

# Fund Manager Commentary

Month ended 31 October 2018

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# Australian Shares

## Pendal Australian Share Fund

### Market Review

The domestic equity market, as measured by the S&P/ASX 300 Accumulation Index, pulled back 6.2% in October, registering the worst monthly performance since August 2015. The Index was down by 10.3% from its August high at one point, before paring some of the losses. Both Resources (-6.5%) and Industrials (-6.1%) finished the month in the red. The swift spike in volatility came on the back of several factors, including fears of overly-aggressive tightening from the US Federal Reserve (Fed), fear of deteriorating US-China trade and signs of higher input costs, particularly in the US. That said, whilst we have seen a valuation de-rating - the S&P/ASX 300 has fallen from 15.5x next-12-month (NTM) price/earnings (P/E) to around 14x - we have not seen a material shift in earnings expectations.

In regard to sector performance, traditional growth stock-related sectors bore the brunt of the pullback as market sentiment returned to a risk-off mode during the month. Information Technology (-11.4%), Consumer Discretionary (-8.3%) and Health Care (-7.3%) all reside within that group. In contrast, defensive sectors such as Real Estate (-3.8%) and Consumer Staples (-4.9%) outperformed the headline index, despite posting overall losses.

Looking closer at the sectors, index heavyweight Financials (-6.0%) fared slightly better than the benchmark. The big four banks saw some divergence in performance during October, with Commonwealth Bank (CBA, -3.1%) and Westpac (WBC, -3.9%) contributing to the sector's outperformance, whereas ANZ (ANZ, -8.0%) and National Australia Bank (NAB, -9.3%) detracted. Both ANZ and NAB updated the market on costs relating to consumer remediation in response to the Royal Commission's recent probe into the industry. ANZ was also the first of the banking fraternity to release its full year results. Its results showed the bank continuing to lead on cost reduction, and beat consensus on expenses. ANZ's tier-1 Capital Ratio (CET1) increased to 11.4% on the back of contained risk-weighted-asset growth. Meanwhile, CBA announced the sale of its asset management business, CFS Global Asset Management to Mitsubishi UFJ Trust & Banking Corporation of Japan for A\$4.13 billion. The transaction is expected to be completed by mid-2019 and result in an approximate 60 basis points (bp) uplift on CBA's pro forma FY18 CET1 ratio. Lastly, the beleaguered AMP (AMP, -22.6%) experienced another decline this month. Whilst its ongoing cash outflows remain a drag on investor sentiment, it was the company's sale of the wealth protection and mature businesses that dominated the headlines this month. Despite management's claim that these sales would help the company to become a cleaner business, the market questioned the underwhelming sale price shareholders will receive from the transactions.

Outside of Financials, miners (-5.0%) also generally declined over the month, but were able to outperform the broad market index. Base metals such as Copper (-5.2%) retreated amid concerns around global growth, while the same jitters propelled the price of gold (+1.6%) as investors rotated into the safe-haven asset. As a result, gold miners including Newcrest Mining (NCM, +6.2%) and Evolution Mining (EVN, +12.5%) finished the month higher, whereas diversified miners such as BHP Billiton (BHP, -7.0%), South 32 (S32, -7.7%) and Rio Tinto (RIO, -3.0%) all recorded losses. Fortescue Metals (FMG, +2.0%) was the standout amongst its peers as investors took a positive read of the company's first quarter-2019 update. Shipment volumes were reported to be weaker than expected due to inventories built over the quarter, although there was an improvement in pricing. Management also maintained guidance for FY19.

Finally, the Federal Government announced it will adopt a number of the recommendations coming out of the retail electricity price inquiry recently conducted by the ACCC. Specifically, the Government will develop a maximum price for the default market offer to apply from July next year

for customers not subject to state-based price regulation. It will also develop a mechanism for determining a reference bill amount for each network distribution region, from which headline discounts can be calculated. This weighed on earnings outlook for domestic energy retailers, AGL (AGL, -7.7%) and Origin Energy (ORG, -11.7%).

## Portfolio performance

The Pental Australian Share Fund (formerly the BT Wholesale Core Australian Share Fund) returned -6.88% (post-fee, pre-tax) in October, underperforming its benchmark by 0.72%.

### *Contributors*

#### Overweight Ramsay Health Care

Private hospital operator Ramsay Health Care (RHC, +2.3%) bucked the trend within Healthcare (-7.2%) over the month. The stock has been under some pressure lately due to a confluence of weak volumes within its UK operations as well as benign operating conditions in Australia due to the deteriorating affordability of private health insurance. As these cyclical headwinds are priced in, the market started to refocus on the business' growth profile. RHC made an acquisition offer to Capio AB, a pan-European health service provider, in July. RHC increased its bid for the business in October and received a 96% shareholder acceptance rate. The deal will help RHC boost its European footprint.

#### Underweight National Australia Bank

Banks (-5.7%) fared marginally better than the headline index over the month, largely helped by Commonwealth Bank (CBA, -3.1%) and Westpac (WBC, -3.9%). The sector's earnings outlook remains bleak, given the somewhat benign domestic mortgage market growth rate. Investors are also holding back due to uncertainties around the final report from the Royal Commission, due for release in February next year. NAB (NAB, -9.4%) announced its second-half customer remediation charge of \$314m (after-tax), ahead of their full year results release in early November. NAB still has the highest dividend payout ratio amongst the big four and we remain sceptical of its sustainability.

#### Woodside Petroleum - not held

The crude oil price retreated from its multi-year highs in October, with the West Texas Intermediate (WTI) price finishing the month 10.8% lower at US\$65.3/bbl. Both Saudi Arabia and Russia have reportedly agreed to increase production volume, while the US Government also encouraged the OPEC pact to increase their production rate. This weighed on Woodside Petroleum (WPL, -9.7%). In addition, WPL released its third-quarter results which failed to impress the market. Production reached a record-high for almost two years, although weaker than expected sales volumes dragged on headline revenues. We do not own WPL and Santos (STO, -8.5%) remains our preferred exposure to the Energy sector.

#### Overweight Amcor

Paper packaging company Amcor (AMC, -2.8%) outperformed the market in October, as defensive names generally attracted attention during the market pullback. In addition, AMC's latest acquisition target, Bemis, reported its third quarter results which were in line with expectations. As communicated previously, we believe the acquisition makes strategic sense, given Bemis is focused on producing flexibles packaging products in North America, which complements AMC's existing position in the 'rigids' packaging market and provides potential synergies for the latter's flexibles business in Europe. AMC management have a good track record in acquisition integration and in extracting synergies. Despite the somewhat high valuation paid for this acquisition, our underlying thesis in AMC remains intact. We expect an improvement in some of the short-term

factors which were concerning the market, such as higher input prices and softer demand in the US and Latin America.

### ***Detractors***

#### **Overweight CYBG**

British Bank CYBG (CYB, -18.0%), which spun out of National Australian Bank (NAB), pulled back in October. It is now trading at a 9.0x next twelve-months (NTM) price/earnings (P/E) multiple, which may suggest the company is being valued by UK banking analysts alongside its larger peers which all trade on a single-digit P/E multiples as the mid-tier bank is gaining coverage. We believe it deserves to trade at a premium given superior growth prospects, backed by synergies from its recent merger with Virgin Money. In our view, the other more relevant risk is related to Brexit, given that a UK recession could provide a headwind to growth via both bad debts and a lower outlook for interest rates. Like the frictions between China and the US, there is likely to be further noise and volatility as the UK and EU try to hammer out a post-Brexit agreement. We think the bear case of no deal and a recession is unlikely, although it cannot be discounted. Under any other scenario, we think CYB is attractive at these levels. The recent announcement that it has been granted advanced accreditation will also free up significant capital from its balance sheet. We therefore uphold our conviction in CYB.

#### **Woolworths - not held**

Woolworths (WOW, +1.2%) finished the month in positive territory, as the relatively defensive nature of the Consumer Staples (-4.9%) sector attracted renewed investor attention. In addition, Wesfarmers (WES, -6.5%)—the parent company of WOW's key rival Coles—released its first quarter sales results. Food price-inflation of 0.6% was the first positive print for the category since 2011 which also supported sentiment towards WOW. Within the food and beverage retailing market we prefer Metcash (MTS), as the company is most leveraged to a rise in food price inflation.

#### **Overweight AMP**

The recently beleaguered AMP (AMP, -22.6%) experienced further weakness this month. Management announced the sale of its life insurance and mature business divisions, a move which the market had been looking for to unlock shareholder value. However, the market was very disappointed with the price and a lack of clarity in the messaging around an admittedly complex deal. The price for the mature business looks reasonable; however, there is a sense that management have rushed the sale of the life insurance business which has deteriorated in recent halves. The disappointing price, in tandem with some uncertainties over the impact on earnings and additional costs from the sale that were not well explained by management took a heavy toll on the share price. There is no doubt the deal destroys value for shareholders. Our analysis suggests this to be in the order of 12%, with the rest of the share price fall reflecting broader market weakness and the ambiguity arising from poor communication around the deal. The deal does provide a cleaner, simpler company for the new CEO, although the deal presents considerable uncertainty for shareholders in terms of his likely strategy for turning around the business and the use of proceeds from asset sales.

#### **Overweight Nine Entertainment**

Nine Entertainment (NEC, -25.2%), alongside Fairfax Media (FXJ) and Domain (DHG) updated the market during the month, ahead of their formal merger proceedings. This was not well received by an already jittery market. NEC's update was relatively benign. Market-wide advertising was slightly weaker than expected, in part due to flagging viewership at Channel Ten, while NEC continues to take market share and management reiterated their expected guidance range for FY19. However, it was DHG—majority owned by FXJ—which concerned investors after the company revealed weaker than expected listings, particularly in its traditional heartland of Sydney's Inner West. In our view, NEC's fall looks less rational, given DHG will only account for one-third of the combined

group. As stated previously, we believe the merger makes strategic sense given cost synergies and a more diversified business mix, which will leave the combined group less beholden to traditional media. With NEC's valuation now back to 8.2x next 12-months P/E, we think this is an over-reaction that could provide a buying opportunity. We continue to hold our conviction in NEC.

## Strategy and outlook

At this point last month's weakness looks like the market letting off some steam, rather than the early stages of a more sustained, recession-driven bear market. The volatility was confined to equities, with little movement in corporate credit spreads which suggests that there was no broader deterioration in business conditions. The underlying economic picture also remains benign, particularly in the US where—apart from a softer patch in housing activity—data indicates momentum remains strong.

Growth stocks were among the worst performers through the month. Given the starting valuation was extreme for many of these, we do not consider the correction as an opportunity to broadly 'buy the market'. Valuations for many of the growth stocks still remain well above their long-term averages. However, we have taken the opportunity to add to individual stocks which we considered to be oversold during the month. Examples include Nine Entertainment, where an over-reaction to a poorly received trading update from Domain (DHG)—which will become a partial subsidiary—was a large driver of the Fund's underperformance. We also added to CSL, which is among our preferred growth stocks. Although the stock is trading on a higher valuation than its historical average, in our view the valuation is justified by the visibility and strength of its earnings trajectory.

We remain relatively cautious on resources, which also came under pressure on concerns over the related issues of global demand and US-China trade frictions. With the US mid-term elections out of the way, we think the Trump administration will continue to apply pressure on trade, particularly as it appears to be one of the few areas that enjoys bipartisan domestic support. This is likely to provide a persistent headwind for sentiment towards resource stocks. However, it is important to remember that the miners remain in good shape fundamentally. They continue to generate strong cash flow and remain disciplined in its use, as demonstrated by BHP's buyback and special dividend resulting from the proceeds of its US shale asset sale. The weak Australian dollar is also helping to offset some of the geopolitical pressure. China's authorities continue to indicate release of further stimulus for the economy in response to economic deceleration, which could lead to a buying opportunity for mining stocks, but at the current time we retain a relatively modest position.

We retain a large active position in Qantas (QAN), which has underperformed since the release of its earnings result on fears over increased fuel costs and more recently, on broader concerns over global demand. We believe the market is too pessimistic on QAN's outlook. A relatively tight domestic airline market is allowing QAN to reduce discounting on tickets which, in combination with improved performance from their international division, should see revenue growth offset higher fuel costs. Other key overweights include Santos (STO), Amcor (AMC) and Metcash (MTS).

## Pendal Smaller Companies Fund

### Market review

The S&P/ASX Small Ordinaries Accumulation Index lost 9.6% amid the market pull back in October, underperforming its large cap counterpart by 3.4%. Small Resources (-6.1%) outperformed Small Industrials (-10.6%). A key driver of the latter's underperformance came from some of the growth stocks which had run particularly hard over the year and through the reporting season. These bore the brunt of the sell-off in October. Afterpay Touch (APT, -30.4%), Wisetech (WTC, -27.3%) and Appen (APX, -23.8%) were clear examples of this. Investor sentiment towards APT in particular was also negatively impacted by ASIC's probe into the buy-now pay-later sector. A detailed report on the non-bank consumer lending space is expected to be released in December this year. Offsetting some of these losses, accounting software provider, MYOB (MYO, +13.7%), saw its share price rise after receiving a non-binding cash acquisition offer from private equity firm, KKR. It valued MYO at A\$3.70 a share, representing a 24% premium to the company's prevailing share price. Overall, Information Technology (-16.2%) finished the month as the worst performing sector.

On the contrary, Gold (+1.6%) received some buying support over the month, reflective of its safe-haven asset status. This supported performance of the gold miners: St Barbara (SBM, +19.2%), Regis Resources (RRL, +13.4%) and Saracen Mineral (SAR, +31.4%) all recorded double-digit gains amid a declining market. All three miners also updated the market with their September quarter production results, with SAR being the standout. The small miner reached a record quarterly production during its third quarter, although guidance for the full financial year was maintained. Outside of the gold miners, mining companies generally retreated as base metals such as Copper (-5.2%) saw price declines on concerns around global growth. That said, rare earth miner, Lynas (LYC, +30.4%) was a positive highlight. Its share price swung back strongly after the company was granted an extension to its permit for the temporary storage of waste at its Malaysian plant until February next year.

Elsewhere, a declining oil price over the month weighed on the Energy (-11.3%) sector's performance. The crude oil price retreated from its multi-year highs in October, with West Texas Intermediate (WTI) closing the month 10.8% lower at US\$65.3/bbl. Both Saudi Arabia and Russia have reportedly agreed to increase production volumes, whilst the US Government also directed the OPEC pact to increase their production rate. Sector heavyweight Beach Energy (BPT, -17.8%) saw its share price decline as a result, despite reporting relatively strong first-quarter results. Revenue came in at \$514m, representing a 9% gain over the prior period. The company was also able to achieve its 20% net gearing target nine months ahead of schedule supported by an elevated oil price. Also within the Energy sector, WorleyParsons (WOR, -24.7%) posted double-digit losses after announcing its US\$3.3b acquisition of Jacobs Engineering Group's energy, chemicals and resources business. While the transaction appears logical from a strategic point of view, the deal comes at a time where some observers believe the chemicals segment is seeing a peak in the cycle.

The performance of index heavyweight, Consumer Discretionary (-11.6%), was somewhat divergent over the month. On one end, we saw language education provider Navitas (NVT, +13.4%) deliver a double-digit gain in a soft market. The company received a non-binding takeover proposal in cash from a private equity-led consortium, amounting to \$5.50 per share which represents a 26% premium to the prevailing share price. Although the offer was subsequently rejected by NVT's Board, management flagged its willingness to engage with the acquirers for a better offer. Corporate Travel Management (CTD, -34.3%) offset NVT's contribution to sector performance after the company saw its value shrink by more than one third, following the release of a research report by VGI, a fund manager which raised 20 "red flags" relating to the business. Management has orchestrated a formal response to address all 20 questions, although investors

remain wary as the disharmony between VGI, which holds significant short positions in CTD, and the company is unlikely to get resolved anytime soon.

## Portfolio performance

The Pandal Smaller Companies Fund (formerly the BT Wholesale Smaller Companies Fund) returned -9.86% (post-fee, pre-tax) in October, underperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.26%.

### *Contributors*

#### Overweight AUB Group

Insurance brokers to small business AUB Group (AUB)—previously known as Austbrokers—was among the few stocks able to buck the market's weakness and post a positive result for the month. It was helped in this regard by signs of further consolidation in the industry as Suncorp implemented a review of its general insurance distribution division.

#### Underweight Wisetech Global

Wisetech Global (WTC, -27.3%) is one of a group of small cap tech companies which have been among the best performing stocks in the market in recent months. In part, this is due to the relatively small cohort of growth stocks in the Australian market compared to the US, which suggests there is plenty of interest chasing a small part of the market. We have liked some of these companies, but have abstained from taking a position on the basis of valuation, which left little cushion for downside surprise. This part of the market saw a swift reversal in October, with Wisetech down 27.3%, and our underweight position helped performance.

### *Detractors*

#### Overweight Seven Group Holdings

Seven Group (SVW, -21.6%) has exposure to both transport infrastructure on the east coast and mining services in the west. It was exposure to the latter which weighed on the stock in October as trade frictions and a slowing Chinese economy saw softer sentiment around the resource sector. We maintain conviction in our position here, as the multi-year outlook for earnings growth is underpinned by long-delayed mine expansions and equipment refurbishments, as well as the pipeline of east coast projects.

#### Underweight Washington H Soul Pattinson

Washington H Soul Pattinson (SOL, +11.3%) is a conglomerate which undertakes investments, among other business lines, and has a significant stake in new mobile phone entrant TPG Telecom. Our underweight here dragged on performance in October.

## Strategy and outlook

The portfolio fell largely in line with the index in October, as the combination of concern over higher US rates and trade friction saw a significant market pullback. At this point last month's weakness looks like the market letting off some steam, rather than the early stages of a more sustained, recession-driven bear market. The volatility was largely confined to equities, with little movement in corporate credit spreads, which suggests there was no broader deterioration in business conditions. The underlying economic picture also remains benign, particularly in the US where, apart from a softer patch in housing activity, data indicates that momentum remains strong.

Those parts of the market which had surge in recent months—notably the high growth tech stocks such as Wisetech and Afterpay Touch—were among those hardest hit in October. Our underweight here—driven by our valuation discipline—was beneficial. At the same time, Technology One, a preferred technology holding in our portfolio, held up relatively well against the market’s weakness. Gold was one of the few areas to see strong positive returns and our slight overweight here, via several junior miners, was also a net positive for performance.

However, the resources sector more broadly fared poorly on the markets’ concern over Chinese demand and the possibility of further trade sanction by the US. This weighed on our position in mining services – most notably via Seven Group. We retain our conviction in this position. The earnings outlook for Seven Group is being driven by a pick-up in spending by the mining companies, who have long-delayed capacity expansions and equipment refurbishments and where the need to replace depleted mines and address their aging equipment is becoming more pressing. At the same time, there is exposure to the east coast transport infrastructure pipeline. This is resulting in greater visibility of earnings and a multi-year outlook for attractive returns.

We have used the market’s weakness as an opportunity to add new stocks and increase some existing positions which we find attractive at these levels. We have added to the mining services exposure as well as to some stocks in the growth areas which have pulled back to far more reasonable levels.

## International Shares

### Pendal Concentrated Global Share Fund

#### Market review

Global equity markets experienced a long anticipated reversal of fortunes in October as the sustained positive sentiment holding markets afloat this year gave way to a number of causes for concern. US online mega-retailer, Amazon, spooked investors after issuing a caution on expectations for its festive season trading volumes. Alphabet added to the concerns after reporting its advertising revenue was lower than expected. These came amid some disappointing earnings results from the technology sector. Adding the concerns of continued US monetary tightening and the Sino-US trade tensions was enough to send markets into correction mode.

The broader US stock market was tempered somewhat by a favourable earnings season, with more than 80% of companies exceeding market earnings expectations. Energy, Consumer Discretionary and Industrials were the weakest sectors over the month, while investors shifted support towards the less economically sensitive sectors like Consumer Staples, which was the only sector with a positive return for the month. Data on the economy continued to indicate solid expansion: US economic growth expanded at an annual rate of 3.5% in the third quarter, lower than the 4.2% rate of the prior quarter, albeit still robust. Expansion was supported by strength in consumer spending, which accounts for around two-thirds of economic growth. For the month of October, the S&P500 declined by 6.9% while the NASDAQ lost 9.2%.

European markets were almost uniformly lower, in concert with developments in the US although regional factors dominated sentiment. Italy was again in the spotlight after the European Union rejected its latest budget proposal. Subsequent reports emerged that Italy would target lower budget deficits for 2019 and 2020, although ratings agency Moody’s proceeded to announce a downgrade to Italy’s sovereign debt rating to Baa3 - one notch above junk bond status. Elsewhere, markets were impacted by lower oil prices and growing uncertainty over the shape and form of Brexit as the target date draws near. Italy (-8.0%) led the region lower for October, followed by France (-7.3%), Germany (-6.5%) and Spain (-5.3%), while losses were limited for Switzerland (-0.7%). The UK (-5.1%) was also decidedly lower.

Asian equity markets were not immune to the weakness across the developed world, with prospects for regional trade under the microscope thanks to the newly installed tariff regime. China's economic growth also eased to 6.5%, signalling a slowing of expansion, while weakness in technology stocks offshore transpired to weakness among Asia's technology sector. China's Shanghai Composite index ended the month 7.8% lower, while Korea (-11.6%), Taiwan (-10.9%), Hong Kong (-10.1%), Japan (-9.1%) and Singapore (-7.1%) all succumbed to weakness.

The Australian dollar resumed its weakening trend to end the month 2.1% lower against the US dollar. It was however 0.5% stronger against the euro and relatively unchanged against the British pound. Commodity markets witnessed a strong correction as the crude oil price fell by 10.8% to close at US\$65 per barrel, while Gold rose by 1.9% to just over US\$1200.

## Portfolio performance

The Pandal Concentrated Global Share Fund (formerly the BT Concentrated Global Share Fund) returned -3.12% (post fee, pre-tax) in October, outperforming its benchmark by 2.28%.

October lived up to its reputation of being a difficult month. The S&P 500, which closed down 7%, had its worst monthly performance since September 2011, whilst the VIX index, a measure of future volatility, spiked by 75%. Outside of the US, markets exposed to China and technology also suffered, with the Chinese, Hong Kong, Japanese and German markets all having their worst month since January 2016. US markets are the only major market still in positive territory for the year to date, with the S&P having risen by 1.4% in 2018, after briefly flirting with negative territory during the month of October.

Amid the turmoil, the bulk of US companies reported third-quarter earnings in October. Of the companies that reported, 87% of them reported earnings growth, with aggregate growth of 23%. While about 82% of companies reported earnings ahead of consensus expectations, with an aggregate 'beat' of 6.3%. However, the performance of equity markets this month has been less about third-quarter results and more about the increasingly uncertain outlook for earnings, amid escalating tensions between China and the US, a stronger US dollar and stronger US bond yields. Commentary from management teams, particularly in the technology and industrial sectors, suggest a slow-down in sales was evident in the later part of the quarter, while outlook statements have certainly become less certain in regard to the prospects for 2019.

The best performer for the Fund this month was CME (+8%). CME is the largest derivatives exchange operator in the world, with the company handling more than 90% of futures trades in the US. Its products include futures and options on interest rates, equities, foreign exchange and metals. Our position in CME is consistent with the view we held at the time of Fund launch: Interest rates would normalise over time and volatility would increase from cyclically low levels. While volumes in the third quarter were flat over the prior year, fourth-quarter volumes are currently tracking at around 30% higher. The product pipeline is encouraging, as is management's control on costs. The acquisition of UK trading and technology company, NEX, is expected to complete at year end, with the combined company becoming the dominant player in the US\$500b a day US government debt market. With significant leverage to increasing market volatility and volumes, a strong balance sheet, operating margins in excess of 65% and a 4% dividend yield, we remain of the view the market is underestimating the company's ability to drive volume growth.

With weakness in Chinese companies generally, together with a weaker technology sector, our holding in Chinese internet search engine Baidu (-17%) detracted from returns in October. Baidu's third-quarter results were in line with consensus estimates, with revenues up 27% over the year and adjusted net profit rising by 47% over the same period. Management set a more cautious tone on the near-term outlook for revenue growth, although they maintained guidance for annual growth for the fourth quarter of between 20-26%, reflecting the impact of macro and regulatory uncertainty on some of its advertiser segments. Baidu is the number-one search engine for PCs in China, with an 80% market share. Internet penetration is 60% in China compared with 90% in the US. In our

view, investments being made in technology will continue to grow their market share and drive revenues over the longer term.

## Strategy and outlook

We expect continued volatility in markets. Equity markets are in the midst of transition from an environment where they have benefited from low interest rates with plentiful liquidity to an environment that is moving in the opposite direction. We believe owning a concentrated portfolio of companies, rather than having indiscriminate broader market exposure, is the way to maximise equity market returns. We own a resilient portfolio of companies that have the business models to not only withstand volatility but prosper, regardless of the ups and downs of economic cycles.

### Pendal Core Global Share Fund

## Market review

Global equity markets experienced a long anticipated reversal of fortunes in October as the sustained positive sentiment holding markets afloat this year gave way to a number of causes for concern. US online mega-retailer, Amazon, spooked investors after issuing a caution on expectations for its festive season trading volumes. Alphabet added to the concerns after reporting its advertising revenue was lower than expected. These came amid some disappointing earnings results from the technology sector. Adding the concerns of continued US monetary tightening and the Sino-US trade tensions was enough to send markets into correction mode.

The broader US stock market was tempered somewhat by a favourable earnings season, with more than 80% of companies exceeding market earnings expectations. Energy, Consumer Discretionary and Industrials were the weakest sectors over the month, while investors shifted support towards the less economically sensitive sectors like Consumer Staples, which was the only sector with a positive return for the month. Data on the economy continued to indicate solid expansion: US economic growth expanded at an annual rate of 3.5% in the third quarter, lower than the 4.2% rate of the prior quarter, albeit still robust. Expansion was supported by strength in consumer spending, which accounts for around two-thirds of economic growth. For the month of October, the S&P500 declined by 6.9% while the NASDAQ lost 9.2%.

European markets were almost uniformly lower, in concert with developments in the US although regional factors dominated sentiment. Italy was again in the spotlight after the European Union rejected its latest budget proposal. Subsequent reports emerged that Italy would target lower budget deficits for 2019 and 2020, although ratings agency Moody's proceeded to announce a downgrade to Italy's sovereign debt rating to Baa3 - one notch above junk bond status. Elsewhere, markets were impacted by lower oil prices and growing uncertainty over the shape and form of Brexit as the target date draws near. Italy (-8.0%) led the region lower for October, followed by France (-7.3%), Germany (-6.5%) and Spain (-5.3%), while losses were limited for Switzerland (-0.7%). The UK (-5.1%) was also decidedly lower.

Asian equity markets were not immune to the weakness across the developed world, with prospects for regional trade under the microscope thanks to the newly installed tariff regime. China's economic growth also eased to 6.5%, signalling a slowing of expansion, while weakness in technology stocks offshore transpired to weakness among Asia's technology sector. China's Shanghai Composite index ended the month 7.8% lower, while Korea (-11.6%), Taiwan (-10.9%), Hong Kong (-10.1%), Japan (-9.1%) and Singapore (-7.1%) all succumbed to weakness.

The Australian dollar resumed its weakening trend to end the month 2.1% lower against the US dollar. It was however 0.5% stronger against the euro and relatively unchanged against the British pound. Commodity markets witnessed a strong correction as the crude oil price fell by 10.8% to close at US\$65 per barrel, while Gold rose by 1.9% to just over US\$1200.

## Portfolio performance

The Pental Core Global Share Fund (formerly the BT Wholesale Core Global Share Fund) returned -6.60% (post-fee, pre-tax) in October, underperforming its benchmark by 1.20%.

The Fund underperformed its benchmark over October 2018 due to negative performance in North America and Europe, while Asia performed in line with its regional benchmark over the month.

Underperformance in the US was due to negative performance in our momentum and investor sentiment signals which outweighed positive performance from our valuation and management signalling factors. The underperformance in Canada was similar to that in the US with the exception of positive performance in valuation. The underperformance in Europe was due to negative performance in our momentum and stability signals which outweighed positive performance in our valuation and earnings quality factors.

From a stock and industry attribution perspective, both active industry tilts and intra-industry stock selection detracted from performance over the month. At a sector level, underweight positions to Consumer Staples and Utilities and an overweight position to Consumer Discretionary were the largest detractors from active returns, while an overweight position to Healthcare and an underweight position in Industrials contributed to performance. Within sectors, stock selection in Health Care and Materials drove underperformance which outweighed positive performance from stock selection in Financials and Information Technology.

At a stock level, the largest detractors from active returns over the month came from overweight positions in: Valero Energy Corporation, an US headquartered international manufacturer and marketer of transportation fuels; Covestro AG, a German adhesive manufacturing company; Southwest Airlines Co., a major US discount airline; Michael Kors Holdings Ltd., an American fashion company and Abiomed, a manufacturer of medical implant devices headquartered in the US.

The largest contributors to active returns came from an overweight position in Walmart Inc., an American multi-national retail corporation and underweight positions in; Netflix Inc., a US-headquartered global entertainment company; DowDuPont Inc., a US company formed after the merger of Dow Chemical and DuPont (now the world's largest chemical company in terms of sales); Merck & Company, Inc., a US pharmaceutical company and one of the largest in the world; Visa Inc., and an US multi-national financial services corporation headquartered in Foster City, California, United States.

## Strategy and outlook

Moving into November the largest sector tilts are overweights in Health Care and Consumer Discretionary and underweights in Financials and Consumer Staples.

## Australian Fixed Income

### Pental Fixed Interest Fund

#### Market review

Australian bond yields fell during October as a risk-off turn mid-month drove investors to safe-havens. There was no specific driver behind the deterioration in sentiment, although the combination of several factors likely played a part. These included continued trade war tensions, ongoing monetary policy normalisation, political uncertainty in Europe and stretched market valuations. Meanwhile, there was little action on the domestic monetary policy front with the

Reserve Bank of Australia (RBA) leaving rates on hold once again. The accompanying statement also suggested no changes in the near-term; however, more constructive comments on the labour market and GDP growth were two small alterations to the communication. This was echoed in the monthly employment figures that revealed a drop in the unemployment rate from 5.3% to 5.0%, a six year low. Third quarter inflation data was softer-than-anticipated, with a 0.4% rise in the trimmed mean measure over the period. Other data points were more mixed, with retail sales at a sluggish +0.2% and small increases in business and consumer confidence. On market movements, the Australian 3- and 10-year yields both fell 4 basis points (bp) to 2.04% and 2.64% respectively. At the very front-end, the 90-day BBSW dropped 3bp to 1.91%.

## Portfolio performance

The Pandal Fixed Interest Fund (formerly the BT Wholesale Fixed Interest Fund) returned 0.43% in October (post-fees, pre-tax), underperforming its benchmark by 0.05%.

Within the Fund's alpha overlay, the Duration strategy made the largest contribution, with the strongest return from a long Euro front-end position. The Relative Value strategy also made a positive contribution, which was attributable to a US invoice swap. The Cross-Market and Yield Curve strategies had a neutral impact. In contrast, the FX and Macro strategies detracted. The former held a range of positions with losses on several emerging market currencies more than offsetting gains elsewhere. The latter's negative return was related to a short Brazil CDS exposure, which was subsequently closed out. Finally, the government bond and credit components were both flat versus their benchmarks.

## Strategy and outlook

The RBA releases its Statement on Monetary Policy in early November, which will contain updated forecasts. Third quarter inflation was in line with the Reserve Bank's estimate at 1.9%. However, the unemployment rate printed at 5% in October, a level the RBA did not expect to reach till late 2020. The trend now sits at 5.15%, lower than what they had expected. A tighter labour market may see them increase their inflation forecasts, although any upward revision is likely to be only slight and would not indicate any near term monetary policy tightening.

The housing market continues to garner plenty of negative headlines. While the headlines are dramatic, the retracement in prices has largely been orderly. We do expect house prices to continue to fall gradually by another 5% in the year ahead. Building approvals are already falling, construction will fall in around 12 months and credit is slowing. However, this is being more than offset by non-residential construction and unless consumer spending is materially affected, GDP numbers should remain positive.

What hasn't been receiving the headlines that it should is the iron ore price. Iron ore is Australia's main export and its price has risen by just under 30% over the past year. The Newcastle coal price has also performed strongly over this period. Normally, stronger commodity prices would lead to a stronger Australian dollar and weigh on key services exports such as tourism and education. That is not the case at the moment with the Aussie dollar and the trade weighted index falling by around 8% and 5%, respectively. Economic growth in Australia is healthy; it is only the benign inflation environment at the moment that is preventing the RBA from removing some monetary policy accommodation.

# International Fixed Income

## Pendal Global Fixed Interest Fund

### Market review

Global bonds experienced a relatively volatile month. After yields rose in the first half of the month they retraced most of their move in the second half as risk appetite soured and investors flocked to safe-havens. There was no specific driver behind the deterioration in sentiment; however, the combination of several factors likely played a part. These included continued trade war tensions, ongoing monetary policy normalisation, political uncertainty in Europe and stretched market valuations. Looking at data for the world's largest economy; US third quarter real GDP grew a healthy 3.5% annual rate, the monthly Non-Farm Payrolls print was weak at only 134,000, however, the 6-month average remained above 200,000. The unemployment rate also dropped from 3.9% to 3.7%, the lowest level since 1969. Regarding monetary policy abroad, the Fed did not meet during the month; however, comments from Chairman Powell were perceived as hawkish. Similarly, the post-meeting press conference with European Central Bank (ECB) President, Mario Draghi, was interpreted as more positive. On market movements, the US the 2- and 10-year yields retraced most of their earlier increase to respectively finish only 5bp and 8bp higher at 2.87% and 3.14%.

### Portfolio performance

The Pendal Global Fixed Interest Fund (formerly the BT Wholesale Global Fixed Interest Fund) returned -0.11% in October (post-fees, pre-tax), underperforming its benchmark by 0.06%.

Over the month, the Duration and Relative Value strategies contributed to returns while the Macro and FX strategies detracted. Cross-Market and Yield Curve strategies had a neutral impact.

Most of the gains in the Duration strategy were from the long duration position in the European front end. We also made small gains in the long duration position in German Bunds. Losses were incurred from short duration position in the long end of Japan's yield curve. During the month we reached our limits on a short duration position in China and closed the position. The long duration positions in Australia and the US earlier in the month had also contributed to some losses. During the month we closed positions in Italian bonds, German 5-year Federal notes (Bobl) and in the New Zealand front end, with a largely neutral outcome.

The FX strategy detracted from performance over the month. We maintained a long US dollar bias through the month against both developed market and emerging market currencies, expressed in both outright positions and options. Gains and losses offset each other. The gains from EUR and KRW positions offset losses from TWD and CNH. Within emerging market currencies, small losses occurred in a long SGD against INR position. In long volatility positions, losses were mainly from CAD/JPY, which was mitigated by gains from NZD/USD. As at month end we maintained a long bias in USD and JPY, while keeping a short bias in EUR and emerging market currencies.

The Yield Curve strategy had a neutral impact in October. Gains were sourced from steepening positions in the US 5y-30y and in the Japanese long end. These gains were offset by losses from curve flattening position in the Europe long end. Toward the end of the month we opened a steepening position in New Zealand.

The Macro strategy was the largest detractor over the month. We reduced our explicit buy protection positions as the risk aversion sentiment eased. The majority of the losses were from buy protection positions in Brazil which were closed out in the middle of the month. There was also a small loss on the flattening position along the CDX high yield curve. On the other side, gains were

made in the buy protection positions in the larger European markets and Turkey. Earlier in the month we also closed the positions in South Africa and Indonesia after accruing small gains.

The Relative Value strategy contributed to performance this month. Most of the gains were from the US 5-year invoice spread, while small profits were also made from the Australian 3-year EFP spread positions.

The Cross-Market strategy was roughly flat over the month. We closed long Bund vs BTP positions to take profits and the gains were partially offset by losses from a long New Zealand vs short Australian front end position.

## Strategy and outlook

October's US equity market correction has perhaps been one of the most widely anticipated in recent history, yet the volatility has not been evenly reflected across other asset classes. Their sensitivity seems to have diminished in response to US equity market weakness, for which there are a number of theories currently being offered. However, this does not mean that the traditional correlations have broken. Our medium term themes on liquidity and volatility continue to hold, alongside which we maintain non-consensus views on regional and fundamental macroeconomic trends. As central banks step back, these fundamental trends will continue to offer alpha opportunities, for which we are positioned across a number of our strategies. As carry returns to the front end of the US curve, investors' tolerance for volatility and related spikes will diminish. At the extremes, the correlations between equities and their risk proxies still hold.

## Credit

### Pendal Enhanced Credit Fund

#### Market review

Domestic credit posted a positive return for October, which was driven by a fall in underlying yields. The drop in yields was tied to a combination of several enduring concerns, rather than a specific catalyst. These included continued trade war tensions, ongoing monetary policy normalisation, political uncertainty in Europe and stretched market valuations.

Weaker risk appetite was also reflected in primary market activity during the month. It was the lightest October issuance since the GFC, with volumes at only A\$2.6b. There were no debt capital raisings by the major banks. However, second-tier names—Suncorp and Bendigo & Adelaide Bank—tapped the market for \$500m each. Infrastructure issuers—Heathrow and Port of Melbourne—also completed deals for \$175m and \$550m respectively.

Finally, the Australian iTraxx index (Series 30 contract) traded in a 10bp range finishing the month 7.5bp wider to +82bp. On average, physical credit spreads finished the month unchanged. Semi-government bonds were also unchanged to government bonds over the month.

## Portfolio performance

The Pendal Enhanced Credit Fund (formerly the BT Wholesale Enhanced Credit Fund) returned 0.43% in October (post-fees, pre-tax), underperforming the benchmark by 0.02%.

A fall in underlying swap rates was the largest contributor to returns in October. Accruals were also positive, while physical credit spreads were roughly flat. Positions in infrastructure and utilities, where the fund is overweight, performed well over the period relative to other sectors. Portfolio purchases over the period were relatively light, given little activity in the primary market during the

month. The Fund purchased bonds from Bendigo & Adelaide Bank as well as Lonsdale Finance and reduced its exposure to supranational issuer, EIB.

## Strategy and outlook

Our macro credit view remains neutral. While we continue to be cautiously constructive on a fundamental basis, we acknowledge risks have risen due to increasing volatility across markets. This has been driven in part by firmer expectations for US rate normalisation and higher inflation. Geopolitical risks have also escalated in 2018 and markets appear less forgiving, as witnessed by the reaction to Italian political uncertainty in May, the rout in emerging markets and ongoing Sino-US trade tensions. The combination of enduring concerns over geopolitics and monetary normalisation weighed particularly heavily on risk assets during October.

Over the next year, it is expected there will be further cash rate increases in the US, a view reinforced by the Fed in September. Additionally, the ECB has effectively halted asset purchases. Market price dislocations will occur, should expectations of central bank actions and incoming data not align to 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 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 which 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. As such, we continue to recommend a defensive approach with any overweights in operationally resilient sectors such as Utilities and Infrastructure that provide a higher yield than index returns.

## Cash

### **Pendal Managed Cash Fund and Pendal Enhanced Cash Fund**

## Market review

Australian bond yields fell during October as a risk-off turn mid-month drove investors to safe-havens. There was no specific driver behind the deterioration in sentiment, although the combination of several factors likely played a part. These included continued trade war tensions, ongoing monetary policy normalisation, political uncertainty in Europe and stretched market valuations.

At the outset of the month, there was little action on the domestic monetary policy front with the RBA leaving rates on hold once again. The accompanying statement also suggested no changes in the near-term, however more constructive comments on the labour market and GDP growth were two small alterations to the communication. This was echoed in the monthly employment figures that revealed a drop in the unemployment rate from 5.3% to 5.0%, a six-year low. The details were weaker than expected, with a fall in the participation rate and only 5,600 jobs added.

Third quarter inflation data was also softer-than-anticipated with a 0.4% rise in the trimmed mean measure over the period. This brought the annual rate to 1.8%, well-below the midpoint of the

RBA's 2-3% target band. Other domestic data points were more mixed, with retail sales at a sluggish +0.2% and small increases in business and consumer confidence.

Looking abroad, the significant correction across global equity markets captured headlines over the month. Geopolitical developments remained a mainstay for markets. In the ongoing trade war, the US signed an agreement with Mexico and Canada that stands to shift more auto manufacturing to North America. Also state-side, political debate intensified ahead of the mid-term elections, which added to investor uncertainty. Political doubts also lingered in Europe as Italian fiscal policy remained contested and separately Angela Merkel announced she would not run for another term as Chancellor. Further north, contention persisted over the terms of Brexit, including the border of Northern Ireland. While in contrast, a victory by far-right candidate Jair Bolsonaro in Brazil's federal election was welcomed by investors.

Looking at data for the world's largest economy: US third quarter real GDP grew a healthy 3.5% annual rate, which was driven by consumer and government spending. The monthly Non-Farm Payrolls print was weak at only 134,000, however the six-month average remained above 200,000. The unemployment rate also dropped from 3.9% to 3.7%, the lowest since 1969. Meanwhile, the Institute of Supply Management Manufacturing survey fell 1.5 points to 59.8 and the Non-Manufacturing gauge rose to 3.1 to 61.6.

Turning to monetary policy abroad, the US Federal Reserve did not meet during the month, although comments from Chairman Powell during the month were perceived as hawkish. Similarly, the post-meeting press conference with ECB President Mario Draghi was interpreted as more positive. The central bank's monthly asset purchases dropped from 30b euros to 15b euros as scheduled and remain on track for completion in December. Purchases from the Bank of Japan have also effectively decreased over the past year as part of their policy settings, which were left unchanged at its meeting during the month. In stark contrast, China's PBoC cut its Reserve Ratio Requirement (RRR) rate for the third time in 2018, by 1.00% to 14.5%. Data in the region also deteriorated with softer GDP growth for the third quarter and weaker manufacturing surveys and industrial production.

On market movements, the Australian 3- and 10-year yields both fell 4bp to 2.04% and 2.64% respectively. At the very front-end, 90 day BBSW dropped 3bp to 1.91%. With RBA expectations firmly on hold, this led to a small tightening in the BBSW-OIS spread, although it remains elevated relative to history. In the US, the 2- and 10-year yields retraced most of their earlier increase to respectively finish only 5bp and 8bp higher at 2.87% and 3.14%. In turn, the AU-US yield spread fell deeper into negative territory. This put pressure on the Australian dollar among other factors, which slid 1.8% versus its US counterpart.

## Portfolio performance

### *Managed Cash*

The Pandal Managed Cash Fund (formerly the BT Wholesale Managed Cash Fund) returned 0.16% in October (post-fees, pre-tax), underperforming the benchmark by 0.01%.

Themes and credit exposure remain consistent with prior months, with excess spread from A-1 rated issuers and yield curve positioning likely to be the main driver of outperformance. The Fund ended the month with a weighted average maturity of 60 days (maximum limit of 70 days). The RBA is unlikely to tighten monetary policy in the near term and yields further out the curve continue to offer better relative value. The weighted average maturity has consistently been longer than benchmark due to this. Increasing supply in the US could weigh on the US market, an important funding source for Australian banks. We remain wary of any spillover effects from a rising LIBOR rate on the Australian market. The lack of volatility in BBSW in September though indicates that the Australian banks appear to be well funded. With a higher running yield than the index the Fund remains well positioned to outperform.

### **Enhanced Cash**

The Pental Enhanced Cash Fund (formerly the BT Wholesale Enhanced Cash Fund) returned 0.15% in October (post-fees, pre-tax) underperforming the benchmark by 0.02%.

Positive performance came from the Industrials and Financials sectors whilst the long iTraxx position detracted. The portfolio has outperformed its benchmark by 0.73% over the past 12 months (before fees).

Activity during the month included closing the long Australia iTraxx position as volatility increased. As at the end of the month, the portfolio had a credit spread of 60bp over bank bills, interest rate duration of 0.11 years and credit spread duration of 1.53 years.

## **Strategy and outlook**

The RBA releases its Statement on Monetary Policy in early November, which will contain updated forecasts. Third quarter inflation was in line with the Reserve Bank's estimate at 1.9%. However, the unemployment rate printed at 5% in October, a level the RBA did not expect to reach till late 2020. The trend now sits at 5.15%, lower than what they had expected. A tighter labour market may see them increase their inflation forecasts, although any upward revision is likely to be only slight and would not indicate any near term monetary policy tightening.

The housing market continues to garner plenty of negative headlines. While the headlines are dramatic, the retracement in prices has largely been orderly. We do expect house prices to continue to fall gradually by another 5% in the year ahead. Building approvals are already falling, construction will fall in around 12 months and credit is slowing. However, this is being more than offset by non-residential construction and unless consumer spending is materially affected, GDP numbers should remain positive.

What hasn't been receiving the headlines that it should is the iron ore price. Iron ore is Australia's main export and its price has risen by just under 30% over the past year. The Newcastle coal price has also performed strongly over this period. Normally, stronger commodity prices would lead to a stronger Australian dollar and weigh on key services exports such as tourism and education. That is not the case at the moment with the Aussie dollar and the trade weighted index falling by around 8% and 5%, respectively. Economic growth in Australia is healthy; it is only the benign inflation environment at the moment that is preventing the RBA from removing some monetary policy accommodation.

## **Australian Property**

### **Pental Property Securities Fund**

#### **Market review**

The S&P/ASX 300 A-REIT Index declined 3.1% in October, outperforming the broader Australian share market by 3%. Over the 12-month period, A-REITs have returned 7.3%, 4.3% ahead of the broader market. The key themes for the month were merger and acquisition activity, ongoing buy-backs and capital raisings. The global REIT market declined by 3.9%, with the US outperforming (-1.7%) and emerging market REITs the laggard at -6.7%.

During the month Shopping Centres Australia raised \$259m to help fund the purchase of 10 centres from Vicinity Centres (VCX) for \$573m, representing a 7.5% yield. Including income guarantees, the centres were sold by VCX at a 6% discount to book value. Charter Hall Long WALE also raised \$80m to fund the purchase of an industrial and office building, while Centuria Metropolitan REIT raised \$276m in equity to finance the purchase of a \$520m office portfolio. In

other developments during October, Oxford Properties was successful in its bid for Investa Office Fund, Asian logistics group, ESR Real Estate, announced its intention to acquire PropertyLink Group (subject to due diligence) and Starwood Capital made a cash bid for Australian Unity Office Fund. Buybacks were also operational during the month, with Lend Lease, Mirvac, Stockland and Vicinity Centres acquiring an aggregate \$272m of securities.

## Portfolio performance

The Pental Property Securities Fund (formerly the BT Wholesale Property Securities Fund) returned -3.89% in October (post-fee, pre-tax), underperforming its benchmark by 0.77%.

The portfolio underperformed over the month, with positive contributions from overweight positions in PropertyLink Group, Goodman Group and Charter Hall Long WALE and underweight positions in Growthpoint Property and Aventus Retail Property. Underweight positions in Vicinity Centres and Shopping Centres Australia together with overweight positions in Unibail-Rodamco Westfield and Mirvac Group detracted from performance.

During October we participated in the Charter Hall Long WALE raising (increasing our overweight) and participated in the Centuria Metropolitan raising (and are now overweight). We also reduced our underweight position in Scentre Group and increased our overweight in National Storage REIT. This buying was funded by increasing our underweight positions in Stockland and Vicinity Centres and reducing our overweight in Mirvac.

## Strategy and outlook

The A-REIT sector is now priced on an FY19 dividend yield of 5.4%, a P/E ratio of 16.6 times and a 21% premium to net tangible assets, slightly above its long-term average of 16%. Cap rates are unlikely to compress any further from current levels and asset valuation improvements will be dependent on income growth and tenancy retention. Non-dominant discretionary malls with high specialty occupancy costs are actually expected to fall in value in the short to medium term. Balance sheets are stable, with sector gearing at 28%.

## International Property

### Pental Global Property Securities Fund

#### Market review (in US\$)

Performance of the global property securities market (on an ex-Australia basis) as measured by the FTSE EPRA Nareit Developed Index continued to decline in October, posting a total return of -3.6%. Asia Pacific (-5.6%) showed the largest decline, followed by Europe (-5.4%) and North America (-2.3%). In Asia Pacific, results were negative across the region. Hong Kong (-9.5%) was the weakest performer, followed by Singapore (-7.2%), New Zealand (-6.8%) and Japan (-2.4%). In Europe, results were similarly negative throughout the region. Austria (-8.9%) posted the largest decline, followed by the Netherlands (-8.3%) and France (-8.0%). In North America, the US and Canada returned -2.3% and -3.2%, respectively.

## Portfolio performance

The Pental Global Property Securities Fund (formerly the BT Wholesale Global Property Securities Fund) returned -3.27% in October (post-fee, pre-tax), outperforming the benchmark by 0.06%.

## ***North America***

The North America portfolio returned -2.10% in October (before fees and withholding taxes), exceeding the FTSE EPRA Nareit North America Index by 22 basis points. Outperformance relative to the benchmark was attributable to positive stock selection results, which were partially offset by negative sector allocation results. In terms of stock selection, results were strongest in the office, shopping center, and health care sectors and were weakest in the hotel, apartment, and data center sectors. Regarding sector allocation, negative results were driven by the portfolio's underweight to the outperforming triple net lease and health care sectors, as well as an overweight to the underperforming data center sector. Among the portfolio's holdings, top individual contributors to relative performance included overweight positions in the outperforming HCP, Inc. (HCP), Simon Property Group (SPG), and American Assets Trust (AAT). Detractors most notably included an overweight position in the underperforming Extended Stay America (STAY) and a lack of exposure to the outperforming Ventas (VTR) and Realty Income (O).

## ***Europe***

The European portfolio returned -6.13% for October (before fees and withholding taxes), underperforming the regional EPRA benchmark by 71 basis points. Underperformance relative to the benchmark was driven by negative stock selection results and, to a lesser extent, negative country allocation results. In terms of stock selection, results were weakest in the United Kingdom, France, and Spain and were strongest in Switzerland. Regarding country allocation, negative results were attributable to the portfolio's underweight to the outperforming Switzerland and a lack of exposure to the outperforming Belgium. Conversely, the portfolio's small cash position was a modest contributor to relative performance, given the regional benchmark's negative absolute performance for the period. Among the portfolio's holdings, top contributors to relative performance included an underweight position in the underperforming Unibail-Rodamco-Westfield (Netherlands), an overweight position in outperforming ADO Properties SA (Germany), and a lack of exposure to underperforming Fastighets AB Balder Class B (Sweden). Detractors most notably included a lack of exposure to the outperforming Intu Properties PLC (United Kingdom) and Derwent London PLC (United Kingdom), and an overweight position in the underperforming Gecina SA (France).

## ***Asia***

The Asia portfolio returned -5.40% in October (before fees and withholding taxes), outperforming the regional EPRA benchmark by 18 basis points. Outperformance relative to the benchmark was driven by positive stock selection results, while country allocation results were largely neutral. In terms of stock selection, positive results in Japan were partially offset by negative results in Hong Kong and Singapore. The portfolio's small cash position was a contributor to relative performance, given the regional benchmark's negative absolute performance for the month. Among the portfolio's holdings, top contributors to relative performance included overweight positions in the outperforming NTT Urban Development (Japan), Daiwa Office Investment (Japan), and Advance Residence Investment (Japan). Detractors most notably included overweight positions in the underperforming UOL Group (Singapore) and CK Asset Holdings (Hong Kong), and a lack of exposure to the outperforming Japan Retail Fund Investment (Japan).

# Active Balanced

## Pendal Active Balanced Fund

### Markets review

The Australian equity market pulled back by 6.2% in October, registering the worst monthly performance since August 2015. The Index was down 10.3% from its August high at one point, before paring some of the losses. Both Resources (-6.5%) and Industrials (-6.1%) finished the month in the red. The swift spike in volatility came on the back of several factors, including fears of overly-aggressive tightening from the US Federal Reserve (Fed), fear of deteriorating US-China trade and signs of higher input costs, particularly in the US.

In regard to sector performance, traditional growth stock-related sectors bore the brunt of the pullback as market sentiment returned to a risk-off mode during the month. Information Technology (-11.4%), Consumer Discretionary (-8.3%) and Health Care (-7.3%) all reside within that group. In contrast, defensive sectors such as Real Estate (-3.8%) and Consumer Staples (-4.9%) outperformed the headline index, despite posting overall losses. Index heavyweight Financials (-6.0%) fared slightly better than the benchmark. The big four banks saw some divergence in performance during October, with Commonwealth Bank (CBA, -3.1%) and Westpac (WBC, -3.9%) contributing to the sector's outperformance, whereas ANZ (ANZ, -8.0%) and National Australia Bank (NAB, -9.3%) detracted.

Outside of Financials, miners (-5.0%) also generally declined over the month, but were able to outperform the broad market index. Base metals such as Copper (-5.2%) retreated amid concerns around global growth, while the same jitters propelled the price of gold (+1.6%) as investors rotated into the safe-haven asset.

Global equity markets experienced a long anticipated reversal of fortunes in October as the sustained positive sentiment holding markets afloat this year gave way to a number of causes for concern. US online mega-retailer, Amazon, spooked investors after issuing a caution on expectations for its festive season trading volumes. Alphabet added to the concerns after reporting its advertising revenue was lower than expected. These came amid some disappointing earnings results from the technology sector. Adding the concerns of continued US monetary tightening and the Sino-US trade tensions was enough to send markets into correction mode.

The broader US stock market was tempered somewhat by a favourable earnings season, with more than 80% of companies exceeding market earnings expectations. Energy, Consumer Discretionary and Industrials were the weakest sectors over the month, while investors shifted support towards the less economically sensitive sectors like Consumer Staples, which was the only sector with a positive return for the month. Data on the economy continued to indicate solid expansion. US economic growth expanded at an annual rate of 3.5% in the third quarter, lower than the 4.2% rate of the prior quarter, albeit still robust. Expansion was supported by strength in consumer spending, which accounts for around two-thirds of economic growth. For the month of October, the S&P500 declined by 6.9% while the NASDAQ lost 9.2% of value.

European markets were almost uniformly lower, in concert with developments in the US although regional factors dominated sentiment. Italy was again in the spotlight after the European Union rejected its latest budget proposal. Subsequent reports emerged that Italy would target lower budget deficits for 2019 and 2020, although ratings agency Moody's proceeded to announce a downgrade to Italy's sovereign debt rating to Baa3 - one notch above junk bond status. Elsewhere, markets were impacted by lower oil prices and growing uncertainty over the shape and form of Brexit as the target date draws near. Italy (-8.0%) led the region lower for October, followed by France (-7.3%), Germany (-6.5%) and Spain (-5.3%), while losses were limited for Switzerland (-0.7%). The UK (-5.1%) was also decidedly lower.

Asian equity markets were not immune to the weakness across the developed world, with prospects for regional trade under the microscope thanks to the newly installed tariff regime. China's economic growth also eased to 6.5%, signalling a slowing of expansion, while weakness in technology stocks offshore transpired to weakness among Asia's technology sector. China's Shanghai Composite index ended the month 7.8% lower, while Korea (-11.6%), Taiwan (-10.9%), Hong Kong (-10.1%), Japan (-9.1%) and Singapore (-7.1%) all succumbed to weakness.

The Australian dollar resumed its weakening trend to end the month 2.1% lower against the US dollar. It was however 0.5% stronger against the euro and relatively unchanged against the British pound. Commodity markets witnessed a strong correction as the crude oil price fell by 10.8% to close at US\$65 per barrel, while Gold rose by 1.9% to just over US\$1200.

Australian bond yields fell during October as a risk-off turn mid-month drove investors to safe-havens. There was no specific driver behind the deterioration in sentiment, although the combination of several factors likely played a part. These included continued trade war tensions, ongoing monetary policy normalisation, political uncertainty in Europe and stretched market valuations. Meanwhile, there was little action on the domestic monetary policy front with the Reserve Bank of Australia (RBA) leaving rates on hold once again. The accompanying statement also suggested no changes in the near-term; however, more constructive comments on the labour market and GDP growth were two small alterations to the communication. This was echoed in the monthly employment figures that revealed a drop in the unemployment rate from 5.3% to 5.0%, a six year low. Third quarter inflation data was softer-than-anticipated, with a 0.4% rise in the trimmed mean measure over the period. On market movements, the Australian 3- and 10-year yields both fell 4 basis points (bp) to 2.04% and 2.64% respectively. At the very front-end, the 90-day BBSW dropped 3bp to 1.91%.

Global bonds experienced a relatively volatile month. After yields rose in the first half of the month they retraced most of their move in the second half as risk appetite soured and investors flocked to safe-havens. Looking at data for the world's largest economy; US third quarter real GDP grew a healthy 3.5% annual rate, the monthly Non-Farm Payrolls print was weak at only 134,000, however, the 6-month average remained above 200,000. The unemployment rate also dropped from 3.9% to 3.7%, the lowest level since 1969. Regarding monetary policy abroad, the Fed did not meet during the month; however, comments from Chairman Powell were perceived as hawkish. Similarly, the post-meeting press conference with European Central Bank (ECB) President, Mario Draghi, was interpreted as more positive. On market movements, the US the 2- and 10-year yields retraced most of their earlier increase to respectively finish only 5bp and 8bp higher at 2.87% and 3.14%.

## Portfolio performance

The Pandal Active Balanced Fund (formerly the BT Wholesale Active Balanced Fund) returned -4.47% (post-fee, pre-tax) for the month of October, underperforming its benchmark by 0.84%.

The Fund's negative return for October was largely a function of its exposure to Australian and offshore equity and listed property markets which declined in value through the month. Exposure to alternatives also detracted from returns this month. Global fixed income was also negative for the month, largely related to rising US bond yields. Australian fixed income generated a positive return, albeit with limited impact to overall performance.

At a Fund level, the underperformance was primarily driven by manager contribution which was most prevalent in Australian equities, the core global equity strategy, and alternatives. The contribution from tactical asset allocation was largely driven by the Fund's overweight exposure to Australian equities and alternatives.

The key factors influencing the alpha generated through active management were stock selection outcomes within Australian equities. Within the Australian equity strategy, overweight positions in Ramsay Health Care and Amcor, plus holding no exposure to Woodside Petroleum and an

underweight to National Australia Bank contributed to returns. These contributions were more than offset by overweight positions in CYBG, AMP and Nine Entertainment, and holding no exposure to Woolworths.

Within the global equities portfolio, the Concentrated and Emerging Markets portfolios outperformed their benchmarks but the core and European Select portfolios detracted from relative performance.

Our Alternatives core portfolio registered a negative return this month. Through the month, six of the eight sub-strategies delivered negative returns, while the other two had a neutral impact. The Alternatives strategy delivered a total return (before fees) of -1.46% versus a cash return of 0.17%.

The Managed Futures, Equity Market Neutral, Global Macro and Equity Market Neutral strategies generated negative returns this month after being impacted by long positions in equity and commodity markets. Momentum and quality themes were the main detractors this month. These were offset by some contributions from value themes.

In relation to our tactical positioning within the Alternatives component of the Fund, the overall positioning had a negative impact on performance. Gains through our short position in copper were offset by losses from a long position in crude oil. Both positions were neutralised at the end of the month. Small contributions from positioning in Australian and German bonds were offset by deductions from long equity market positions. At the end of October we held long equity positions in the US and Australia, and short positions in German and US bonds, and gold.

## Strategy and outlook

The increased volatility of equity markets we have witnessed in recent weeks have naturally made investors feel uncomfortable. However, what we are actually seeing is a return to more normal market conditions. Even with the turmoil experienced in the S&P500 in February, April and now October, the realised volatility of daily market movements is still nearly 2% below the average since the 1970s and exactly in line with the median. Hence, this can be viewed as fairly typical of market behaviour.

There are many possible causes for the increased volatility, but a key factor relates to central bank suppression of properly functioning markets, which now appears to be coming to an end (at least in the US). Given the strong market returns in the nearly 10 years since the GFC, it's easy to forget that investing to earn a risk premium is associated with exposure to risk (in this case an equity market decline). There is nothing of which we are aware that challenges our belief that equities will not deliver a positive excess return over meaningful investment horizons and as such, equities retain a central part of the Fund with the role of generating long-term absolute and cash/CPI-plus returns. Further, it appears a lot of the recent volatility reflects recent geopolitical issues (in particular around global trade) and a change in sentiment around the potential for inflation. While it is very difficult to predict the outcome of the recent trade skirmish, consensus is moving towards an increase in inflationary pressure. Further, global economic conditions remain reasonable, and the current US earnings season is playing out to be above expectations.

Our aggregate tactical positions are relatively market-neutral at present, reflecting that different regions are at different stages in their economic cycles: long positions in the US and Australia are offset by short positions in German equities and positioning to take advantage of further equity market volatility. The outlook for our tactical positioning depends upon future market movements. Should the recent declines in the S&P500 and ASX indices prove to be the start of a larger decline, rather than corrective, our tactical models are likely to point to reducing exposure to those markets over the course of the next few months. That is, in a material market decline, the tactical positions would likely generate positive returns from being short. We will continue to apply a multi-faceted approach to generating additional returns on investments and managing risks, most notably with a balanced allocation across traditional markets and the diversifying properties of alternatives.

# Performance as at 31 October 2018

(%)	1 Month	3 Months	6 Months	FYTD	1 year	2 Years	3 Years	5 Years	Since
					(pa)	(pa)	(pa)	(pa)	Incp. (pa)
<b>Australian Shares - All Cap</b>									
<b>Pendal Australian Share Fund</b>									
Total Return (post-fee, pre-tax)	-6.88	-7.05	-2.66	-5.41	2.55	10.86	7.38	6.25	9.72
Total Return (pre-fee, pre-tax)	-6.82	-6.87	-2.27	-5.16	3.36	11.74	8.23	7.09	10.72
Benchmark	-6.16	-5.98	-0.54	-4.75	2.88	9.20	8.24	6.00	9.69
<b>Pendal Imputation Fund</b>									
Total Return (post-fee, pre-tax)	-6.36	-6.54	-0.59	-4.92	2.73	10.15	6.84	5.25	9.20
Total Return (pre-fee, pre-tax)	-6.29	-6.33	-0.14	-4.63	3.66	11.14	7.80	6.20	10.21
Benchmark	-6.16	-5.98	-0.54	-4.75	2.88	9.20	8.24	6.00	8.38
<b>Pendal Focus Australian Share Fund</b>									
Total Return (post-fee, pre-tax)	-7.41	-7.58	-3.28	-5.82	3.10	12.11	9.14	8.03	8.83
Total Return (pre-fee, pre-tax)	-7.37	-7.48	-3.25	-5.57	4.12	13.53	10.26	9.12	9.94
Benchmark	-6.16	-5.98	-0.54	-4.75	2.88	9.20	8.24	6.00	7.10
<b>Pendal Ethical Share Fund</b>									
Total Return (post-fee, pre-tax)	-6.98	-6.86	-3.10	-5.17	2.07	10.63	7.27	6.55	8.21
Total Return (pre-fee, pre-tax)	-6.90	-6.64	-2.64	-4.87	3.05	11.69	8.30	7.56	9.26
Benchmark	-6.16	-5.98	-0.54	-4.75	2.88	9.20	8.24	6.00	7.74
<b>Australian Shares - Mid Cap</b>									
<b>Pendal MidCap Fund</b>									
Total Return (post-fee, pre-tax)	-8.89	-7.70	-5.87	-7.28	4.29	13.37	12.88	12.42	9.99
Total Return (pre-fee, pre-tax)	-8.82	-7.49	-5.81	-7.00	5.88	14.82	14.20	13.89	12.18
Benchmark	-7.95	-6.05	-2.23	-4.96	4.13	12.18	12.67	11.28	5.52
<b>Australian Shares - Small Cap</b>									
<b>Pendal Smaller Companies Fund</b>									
Total Return (post-fee, pre-tax)	-9.86	-7.65	-5.78	-8.61	3.71	8.88	8.39	7.79	12.86
Total Return (pre-fee, pre-tax)	-9.76	-7.37	-5.19	-8.23	5.01	10.23	9.74	9.14	14.15
Benchmark	-9.60	-7.67	-4.22	-8.60	2.59	8.42	10.54	6.00	7.51
<b>Australian Shares - Micro Cap</b>									
<b>Pendal MicroCap Opportunities Fund</b>									
Total Return (post-fee, pre-tax)	-7.73	-4.34	0.85	-3.68	3.84	9.44	14.49	15.27	17.67
Total Return (pre-fee, pre-tax)	-7.49	-3.90	1.62	-3.14	5.25	10.82	16.72	18.91	22.74
Benchmark	-9.60	-7.67	-4.22	-8.60	2.59	8.42	10.54	6.00	2.77
<b>International Shares</b>									
<b>Pendal Core Global Share Fund</b>									
Total Return (post-fee, pre-tax)	-6.60	-3.26	0.36	-1.04	4.80	13.26	6.10	12.24	5.80
Total Return (pre-fee, pre-tax)	-6.52	-3.03	0.83	-0.72	5.80	14.34	7.12	13.31	6.96
Benchmark	-5.40	-0.94	4.30	1.55	9.60	15.63	8.15	13.40	7.37
<b>Pendal Global Emerging Markets Opportunities Fund - WS</b>									
Total Return (post-fee, pre-tax)	-6.22	-6.59	-8.04	-6.17	-6.44	10.34	5.85	8.46	9.49
Total Return (pre-fee, pre-tax)	-6.09	-6.25	-7.38	-5.72	-5.11	11.89	7.33	10.08	11.69
Benchmark	-6.80	-7.33	-11.10	-5.87	-5.36	8.98	6.76	6.80	8.90
<b>Pendal Concentrated Global Share Fund</b>									
Total Return (post-fee, pre-tax)	-3.12	-1.30	3.57	0.80	11.05	17.17	N/A	N/A	14.42
Total Return (pre-fee, pre-tax)	-3.05	-1.08	4.04	1.10	12.18	18.49	N/A	N/A	15.73
Benchmark	-5.40	-0.94	4.30	1.55	9.60	15.63	N/A	N/A	13.08
<b>Property</b>									
<b>Pendal Property Securities Fund</b>									
Total Return (post-fee, pre-tax)	-3.89	-2.07	4.01	-0.96	7.13	7.70	7.10	10.93	7.40
Total Return (pre-fee, pre-tax)	-3.83	-1.90	4.35	-0.74	7.82	8.40	7.80	11.65	8.21
Benchmark	-3.12	-2.13	4.06	-1.19	7.31	7.95	7.43	11.30	7.29
<b>Pendal Global Property Securities Fund</b>									
Total Return (post-fee, pre-tax)	-3.27	-3.60	1.40	-2.77	2.12	4.74	3.76	7.61	8.82
Total Return (pre-fee, pre-tax)	-3.18	-3.38	1.85	-2.47	3.05	5.71	4.71	8.60	9.81
Benchmark	-3.21	-3.92	1.11	-3.02	1.78	4.34	3.88	7.75	8.51
<b>Fixed Interest</b>									
<b>Pendal Fixed Interest Fund</b>									
Total Return (post-fee, pre-tax)	0.43	0.44	2.20	0.32	2.78	1.79	1.97	4.04	6.34
Total Return (pre-fee, pre-tax)	0.48	0.57	2.46	0.49	3.29	2.30	2.48	4.56	6.89
Benchmark	0.48	0.87	2.21	1.03	3.09	2.36	2.92	4.39	6.56
<b>Pendal Global Fixed Interest Fund</b>									
Total Return (post-fee, pre-tax)	-0.11	-0.91	-0.37	-1.57	-0.56	-0.38	1.33	3.60	5.75
Total Return (pre-fee, pre-tax)	-0.06	-0.78	-0.10	-1.39	-0.04	0.15	1.86	4.15	6.33
Benchmark	-0.05	-0.43	-0.09	-0.71	0.28	0.61	2.60	4.33	6.67
<b>Pendal Enhanced Credit Fund</b>									
Total Return (post-fee, pre-tax)	0.43	0.94	1.91	1.13	2.93	3.04	3.31	4.44	5.67
Total Return (pre-fee, pre-tax)	0.47	1.05	2.14	1.28	3.39	3.51	3.78	4.91	6.20
Benchmark	0.45	0.99	2.06	1.22	3.15	3.09	3.38	4.45	5.79
<b>Cash &amp; Income</b>									
<b>Pendal Enhanced Cash Fund</b>									
Total Return (post-fee, pre-tax)	0.15	0.57	1.14	0.79	2.36	2.75	2.72	2.81	4.89
Total Return (pre-fee, pre-tax)	0.17	0.63	1.26	0.88	2.62	3.01	2.97	3.07	5.22
Benchmark	0.17	0.49	1.01	0.69	1.89	1.83	1.93	2.18	4.82
<b>Pendal Managed Cash Fund</b>									
Total Return (post-fee, pre-tax)	0.16	0.48	0.95	0.64	1.83	1.82	1.93	2.15	6.37
Total Return (pre-fee, pre-tax)	0.18	0.54	1.06	0.72	2.06	2.04	2.16	2.37	6.67
Benchmark	0.17	0.49	1.01	0.69	1.89	1.83	1.93	2.18	6.45
<b>Pendal Monthly Income Plus Fund</b>									
Total Return (post-fee, pre-tax)	-0.78	-0.41	0.91	0.01	2.31	3.67	3.50	4.19	5.29
Total Return (pre-fee, pre-tax)	-0.73	-0.25	1.24	0.22	2.98	4.34	4.18	4.87	5.96
Benchmark	0.13	0.38	0.76	0.51	1.51	1.51	1.62	1.92	2.85
<b>Diversified</b>									
<b>Pendal Active Balanced Fund</b>									
Total Return (post-fee, pre-tax)	-4.47	-4.09	-1.86	-3.05	1.13	7.51	5.10	6.58	7.50
Total Return (pre-fee, pre-tax)	-4.39	-3.86	-1.38	-2.73	2.10	8.53	6.09	7.59	8.57
Benchmark	-3.63	-2.55	0.91	-1.40	3.89	7.85	6.49	6.96	7.39

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