PENDAL

Pendal Bonds, Income and Defensive Strategies (BIDS)

Fund Performance, Positioning and Outlook

March 20 2020

The Pendal BIDS team is navigating this volatile market environment in a defensive manner in line with its overall investment philosophy.

This has enabled us to outperform both bond and credit markets as well as our peers. In this environment, when we are seeing bond markets exhibit equity-like volatility, it is even more important to actively preserve capital and look for opportunities.

Our large team is very experienced at navigating various financial market events similar to the current market volatility we are seeing at the moment.

Below we outline how each individual strategy was positioned for the lead-up to this market volatility and more importantly how we are now managing the portfolio with the aim to preserve capital and identify attractive opportunities to deliver returns for our clients.

We always aim to be the most defensive manager in the market – and the last few weeks and months have shown the benefits by adding active returns.

It is important at this time that your clients do not panic and are reassured that we are seeing some of the most attractive opportunities to deliver returns while ensuring we maintain our defensive philosophy.

Performance during the current CoVid Crisis

(01 March - 18th March) and (1 April 2019-18th March 2020)

Portfolio Name	Portfolio Return (MTD)	Benchmark Return (MTD)	Active Return (MTD)	Portfolio Return (Since 01/04/2019)	Benchmark Return (Since 01/04/2019)	Active Return (Since 01/04/2019)
Pendal Fixed Interest Fund	-1.70%	-2.26%	0.56%	6.00%	4.61%	1.39%
Pendal Pure Alpha Fixed Income Fund	2.30%	0.05%	2.25%	5.16%	1.18%	3.97%
Pendal Sustainable Australian Fixed Interest Fund	-1.86%	-2.26%	0.40%	5.65%	4.61%	1.05%
Pendal Monthly Income Plus Fund	-3.18%	0.03%	-3.21%	2.06%	0.95%	1.10%
Pendal Enhanced Cash Fund	-0.09%	0.05%	-0.14%	1.75%	1.18%	0.56%

Pendal Fixed Interest Fund

The fund has delivered very strong active performance in this environment. It's about looking for ways to be defensive in this ever-changing market – but it's also important to be active. We have always positioned the fund with that in mind – looking to avoid less-liquid, higher-risk credit and looking to be overweight quality Australian government and corporate bonds.

January and February were about looking for long-duration positions across multiple markets. With an acceleration in central bank stimulus we quickly shifted to protecting against rising bond yields primarily via curve steepeners (where we take a long position in shorter duration government bonds 1-3yr typically and a short position in the longer maturity 10yr+ bonds), while maintaining flexibility on selective long positions in front ends (1-3years maturity typically).

As we head into the next leg of Quantitative Easing (QE) and yield targeting from central banks globally and the RBA domestically, we again look to reposition towards selective long exposures in government bonds in the front end of curves (0-3 years).

It is critical in these environments to remain liquid and to understand some of the market pricing is not fundamentally driven but liquidity driven. Opportunities for active management are never greater than in many markets today.

Importantly we see fixed interest as the defensive asset class to continue to maintain true defensiveness which aims to is preserve capital.

Pendal Sustainable Australian Fixed Interest Fund

This fund has performed very strongly over the past year. Key overweights in credit and government bonds have added value. As we headed into March we started to reduce our credit exposures primarily via selling 5-year senior bank paper and buying iTraxx protection.

This had the immediate effect of reducing our credit spread duration. We continued to maintain selective long duration exposure in Australian and New Zealand front ends as we expect continued demand for these bonds.

With our impact bonds we have had the additional benefit that during this increased market volatility, our high-quality impact bonds have outperformed their non-impact counterparts from the same or similar type of issuer. This continues to showcase the importance of credit selection as well as the higher quality of the impact bonds.

While it is difficult to predict where credit markets go from here, with our reduction in credit we can look to buy back at some stage into higher quality Australian corporate bonds at higher yields (lower prices) than what we sold them for, and this has the potential to delvier stronger performance into the future.

Pendal Monthly Income Plus Fund

The fund has experienced a small drawdown as expected in these types of market environments. Our active asset allocation process is designed to minimise the drawdowns. The following outlines the recent steps we have taken:

- Our rigorous de-risking process has had the fund at minimum equity exposure since the end of February. Equity exposure in the fund now sits at 8%
- We rotated into government bonds – a safe haven asset when equity markets come under stress. However as liquidity stresses built up many investors had to sell government bonds to fund positions in equities or for cash to pay back margin loans.

- The longer end of most major government curves also started to come under pressure about a week ago, suffering from the above dynamic (good assets sold to fund bad ones) as well as anticipated large bond issuance to fund significant stimulus programs
- At this point, we took the government bond weighting (17%) down to zero with the fund carrying 60% exposure to high-quality, investment grade (IG) Australian credit and the corresponding interest rate risk associated with that to maintain a level of diversification for the fund
- The fund now sits at 32% cash, 60% Australia IG credit, and 8% equities
- We think QE in Australia will also include measures to prevent over-steepening of yield curves. We are ready to start increasing the fund's government bond weights, taking the opportunity of recent yield curve steepening moves we've seen globally

To put the performance into context we can look at returns in the markets up until March18:

- Australian shares are down -23% this month
- Australian Government bonds are down -2.45%
- International Government bonds are down -2.55%

While we do not like seeing negative numbers in this strategy these markets are very unusual and have required a lot of active management. Our process is designed to be active to reduce risks and then look for opportunities as markets and volatility settle down.

We now have high levels of cash and secure quality Australian corporate bond exposures. We continue to maintain a high proportion in liquid assets.

Pendal Enhanced Cash Fund

The fund has delivered a small negative return month-to-date due to substantial widening of credit spreads on all security types in March. However the fund has delivered strong active returns vs the peer group as our defensive process kicked in to preserve capital.

Enhanced cash has actively been reducing credit risk as per its investment process during the end of February leading into March.

We reduced our credit spread duration Iwhich measure the amount of credit risk based on avg matrity profile) from 2.2 years in mid February to around one year presently. This was done via a combination of selling physical longer-dated securities as well as iTraxx which we still have in place.

This has benefitted performance so far in March as we saw large movements down in price for corporate securities which saw negative returns for the month of March, by reducing the exposure to these securities we were able to insulate the fund from larger drops in value due to this.

Many other funds that have larger exposure to credit and longer dated credit returning larger negative numbers in March.

Our fund performance is around 0.1% below benchmark month to date (18th March).

At the same time, extreme market volatility – combined with uncertainty regarding coronavirus and its economic impacts – means credit market liquidity has become difficult with much higher bid/offer spreads on offer.

Our fund now has 50% liquid cash holdings with the other 50% in high quality (average AA) credit in shorter-dated securities.

Pendal Pure Alpha Fixed Income fund (PAFI)

The PAFI strategy has delivered strong month-to-date and year-to-date returns, differentiating this strategy and showcasing the benefits of a long volatility biased, alternative fixed income strategy in a client's portfolio.

This is especially so in a month where we have seen traditional safe havens such as gold and government bonds delivering negative returns.

The PAFI strategy is designed for these types of market environment. It is a truly active approach to investing in liquid alpha positions with a bias to long volatility.

The strong returns have been driven by a number of different drivers. While traditionally long duration has been the core of returns, this month we have had to be flexible in adapting to rising bond yields while looking to be more tactical in our positioning, maintaining very liquid positions that can be quickly monetised to take advantage of market volatility.

The PAFI fund has engaged in meaningful and purposeful shifts in its risk and positioning over the course of the past few weeks.

These shifts have taken place as the current crisis deepened, divorcing market moves from economic fundamentals.

Here are the stages the fund positioning takes into account in this market environment:

Stage 1: Duration is your friend

Starting from a fairly neutral duration position – mainly driven by cross-market and yield curve trades with only net long positions at the front ends of the US, Australian and New Zealand curves – the fund stepped up its long US duration position from a starting point of lower exposure to a much higher expsoure. We chose US treasury futures as the main market due to its liquidity advantage over other forms of duration.

Stage 2: Credit cracks

Recent short triggers have involved us establishing short positions in CDX HY, CDX IG, iTraxx Asia ex-Japan, and iTraxx Main. At the time of writing, our short in iTraxx Main remains.

We are cautious of the next stage if the crisis deepens

Stage 3: Sell the good to fund the bad – and stimulus-related inflation fears

On March 9, the considerable long duration exposure in PAFI was neutralised. In its place US yield curve steepeners were established. This has been the fund's way of implementing a soft short on duration.

We also established modest curve-steepening positions in Australia, and this added to our existing curve steepeners in Asia. These positions are the main reason why PAFI has continued to perform despite the dramatic turnaround in global yields.

Stage 4: Cash (and the US dollar) is king

Our favoured long dollar positions have been against Emerging Markets currencies. But the liquidity of these markets has also become problematic in recent days, with drastic actions taken by several governments to shut down as much FX trading as possible.

At the time of writing, we are not running any FX positions, but have benefitted from long USD positions intra month against currencies such as THB, SGD and IDR.

The liquidity situation in most markets has become problematic enough for us to significantly dial down risk levels at the portfolio level. Although we do not target VaR (Value at risk), our incorporation of VaR when sizing our positions also naturally leads to smaller position sizes as volatility has risen considerably across all asset classes. We think this is a prudent way to approach risk in the coming weeks, while remaining nimble and *liquid* to take advantage of any sharp and sudden turns.

The last thing to mention is that the performance of the fund has been evenly spread among a number of strategies this month, including Yield Curve, Duration, Cross-Market, FX and Macro, and not concentrated in any one given strategy.

This speaks to the power of our investment process in identifying diverse sets of opportunities and the effectiveness of the way we have implemented our core investment views.

	1 year			3 years			5 years		
	Return (Annualized)	Benchmark Return	Excess Return (Cumulative)	Return (Annualized)	Benchmark Return	Excess Return (Annualized)	Return (Annualized)	Benchmark Return	Excess Return (Annualized)
Pendal Enhanced Cash	2.11	1.30*	0.81	2.46	1.68*	0.78	2.49	1.85*	0.64
Pendal Fixed Interest	9.69	8.98˜	0.72	5.65	5.98˜	-0.33	3.69	4.45˜	-0.75
Pendal Monthly Income Plus	6.50	1.04˚	5.46	5.03	1.35˚	3.68	4.02	1.55˚	2.47
Pendal Pure Alpha Fixed Income	3.48	1.30*	2.18	0.25	1.68*	-1.42	-0.21	1.85*	-2.06
Pendal Sustainable Aust Fixed Interest	9.69	8.98˜	0.71	6.05	5.98˜	0.07		˜	

*Benchmark 1: RBA Cash Rate Target

˚Benchmark 2: Bloomberg AusBond Bank 0+Y TR AUD

˜Benchmark 3: Bloomberg AusBond Composite 0+Y TR AUD

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key account manager or visit **pendalgroup.com**