Fund Manager Commentary

Quarter ended 30 June 2019

Table of Contents

Australian Shares

Pendal Australian Share Fund

Market Review

The S&P/ASX 300 Accumulation Index had a strong second quarter, adding 8.1% to what was already a solid recovery in the previous quarter (+10.9%) following the market's decline in late 2018. Overall, the market returned +11.4% for FY19, with Resources (+15.0%) outperforming and Industrials (+10.5%) the laggard.

Domestically, sentiment improved somewhat following the Coalition's surprise win in the Federal election. Nevertheless, the 10-year bond yield is now at record lows, down by 45bps over the June quarter, and by 132bps over the year. The subdued outlook for the economy, and the dovish stance of global central banks, including the RBA which cut the cash rate to a record low of 1.25% in June, have been driving down long-term bond yields. In that vein, gold is also fetching multi-year high prices, as investors make the rotation into the safe haven asset. Outside Australia, the reprieve achieved in US-Sino trade is expected to somewhat allay concerns around the outlook for global economic growth, although this may prove temporary.

Over the quarter, Energy (-0.2%) was the worst performing GICS sector, and the only one posting a loss. The oil price, which had been volatile over the period is starting to stabilise somewhat, finishing the quarter at US$65/bbl, down from US$68/bbl at March end after rising as high as $75/bbl and to a low of $60/bbl during the period. Global supply could become tight again given OPEC has decided to extend existing production curtailment. Within the sector, Oil Search (OSH, -9.9%), Viva Energy (VEA, -13.9%) and Caltex (CTX, -5.6%) were the largest performance detractors. For OSH, the political unrest in PNG, which saw the country's Prime Minister resign in May, has led to some concerns that it could result in a re-negotiation of OSH's gas agreements with the local government. For VEA and CTX, the combination of weak refiner margins and subdued retail fuel margins was a key drag on investor sentiment.

Communication Services (+12.2%) gained the most over the quarter with the help of some retail cyclicals following the Federal election. No change in government and therefore no significant policy shifts is expected to improve sentiment for older consumers and help business confidence. The subsequent cut to the cash rate by the RBA, together with news APRA may reduce its mortgage serviceability assessment rate from 7.25% provided investors with some assurance policy makers are actively trying to avoid a housing confidence-led downturn. REA (+28.6%), Nine Entertainment (NEC, +9.7%) and Domain Holdings (DHG, +24.7%) all advanced in that regard. However, the largest contributor to sector returns was Telstra (TLS, +16.0%), which has recently come out of the nadir of sentiment. In that vein, the Australian Competition and Consumer Commission (ACCC) ruled against the merger between telecom operators TPG Telecom (TPM, -7.1%) and Vodafone. The outcome will be a legal tussle which is likely to be resolved towards the end of CY19 – at best – but could drag on into mid-next year. It is a positive for Telstra in the near term as it further delays a roll-out of a competitive 5G network.

Lastly, index heavyweight Banks (+13.4%) outperformed for the quarter. The retention of negative gearing, lower rates and an easier serviceability hurdle in conjunction is expected to stabilise the housing market and, in turn, reduce pressure on the banks. The 'big four' banks all recorded strong returns for the quarter as a result, ranging from 9.4% (NAB) to 17.2% (CBA).

The other key cohort of the market, the Miners had mixed performance over the quarter: gold miners (+19.7%) outperformed strongly; whereas the iron ore miners such as BHP (+6.9%) and Rio Tinto (RIO, +6.0%) were the laggards. That said, Australian iron ore miners continue to operate in their sweet spot, with the commodity now trading ~US$110/mt and the Australian dollar hovering around US$0.70.

Portfolio performance

The Pendal Australian Share Fund returned 6.80% (post-fee, pre-tax) for the June quarter, underperforming its benchmark by 1.25%.

Contributors

Overweight Fortescue Metals

The Australian iron ore miners as a cohort is operating in a sweet spot, given the confluence of a number of macro and stock-specific factors. Reasonable Chinese demand and a reduction in Brazilian production is supporting prices at a far higher level than the market expected. The return of Fortescue (FMG, +35.9%) was boosted by the announcement of a 60c-a-share special dividend. The company's total yield, including special dividends and buy-backs, is now running at about 20%, providing plenty of stock support. While we do not anticipate global iron ore prices to stay elevated at the US$110-120/mt level, it is also hard to see the commodity trade on the downside of $80/mt due to the supply constraints globally. The demand side of the equation is somewhat bifurcated: weak demand from autos is offset by strong demand from infrastructure. Overall, it still looks strong, and we continue to see an upbeat outlook for FMG for the near term.

Overweight Aristocrat

Aristocrat (ALL, +26.3%) delivered a good set of first half results where the normalised profit after tax and before amortisation of acquired intangibles (NPATA) came in strongly at $422.3m. It represented a 17% increase compared to that of H1-2018, beating market expectation. Investors were also pleased to see management reiterate the "continued growth" outlook for FY19, suggesting some earnings skew towards the second half of FY19.

Overweight Telstra

The long-beleaguered Telstra (TLS, +16.0%) has recently come out of the nadir of sentiment. In that vein, the Australian Competition and Consumer Commission (ACCC) ruled against the tie-up between telecom operators TPG Telecom (TPM, -7.1%) and Vodafone. The outcome at best will be a legal tussle which is likely to be resolved towards the end of CY19 but could drag on into mid-next year. It is a positive for Telstra in the near term as it further delays a roll-out of a competitive 5G network.

Detractors

Overweight Qantas

A stronger oil price and softer domestic environment has weighed on Qantas (QAN, -4.6%) in recent months. We believe that improved demand in the international sector and disciplined capacity growth by global airliners should help Qantas offset a slowdown in domestic corporate travel. QAN has also been able to grow revenues off the back of less fare discounting, which should enable it to offset higher fuel costs for FY19.

Overweight Viva Energy

Viva Energy (VEA, -13.9%), which supplies more than 50% of all fuel used in Victoria, and the sole distributor of Shell-branded fuel in Australia pulled back over the quarter. The refiner margin, which has always been volatile, has been at the downside lately. In addition, VEA's retail business update in April revealed that lower retail fuel margins on the back of the rising oil prices, and the lag in passing these on to end customers is also going to hit earnings harder than expected. We remain mindful that there have been unmistakeable signs of economic deceleration in recent months. However, the Coalition’s surprise victory in the Federal election, coupled with a rate cut from the RBA, should help to underpin consumer sentiment. Economic growth remains muted, but government and regulator efforts to combat a housing-induced economic slowdown does remove a material portion of downside risk for the economy. In addition to these cyclical factors, the recent favourable restructuring of VEA's fuel supply agreement with Coles should add substantial value and see benefits in both fuel and non-fuel revenues. VEA paid a low price for access to the retail fuel margin and there is the potential for the retail network to return to growth on the back of a better approach to pricing. It also possesses attractive infrastructure assets – one of only four refineries in Australia as well as pipelines and terminals and other pieces of key infrastructure which underpin strong positions in mining, marine, airports etc. We continue to hold conviction in the company.

Overweight Oil Search

The recent political unrest in Papua New Guinea (PNG), which saw the country's Prime Minister resign in May, has led to some investor concerns that it could result in a re-negotiation of OSH's gas agreements with the local government. In addition, management elected to exercise the Armstrong option for US$450m in June, which will double the company's interests in the Pikka Unit, Horseshoe Block and other exploration leases in Alaska. Although the option will be funded via existing corporate facilities, and the company has indicated its intension to divest some of these assets before mid-2020, the market remains sceptical for now. Any hiccup in executing the sell down plan could potentially see OSH run into financial issues down the road.

Strategy and outlook

Solid gains in June capped a strong first half to 2019, in which Australian equities have staged a rapid rebound from the sell-off in late 2018. The S&P/ASX 300 is up +3.6% for the month, +8.1% for the quarter and +19.8% for the first half.

At an economic level, we remain in an environment of muted growth. While the effect of interest rate cuts on broader economic activity is questionable, it does demonstrate that policy makers are actively working to avoid a housing-led economic downturn. The reduction in this threat has improved sentiment; however, we believe that it is a case of removing downside risk, rather than expecting a meaningful pick-up in near-term economic growth. This is a view echoed in our meetings with domestic cyclical companies, who have noted that the environment remains challenging.

Corporate earnings look set to grow in the mid-single-digit range over the near term. There is considerable dispersion underneath this headline figure. Resource stocks – and in particular iron ore miners – remain in a sweet spot, as do the contracting companies which service them. The bank sector has seen some sentimental improvement alongside the housing sector. However, the already stiff headwinds for earnings are only exacerbated by rate cuts. Beyond these, growth remains patchy.

This underpins the benefits of being able to distinguish between those companies which can adapt to the current environment — and those which are more challenged — and allocate capital accordingly.

While elevated macro risk, primarily related to trade, dominates headlines, there are several positive factors for Australian equities including high commodity prices, a depreciated currency, and falling interest rates. As a result, we believe that despite the market's strong run over the year to date, the outlook for equities remains reasonable.

The portfolio made decent absolute gains in June, with strong performance from the iron ore stocks. The bond-sensitives exposures via infrastructure stocks such as Transurban and Atlas Arteria also performed well. However, it underperformed the index given a weak month for Qantas, one of the Fund's largest positions, as well as a drag from Metcash, Nine Entertainment and Caltex.

Qantas also weighed on returns over the quarter, largely on the back of a higher oil price. We retain the view that Qantas can offset a higher fuel bill via revenue growth. The oil price has also seen weaker volumes for fuel companies, Viva Energy and Caltex Australia, which are also among detractors for the quarter. Both are facing headwinds, although they are largely cyclical rather than structural and we believe the market is under appreciating the value in both companies.

On the positive side, the iron ore exposure has worked well in Q2 2019. Iron ore miners are in a sweet spot given a high US dollar price combined with a weaker dollar and a far lower cost base than has been the case in previous years. The infrastructure exposure has also worked well, as has the position in Telstra which has rebounded following the ACCC's decision to try and block the tie up between TPG Telecom and Vodafone.

Growth exposure has been one of the more challenging areas over the last twelve months, given the relative scarcity of genuine growth opportunities in the Australian market and the heady valuation that many of the stocks are subsequently pushed to. Nevertheless, our preferred growth stocks such as Xero and Aristocrat Leisure also performed well.

Pendal Smaller Companies Fund

Market review

There was some performance divergence between the S&P/ASX Small Ordinaries Accumulation Index and its large cap counterpart, the S&P/ASX 100 Accumulation Index over the quarter. The former index finished the period +3.7% higher, underperforming the latter by 4.8%. The small cap universe did not benefit as much from the boost of mining stocks, while weakness among some of the larger index-weights also detracted from relative performance.

Small Resources (-2.3%) finished the quarter with a negative return. Gold miners (+5.5%) performed strongly as the precious metal rose to multi-year highs, although it was more than offset by the diversified miners (-7.4%). Rising concerns that demand from China for lithium ore could deteriorate further weighed on investor sentiment for Pilbara Minerals (PLS, -31.0%) and Galaxy Resources (GXY, -44.4%); whereas Aurelia Metals (AMI, -44.4%) missed market expectation on both volume and All-In-Sustainable-Costs for the third quarter. Offsetting some of the losses was Lynas Corporation (LYC, +23.0%). The rare earth miner was one of the few beneficiaries from intensifying China-US trade tensions, with speculation China could withhold global rare earth supplies in retaliation to the latest round of tariffs imposed by the Trump administration. Management also outlined a $500m growth program that will be self-funded.

Also weighing on Resources, Energy (-4.4%) recorded losses over the June quarter. The oil price stabilised somewhat, finishing the quarter at US$65/bbl; down from US$68/bbl at March end. Oil traded as high as $75/bbl and a low of $60/bbl during the period. Global supply could become tight again given OPEC has decided to extend the existing production curtailment. Within the sector, Viva Energy (VEA, -13.9%), which supplies more than 50% of all fuel used in Victoria and is the sole distributor of Shell-branded fuel in Australia, was the largest performance detractor. Refiner margins are inherently volatile and has been under pressure in recent months. In addition, VEA's Retail business update in April revealed lower retail fuel margins on the back of rising oil prices, together with a lag in passing these on to end customers is going to impact earnings more than anticipated.

Elsewhere, Consumer Staples (-6.4%) posted the largest sector loss over the quarter, mainly ascribed to the poor performance of Costa Group (CGC, -21.4%) and Graincorp (GNC, -13.2%). In May, CGC delivered a guidance downgrade that disappointed the market. The company disappointed on a number of fronts, including a later-than-usual blueberries harvest from its Moroccan acreage which brings the product into competition with Spanish suppliers, putting pressure on prices. At the same time, CGC has experienced issues with the quality of its raspberry crop and the discovery of a fruit fly at its NSW citrus farms, which could see an increase in costs as fruit is shipped elsewhere for storage and packing. Some pressure on costs also arose for its mushroom produce. Conversely, crop grower GNC released its first-half results, where earnings (EBITDA) for the period dropped by 78% year-on-year, despite a 25% increase in sales. The persistent east coast drought conditions continue to weigh on the Grains division, whereas margin compression was evident in both the malt and oils businesses. The market also remains sceptical about management's commentary around the proposed spin-off of the malts business towards the end of 2019. In contrast, Select Harvests (SHV, +21.4%) reported some strong numbers for its first-half results, driven by the best almond crop yield in six years which was well received by the market.

Industrials (+15.9%), Health Care (+14.3%) and Financials (+9.4%) performed well over the quarter. Nearmap (NEA, +34.5%), Austal (ASB, +51.6%) and Bingo Industries (BIN, +47.7%) led the Industrials sector higher. NEA is a provider for location intelligence services, with high resolution and timely aerial imagery. Deploying a Software-as-a-Service (SaaS) business model, investors are currently giving management great credibility in their ability to scale up the business, with continuous market expansion in the US.

Portfolio performance

The Pendal Smaller Companies Fund returned 1.77% (post-fee, pre-tax) for the quarter, underperforming its benchmark by 1.98%.

Contributors

Overweight Austal

Austal is a shipbuilder specialising in defence and commercial vessels. It benefited from inclusion in the S&P/ASX 200 Index during the month as well as steady supportive news flow. A modification of its existing contract to provide the design and construction for two fast transport vessels for the US Navy was announced in late April. This comes on the back of several recent contract wins to build ships and service contracts for the US Navy and the expectation that it is in a good position to win further work, given the withdrawal of a key competitor.

Overweight AP Eagers

A softer domestic economy has dragged on car sales, which has had a negative impact on operational performance of car yard owner, AP Eagers. However, the market has welcomed the news of a proposed merger with Automotive Holdings Group (AHG). The combined group will have just over 10% market share of the national new car dealership market. The deal offers significant synergies and fits well on a geographical basis, given AHG is primarily west-coast focused and AP Eagers on the east.

Detractors

Overweight AUB

Insurance services company AUB Group delivered a soft set of earnings, driving near term underperformance. While the underlying insurance cycle remains supportive, some of this has been offset in recent months by changes in iCare (formerly WorkCoverNSW) which have led to a transitory slowdown in referrals. We expect a recovery in earnings for the relevant division in FY20. More broadly, the company raised $142m in November 2018 to position them to take advantage of M&A opportunities. In the near term, dilution from the capital raise has weighed on the stock. In the medium term we expect the company to continue to allocate capital efficiently into M&A, driving shareholder value.

Underweight NIB Holdings

The Coalition's surprise victory in the Federal election sent NIB's share price higher. Labor's proposed policies included mandatory caps on annual health insurance premium increases. The stock has bounced on the removal of this threat and our underweight position dragged on relative performance.

Strategy and outlook

A positive June capped a strong 2019 first half for the Australian small cap equity sector, which has staged a rapid rebound from the sell-off in late 2018. The S&P/ASX Small Ordinaries Index is up +0.9% for the month, +3.8% for the quarter and +16.8% for the half year.

Smaller companies have underperformed the larger end of the index over 2019 to date. This has been driven by strength in the iron ore sector, dominated by the big three of Rio Tinto, BHP and Fortescue Metals. At the same time, conclusion of the Banking Royal Commission, coupled with an improvement in sentiment towards the housing sector has seen the big four banks outperform.

Nevertheless, smaller companies have delivered strong absolute returns over the last half in aggregate, although performance has been mixed at a sector level. Information technology is up +43.7% calendar year to date, led by software-as-a-service companies Wisetech and Appen. This high-profile growth cohort continues to perform well and this quarter Altium joined Xero and Afterpay in the ASX 100, leaving the Small Ordinaries.

Consumer staples, in contrast, are down -9.7% over the half. This reflects a combination of challenges including concern over the domestic supermarket sector (Metcash), uncertainty around Chinese growth (Blackmores) and company-specific issues at other companies such as Costa Group and Graincorp.

The portfolio performed in line with the index in June. Insurance brokers AUB Group downgraded earnings on the back of weaker volumes and higher-than-expected costs of a new IT system, however this was offset by strong gains from Austal and Nanosonics. The latter two are good examples of the kind of niche growth opportunities available in the small cap universe. Austal builds and services specialised ships, with contracts with the US Navy. Nanosonics manufactures equipment to clean ultrasound probes in hospitals.

The portfolio lagged the index over the quarter. Austal has been a strong performer for some time, while auto dealership AP Eagers has also done well as it looks to merge with rival Automotive Holdings Group. However, this was offset by the drag from AUB Group and the underweight in NIB Holdings, the latter continuing to outperform following the Coalition's election victory which removes the probability of near term caps on health insurance premiums.

Looking forward, we continue to see a challenging environment in domestic cyclicals on the back of tighter bank lending and softer house prices, which is showing up in weaker new car sales, media advertising and general retail. That said, government efforts to stimulate demand should provide some degree of support.

Elsewhere in small caps, a weak Australian dollar is supporting offshore earnings and helping those companies with niche growth opportunities in technology, health care and education.

Lower interest rates in Australia and elsewhere is providing further fuel for the growth parts of the market. There are valid opportunities here with some valuation support, however there are also stocks where we believe valuation has run ahead of reasonable levels and the market is being less discerning over the quality of these companies. While several of the more popular technology stocks have now left the index, finding attractively-priced growth remains a challenge for small cap investors.

As always, we retain our valuation discipline and look to have a diverse range of ideas within the portfolio. Our favoured tech stock remains Technology One. Elsewhere, the Fund's largest positions also include mining services (Seven Group), logistics (Mainfreight) and quality stocks with defensive earnings such as INvocare and Ryman Healthcare.

International Shares

Pendal Concentrated Global Share Fund

Market review

Global equity markets followed the yo-yo path through the June quarter, rising in April before trade-related fears weighed on sentiment in May only to be resurrected in June as markets gained on expectations the US Fed would pivot on its path to ease monetary conditions. The G20 meetings took place in the last days of June and while no definitive agreement was concluded, a resumption of US-China trade talks, the absence of additional tariff announcements and the resumption of US technology exports to Huawei appeared to placate investors. This led the benchmark MSCI World ex Australia (A$) Index to deliver a 5.2% return for the quarter.

The bulk of the US second quarter reporting season proceeded in April, with a majority of companies reporting earnings ahead of expectations, although earnings growth was considerably muted. Economic data also continued to support sentiment, with first quarter GDP coming in at an annual growth rate of 3.2%. Positive data on consumer sentiment, retail sales and employment growth also supported market sentiment. The S&P500 registered a 3.8% gain for the quarter, while the NASDAQ had risen by 3.6%.

The Australian dollar was relatively unchanged against the US dollar, euro and Japanese yen. In commodity markets the oil price held onto its strength being range bound to close the quarter at US$65 per barrel.

Portfolio performance

The Pendal Concentrated Global Share Fund returned 3.54% (post-fee, pre-tax) for the quarter, underperforming its benchmark by 1.65%.

The gains of the first quarter were extended into the second quarter of 2019, with the S&P 500 & MSCI World reaching all-time highs. The gains in equity markets have taken place amid a backdrop of messaging from the US Federal Reserve signalling interest rates are on hold, whilst the European Central Bank indicated rate increases are not under consideration until at least 2020. Meanwhile, Global PMI data disappointed, Brexit negotiations failed and the pendulum representing the to and fro of US/China trade talks ended on a more positive note at the G20 meeting. While the Chinese market underperformed global peers this quarter, it remains the best performing major market for the year to date.

The underperformance of the Fund this quarter can be attributed primarily to our cash holding which ended the quarter at 6.6%.

Continuing the research agenda

The team travelled extensively this quarter, visiting companies in the UK, Europe, US and India. In the US we found domestically focused businesses to be relatively upbeat regarding the operating environment. US businesses with global operations have understandably become increasingly cautious as future global trading conditions remain uncertain. In Europe, corporates are dealing with the added uncertainty of the outcome of Brexit negotiations under a yet to be decided new Prime Minister in the UK. Our trip to India was exploratory in nature and although the economy's dynamics are promising, valuations in the most part reflect that promise. In the context of our global research, we will continue to monitor and do more work on the companies of interest in India.

We made a number of changes to the portfolio this quarter. We sold our position in Restaurant Brands (QSR), Baidu, and Seven & I Holdings (Seven Eleven Japan), while initiating a new position in Facebook. QSR owns the Burger King, Popeye's and Tim Horton restaurant brands and had been in the portfolio since inception. Our view was that the market was under-appreciating the earnings potential that a number of new store openings would unlock, in addition to the power of the franchise model at scale. Our thesis largely played out, with the company accelerating its net restaurant openings to over one thousand per annum in the last couple of years, while delivering the requisite boost to earnings. However, the share price rose to a record high this quarter to the point where it no longer reflected a large enough discount to what we consider the intrinsic value of the company to be. Hence, we opted lock in the gain and exit our position.

Portfolio exits

Our decisions to exit positons in Baidu and Seven Eleven were based on a thorough re-assessment of the outlook and business case for both companies after disappointing share price performances since initiating the original positons. The positon in Baidu represented less than 1% of the Fund. Although its valuation was compelling, an increase in investment spend by the company suggested their competitive advantage in the Chinese online advertising market was not as strong as we originally thought. We did not have the confidence to increase our holding to a more meaningful position and hence opted to exit. We continue to research the Chinese internet sector and monitor the competitive dynamics of the industry.

Similarly in Seven Eleven, our original positon was predicated on a view that the consolidation opportunities open to their US business were being under appreciated, with the market discounting the company because of the structurally challenged department store and supermarket business in Japan. We subsequently became concerned over news that disgruntled franchisees appeared to be making head-way with policy-makers in regard to the franchise terms previously agreed with the parent company. While we still believe that there are consolidation opportunities for their US business, the lack of reform in the structurally challenged department store and supermarket industry in Japan, as well as our lack of confidence in the path to dispute resolution between franchisor and franchisee, led us to make a decision to exit the position.

Facebook gets a like

We have been researching Facebook (FB) for some time and its metrics are compelling. It is the world's largest social networking platform with 1.5b daily active users. Together with Google, the two platforms account for over 75% of total Global (ex-China) online advertising spend. The bulk of advertising revenue coming from mobile advertising, with the total mobile advertising growing at a double-digit rate. Operating margins are in the mid-thirties and the company has no debt. Facebook also offers the potential from under-monetised adjacent businesses such as Instagram and WhatsApp.

Facebook has developed a track record of innovation and the ability to drive user engagement. As such, it is generating strong free cash flow at an attractive valuation. Given the long term nature of our investment time horizon, our research was focused on becoming confident in the sustainability of margins and the containment of costs in light of the regulatory headwinds facing the company. We believe that the regulatory scrutiny will continue for some time, and that there will be costs associated. However, we have also come to the conclusion that the company management have acknowledged the reality of the situation and are driving operational change. The most recent quarterly earnings revealed what appears to be a peak in content control cost growth, with the absolute number unlikely to be as much as many in the market were expecting. We believe over time this will see capital expenditure come down, and margin pressure abate. As such, we initiated a 2.5% weighting in the Fund.

Strategy and outlook

The Fund's cash weighting has reduced to around 6% from about 10% at the end of 2018. This allocation continues to reflect some concern that the earnings growth and margins implied by consensus estimates appears optimistic for the second half of the year. With a number of macro uncertainties clouding the outlook, we expect future volatility to present opportunities for the Fund, as it enables us to either add to existing positons or initiate new positions.

We believe the Fund is positioned to outperform over the longer term. Although markets reversed the losses of the prior month, there remains a high degree of uncertainty regarding the near term outlook.

Our focus remains on owning companies that are equipped with robust business models, have nimble management teams and dominant market shares. We buy these companies when valuations are compelling and when we have the confidence they are able to not only withstand but prosper, regardless of what the economic cycle may have to offer.

Our philosophical belief in owning a concentrated portfolio of businesses, rather than having indiscriminate broader market exposure, continues to reflect the way we manage the Fund. Our approach is to generate compelling returns over the long term while retaining a disciplined, yet opportunistic approach to identifying undervalued companies with the fundamental characteristics that will support its long term performance.

Pendal Core Global Share Fund

Market review

Global equity markets followed the yo-yo path through the June quarter, rising in April before trade-related fears weighed on sentiment in May only to be resurrected in June as markets gained on expectations the US Fed would pivot on its path to ease monetary conditions. The G20 meetings took place in the last days of June and while no definitive agreement was concluded, a resumption of US-China trade talks, the absence of additional tariff announcements and the resumption of US technology exports to Huawei appeared to placate investors. This led the benchmark MSCI World ex Australia (A$) Index to deliver a 5.2% return for the quarter.

The bulk of the US second quarter reporting season proceeded in April, with a majority of companies reporting earnings ahead of expectations, although earnings growth was considerably muted. Economic data also continued to support sentiment, with first quarter GDP coming in at an annual growth rate of 3.2%. Positive data on consumer sentiment, retail sales and employment growth also supported market sentiment. The S&P500 registered a 3.8% gain for the quarter, while the NASDAQ had risen by 3.6%.

The Australian dollar was relatively unchanged against the US dollar, euro and Japanese yen. In commodity markets the oil price held onto its strength being range bound to close the quarter at US$65 per barrel.

Portfolio performance

The Pendal Core Global Share Fund returned 2.08% (post-fee, pre-tax) for the quarter, underperforming its benchmark by 3.11%.

Thematically, Valuation was weak in all regions and primarily responsible for overall underperformance over the quarter. In the North America and Europe regions all themes contributed to underperformance, specifically Momentum and Value generated the largest negative returns. In developed Asia, Value was the biggest detractor, whilst Momentum and Sentiment signals were notable outperformers.

From a stock and industry attribution perspective, intra-industry stock selection drove underperformance and industry tilts produced mild negative active returns over the quarter. Stock selection within industries was weakest in Industrials and Consumer Discretionary, offset slightly by positive active returns within Energy. At a sector level, the overweight to Health Care and underweight to Financials were the largest contributors to underperformance, partly offset by an overweight to Information Technology.

At a stock level, the largest detractors from active returns came from an overweight position in Capri Holdings Limited, a multinational fashion holding company with operational headquarters in New York; an underweight position in Walt Disney Company, a US diversified multinational mass media and entertainment conglomerate; an overweight position in Deutsche Lufthansa AG (Lufthansa), a major European airline headquartered in Germany; an overweight position in Swedish Match AB, a Swedish company based in Stockholm that makes tobacco-related products; and an underweight position in J.P. Morgan Chase & Co., a US multinational investment bank and financial services company headquartered in New York City.

The largest positive contributors to active returns came from overweight positions in: Microsoft Corporation, a US multinational technology company; Synchrony Financial, a consumer financial services company headquartered in Stamford, Connecticut; Adobe Inc., a US multinational computer software company; Applied Industrial Technologies, a US based company focused on the distribution of bearings, power transmission products and other industrial supplies; and Allianz SE, a German multinational financial services company headquartered in Munich, Germany.

Strategy and outlook

Entering July, the largest sector tilts are overweights in Information Technology and Health Care and underweight positions in Financials and Energy.

Australian Fixed Income

Pendal Fixed Interest Fund

Market review

Australian bonds continued their rally in the June quarter as yields fell to new record lows. The decline in yields was shared by global counterparts alongside growing speculation of easing by major global central banks. The RBA delivered on expectations with a cut of 25bps to 1.25% during June and messaging from the Board suggesting further easing ahead. This was evident in addresses by Assistant Governor Luci Ellis and Governor Philip Lowe, who both indicated that their estimate of the unemployment rate associated with full employment had fallen from 5% to 4.5%. Labour market data during the quarter illustrated the gap between the unemployment rate of 5.2% and full employment persisted, which suggested the RBA has scope to reduce the cash rate further. By quarter-end the market was pricing an additional two cuts in 2019. Meanwhile some leading economic indicators in June reflected signs of optimism in the wake of the surprise Coalition victory at the Federal Election. Finally on market movements, Australian 3 and 10 year yields both dropped by -44bps to 0.96% and 1.34% respectively. At the very front-end of the curve, 90 day BBSW fell by a sharper -57bps to 1.20%, partly on the back of the RBA rate cut.

Portfolio performance

The Pendal Fixed Interest Fund returned 3.32% for the quarter (post-fees, pre-tax), outperforming its benchmark by 0.27%.

The portfolio outperformed its benchmark in the June quarter. In the alpha overlay, the largest contributor was the Duration strategy, which benefited from long duration exposures across a number of regions. This included the US, Australia and New Zealand. The FX strategy also added value from a number of long USD versus EM positions in May. Meanwhile, the largest contributor in the Yield Curve strategy was a US front-end flattener. In contrast, the Macro strategy detracted due to short credit exposures that suffered from the tightening of credit spreads in April and positions were subsequently taken off. Little exposure was taken in the Cross-Market and Relative value strategies and performance was roughly flat.

The government bond component also outperformed over the quarter. The Duration strategy generated gains on long 3 and 10 year Australia positions, as well as a long US 5 year position in June. The Yield Curve and Cross Market strategies also made positive contributions, as did the physical portfolio.

Finally the credit component outperformed with overweights in infrastructure and utilities and an underweight exposure to supranationals.

Strategy and outlook

The Reserve Bank eased monetary policy further at its meeting in early July. Further easing is likely to occur, although we view a further rate cut occurring in August as being unlikely. Waiting until October, or as early as September, would afford the central bank more time to assess how data evolves in the more accommodative environment. In that respect, the labour market data remains key. The Reserve Bank sees the non-accelerating inflation rate of unemployment (NAIRU) as being 4.5%, well below the current unemployment rate of 5.2%.

Progress in getting the unemployment rate moving lower will require further stimulus, including via fiscal policy. Second quarter inflation data is also due to be released in late July. Inflation has been consistently under the Reserve Bank's target band for an extended period and only a significant undershoot would prompt any action from them in August.

Central banks globally have become more dovish recently, weighed down by slowing global trade and falling inflation expectations. The Reserve Bank's adjustment to monetary policy has to-date been in response to domestic factors. A deteriorating external environment would only add to the case for further monetary policy accommodation. As such, we expect further policy easing in the fourth quarter.

International Fixed Income

Pendal Global Fixed Interest Fund

Market review

Global bonds continued their rally in the June quarter as yields fell alongside growing speculation of easing by major global central banks. Movements were dominated by expectations that the Federal Reserve would cut rates during the remainder of the year. By the end of the quarter, roughly 1.00% of reductions were priced over the next twelve months. Such expectations were not dismissed by Fed Chairman Jerome Powell at the Fed's June meeting. Weaker data also built the case for easing with soft employment growth of 75K in June and a drop in the ISM manufacturing survey. Expectations for more accommodative policy were also evident elsewhere after ECB President Mario Draghi offered a more dovish than anticipated message at the central bank's gathering in Sintra, Portugal. Meanwhile, the level of attention on trade war developments fluctuated significantly over the quarter. Investors became acutely concerned after a proposed deal between Washington and Beijing fell apart in May, but sentiment quickly improved and progress was made at the end of the quarter. Finally on market movements, US yields fell by -51bps for the 2 year and -40bps for the 10 year to 1.76% and 2.01% respectively.

Portfolio performance

The Pendal Global Fixed Interest Fund returned 2.99% for the quarter (post-fees, pre-tax), outperforming its benchmark by 0.10%.

In the alpha overlay, the largest contributor was the Duration strategy, which benefited from long duration exposures across a number of regions. This included the US, Australia and New Zealand. The FX strategy also added value from a number of long USD versus EM positions in May. Meanwhile, the largest contributor in the Yield Curve strategy was a US front-end flattener. In contrast, the Macro strategy detracted due to short credit exposures that suffered from the tightening of credit spreads in April and positions were subsequently taken off. Little exposure was taken in the Cross-Market and Relative value strategies and performance was roughly flat.

Strategy and outlook

As long as the soothing suggestions of further monetary easing remain, the yield grab is back and deteriorating economic fundamentals effectively become a positive for risk. Moreover, the backdrop for risk has improved with a more optimistic (or complacent) perspective on the trade front. For these reasons, we have stayed away from shorts in global credit as this phenomenon may play out for a while longer. At the same time, the mounting expectations for stimulus continue to support the outlook for lower yields and our preference for long duration positions. However we also note this preference has become more popular in the market and suggests some patience is required to re-initiate positions.

Credit

Pendal Enhanced Credit Fund

Market review

Domestic credit generated a strong return over the quarter. This was driven by a large fall in underlying yields and healthy accruals. The broader risk environment was not as supportive as the first quarter where sentiment was buoyed by the Fed 'Pivot'. Spreads widened in May on trade war concerns, but ultimately ended the quarter lower as speculation over central bank easing grew and dominated the market's direction.

Turning to market activity, issuance fluctuated over the quarter as the Big Four were absent from the market during April, resulting in light issuance of only $4.7b. Their return in May saw volumes more than double to $11.3b and an issue from NAB and several other financials saw volumes of $7.8b in June. Overall, issuance was relatively light for the period.

The Australian iTraxx index (Series 31 contract) traded in a wide 18.5bp range finishing the quarter 12bps tighter to +63.5bps. Physical credit spreads narrowed 5bps with the best performing sectors being utilities and real estate tightening 12 and 7bps respectively. The worst performing sector was supranationals that only narrowed 3bps. Semi-government bonds performed well tightening 3bps to government bonds over the quarter.

Portfolio performance

The Pendal Enhanced Credit Fund returned 2.46% for the quarter (post-fees, pre-tax), matching the benchmark return.

The positive return was driven by a fall in underlying swap rates, tightening of credit spreads as well as strong accruals. Overweights in the infrastructure and utilities sectors performed well relative to other sectors.

Purchases over the quarter included issuance from the major banks and truck manufacturer Paccar. Divestments included Aquasure and Transurban.

Strategy and outlook

Our overall credit view remains cautiously constructive. We are positive on corporate fundamentals, but are wary that appetite for credit has demonstrated varying sensitivity to geopolitical developments and the ongoing trade war.

From a bottom-up perspective, corporates in the US have demonstrated resilience with upside surprises to earnings growth in the Q1 reporting season. Similarly, domestic fundamentals remain relatively healthy as issuers have not increased balance sheet leverage materially over the past several years. The major Australian banks also have stronger capital ratios than previous years, which should support domestic financial stability. Moreover the weight of the Royal Commission has finally been lifted from their shoulders. That said, recent results from the majors have revealed challenges as a result of the Commission as well as slowing mortgage growth.

From a macro standpoint, volatility has quickly spiked then evaporated over the past year. Elevated levels during 2018 (particularly December), subsided in January and have been muted over the past month. This has been alongside shifting perspectives towards the trade war and central bank policy stance. While the more dovish tilt from central bankers is a significant positive, we are wary that attitudes towards these developments can shift quickly as the story evolves, particularly with geopolitical flare-ups.

Of further consideration is the softening of domestic economic growth, where there is likely further risk to the downside as weak wage growth and the house price correction threaten to dampen consumption. 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 bonds continued their rally in the June quarter as yields fell to new record lows. The decline in yields was shared by global counterparts alongside growing speculation of easing by major global central banks. The RBA delivered on expectations with a cut of 25bps to 1.25% during June and messaging from the Board suggesting further easing ahead. This was evident in addresses by Assistant Governor Luci Ellis and Governor Philip Lowe, who both indicated that their estimate of the unemployment rate associated with full employment had fallen from 5% to 4.5%.

Labour market data during the quarter illustrated the gap between the unemployment rate of 5.2% and full employment persisted, which suggested the RBA has scope to reduce the cash rate further. By quarter-end the market was pricing an additional two cuts in 2019. Meanwhile some leading economic indicators in June reflected signs of optimism in the wake of the surprise Coalition victory at the Federal Election.

Offshore, bond movements were dominated by expectations that the Federal Reserve would cut rates during the remainder of the year. By the end of the quarter, roughly 1.00% of reductions were priced over the next twelve months. Such expectations were not dismissed by Fed Chairman Jerome Powell at the Fed's June meeting. Weaker data also built the case for easing with soft employment growth of 75K in June and a drop in the ISM manufacturing survey. Expectations for more accommodative policy were also evident elsewhere after ECB President Mario Draghi offered a more dovish than anticipated message at the central bank's gathering in Sintra, Portugal.

Meanwhile, the level of attention on trade war developments fluctuated significantly over the quarter. Investors became acutely concerned after a proposed deal between Washington and Beijing fell apart in May and restrictions placed on Huawei. However such concerns were quickly replaced by optimism in June and as such the trade front bore less influence over rates into the end of the quarter. Ultimately in a meeting between President Trump and Xi Jinping at the G20 summit in Osaka, Trump withdrew his threat of additional tariffs on US$300b of Chinese imports and removed some restrictions on supplies to Huawei. In exchange Trump claimed that China would purchase large scale quantities of US agricultural produce, although this was not confirmed by the Chinese.

Turning to market movements, Australian 3 and 10 year yields both dropped by -44bps to 0.96% and 1.34% respectively. At the very front-end of the curve, 90 day BBSW fell by a sharper -57bps to 1.20%, partly on the back of the RBA rate cut. US yields experienced similar declines of -51bps for the 2 year and -40bps for the 10 year to 1.76% and 2.01% respectively.

In credit markets, spreads were driven by a combination of central bank expectations and sentiment towards trade wars. Concerns were elevated after trade talks broke down in May and led spreads to widen mid-way through the quarter. However, optimism over a potential resolution and growing speculation over Fed easing reversed the widening and saw synthetic spreads finish the quarter tighter.

The Australian iTraxx index (Series 31 contract) traded in a wide 18.5bp range finishing the quarter 12bps tighter to +63.5bps. Physical credit spreads narrowed 5bps with the best performing sectors being utilities and real estate tightening 12 and 7bps respectively. The worst performing sector was supranationals that only narrowed 3bps. Semi-government bonds performed well tightening 3bps to government bonds over the quarter.

Portfolio performance

Managed Cash

The Pendal Managed Cash Fund returned 0.46% for the quarter (post-fees, pre-tax), outperforming the benchmark by 0.01%.

Themes and credit exposure remain consistent with prior months. Given the significant rally and the flattening of the yield curve excess spread from A-1 rated issuers and security selection is more likely to be the main driver of outperformance in the near term rather than yield curve positioning. The fund ended the quarter with a weighted average maturity of 65 days (maximum limit of 70 days). The weighted average maturity had consistently been longer than benchmark due to the higher yields available further out the curve and with little prospect of policy tightening occurring. With the Reserve Bank having eased monetary policy following the benign inflation and deteriorating labour data and with the market pricing in the possibility of further monetary policy easing the bank bill curve has flattened significantly. Consequently longer dated yields do not look as attractive unless further monetary policy easing does occur - we remain wary of extending further, particularly if the yield curve inverts.

Enhanced Cash

The Pendal Enhanced Cash Fund returned 0.65% for the quarter (post-fees, pre-tax), outperforming the benchmark by 0.20%

Positive performance came from financials, industrials, RMBS, infrastructure and utilities sectors.

Activity in April included issuer switches in the industrial sector, while also reducing financials exposure ahead of expected new issuance supply post bank reporting. In May we invested in a primary market short dated major bank deal funded out of cash. Activity in June included investing in three new primary market deals, all from the financials sector which were funded out of cash.

As at the end of the quarter, the portfolio had a credit spread of 58bps over bank bills, interest rate duration of 0.15 years and credit spread duration of 1.35 years.

Strategy and outlook

The Reserve Bank eased monetary policy at its meeting in early June. It is highly likely that further easing occurs in the coming months. There had been ample opportunity for the Reserve Bank to ease at the June meeting - inflation data disappointed in late April and economic growth weakened over the second half of 2018. Why didn't the Board cut? The labour data had shown strong employment growth over the past 12 months and was at odds with the weak household consumption in the national accounts. Business liaison also indicated some labour tightness emerging in some areas. However, the increase in the unemployment rate from 5% to 5.2% revealed a weaker picture and in turn was the last domino to fall. The Reserve Bank had been looking for increasing labour market tightness feeding into underlying inflation. The increase in the unemployment rate put that to bed - there is more than ample slack in the labour market that will not result in the wage inflation outcomes they are looking for. For their forecasts to be achieved further policy easing will be required and soon, the question is not whether they ease again but how many times it occurs. The labour data will again be key in determining when the next rate cut occurs.

Australian Property

Pendal Property Securities Fund

Market review

The AREIT sector generated a total return of 4.1% for the June 2019 quarter, underperforming the broader market which was up 7.8%. However, year rolling REITs were up 19.3%, outperforming the broader market by 7.8%. Globally, REITs were flat over the quarter but were up 10.8% for the year, with Australian REITs the best performing market +19.3% and European REITs the worst, down 10.9%. The best performing AREITs over the quarter were Mirvac Group (+16.1%), reflecting the quality office portfolio and relief rally for residential stocks post the Coalition win, and Goodman Group (+13.7%) reflecting strong asset value uplift in industrial property and confidence about medium to long term earnings from its development pipeline. Underperformers for the period included Unibail Rodamco-Westfield (-11.2%) reflecting ongoing concerns about shopping centre values and implications for its highly geared balance sheet and Shopping Centres Australia (6.7%) reflecting falling values across its retail portfolio.

The June quarter saw a continuation of capital raisings for the sector with large opportunistic equity raisings totaling $3.4b from Dexus, Mirvac Group, GPT Group, Cromwell Group, Charter Hall Long WALE, Growthpoint Properties, Centuria Industrial and National Storage REIT. The raisings were either to fund actual acquisitions or development pipelines. Other notable transactions included Scentre Group's sale of the three office towers above Westfield Sydney to Blackstone for $1.52b, a 4.4% cap rate and 13% premium to book value and its 50% sale of Burwood at a 4% premium to book value. Scentre Group will deploy the proceeds into paying down debt and an $800m stock buy-back.

It was a solid quarter for equity markets with the S&P500 +3.8%, with investors more comfortable about a trade truce between China and the US, but more importantly with the US Fed now likely to cut rates in 2019. Macro data continues to disappoint with weak global PMIs, particularly in manufacturing (now in contraction mode). Bond yields fell across most markets with the US bond yield below 2%, the first time since 2016 and German bonds hitting an all-time low of -36bp.

The Reserve Bank cut the cash rate by 25bp to 1.25%, Australian GDP was soft (+0.4%) and retail sales turned negative (-0.1%). The biggest surprise over the quarter was a Coalition victory at the Federal election, with bank stocks bouncing particularly hard. In Australia employment remains solid +42.3k positions, with the unemployment rate flat 5.2%, however credit growth continues to be lacklustre, +3.6%, a six year low. The Australian dollar was largely flat versus the USD, but the 10 year bond yield fell 45bp over the quarter to 1.35%, reflecting a weaker economic outlook for Australia.

AREIT quarterlies released during the quarter continue to reinforce the divergence of performance in the Office/Industrial stocks with those in the Retail/Residential sectors. Retail sales growth decelerated with GPT's sales growth falling from 2.4% to 1.3%, Stockland's falling from 1.4% to 1.2% and Scentre Group's specialty sales growth falling from 1.7% to 1.5%. In addition Stockland noted that its residential lot sales were down 28% over 3Q19, its weakest quarter of sales since 2011. In contrast leasing spreads were positive for Mirvac's office portfolio (+14%).

Portfolio performance

The Pendal Property Securities Fund returned 5.79% for the quarter (post-fee, pre-tax), outperforming its benchmark by 1.67%.

The portfolio outperformed the benchmark over the June quarter. Underweight positions in Unibail Rodamco-Westfield, Vicinity Centres and Scentre Group and overweight positions in Mirvac Group and Precinct Properties NZ assisted performance. Overweight positions in Japara Healthcare and Charter Hall Retail and underweight positions in Stockland Trust Group, GPT Group and Abacus Property Group detracted from performance.

Over the month we increased our overweight positions in Goodman Group, Charter Hall Long WALE and Centuria Industrial Trust and reduced our underweight position in Unibail-Rodamco Westfield, reduced our overweight in Charter Hall Retail REIT and moved from an overweight to underweight position in both National Storage REIT and GPT Group.

Strategy and outlook

The AREIT sector is now priced on an FY20 dividend yield of 4.7%, a PE ratio of 18.7 times and a 45% premium to NTA, well above its long-term average of 17%. Cap rates are unlikely to compress much 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 27%.

International Property

Pendal Global Property Securities Fund

Market review (in US$)

For the quarter ended June 30, 2019, performance of the global property securities market (on an ex-Australia basis) as measured by the FTSE EPRA Nareit Developed Index was roughly flat. North America (+ 0.7%) was the strongest performing region, followed by Asia Pacific (+ 0.2%), while Europe (-2.3%) underperformed during the quarter. Within Europe, results were mixed across the region. Germany (-8.2%) was the weakest performer, followed by the Netherlands (-8.0%) and the United Kingdom (-4.2%). On the other hand, notable positive performers included Israel (+ 15.4%), Finland (+ 15.3%), and Ireland (+ 14.5%). Results in Asia Pacific were mostly positive across the region. New Zealand (+ 9.6%) was the strongest performer, followed by Singapore (+ 7.2%) and Japan (+ 1.2%), while Hong Kong (-3.3%) was the only underperformer. Within North America, the U.S. and Canada returned 0.7% and 1.0%, respectively.

Portfolio performance

The Pendal Global Property Securities Fund returned -0.46% for the quarter (post-fee, pre-tax), outperforming the benchmark by 0.24%.

North America

For the quarter ended June 30, the portfolio returned 1.06% before fees and taxes, exceeding the FTSE EPRA Nareit North America Index by 34 basis points. Outperformance relative to the benchmark was driven by positive stock selection results and, to a lesser extent, positive sector allocation results. In terms of stock selection, results were strongest in the diversified, office, and hotel sectors and were weakest in the triple net lease, shopping center, and apartment sectors. Regarding sector allocation, positive results were largely driven by the portfolio’s overweight to the outperforming industrial and other residential sectors. Among the portfolio’s holdings, top individual contributors to relative performance included overweight positions in outperforming Rexford Industrial Realty (REXR) and Americold Realty Trust (COLD), and a lack of exposure to underperforming Realty Income Corp. (O). Detractors most notably included an underweight position in outperforming Prologis (PLD), lack of exposure to outperforming Ventas (VTR), and an overweight position in underperforming Simon Property Group (SPG).

Europe

For the quarter ended June 30, 2019, the portfolio returned -2.65% before fees and taxes, lagging the FTSE EPRA Nareit Developed Europe Index by 18 basis points. Underperformance relative to the benchmark was attributable to negative country allocation results, which were partially offset by positive stock selection results. Regarding country allocation, negative results were attributable to the portfolio’s lack of exposure to the outperforming Switzerland, Belgium, and Finland, as well as an overweight to the underperforming Germany. Conversely, the portfolio’s overweight to the outperforming Spain, Sweden, and Norway were notable positive contributors to relative performance. In terms of stock selection, results were strongest in the United Kingdom, Sweden, and the Netherlands and were weakest in Germany, Spain, and Norway. Among the portfolio’s holdings, top positive contributors to relative performance included overweight positions in outperforming Segro PLC (United Kingdom), Wihlborgs Fastigheter AB (Sweden), and Unite Group PLC (United Kingdom). Detractors most notably included overweight positions in underperforming

Deutsche Wohnen SE (Germany) and ADO Properties SA (Germany), and a lack of exposure to outperforming PSP Swiss Property AG (Switzerland).

Asia

For the quarter ended June 30, 2019, the portfolio returned 0.32% before fees and taxes, outperforming the regional EPRA benchmark by 14 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, positive results in Japan and Hong Kong were partially offset by negative results in Singapore. Regarding country allocation, negative results were driven by the portfolio's underweight to the outperforming Singapore and a lack of exposure to the outperforming New Zealand. Among the portfolio's holdings, top contributors to relative performance included a lack of exposure to underperforming Sino Land (Hong Kong) and overweight positions in outperforming Frasers Centrepoint Trust (Singapore) and LaSalle Logiport REIT (Japan). Detractors most notably included an overweight position in underperforming CK Asset Holdings (Hong Kong) and a lack of exposure to outperforming Ascendas REIT (Singapore) and CapitaLand Mall Trust (Singapore).

Strategy and outlook

North America – While there is some evidence that the economy slowed in the second quarter, wage growth has been solid but not strong enough to raise inflation concerns. The Fed has continued to back away from its tightening cycle and is now expected to cut the Federal Funds rate sooner, possibly as early as July. With inflation largely dormant, the Fed has the flexibility to make several cuts in the Federal Funds rate to shore up the economy if warranted. It also plans to stop reducing the size of its balance sheet by September or earlier. U.S. property market fundamentals continue to be strong with few signs of weakening outside of certain subsectors. With the exception of self storage and some seniors housing segments, construction appears to be peaking in most sectors. On the other hand, malls and power centres continue to be hit by store closures and are the main areas of demand weakness, with most other sectors seeing demand that is sufficient to keep vacancy rates near recent cyclical lows. Overall, we continue to expect 5-6% growth in REIT cash flows in 2019 as leases roll and as rents continue to rise at a slowing but still positive pace. After quarter-end, REITs traded at a 4% premium to net asset value, unchanged from prior quarter-end and in line with the historical average of a 2% premium. REIT dividend yields were only 28 basis points lower than BAA corporate bond yields, an attractive spread compared to the historical average of 119 basis points lower. Following the stock market's strong performance, REITs became slightly more attractive versus general equities. Overall, at quarter-end, REITs traded at more attractive valuations compared to the prior quarter-end.

Europe – European property equities are expected to post an attractive relative performance in the current environment of low interest rates, reasonable economic growth, and positive inflation. New construction levels generally are low as bank financing for speculative development projects is difficult to obtain. This is a competitive advantage for the REITs, which generally have access to cheap financing given that the European REITs typically do not buy assets in the "hot" investment markets but instead develop assets in undersupplied markets. The main risks for the sector are European politics and the German regulatory environment. The United Kingdom will get a new prime minister, and neither leading candidate has ruled out a "hard Brexit", while the UK Parliament continues to be against a hard Brexit. It is likely that uncertainty will persist in the near term. At quarter-end, European property equities were reasonably valued with European REITs trading at a 9% discount to net asset values and offering a cash flow yield of 5.5% and a dividend yield of 4.3%.

Asia – At quarter-end, Asia Pacific traded roughly around fair value and supported by strong fundamentals and lower interest rates in some markets. With the Federal Reserve turning more dovish and with rate cuts in Australia, we believe it will be a conducive environment for the property stocks. We continue to like the office markets across the region, which are driven by positive demand and supply dynamics. We are generally cautious on retail but we like the Hong Kong retail sector where demand is unthreatened by e-commerce, although we acknowledge that in the medium term, the ongoing protests and political environment will affect tourism.

Active Balanced

Pendal Active Balanced Fund

Markets review

The S&P/ASX 300 Accumulation Index had a strong second quarter, adding 8.1% to what was already a solid recovery in the previous quarter (+10.9%) following the market's decline in late 2018. Overall, the market returned +11.4% for FY19, with Resources (+15.0%) outperforming and Industrials (+10.5%) the laggard. Sentiment improved somewhat following the Coalition's surprise win in the Federal election. Nevertheless, the 10-year bond yield is now at record lows, down by 45bps over the June quarter, and by 132bps over the year. The subdued outlook for the economy, and the dovish stance by global central banks, including the RBA which cut the cash rate to a record low of 1.25% in June, have been driving down long-term bond yields globally. In that vein, gold is also fetching multi-year high prices, as investors make the rotation into the safe haven asset.

Over the quarter, Energy (-0.2%) was the worst performing GICS sector, and the only one posting a loss. Communication Services (+12.2%) gained the most over the quarter with the help of some retail cyclicals following the Federal election. No change in government and therefore no significant policy shifts is expected to improve sentiment for older consumers and help business confidence. Banks (+13.4%) outperformed for the quarter following the retention of negative gearing, lower rates and an easier serviceability hurdle in conjunction is expected to stabilise the housing market and, in turn, reduce pressure on the banks. The 'big four' banks all recorded strong returns for the quarter as a result, ranging from 9.4% (NAB) to 17.2% (CBA).

Global equity markets followed the yo-yo path through the June quarter, rising in April before trade-related fears weighed on sentiment in May only to be resurrected in June as markets gained on expectations the US Fed would pivot on its path to ease monetary conditions. The G20 meetings took place in the last days of June and while no definitive agreement was concluded, a resumption of US-China trade talks, the absence of additional tariff announcements and the resumption of US technology exports to Huawei appeared to placate investors. This led the benchmark MSCI World ex Australia (A$) Index to deliver a 5.2% return for the quarter.

The bulk of the US second quarter reporting season proceeded in April, with a majority of companies reporting earnings ahead of expectations, although earnings growth was considerably muted. Economic data also continued to support sentiment, with first quarter GDP coming in at an annual growth rate of 3.2%. Positive data on consumer sentiment, retail sales and employment growth also supported market sentiment. The S&P500 registered a 3.8% gain for the quarter, while the NASDAQ rose 3.6%.

The Australian dollar was relatively unchanged against the US dollar, euro and Japanese yen. In commodity markets the oil price held onto its strength being range bound to close the quarter at US$65 per barrel.

Australian bonds continued their rally in the June quarter as yields fell to new record lows. The decline in yields was shared by global counterparts alongside growing speculation of easing by major global central banks. The RBA delivered on expectations with a cut of 25bps to 1.25% during June and messaging from the Board suggesting further easing ahead. This was evident in addresses by Assistant Governor Luci Ellis and Governor Philip Lowe, who both indicated that their estimate of the unemployment rate associated with full employment had fallen from 5% to 4.5%. Labour market data during the quarter illustrated the gap between the unemployment rate of 5.2% and full employment persisted, which suggested the RBA has scope to reduce the cash rate further. By quarter-end the market was pricing an additional two cuts in 2019. Meanwhile some leading economic indicators in June reflected signs of optimism in the wake of the surprise Coalition victory at the Federal election.

On markets, Australian 3 and 10 year yields both dropped by -44bps to 0.96% and 1.34% respectively. At the very front-end of the curve, 90 day BBSW fell by a sharper -57bps to 1.20%, partly on the back of the RBA rate cut.

Global bonds continued their rally in the June quarter as yields fell alongside growing speculation of easing by major global central banks. Movements were dominated by expectations that the Federal Reserve would cut rates during the remainder of the year. By the end of the quarter, roughly 1.00% of reductions were priced over the next twelve months. Such expectations were not dismissed by Fed Chairman Jerome Powell at the Fed's June meeting. Weaker data also built the case for easing with soft employment growth of 75K in June and a drop in the ISM manufacturing survey. Expectations for more accommodative policy were also evident elsewhere after ECB President Mario Draghi offered a more dovish than anticipated message at the central bank's gathering in Sintra, Portugal. Meanwhile, the level of attention on trade war developments fluctuated significantly over the quarter. Investors became acutely concerned after a proposed deal between Washington and Beijing fell apart in May, but sentiment quickly improved and progress was made at the end of the quarter. Finally on market movements, US yields fell by -51bps for the 2 year and -40bps for the 10 year to 1.76% and 2.01% respectively.

Portfolio performance

The Pendal Active Balanced Fund returned 3.32% (post-fee, pre-tax) for the quarter, underperforming its benchmark by 1.30%.

The Fund's return for the June quarter was largely driven by its exposure to Australian and offshore equity and property markets which experienced positive returns. Overweight exposures to the best performing asset classes contributed to returns. The Australian and international fixed income made positive contributions to returns as markets delivered gains from easing pressure on bond yields.

Performance relative to the benchmark was primarily driven by a function of our active asset allocation processes. Our tactical decisions saw the Fund's overweight exposure to global equities contribute to relative returns, while modest exposure to fixed interest assets generated a positive contribution.

The key factors influencing the alpha generated through active management were stock selection outcomes within Australian and international equities. Within the Australian equity strategy, overweight positions in Qantas, Viva Energy and Santos detracted from performance while overweight positions in Telstra, Fortescue Metals and Aristocrat Leisure contributed to performance.

Within the global equities portfolio, all underlying strategies delivered gains although the Core strategy underperformed its benchmarks due to a number of market factors moving against the strategy.

The Alternatives strategy delivered a total return (before fees) of -0.35% versus a cash return of 0.45%. Within our Alternatives core portfolio the Managed Futures, Event Driven and Convertible & Volatility Arbitrage strategies contributed to returns but were offset by detractions from the Equity Market Neutral, Global Macro and Dedicated Short Bias strategies.

In relation to our tactical positioning within the Alternatives component of the Fund, contributions from positioning in equity and bond markets were more than offset by detractions from positioning in volatility and crude oil.

Since the end of the quarter we have added a new long position in gold.

Strategy and outlook

The Australian market has now moved past some concerns felt earlier in the year, mainly in relation to the Federal election, developments in the housing market and policy direction of the RBA. With economic monetary and fiscal policy now proceeding together towards stimulatory settings, growth assets like shares and property are well placed to benefit, albeit to a degree.

The labour market needs to be a key area of focus, considering the bearing it has on management of related pressures such as household debt, low inflation and benign wages growth. Further easing of monetary policy in conjunction with tax relief can play its role in shoring up a weakening economy. Expansionary settings employed in the past few economic cycles have generally had the desired effect, although the record low level of the cash rate and external factors relating to trade warrant a degree of caution for investors, particularly those with a greater reliance on cash-based yields.

The Fund’s performance exhibits the benefit of having a well-diversified and disciplined investment strategy that can smooth returns from underlying assets which tend to be more volatile in isolation. We also structure the Fund to adequately diversify on many levels to capture opportunities for generating long term gains within a tightly controlled risk management framework.

Regardless of short term market developments, we are always focused on continual improvement through a rigorous, research-based approach and are focused on ensuring our funds are well positioned to achieve their long term objectives.

We remain confident that our tried and tested investment philosophy and asset allocation processes will continue to deliver favourable investment outcomes over the long term. We continue to employ an active approach to modelling scenarios and assessing market technical factors to identify opportunities and limit risks for our investors.

Performance as at 30 June 2019

(%)	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)	2.87	6.80	18.53	7.87	7.87	11.30	12.77	8.77	10.01
Total Return (pre-fee, pre-tax)	2.94	7.02	19.01	8.74	8.74	12.20	13.67	9.63	11.00
Benchmark	3.64	8.05	19.84	11.42	11.42	12.33	12.82	8.88	10.08
Pendal Imputation Fund									APIR - RFA0103AU
Total Return (post-fee, pre-tax)	2.66	6.65	17.02	8.77	8.77	11.11	12.43	7.86	9.62
Total Return (pre-fee, pre-tax)	2.74	6.89	17.54	9.75	9.75	12.11	13.44	8.83	10.63
Benchmark	3.64	8.05	19.84	11.42	11.42	12.33	12.82	8.88	8.95
Pendal Focus Australian Share Fund									APIR - RFA0059AU
Total Return (post-fee, pre-tax)	2.51	8.11	20.42	8.72	8.72	12.26	14.61	10.47	9.50
Total Return (pre-fee, pre-tax)	2.57	8.31	20.87	9.54	9.54	13.32	15.86	11.59	10.60
Benchmark	3.64	8.05	19.84	11.42	11.42	12.33	12.82	8.88	7.94
Pendal Ethical Share Fund									APIR - RFA0025AU
Total Return (post-fee, pre-tax)	2.82	6.34	18.79	7.84	7.84	10.84	12.49	8.96	8.66
Total Return (pre-fee, pre-tax)	2.90	6.59	19.34	8.87	8.87	11.89	13.56	10.00	9.72
Benchmark	3.64	8.05	19.84	11.42	11.42	12.33	12.82	8.88	8.38
Australian Shares - Mid Cap									
Pendal MidCap Fund									APIR - BTA0313AU
Total Return (post-fee, pre-tax)	0.24	4.00	12.38	-1.77	-1.77	10.01	12.04	12.18	9.93
Total Return (pre-fee, pre-tax)	0.31	4.23	12.88	-0.88	-0.88	11.42	13.34	13.55	12.05
Benchmark	1.99	3.81	14.95	2.88	2.88	10.04	11.67	12.02	5.93
Australian Shares - Small Cap									
Pendal Smaller Companies Fund									APIR - RFA0819AU
Total Return (post-fee, pre-tax)	0.83	1.77	12.35	-3.53	-3.53	9.89	8.42	9.19	12.75
Total Return (pre-fee, pre-tax)	0.93	2.09	13.04	-2.32	-2.32	11.26	9.77	10.56	14.04
Benchmark	0.92	3.75	16.81	1.92	1.92	12.53	10.66	9.26	7.76
Australian Shares - Micro Cap									
Pendal MicroCap Opportunities Fund									APIR - RFA0061AU
Total Return (post-fee, pre-tax)	0.16	3.35	17.68	7.77	7.77	13.61	14.20	16.72	17.70
Total Return (pre-fee, pre-tax)	0.12	3.51	18.67	9.50	9.50	15.21	16.44	19.97	22.61
Benchmark	0.92	3.75	16.81	1.92	1.92	12.53	10.66	9.26	3.47
International Shares									
Pendal Core Global Share Fund									APIR - RFA0821AU
Total Return (post-fee, pre-tax)	4.79	2.08	13.05	3.12	3.12	8.40	10.85	10.73	5.81
Total Return (pre-fee, pre-tax)	4.85	2.29	13.55	4.08	4.08	9.42	11.90	11.79	6.97
Benchmark	5.27	5.19	17.29	11.95	11.95	13.66	14.01	13.25	7.57
Pendal Global Emerging Markets Opportunities Fund - WS									APIR - BTA0419AU
Total Return (post-fee, pre-tax)	4.49	2.44	12.38	6.82	6.82	9.50	13.24	10.04	10.64
Total Return (pre-fee, pre-tax)	4.59	2.79	13.13	8.30	8.30	11.02	14.81	11.61	12.76
Benchmark	4.89	1.84	10.95	6.56	6.56	9.41	12.87	8.75	9.98
Pendal Concentrated Global Share Fund									APIR - BTA0503AU
Total Return (post-fee, pre-tax)	5.00	3.54	13.60	9.75	9.75	13.45	N/A	N/A	14.23
Total Return (pre-fee, pre-tax)	5.09	3.82	14.22	10.86	10.86	14.67	N/A	N/A	15.52
Benchmark	5.27	5.19	17.29	11.95	11.95	13.66	N/A	N/A	13.68
Property									
Pendal Property Securities Fund									APIR - BTA0061AU
Total Return (post-fee, pre-tax)	5.53	5.79	22.50	23.61	23.61	17.72	9.69	14.35	8.27
Total Return (pre-fee, pre-tax)	5.59	5.96	22.89	24.41	24.41	18.48	10.40	15.10	9.08
Benchmark	4.16	4.12	19.10	19.39	19.39	16.25	8.44	13.81	8.00
Pendal Global Property Securities Fund									APIR - RFA0051AU
Total Return (post-fee, pre-tax)	0.51	-0.46	13.62	7.62	7.62	7.18	5.61	7.46	9.14
Total Return (pre-fee, pre-tax)	0.57	-0.24	14.14	8.61	8.61	8.16	6.59	8.46	10.14
Benchmark	0.72	-0.70	13.72	7.07	7.07	6.58	5.32	7.46	8.84
Fixed Interest									
Pendal Fixed Interest Fund									APIR - RFA0813AU
Total Return (post-fee, pre-tax)	1.25	3.32	6.29	7.71	7.71	5.53	3.35	4.47	6.45
Total Return (pre-fee, pre-tax)	1.29	3.45	6.55	8.25	8.25	6.06	3.87	4.99	7.01
Benchmark	1.04	3.05	6.59	9.57	9.57	6.28	4.23	5.06	6.72
Pendal Global Fixed Interest Fund									APIR - RFA0032AU
Total Return (post-fee, pre-tax)	1.43	2.99	5.22	5.72	5.72	3.77	1.68	4.22	5.96
Total Return (pre-fee, pre-tax)	1.48	3.13	5.50	6.28	6.28	4.32	2.22	4.77	6.54
Benchmark	1.27	2.89	5.47	7.34	7.34	4.69	2.66	5.00	6.89
Pendal Enhanced Credit Fund									APIR - RFA0100AU
Total Return (post-fee, pre-tax)	0.83	2.46	5.17	7.41	7.41	5.35	4.30	4.67	5.80
Total Return (pre-fee, pre-tax)	0.86	2.57	5.40	7.89	7.89	5.83	4.77	5.14	6.32
Benchmark	0.84	2.46	5.18	7.56	7.56	5.44	4.34	4.75	5.91
Cash & Income									
Pendal Enhanced Cash Fund									APIR - WFS0377AU
Total Return (post-fee, pre-tax)	0.21	0.65	1.39	2.46	2.46	2.58	2.74	2.67	4.82
Total Return (pre-fee, pre-tax)	0.23	0.71	1.52	2.71	2.71	2.84	2.99	2.92	5.16
Benchmark	0.13	0.45	0.97	1.97	1.97	1.88	1.86	2.08	4.75
Pendal Managed Cash Fund									APIR - WFS0245AU
Total Return (post-fee, pre-tax)	0.15	0.46	0.94	1.91	1.91	1.85	1.86	2.06	6.28
Total Return (pre-fee, pre-tax)	0.17	0.52	1.05	2.14	2.14	2.07	2.08	2.28	6.58
Benchmark	0.13	0.45	0.97	1.97	1.97	1.88	1.86	2.08	6.36
Pendal Monthly Income Plus Fund									APIR - BTA0318AU
Total Return (post-fee, pre-tax)	1.16	3.15	6.17	6.33	6.33	5.68	4.83	4.87	5.58
Total Return (pre-fee, pre-tax)	1.22	3.32	6.52	7.03	7.03	6.37	5.52	5.55	6.25
Benchmark	0.11	0.36	0.73	1.49	1.49	1.50	1.51	1.78	2.76
Diversified									
Pendal Active Balanced Fund									APIR - RFA0815AU
Total Return (post-fee, pre-tax)	2.62	3.32	10.67	4.46	4.46	7.12	7.87	7.27	7.59
Total Return (pre-fee, pre-tax)	2.70	3.57	11.19	5.46	5.46	8.15	8.90	8.29	8.66
Benchmark	2.96	4.62	12.80	9.34	9.34	9.51	9.24	8.18	7.60

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