer Discretionary (+9.2%) also outperformed, while Materials (+19.9%) detracted. IDP Education (IEL, +41.1%), which provides university placement and English language testing services in Australia, New Zealand, Canada and the US, was the largest contributor within Consumer Discretionary. The company received a broker upgrade in May, which was based on the view that IDP has the potential to become a global leader in its market, given its position across language testing and university placement, as well as the limited and fragmented nature of its direct competition. Similarly, Webjet (WEB, +21.7%), an online travel agent which has grown to become Australia's largest online flight booking site, also received a sell-side upgrade in June on the back of strong demand and increased hotel bookings in its key destination markets such as the US and Western Europe. On the contrary, Greencross (GXL, -15.3%) was one of the largest detractors within the sector over the month. The pet and vet care retailer saw its share price fall as management downgraded profit guidance by 9% and unveiled plans to cut costs by 5% as part of a strategic review in May.

Lastly, positive performance from the likes of St. Barbara (SBM, +21.1%), Saracen Mineral (SAR, +23.4%) and Regis Resources (RRL, +13.0%) was more than offset by negative returns generated by the likes of Ausdrill (ASL, -32.0%), Global Geoscience (GSC, -23.2%) and Mineral Resources (MIN, -5.8%). Ausdrill provides exploration and drilling services to the mining and energy sectors, and it provided a project update in June, where the company advised of reduced scope at the Mineral Resources' Wodgina project which will see the contract value halve to $90m over the next three years. This dampened investor sentiment on both MIN and ASL. In addition, ASL also advised that a wall failure at the Kalgoorlie Super Pit gold mine has reduced their contract scope by 35%.

Portfolio performance

The Pendal Smaller Companies Fund (formerly the BT Wholesale Smaller Companies Fund) returned 6.00% (post-fee, pre-tax) for the quarter, underperforming its benchmark by 1.67%.

Contributors

Overweight IDP Education (IEL)

IDP Education (IEL, 41.1%), a provider of university placement and English language testing services in Australia, New Zealand, Canada and the US, rallied over the second half of the quarter in response to a significant broker upgrade. The upgrade was based on the view that IDP has the potential to become a global leader in its market, given the company's position across language testing and university placement, as well as the limited and fragmented nature of its direct competition. We like the company for the combination of structural tailwinds, conservative management and the steps they are taking to drive greater efficiency through digital solutions.

Overweight Reliance Worldwide

Reliance Worldwide (RWC, +36.2%) makes plumbing supplies including the popular SharkBite system of fittings in Australia, Europe and North America. It delivered a trading update in May which reaffirmed its underlying earnings growth guidance and also announced a capital raising to fund the acquisition of John Guest Holdings Limited, a UK-based competitor. This should provide the potential to push further into the European market, complementing its already strong position in the US market, and prompted earnings upgrades from investment banking analysts.

Detractors:

Overweight Ausdrill

Ausdrill (ASL, -32.0%) provides exploration and drilling services to the mining and energy sectors. The stock fell in June following a project update which advised that reduced scope at the Wodgina project will see the contract value halve to $90m over the next three years. It also advised that a wall failure at the Kalgoorlie Super Pit gold mine has reduced their contract scope by 35%. While this does present a near-term setback, we believe the company will continue to benefit from further cyclical tailwinds as mining companies begin to spend on expansions and replacement projects.

Overweight Technology One

Technology One (TNE, -17.6%) provides cloud-based enterprise software for businesses and government. Its half-yearly earnings report disappointed consensus expectations, with net profit after tax up 1% versus the corresponding six months of the previous year. Management had warned that profit growth might actually be slower in this period, given the base effect of a high number of deals last year, so the result was actually an improvement on their guidance. The stock reaction suggests some fears that TNE may struggle to meet their full year targets. At this point, management remain confident, citing a skew towards the second half in licence fees.

Strategy and outlook

The small cap sector gained +24.3% for the 2018 financial year. Strength in commodity and oil prices saw the S&P/ASX Small Resources gain +49.0%, a surge which saw portfolio holdings Pilbarra Minerals and Whitehaven Coal finish among the best performers in the Index. Strong cash flows are allowing mining companies to begin spending on development again, following several years of drawn purse-strings. This is seeing life return to the mining services sector in the form of new contracts. We do have some positions in mining and energy companies; however, our preferred exposure is via services to the sector, given that small cap resource companies can often be dependent on one asset. As a result, we retain exposure to companies such as Seven Group and Ausdrill. Technology also did well in aggregate for the year and Altium - also in the portfolio - was also among the sector's best performers. In aggregate, the Fund managed to add value through a period of already very strong market returns.

Looking forward, we continue to see attractive opportunities in the sector. The key challenge remains finding the pockets of growth but avoiding over-hyped themes where companies have been priced for perfection. In addition to mining services, we have identified opportunities aligned with structural tailwinds such as IDP Education (overseas education), Ryman Healthcare (aged care), and RCR Tomlinson (renewable energy). The Australian retail sector continues to face an unprecedented level of disruptive challenge. Here, we are positioned in companies which we believe have some level of protection from new competition such as Bapcor, or which are acting as disrupters themselves such as Webjet. A recent research trip to China emphasised the opportunities in those companies that can successfully capture some niche of consumption there, although it is crucial to retain valuation discipline given the cycles of euphoria and despair that often accompany such opportunities. With A2 Milk having risen out of the small cap index, our exposure to this sector includes New Zealand-listed Synlait Milk, a dairy company with exposure across several different products, including a supply contract to A2 Milk.

International Shares

Pendal Concentrated Global Share Fund

Market review

During the June quarter, global equity markets were heavily influenced by geopolitical influences which obscured the more fundamental drivers of performance. The US-instigated trade policy moves were primarily targeted towards China but also encountered Canada, Australia and Europe, which served to provide uncertainty on the impact on multi-national corporations. Amid trade tensions and political brinkmanship, commodity markets proved more buoyant. Crude oil prices moved to their highest level since 2014 to advance above US$80 at their peak. Despite trade war fears and consternation over central bank policy direction, most major share markets advanced for the quarter, while a weaker Australian dollar translated to a 5.5% gain in the MSCI World (A$) Index.

US stocks advanced during the quarter, despite the market's preoccupation with trade tensions. However, there was considerable dispersion across industry sectors. Momentum moved in favour of trade-related and growth oriented sectors, with Energy the standout performer. Consumer Staples lagged on concerns that a stronger US dollar would impact profitability, with many of the major operators having businesses outside of the US. Expectations of higher interest rates also weighed on the sector while US economic data continued to paint a picture of strength. Gross domestic product was revised down to a still strong 2.3% for March quarter, while figures on the labour market saw the national unemployment rate fall to an 18-year low of 3.8% and headline inflation crept up to annual rate of 2%. As expected, the US Federal Reserve raised the cash rate by 0.25%, but what was less expected was the signalling of two more rises this year, with previous indications pointing to only one more hike. The market closed the June quarter with the S&P500 delivering a total return of 3.4%, while the NASDAQ rallied with a return of 6.3%.

The performance of European equity markets saw considerable dispersion through the quarter, with many Nordic markets setting the pace while others like Italy (-2.4%), Germany (+1.2%) and Spain (+0.7%) generally lagged. Political developments in Italy came to the fore when the government formation process was halted after the President vetoed the anti-euro candidate nominated for the Finance ministry. The uncertainty led to a spike in volatility and a blow-out in Italian bond spreads. Meanwhile in Spain, a no confidence motion was put forward by the socialist opposition party and both events stoked fears of a new euro crisis, which saw the regional currency weaken. Economic data also pointed to a mixed outlook. Headline inflation for the region edged up to 2%, driven by higher food and energy prices, although core inflation was subdued at 1%. A rise in the eurozone Purchasing Managers' Index (PMI) from 54.1 to 54.8 was above expectations; however, consumer sentiment and retail sales indicators in some key markets were somewhat disappointing. For the quarter, the UK (+8.2%) was a standout performer, alongside Finland (+6.8%) and France (+4.9%) which were in contrast to the weakness in some other markets.

Most Asian equity markets ended the quarter lower, given the expectation that emerging markets are net losers in a trade war between the US and China. Concerns over China's growth more generally, acted to weaken regional markets. During June, the People's Bank of China announced a reserve ratio cut of 0.50% (the reserve ratio is the portion of depositors' balances that banks must have on hand as cash) to generate liquidity and support growth, which reflected some concerns over the growth trajectory. The region's weakness was reflected in the returns for Thailand (-10.2%), Malaysia (-9.2%), Hong Kong (-3.8%) and Singapore (-4.7%), while Japan (+4.0%) traded into positive territory after assistance from a weaker yen.

The Australian dollar declined by 3.6% against the US dollar but rose against the euro (+1.6%), the British pound (+2.3%) and the Japanese yen (+0.5%).

Portfolio performance

The Pendal Concentrated Global Share Fund (formerly the BT Concentrated Global Share Fund) returned 4.66% (post-fee, pre-tax) for the quarter, underperforming its benchmark by 0.87%.

The June quarter and the Australian financial year ended with no respite from geo-political uncertainty. Whilst markets over the last year have weathered the uncertainty well, tariff threats between the US, Europe and China largely remain unresolved, Brexit negotiations continue with the UK Parliament unable to agree amongst themselves on the terms to be negotiated with the European Union, and Chancellor Merkel, who has been the political stalwart in the European Union for the past 12 years appears to only have a tenuous control of her coalition Government. The cash positon in the Fund has increased to around 11% the highest level since Fund inception and we look forward to taking advantage of increasingly volatile conditions by identifying additional long term investment opportunities for the Fund.

Our holdings in European banks underperformed this quarter largely due to the uncertainty regarding Brexit negotiations and the continuing political uncertainty across the broader European region. Whilst cognisant of the risks that this uncertainty poses to near term growth and business confidence, we remain of the view that the European banking sector offers compelling longer term value. The banks held by the Fund are retail banks with dominant market shares. Balance sheets have been strengthened considerably since the global financial crisis, whilst at the same time business models have been simplified. The sector is trading on a 2019 price to earnings ratios of between 9-11x, and we believe the 4-6% dividend yield shareholders are receiving is more than a reasonable payment for what we expect in the longer term to be an expansion of net interest margins and earnings growth that is yet to be reflected in prevailing valuation multiples.

Despite underperforming this quarter (-5.5%), we remain comfortable with our position in real estate developer, Howard Hughes, after a visit in May to their Seaport District development located on the East River in Lower Manhattan, New York. Lower Manhattan has seen a significant transformation in the aftermath of the 2012 Hurricane Sandy. The area is developing into a hub for media, advertising and technology companies and is easily accessible by public transport which is attracting young affluent New Yorkers. The Seaport District is an impressive development comprising of eight buildings, spread across several city blocks and offering a number of entertainment, retail, and food and beverage attractions. Total construction cost of the project will be close to US$800m, with Howard Hughes targeting a 6-8% annual return. The Seaport development exemplifies the broader business, with master plan communities in Las Vegas, Texas and Columbia. Management take a long term approach to creating entire communities over decades by acquiring large land parcels. Land parcels are subsequently sold to homebuilders, whilst Howard Hughes develops the retail and commercial real estate to service the newly created communities. Prudent balance sheet management means the company is approaching a point where the sale of land and non-core assets will allow for the self-funding of future developments. In our view, this will prove to be an inflection point for the share price.

Outperforming this quarter was our holding in US railway company, Norfolk Southern (+10.3%). Whilst the quarterly result in April reflected a strong pricing environment, management's confidence in the outlook was further substantiated by the increase to the buyback target, from US$1b to US$1.5b, and commentary suggesting the "best environment for top line growth since 2006". However, it was subsequent meetings with management that gave us the greatest comfort on the longer term sustainability of earnings. Management are clearly cognisant of the cyclical nature of the business and remain focused on maximising operational efficiencies to meet demand. Whilst the current environment bodes well for pricing, management are displaying caution in adding permanent costs to the business. We continue to believe that management's 2020 operating ratio target appears conservative.

Strategy and outlook

As long term investors, our portfolio has been positioned since inception for a normalisation in interest rates. Our view since inception has been that the normalisation of interest rates would lead investors to reassess their exposure across asset classes, resulting in increased market volatility. The geopolitical uncertainty that has beset markets for the past two years will also, in our view, only serve to exacerbate what we expect to be further volatility in markets. In order to optimise equity market returns we recommend owning a concentrated portfolio of companies that are well placed to sustain their business models over the longer term.

Pendal Core Global Share Fund

Market review

During the June quarter, global equity markets were heavily influenced by geopolitical influences which obscured the more fundamental drivers of performance. The US-instigated trade policy moves were primarily targeted towards China but also encountered Canada, Australia and Europe, which served to provide uncertainty on the impact on multi-national corporations. Amid trade tensions and political brinkmanship, commodity markets proved more buoyant. Crude oil prices moved to their highest level since 2014 to advance above US$80 at their peak. Despite trade war fears and consternation over central bank policy direction, most major share markets advanced for the quarter, while a weaker Australian dollar translated to a 5.5% gain in the MSCI World (A$) Index.

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The performance of European equity markets saw considerable dispersion through the quarter, with many Nordic markets setting the pace while others like Italy (-2.4%), Germany (+1.2%) and Spain (+0.7%) generally lagged. Political developments in Italy came to the fore when the government formation process was halted after the President vetoed the anti-euro candidate nominated for the Finance ministry. The uncertainty led to a spike in volatility and a blow-out in Italian bond spreads. Meanwhile in Spain, a no confidence motion was put forward by the socialist opposition party and both events stoked fears of a new euro crisis, which saw the regional currency weaken. Economic data also pointed to a mixed outlook. Headline inflation for the region edged up to 2%, driven by higher food and energy prices, although core inflation was subdued at 1%. A rise in the eurozone Purchasing Managers' Index (PMI) from 54.1 to 54.8 was above expectations; however, consumer sentiment and retail sales indicators in some key markets were somewhat disappointing. For the quarter, the UK (+8.2%) was a standout performer, alongside Finland (+6.8%) and France (+4.9%) which were in contrast to the weakness in some other markets.

Most Asian equity markets ended the quarter lower, given the expectation that emerging markets are net losers in a trade war between the US and China. Concerns over China's growth more generally, acted to weaken regional markets. During June, the People's Bank of China announced a reserve ratio cut of 0.50% (the reserve ratio is the portion of depositors' balances that banks must have on hand as cash) to generate liquidity and support growth, which reflected some concerns over the growth trajectory. The region's weakness was reflected in the returns for Thailand (-10.2%), Malaysia (-9.2%), Hong Kong (-3.8%) and Singapore (-4.7%), while Japan (+4.0%) traded into positive territory after assistance from a weaker yen.

The Australian dollar declined by 3.6% against the US dollar but rose against the euro (+1.6%), the British pound (+2.3%) and the Japanese yen (+0.5%).

Portfolio performance

The Pendal Core Global Share Fund (formerly the BT Wholesale Core Global Share Fund) returned 3.40% (post-fee, pre-tax) for the June quarter, underperforming its benchmark by 2.13%.

Thematically, underperformance in Europe was due to negative performance in our valuation and earnings quality signals, offset by positive performance in our indirect momentum and momentum factors. Underperformance in the US was due to negative performance in our valuation and industry momentum signals, with positive performance in our stability and indirect momentum factors partially offsetting this. The underperformance in Japan was due to negative performance in our investor sentiment and indirect momentum signals, though again this was partially offset by positive performance in our earnings quality and industry momentum factors.

From a stock and industry attribution perspective, active intra-industry stock selection drove underperformance over the quarter, marginally offset by a positive contribution from active industry tilts. Stock selection within Information Technology, Industrials and Consumer Discretionary sectors was the largest source of underperformance over the quarter, only marginally offset by positive stock selection within Utilities and Materials. At a sector level, an underweight to Financials and an overweight to Information Technology were the largest positive contributors to active returns, with an underweight to Energy and overweight to Industrials being the largest detractors.

At a stock level, the strongest contributions to active returns came from overweight positions in Darden Restaurants Inc., an American multi-brand restaurant operator; Facebook Inc., an American online social media and social networking service company; and Humana Inc., an American health insurance company. The largest detractors over the quarter were an underweight position in Netflix Inc., a US headquartered global entertainment company; an overweight position in Renault Inc., a French multinational automobile manufacturer; and an overweight position in Applied Materials, Inc., an American corporation that supplies equipment, services and software to enable the manufacture of semiconductor chips for electronics, flat panel displays for computers, smartphones and televisions, and solar products.

Strategy and outlook

Moving into July, the largest sector tilts are an overweight in Information Technology and underweights in Financials and Consumer Staples.

Australian Fixed Income

Pendal Fixed Interest Fund

Market review

Australian bond yields finished the quarter relatively unchanged. After increasing earlier in the quarter on improving broader risk sentiment, concerns over geopolitics caused a retracement lower in late May and June. These worries included Italian political turmoil and escalating trade tensions. Meanwhile, the Reserve Bank of Australia (RBA) left rates unchanged through the period and made few changes to its statement. The board did however highlight some of the aforementioned geopolitical factors as well an easing in the Sydney and Melbourne housing markets. Local data was relatively mixed over the period. First quarter GDP rose a healthy 1.0% while the trimmed mean measure of CPI printed at 0.5% over the same period, as did quarterly wage growth. Leading indicators like business conditions and consumer confidence were reasonably constructive. Other noteworthy local developments included the third round of the banking Royal Commission. Finally in terms of market movements, the 3-year yield fell 4bps to 2.07% while the 10-year yield rose a marginal 3bps to 2.64%. Meanwhile, three month BBSW rose 8bps to 2.11% and importantly, its spread versus OIS widened further, causing some concern over local funding costs.

Portfolio performance

The Pendal Fixed Interest Fund (formerly the BT Wholesale Fixed Interest Fund) returned 1.45% for the June quarter (post-fees, pre-tax), outperforming its benchmark by 0.63%.

In the alpha overlay, majority of the gains came from the Duration, FX and Macro strategies, while the Relative Value and Yield Curve strategies had a largely neutral impact. Gains in Duration were from short duration positions in the US and Italy. In the FX strategy, long USD against short EUR, CNH and KRW were the main contributors, while the gains in the Macro strategy were sourced from buying protection positions in emerging market sovereigns.

The government bond component outperformed its benchmark, with the Duration strategy being the main contributor. Gains were mainly from long duration positions in the Australian long end. In the Relative Value strategy, our position in EFP spread also contributed positively to performance. Finally, the Credit component underperformed its benchmark due predominantly to an underweight in Supranationals which performed well over the period.

Strategy and outlook

The RBA left the cash rate unchanged at its July meeting and indicated no near term change to monetary policy. Economic growth released early in June was in line with their forecasts and forecasts from the Statement on Monetary Policy (SoMP), particularly around inflation and the labour market, indicate that they will likely remain on hold for at least the next 12 months. Higher funding costs for banks are translating into rising mortgage rates more recently for some households, although this needs to be kept in context against longer term moves which have resulted in lower mortgage rates, despite no change in the cash rate. It is unlikely the RBA will be changing their view or stance on monetary policy in response to the more recent increases in funding costs. The key economic data due for release in July includes second quarter inflation. With inflation below target and no change expected from the RBA, the larger market reaction would come from a higher than expected release. In the near term the market will be focused on what happens with the BBSW-OIS spread and repo rates. Previous moves wider have usually mirrored offshore markets, although the widening in June was specific to the Australian market. The lack of liquidity was concerning. With three major banks having a September year end (CBA is the exception with a June year end) we may not have long to wait to witness similar volatility in short end money markets.

Turning to credit markets, we maintain our recently adopted neutral view on investment grade credit. Credit markets have lost the teflon coating they had during most of 2016 and all of 2017. For those two years, credit spreads were much more appealing, with the Australian iTraxx reaching a high of +173 in Feb 2016. The market's concern around a slowdown in China and a hawkish US Federal Reserve had started to recede, we also had the European Central Bank buying corporate bonds. These factors drove down equity volatility with the VIX Index falling from 28 to 9 by the end of 2017, this also saw credit spreads stage a strong rally with the iTraxx closing out 2017 at +58.

However, 2018 has seen a reversal of these factors. We are starting to see signs of a slowdown in growth in China, the Fed is raising rates due to signs of US inflation, and the ECB is planning the tapering of its corporate bond buying program. Additionally, concerns around potential global trade wars and European politics are dragging down risk sentiment. This has seen equity volatility pick up and credit spreads widen with the iTraxx closing out June at +80.5.

Reduced market liquidity, in part due to a withdrawal of central bank stimulus will see increased volatility in markets. All of these factors leave us cautiously positioned until we have further clarity on these developments.

However, we do acknowledge strong corporate fundamentals remain, with healthy balance sheets, positive earnings growth and low high yield default rates. On balance, the uncertainty and less attractive risk-return trade-off warrants a neutral stance for now. We believe investment grade securities should outperform high yield issuers in this environment.

International Fixed Income

Pendal Global Fixed Interest Fund

Market review

Global bond yields finished the quarter higher overall. After increasing in the first half of the period on improving broader risk sentiment, concerns over geopolitics drove a retracement lower in late May and June. These worries included Italian political turmoil and escalating trade tensions. On the former, an unexpected coalition between two Italian populist parties saw intentions for anti-euro policies announced, which spooked investors. However, sentiment improved at the end of May as the proposed measures were abandoned and a less euro-skeptic finance minister was appointed. Turning to the US, the Federal Reserve hiked rates by 0.25% and issued a more hawkish rate outlook. Data was relatively healthy over the period and annual core CPI increased to 2.0%. Meanwhile in Europe, the European Central Bank (ECB) announced it would end its quantitative easing program in December this year, but keep rates at their current levels until at least the European summer 2019. This in turn was perceived as a dovish message from the central bank. Beyond developed markets, several emerging economies endured significant issues over the quarter, including Turkey, Brazil and Argentina that added to investor worries. Finally turning to market movements, the US 2-year yield and 10-year yield rose 26bps and 12bps to 2.53% and 2.86%, respectively.

Portfolio performance

The Pendal Global Fixed Interest Fund (formerly the BT Wholesale Global Fixed Interest Fund) returned 0.60% for the June quarter (post-fees, pre-tax), outperforming its benchmark by 0.43%.

Over the period, all alpha strategies excluding the Yield Curve strategy which was flat, contributed to performance. The Duration strategy was a large contributor, which was driven by positioning in May. The portfolio was short duration in Italian bondss and long duration in German Bunds. This benefited the portfolio as the Italian political situation worsened, causing Italian yields to spike and German yields to fall on a flight to safety.

The FX strategy made the largest contribution to performance. In May, this was tied predominantly to a short EUR exposure against the USD as the former suffered on the aforementioned Italian political turmoil. In June, long USD positioning against CNH and KRW benefited the Fund as escalating trade tensions caused the Asian currencies to suffer.

The Yield Curve strategy had a neutral impact over the period. In April, the strategy benefited from front-end steepeners and a US long-end flattener. The latter subsequently caused losses in May and was later closed. Meanwhile, performance from the Japan long end steepener was neutral.

Positive performance in the Cross-Market strategy was driven by a long duration in Bunds versus short duration in the Italian bond position held in May. This was adopted with a similar rationale to the previously noted short Italy exposure.

The Macro strategy was a significant contributor to returns. This stemmed from buying protection positions in May and June. In May the largest driver was a long protection position on Turkey CDS, which benefited the Fund as speculation over capital outflows worsened. In June a broader buy protection on the CDX EM Index was the largest driver and partial profits were taken.

Finally, the Relative Value strategy was a small contributor. This was largely from a US 5 year invoice spread, while an Australian 3 year EFP spread position was essentially neutral on impact.

Strategy and outlook

Since the GFC, market and trading liquidity has changed structurally and for the worse. The lack of that liquidity when markets are at their maximum pain point can create significant overshoots. This was witnessed in May through the market's reactions on Italy and Turkey. While it may have been a short-lived reaction, it does not mean that the worst is behind us for European and emerging markets.

In June, the larger risk-off driver was the resurfacing of Sino-US trade tensions. This escalation differed from previous episodes because it has highlighted the extent of China's own cyclical weaknesses. It also highlights further cyclical vulnerabilities in Europe and emerging markets and has the potential to snuff out the growth momentum in the US if China's policy makers fail to contain a hard landing. Whilst a return to a 2015 scenario is not our base case, we continue to expect further slowing of the Chinese economy later this year. More broadly, we believe the withdrawal of global liquidity will continue to create vulnerabilities in certain markets that benefited from monetary excess in previous years.

Credit

Pendal Enhanced Credit Fund

Market review

Credit spreads widened further during the June quarter. This was again related to softer global risk appetite, spurred by Italian political turmoil and escalating trade tensions. On the former, an unexpected coalition between two Italian populist parties saw intentions for anti-euro policies announced, which spooked investors. However, sentiment improved at the end of May as the proposed measures were abandoned and a less euro-skeptic finance minister was appointed. Geopolitical risks were also evident in pockets of emerging markets including Turkey, Brazil and Argentina which added to investor concerns. The domestic market also endured a further widening in the BBSW-OIS spread which created concerns over rising funding costs.

Turning to market activity, April and May saw reasonable issuance, with the lion's share from Financials. However, June marked a significant decline in volumes by historical standards, with a light $1.75b in debt capital raised.

The Australian iTraxx index (Series 29 contract) traded in a wide 18bp range finishing the quarter 10.5bps wider to +80.5bps. Physical credit spreads were mixed with the best performing sectors being supranationals and offshore banks narrowing 2 and 1 bp respectively whilst the worst performing sectors were telecommunications, real estate and infrastructure, widening 13, 7 and

5bps respectively. Semi-government bond spreads outperformed contracting 4bps to government bonds over the quarter.

Portfolio performance

The Pendal Enhanced Credit Fund (formerly the BT Wholesale Enhanced Credit Fund) returned 0.62% for the June quarter (post-fees, pre-tax), underperforming the benchmark return by 0.15%.

The Fund's underperformance was partly tied to a short supranationals exposure, which performed well. Meanwhile, overweights in the infrastructure and utilities sectors did not perform as strongly as previous quarters.

Activity over the quarter included acquiring utility, infrastructure and bank bonds.

Strategy and outlook

Our macro credit view is neutral. Whilst we continue to remain cautiously constructive on a fundamental basis, we acknowledge risks have increased due to increasing volatility across markets. This has been driven in part by changing expectations on US inflation and the rates outlook. Geopolitical risks have also flared up this year and markets appear less forgiving, as witnessed by the reaction to Italian political uncertainty in May and Sino-US trade tensions in June.

Over the remainder of the year, it is expected there will be further cash rate increases in the US, as reinforced by the Fed this month. Additionally, the ECB has announced its intention to end quantitative easing by the end of this year. Market price dislocations will occur, should expectations of central bank actions and emerging economic growth, inflation and labour data not align with market positioning.

Balancing these risks are solid corporate fundamentals and in turn, we are constructive on investment grade credit. Balance sheets are generally strong and earnings are improving, as evidenced by solid corporate earnings seasons in Australia, the US and Europe. Further, Australian domestic issuers have not increased balance sheet leverage over the past number of years. The major Australian banks have stronger capital ratios than previous years and should support domestic financial stability.

Domestically, we expect the Australian economy to exhibit improving growth that has become more balanced in recent years. However, weak wage growth could continue to dampen overall domestic demand and housing appears to be softening. The domestic market is also enduring an elevated BBSW-OIS spread, that has created concern among investors. As such we continue to recommend a defensive approach with any overweights in operationally resilient sectors such as Utilities and Infrastructure that provide higher yield to index returns.

Cash

Pendal Managed Cash Fund and Pendal Enhanced Cash Fund

Market review

Australian bond yields finished the quarter relatively unchanged. After increasing earlier in the quarter on improving broader risk sentiment, concerns over geopolitics caused a retracement lower in late May and June. These worries included Italian political turmoil and escalating trade tensions.

Meanwhile, the Reserve Bank of Australia (RBA) left rates unchanged through the period and made few changes to its statement. The board did however highlight some of the aforementioned geopolitical factors as well an easing in the Sydney and Melbourne housing markets. Local data was relatively mixed over the period. First quarter GDP rose a healthy 1.0% while the trimmed mean measure of CPI printed at 0.5% over the same period, as did quarterly wage growth. Leading indicators like business conditions and consumer confidence were reasonably constructive. Other noteworthy local developments included the third round of the banking Royal Commission. Finally in terms of market movements, the 3-year yield fell 4bps to 2.07% while the 10-year yield rose a marginal 3bps to 2.64%. Meanwhile, three month BBSW rose 8bps to 2.11% and importantly, its spread versus OIS widened further, causing some concern over local funding costs.

Looking abroad, Italian political turmoil caused a sell-off in risk assets and Italian bonds in late May. An unexpected coalition between two Italian populist parties saw intentions for anti-euro policies announced, which spooked investors. However, sentiment improved in the final days of the month as the proposed measures were abandoned and a less euro-sceptic finance minister was appointed. Also on the geopolitical front, trade relations between China and the US worsened over the quarter. After President Trump flagged tariffs on US$50b of Chinese imports, policymakers in China responded in-kind with their own levy. Further tariffs were threatened on auto imports from Europe with a similar tit-for-tat response. Beyond developed markets, several emerging economies endured significant issues over the quarter including Turkey, Brazil and Argentina that added to investor worries.

Turning to overseas monetary policy developments, the US Federal Reserve hiked rates by 0.25% as widely-expected. The FOMC also increased its projected rate hikes this year to suggest two more by year-end, which was perceived as a more hawkish shift. Meanwhile, the ECB announced it would end its quantitative easing programme in December, but keep rates at their current settings until at least the European summer. The second part of this forward guidance meant their messaging was interpreted as dovish overall.

Regarding market movements, the Australian 3-year yield fell 4bps to 2.07% while the 10-year rose a marginal 3bps to 2.64% and three month BBSW increased 8bps to 2.11%. In the US, 2-year and 10-year yields rose 26bps and 12bps to 2.53% and 2.86%, respectively. In the FX arena, AUD/USD fell 3.5%, driven in part by broad US Dollar strength.

In credit markets, after tightening in April, spreads widened into the end of the quarter as risk sentiment soured. This was tied to the previously mentioned geopolitical concerns including Italian political worries and trade war fears. The elevated BBSW-OIS spread was also a risk-off factor in the domestic market and liquidity in physical credit was noticeably lighter.

The Australian iTraxx index (Series 29 contract) traded in a wide 18bp range finishing the quarter 10.5bps wider to +80.5bps. Physical credit spreads were mixed with the best performing sectors being supranationals and offshore banks narrowing 2 and 1 bp, respectively, whilst the worst performing sectors were telecommunications, real estate and infrastructure which widened 13, 7 and 5bps respectively. Semi-government bond spreads outperformed contracting 4bps to government bonds over the quarter.

Portfolio performance

Managed Cash

The Pendal Managed Cash Fund (formerly the BT Wholesale Managed Cash Fund) returned 0.45% for the June quarter (post-fees, pre-tax), marginally underperforming its benchmark by 0.04%.

With a higher running yield than the index the Fund remains well positioned to outperform. Themes and credit exposure remain consistent with prior quarters, with excess spread from A-1 rated issuers likely to be the main driver of outperformance. The fund ended the quarter with a weighted average maturity of 61 days (maximum limit of 70 days). Yields further along the curve continue to offer better relative value and the weighted average maturity has consistently been longer than benchmark for this reason. With longer dated yields offering better value and with RBA monetary policy tightening a distant prospect, we will remain longer than benchmark. The Fund is well positioned to continue to outperform its benchmark.

Enhanced Cash

The Pendal Enhanced Cash Fund (formerly the BT Wholesale Enhanced Cash Fund) returned 0.53% for the June quarter (post-fees, pre-tax), marginally underperforming the benchmark by 0.04%.

Positive performance came from exposure to infrastructure, utilities and real estate that represent approximately 60% of the portfolio with further performance from corporate credit accrual. The portfolio has materially outperformed its benchmark by 119bp (before fees) over the past 12 months.

Strategy and outlook

Australian bond yields experienced a small fall and a flattening of the curve over June. During the month, the RBA left rates unchanged at 1.50% for the 20th month in a row. In its statement, the Board noted it continues to expect gradual progress on inflation and unemployment. Support for the local economy from public infrastructure, stronger exports and non-mining business investment was also discussed. It also highlighted recent global developments like political uncertainty in Italy and US trade policy changes. The latter continued to weigh on broader risk sentiment over June. The local market also endured concerns over another leg higher in the BBSW-OIS spread. The spread on the three-month maturity widened 13bp to 61bp and the grind higher appeared independent of its US equivalent.

Domestic data was relatively mixed over the period. First quarter GDP growth at 1.0% beat expectations and brought the year-on-year rate to 3.1%. This was attributed to strength in net exports, while in contrast consumption was subdued. Also during the month, employment data revealed a soft 12,000 increase in jobs, which was skewed to part-time positions. Leading indicators were more constructive with retail sales growth of 0.4% and in increase in consumer confidence to 102.1. At the same time business conditions and confidence measures fell to +15 and +6 respectively.

Turning to credit markets, we maintain our recently adopted neutral view on investment grade credit. Credit markets have lost the teflon coating they had during most of 2016 and all of 2017. For those two years, credit spreads were much more appealing, with the Australian iTraxx reaching a high of +173 in Feb 2016. The market's concern around a slowdown in China and a hawkish US Federal Reserve had started to recede, we also had the European Central Bank buying corporate bonds. These factors drove down equity volatility with the VIX Index falling from 28 to 9 by the end of 2017, this also saw credit spreads stage a strong rally with the iTraxx closing out 2017 at +58.

However, 2018 has seen a reversal of these factors. We are starting to see signs of a slowdown in growth in China, the Fed is raising rates due to signs of US inflation, and the ECB is planning the tapering of its corporate bond buying program. Additionally, concerns around potential global trade wars and European politics are dragging down risk sentiment. This has seen equity volatility pick up and credit spreads widen with the iTraxx closing out June at +80.5.

Reduced market liquidity, in part due to a withdrawal of central bank stimulus will see increased volatility in markets. All of these factors leave us cautiously positioned until we have further clarity on these developments.

However, we do acknowledge strong corporate fundamentals remain, with healthy balance sheets, positive earnings growth and low high yield default rates.

On balance, the uncertainty and less attractive risk-return trade-off warrants a neutral stance for now. We believe investment grade securities should outperform high yield issuers in this environment.

Australian Property

Pendal Property Securities Fund

Market review

The A-REIT sector generated a total return of 10% for the June 2018 quarter, outperforming the broader market which rose by +8.4%. Globally REITs returned 5.5% for the quarter (in US$), with US REITs (+10.2%) the best performers and Singapore (-9%) the worst performer.

The best performing A-REIT over the quarter was Investa Office Fund (+23.7%), with performance driven by Blackstone making a cash offer of $5.15/security and very strong asset revaluations across its portfolio (+7.9%). Other performers were Charter Hall Group (+16.6%) and Goodman Group (+15.8%). Underperformers over the quarter included Stockland Trust Group (+1.9%) and Mirvac Group (+3.7%) on the back of falling house prices and tightening bank credit.

It was a solid quarter for equity markets, with the S&P500 up 3%. The US Federal Reserve lifted rates over the quarter, with the Fed Fund rate now 1.75%-2.00%. The US 10-year Bond yield ticked up 13bp to close at 2.86%; however, the US yield curve flattened, with the short end up 26bp to 2.52%. The US unemployment rate fell to 3.8%, the lowest level since December 1969, and average hourly earnings rose by 2.7% over the year. The Reserve Bank of Australia left the cash rate unchanged at 1.5% over the quarter. The ABS National House Price Index fell -0.8%, falling across Australia for the first time since September 2012. A combination of tighter credit as a result of banks enforcing current guidelines along with muted sentiment towards the sector is likely to see further weakness in 2018. Total private sector credit growth was just 0.2% in May, with investor credit growth at 2%, a fresh low for this series. The unemployment rate dropped 0.2% to 5.4%, while the 10-year bond yield was up 4bp over the quarter to close at 2.63%. The Australian dollar was down 2.8c against the US dollar, to close at 74c.

It was a busy quarter for A-REITs. Investa Office Fund received a takeover offer from Blackstone, offering $5.25 per security in cash (including the distribution for June 18) which was a 4% premium to net tangible assets (NTA) and 13% premium to the previous closing price. The Board of the responsible entity has declared their intention to support the bid, subject to an independent expert's report and in the absence of a higher offer. Also during the quarter, Westfield security holders voted in favour of the Unibail Rodamco takeover and OneMarket demerger. During the month, manufactured housing group, Gateway Lifestyle, received takeover offers from both Brookfield and Hometown America.

Portfolio performance

The Pendal Property Securities Fund (formerly the BT Wholesale Property Securities Fund) returned 9.58% for the June quarter (post-fee, pre-tax), underperforming its benchmark by 0.24%.

Overweight positions in Investa Office Fund, Charter Hall Group, Goodman Group, Lifestyle Communities and Charter Hall Long WALE assisted performance. An underweight position in Scentre Group and overweight positions in Westfield Corporation, Mirvac Group, Arena REIT and Rural Funds Group detracted from performance.

Strategy and outlook

The AREIT sector is now priced on an FY19 dividend yield of 5.2%, a PE ratio of 17.0 times, well ahead of its 27 year average of 13.4x, but in line with its long term average relative to Industrials (0.97x). Office and industrial cap rates will likely compress further in the next reporting period (on the back of recent transaction evidence), but asset valuation uplift thereafter will depend on income growth and tenancy retention. We expect to see cap rates soften for retail assets, especially lower quality malls in the next 6-12 months. Balance sheets are stable with sector gearing at 27%.

International Property

Pendal Global Property Securities Fund

Market review (in US$)

For the June quarter, performance of the global property securities market (on an ex-Australia basis) as measured by the FTSE EPRA/NAREIT Developed Index was strong, with a return of 5.4%. North America (+9.8%) was the strongest performing region, followed by Europe (+0.3%), while Asia Pacific (-0.8%) was a negative performer. In Asia Pacific, results were mixed across the region. Singapore (-9.0%) and New Zealand (-3.1%) were negative performers, while Japan (+0.5%) and Hong Kong (+0.2%) were positive performers. Results in Europe were mixed as well. Israel (+6.1%) was the strongest performer, followed by Italy (+3.8%) and Germany (+2.6%). Conversely, notable negative performers within the region included Ireland (-4.6%), Spain (-2.4%), and the United Kingdom (-1.2%). Within North America, the US and Canada returned 10.2% and 2.0%, respectively.

Portfolio performance

The Pendal Global Property Securities Fund (formerly the BT Wholesale Global Property Securities Fund) returned 7.42% for the June quarter (post-fee, pre-tax), outperforming the benchmark by 0.26%.

North America

The North America portfolio returned 9.93% (before fees and taxes), outpacing the FTSE EPRA/NAREIT North America Index by 13 basis points. Outperformance relative to the benchmark was driven by positive stock selection results, which were partially offset by negative sector allocation results. In terms of stock selection, results were strongest in the diversified, triple net lease, and regional mall sectors and were weakest in the office, industrial, and health care sectors. Regarding sector allocation, negative results were attributable to the portfolio's underweight to the outperforming health care and triple net lease sectors, as well as an overweight to the underperforming data center sector. Moreover, the portfolio's small cash position was also a detractor from relative performance, given the regional benchmark's positive absolute performance for the quarter. Among the portfolio's holdings, top individual contributors to relative performance included an overweight position in the outperforming Gramercy Property Trust (GPT), and a lack of exposure to the underperforming Essex Property Trust (ESS) and GGP, Inc. (GGP). Detractors most notably included overweight positions in the underperforming Boston Properties (BXP) and Healthcare Trust of America Class A (HTA), and an underweight position in the outperforming Ventas (VTR).

Europe

The European portfolio returned 1.05% (before fees and taxes), exceeding the FTSE EPRA/NAREIT Developed Europe Index by 79 basis points. Outperformance relative to the benchmark was attributable to positive stock selection results, which were partially offset by negative country allocation results. In terms of stock selection, results were strongest in Sweden, the United Kingdom, and Netherlands and were weakest in Germany, Ireland and France. Regarding country allocation, negative results were driven by the portfolio's lack of exposure to the outperforming Belgium as well as an overweight to the underperforming France and Spain. The portfolio's small cash position was also a notable detractor to relative performance given the regional benchmark's positive absolute performance for the quarter. Conversely, the portfolio's overweight to the outperforming Sweden and Norway, as well as an underweight to the underperforming Switzerland, were notable contributors to relative performance. Among the portfolio's holdings, top positive contributors to relative performance included overweight positions in the outperforming Fabege AB (Sweden) and Segro PLC (United Kingdom), and a lack of exposure to the underperforming Intu Properties PLC (United Kingdom). Detractors most notably included a lack of exposure to the outperforming Aroundtown SA (Germany), Grand City Properties SA (Germany), and Tag Immobilien AG (Germany).

Asia

The Asia portfolio returned -0.48% (before fees and taxes), outperforming the regional EPRA benchmark by 32 basis points. Outperformance relative to the benchmark was attributable to positive stock selection results in Hong Kong and, to a lesser extent, Singapore and Japan. Country allocation results were mostly neutral. Among the portfolio's holdings, top contributors to relative performance included a lack of exposure to the underperforming City Developments (Singapore) and Hang Lung Properties (Hong Kong), and an overweight position in the outperforming Link REIT (Hong Kong). Detractors most notably included overweight positions in the underperforming UOL Group (Singapore) and NTT Urban Development (Japan), and a lack of exposure to the outperforming Swire Properties (Hong Kong).

Active Balanced

Pendal Active Balanced Fund

Markets review

The S&P/ASX 300 Accumulation Index finished the June quarter with a gain of 8.4%, closing the financial year with a 13.2% return. Earnings growth has powered these gains, as the Royal Commission and a challenging environment has seen the banks de-rate, keeping the market's aggregate valuation rating steady. This is important, as ultimately we see earnings-driven market growth as more sustainable than valuation-driven returns. All of the GICS sectors, except for Telecommunication Services (-13.3%) finished the quarter higher. In particular, most managed to record double-digit gains, including Energy (19.8%), Health Care (+15.9%), Consumer Staples (+12.0%), Materials (+11.4%), Information Technology (+11.0%), Consumer Discretionary (+10.6%) and Real Estate (+10.0%).

During the June quarter, global equity markets were heavily influenced by geopolitical influences which obscured the more fundamental drivers of performance. The US-instigated trade policy moves were primarily targeted towards China but also encountered Canada, Australia and Europe, which served to provide uncertainty on the impact on multi-national corporations. Amid trade tensions and political brinkmanship, commodity markets proved more buoyant. Crude oil prices moved to their highest level since 2014 to advance above US$80 at their peak. Despite trade war fears and consternation over central bank policy direction, most major share markets advanced for the quarter, while a weaker Australian dollar translated to a 5.5% gain in the MSCI World (A$) Index.

US stocks advanced during the quarter, despite the market's preoccupation with trade tensions. However, there was considerable dispersion across industry sectors. Momentum moved in favour of trade-related and growth oriented sectors, with Energy the standout performer. Consumer Staples lagged on concerns that a stronger US dollar would impact profitability, with many of the major operators having businesses outside of the US. Expectations of higher interest rates also weighed on the sector while US economic data continued to paint a picture of strength. The market closed the June quarter with the S&P500 delivering a total return of 3.4%, while the NASDAQ rallied with a return of 6.3%.

The performance of European equity markets saw considerable dispersion through the quarter, with many Nordic markets setting the pace while others like Italy (-2.4%), Germany (+1.2%) and Spain (+0.7%) generally lagged. Economic data pointed to a mixed outlook. Headline inflation for the region edged up to 2%, driven by higher food and energy prices, although core inflation was subdued at 1%. A rise in the eurozone Purchasing Managers' Index (PMI) from 54.1 to 54.8 was above expectations; however, consumer sentiment and retail sales indicators in some key markets were somewhat disappointing. For the quarter, the UK (+8.2%) was a standout performer, alongside Finland (+6.8%) and France (+4.9%) which were in contrast to the weakness in some other markets.

Most Asian equity markets ended the quarter lower, given the expectation that emerging markets are net losers in a trade war between the US and China. Concerns over China's growth more generally, acted to weaken regional markets. During June, the People's Bank of China announced a reserve ratio cut of 0.50% (the reserve ratio is the portion of depositors' balances that banks must have on hand as cash) to generate liquidity and support growth, which reflected some concerns over the growth trajectory. The region's weakness was reflected in the returns for Thailand (-10.2%), Malaysia (-9.2%), Hong Kong (-3.8%) and Singapore (-4.7%), while Japan (+4.0%) traded into positive territory after assistance from a weaker yen.

The Australian dollar declined by 3.6% against the US dollar but rose against the euro (+1.6%), the British pound (+2.3%) and the Japanese yen (+0.5%).

Australian bond yields finished the quarter relatively unchanged. After increasing earlier in the quarter on improving broader risk sentiment, concerns over geopolitics caused a retracement lower in late May and June. These worries included Italian political turmoil and escalating trade tensions. Meanwhile, the Reserve Bank of Australia (RBA) left rates unchanged through the period and made few changes to its statement. The board did however highlight some of the aforementioned geopolitical factors as well an easing in the Sydney and Melbourne housing markets. Local data was relatively mixed over the period. First quarter GDP rose a healthy 1.0% while the trimmed mean measure of CPI printed at 0.5% over the same period, as did quarterly wage growth. Leading indicators like business conditions and consumer confidence were reasonably constructive. Other noteworthy local developments included the third round of the banking Royal Commission. Finally in terms of market movements, the 3-year yield fell 4bps to 2.07% while the 10-year yield rose a marginal 3bps to 2.64%. Meanwhile, three month BBSW rose 8bps to 2.11% and importantly, its spread versus OIS widened further, causing some concern over local funding costs.

Global bond yields finished the quarter higher overall. After increasing in the first half of the period on improving broader risk sentiment, concerns over geopolitics drove a retracement lower in late May and June. These worries included Italian political turmoil and escalating trade tensions. On the former, an unexpected coalition between two Italian populist parties saw intentions for anti-euro policies announced, which spooked investors. However, sentiment improved at the end of May as the proposed measures were abandoned and a less euro-skeptic finance minister was appointed. Turning to the US, the Federal Reserve hiked rates by 0.25% and issued a more hawkish rate outlook. Data was relatively healthy over the period and annual core CPI increased to 2.0%. Meanwhile in Europe, the European Central Bank (ECB) announced it would end its quantitative easing program in December this year, but keep rates at their current levels until at least the European summer 2019. This in turn was perceived as a dovish message from the central bank. Beyond developed markets, several emerging economies endured significant issues over the quarter, including Turkey, Brazil and Argentina that added to investor worries. Finally turning to market movements, the US 2-year yield and 10-year yield rose 26bps and 12bps to 2.53% and 2.86%, respectively.

Portfolio performance

The Pendal Active Balanced Fund (formerly the BT Wholesale Active Balanced Fund) returned 3.70% (post-fee, pre-tax) for the June quarter, underperforming its benchmark by 0.84%.

The Fund delivered a positive return over the June quarter, supported by exposure to Australian and offshore equity and listed property markets. Global and Australian fixed income markets also generated positive, albeit modest returns which contributed to performance. Exposure to alternatives detracted from returns this quarter. At a Fund level, the contribution to performance was primarily driven by asset allocation outcomes, while manager contribution detracted value across a select number of strategies.

The contribution from tactical asset allocation was largely driven by the Fund's overweight exposure to Australian equities and listed property as well as underweight positioning in fixed income.

The key factors influencing the alpha generated through active management returns were stock selection outcomes within Australian equities. Within the Australian equity strategy, overweight positions in BHP, Santos and Aristocrat and an underweight in NAB. These contributions were mitigated by overweight positions in Metcash, Telstra, JB Hi-fi and AMP.

Within the global equities portfolio, the concentrated portfolio outperformed while the Core portfolio fell short of the benchmark but positively contributed to overall returns.

Our Alternatives core portfolio detracted from returns this quarter, with four of the eight sub-strategies within the core portfolio delivering negative returns, which more than offset the positive impact of the remaining four sub-strategies. The Alternatives strategy delivered a total return (before fees) of -2.06% versus a cash return of 0.49%.

The event driven, global macro and relative value strategies made positive contributions this quarter. These were more than offset by detractions from the equity market neutral, dedicated short bias and long-short equity strategies which were hampered by weak equity market trends.

In relation to our tactical positioning within the Alternatives component of the Fund, positioning in each sub-segment contributed to performance. Our long position in equity market futures added value, together with positioning in Australian and US bonds. Long positions in gold and copper detracted from returns, however our short volatility and long oil positions generated value. At the end of the period we added long positions in German equities and Australian bonds, and moved to a short on US bonds.

Strategy and outlook

Asset market valuations are not a material source of concern, however the degree to which these are being complicated by more esoteric forces like global trade and political brinkmanship give rise to factors which can distort underlying fundamentals. At the same time, uncertainties such as these can lead to temporary bouts of volatility and greater dispersion between the performance of different asset classes, sectors, industries and companies. This is a very fertile ground for investors to take active, research based decisions on where and how to allocate capital.

While some challenges may persist due to imbalances across markets to warrant a degree of caution, Pendal continues to apply its multi-faceted approach to generating additional returns on these investments and managing risks. This encompasses both short term and medium term considerations as well as being cognisant of structural and cyclical drivers. We have recently taken advantage of such changes to asset allocation which have been supported by our modelling. By managing our relative exposures to growth and defensive assets and maintaining a material allocation to the diversifying properties of Alternatives, we can demonstrate that opportunities do exist when employing a dynamic approach to allocating capital.

Investors can expect to see some refinements in asset allocation as we actively position the Fund to meet its longer term targeted outcomes, while retaining the ability to take advantage of active allocation opportunities as they arise.

Performance as at 30 June 2018

(%)	1 Month	3 Months	6 Months	FYTD	1 year (pa)	2 Years (pa)	3 Years (pa)	5 Years (pa)	Since Incp. (pa)
Australian Shares - All Cap									
Pendal Australian Share Fund									APIR - RFA0818AU
Total Return (post-fee, pre-tax)	2.08	6.99	4.81	14.83	14.83	15.30	9.16	10.67	10.09
Total Return (pre-fee, pre-tax)	2.15	7.20	5.22	15.76	15.76	16.22	10.02	11.55	11.09
Benchmark	3.19	8.36	4.27	13.24	13.24	13.53	9.14	9.99	10.02
Pendal Imputation Fund									APIR - RFA0103AU
Total Return (post-fee, pre-tax)	3.04	8.53	5.61	13.50	13.50	14.30	7.88	9.13	9.66
Total Return (pre-fee, pre-tax)	3.12	8.77	6.08	14.52	14.52	15.32	8.85	10.11	10.68
Benchmark	3.19	8.36	4.27	13.24	13.24	13.53	9.14	9.99	8.82
Pendal Focus Australian Share Fund									APIR - RFA0059AU
Total Return (post-fee, pre-tax)	2.06	7.01	5.96	15.91	15.91	17.67	11.18	12.74	9.56
Total Return (pre-fee, pre-tax)	1.97	6.96	6.62	17.22	17.22	19.14	12.39	13.88	10.68
Benchmark	3.19	8.36	4.27	13.24	13.24	13.53	9.14	9.99	7.68
Pendal Ethical Share Fund									APIR - RFA0025AU
Total Return (post-fee, pre-tax)	2.18	6.32	3.93	13.92	13.92	14.89	8.97	10.80	8.71
Total Return (pre-fee, pre-tax)	2.26	6.57	4.42	15.00	15.00	15.98	10.01	11.85	9.77
Benchmark	3.19	8.36	4.27	13.24	13.24	13.53	9.14	9.99	8.21
Australian Shares - Mid Cap									
Pendal MidCap Fund									APIR - BTA0313AU
Total Return (post-fee, pre-tax)	1.05	5.59	6.13	23.19	23.19	19.66	17.32	17.62	11.17
Total Return (pre-fee, pre-tax)	1.05	5.62	7.25	25.25	25.25	21.20	18.70	19.30	13.43
Benchmark	1.78	6.34	3.48	17.70	17.70	16.35	16.35	15.36	6.24
Australian Shares - Small Cap									
Pendal Smaller Companies Fund									APIR - RFA0819AU
Total Return (post-fee, pre-tax)	-0.36	6.00	7.79	25.16	25.16	14.93	14.94	13.41	13.44
Total Return (pre-fee, pre-tax)	-0.26	6.34	8.46	26.73	26.73	16.36	16.38	14.83	14.74
Benchmark	1.06	7.67	4.67	24.25	24.25	15.31	15.01	11.56	7.99
Australian Shares - Micro Cap									
Pendal MicroCap Opportunities Fund									APIR - RFA0061AU
Total Return (post-fee, pre-tax)	1.05	3.15	0.84	19.76	19.76	17.56	18.44	21.50	18.55
Total Return (pre-fee, pre-tax)	1.15	3.46	1.44	21.22	21.22	20.07	21.01	25.71	23.74
Benchmark	1.06	7.67	4.67	24.25	24.25	15.31	15.01	11.56	3.60
International Shares									
Pendal Core Global Share Fund									APIR - RFA0821AU
Total Return (post-fee, pre-tax)	0.88	3.40	4.42	13.95	13.95	14.93	8.67	14.20	5.92
Total Return (pre-fee, pre-tax)	0.95	3.64	4.91	15.04	15.04	16.02	9.70	15.29	7.08
Benchmark	2.33	5.53	6.37	15.39	15.39	15.06	9.95	14.91	7.41
Pendal Global Emerging Markets Opportunities Fund - WS									APIR - BTA0419AU
Total Return (post-fee, pre-tax)	-0.36	0.73	-0.12	12.25	12.25	16.59	7.12	11.68	11.33
Total Return (pre-fee, pre-tax)	-0.25	1.09	0.59	13.81	13.81	18.21	8.62	13.37	13.54
Benchmark	-1.85	-4.45	-1.19	12.33	12.33	16.16	7.00	9.61	10.57
Pendal Concentrated Global Share Fund									APIR - BTA0503AU
Total Return (post-fee, pre-tax)	2.53	4.66	7.21	17.27	17.27	N/A	N/A	N/A	16.65
Total Return (pre-fee, pre-tax)	2.61	4.89	7.75	18.60	18.60	N/A	N/A	N/A	18.03
Benchmark	2.33	5.53	6.37	15.39	15.39	N/A	N/A	N/A	14.60
Property									
Pendal Property Securities Fund									APIR - BTA0061AU
Total Return (post-fee, pre-tax)	2.18	9.58	2.39	12.11	12.11	3.33	9.75	11.73	7.58
Total Return (pre-fee, pre-tax)	2.24	9.75	2.71	12.84	12.84	4.01	10.46	12.46	8.39
Benchmark	2.27	9.82	3.02	13.20	13.20	3.35	9.99	12.18	7.47
Pendal Global Property Securities Fund									APIR - RFA0051AU
Total Return (post-fee, pre-tax)	2.32	7.42	1.84	6.74	6.74	4.63	6.65	8.92	9.26
Total Return (pre-fee, pre-tax)	2.38	7.65	2.30	7.72	7.72	5.59	7.63	9.93	10.25
Benchmark	2.04	7.16	1.55	6.09	6.09	4.45	6.78	9.15	8.97
Fixed Interest									
Pendal Fixed Interest Fund									APIR - RFA0813AU
Total Return (post-fee, pre-tax)	0.78	1.45	2.44	3.39	3.39	1.24	2.90	4.12	6.41
Total Return (pre-fee, pre-tax)	0.83	1.58	2.69	3.91	3.91	1.74	3.42	4.64	6.96
Benchmark	0.48	0.82	1.69	3.09	3.09	1.66	3.41	4.38	6.61
Pendal Global Fixed Interest Fund									APIR - RFA0032AU
Total Return (post-fee, pre-tax)	0.72	0.60	0.91	1.85	1.85	-0.28	2.92	4.36	5.98
Total Return (pre-fee, pre-tax)	0.76	0.73	1.18	2.39	2.39	0.25	3.46	4.91	6.56
Benchmark	0.31	0.17	0.60	2.11	2.11	0.39	3.83	4.97	6.86
Pendal Enhanced Credit Fund									APIR - RFA0100AU
Total Return (post-fee, pre-tax)	0.30	0.62	1.41	3.34	3.34	2.77	3.60	4.54	5.71
Total Return (pre-fee, pre-tax)	0.34	0.73	1.64	3.80	3.80	3.24	4.06	5.01	6.24
Benchmark	0.36	0.77	1.50	3.36	3.36	2.76	3.66	4.54	5.82
Cash & Income									
Pendal Enhanced Cash Fund									APIR - WFS0377AU
Total Return (post-fee, pre-tax)	0.17	0.53	1.10	2.70	2.70	2.88	2.67	2.88	4.92
Total Return (pre-fee, pre-tax)	0.19	0.59	1.23	2.96	2.96	3.13	2.92	3.14	5.26
Benchmark	0.15	0.49	0.92	1.78	1.78	1.80	1.95	2.22	4.86
Pendal Managed Cash Fund									APIR - WFS0245AU
Total Return (post-fee, pre-tax)	0.15	0.45	0.89	1.79	1.79	1.83	1.96	2.20	6.42
Total Return (pre-fee, pre-tax)	0.17	0.51	1.00	2.01	2.01	2.05	2.18	2.43	6.72
Benchmark	0.15	0.49	0.92	1.78	1.78	1.80	1.95	2.22	6.50
Pendal Monthly Income Plus Fund									APIR - BTA0318AU
Total Return (post-fee, pre-tax)	0.52	1.14	1.19	5.03	5.03	4.09	4.25	4.91	5.49
Total Return (pre-fee, pre-tax)	0.58	1.31	1.52	5.72	5.72	4.77	4.93	5.59	6.16
Benchmark	0.12	0.37	0.75	1.51	1.51	1.52	1.68	1.99	2.90
Diversified									
Pendal Active Balanced Fund									APIR - RFA0815AU
Total Return (post-fee, pre-tax)	0.68	3.70	2.07	9.85	9.85	9.62	6.91	8.86	7.70
Total Return (pre-fee, pre-tax)	0.75	3.95	2.55	10.90	10.90	10.66	7.92	9.89	8.78
Benchmark	1.65	4.54	3.23	9.68	9.68	9.19	7.45	8.79	7.54

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PENDAL

All returns are calculated by Pendal Fund Services Limited ABN 13 161 249 332, AFSL No: 431426 (PFSL, Pendal). No part of this Fund Manager Commentary (Commentary) is to be circulated without this page attached.

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Pendal is the issuer of the following products:

Pendal Australian Share Fund ARSN 089 935 964

Pendal Smaller Companies Fund ARSN 089 939 328

Pendal Concentrated Global Share Fund ARSN 613 608 085

Pendal Core Global Share Fund ARSN 089 938 492 #

Pendal Global Fixed Interest Fund ARSN 099 567 558

Pendal Enhanced Credit Fund ARSN 089 937 815

Pendal Fixed Interest Fund ARSN 089 939 542

Pendal Property Securities Fund ARSN 089 939 819

Pendal Global Property Securities Fund ARSN 108 227 005

Pendal Managed Cash Fund ARSN 088 832 491

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Pendal Active Balanced Fund ARSN 088 251 496

A product disclosure statement (PDS) is available for each of the above products and can be obtained by contacting Pendal on 1800 813 886, or by visiting www.pendalgroup.com. You should consider the relevant PDS in deciding whether to acquire, or to continue to hold, the product.

AQR began managing international equity for BT Financial Group in June 2006.