PENDAL

Pendal Enhanced Cash Fund Update

Performance, positioning and outlook

May 4, 2020

March was an extraordinary month on all measures. For the first time since formal monetary policy was introduced we saw the RBA cut rates twice in a month. For the first time ever the RBA has engaged in Quantitative Easing – although it's formally called Yield Curve Control (targeting 3yrs at 25bp). There is now almost $70 billion sitting in the RBA exchange settlements accounts earning 10bp (this is excess cash banks cannot lend out). This is weighing on nearly all short-term instruments.

Coronavirus fears had a significant impact on credit markets during the month as new cases of the virus increased substantially across the globe. Concerns about the virus's impact from a global health, GDP and corporate profitability perspective drove risk-off price action across all markets.

The Australian iTraxx index (Series 32 contract) traded in an incredibly wide 131bp range finishing the month 59bps wider to +128bps. The new Series 33 closed the month at 175bps. Physical credit spreads also performed poorly, widening 51bps on average. The best-performing sector was supranationals which widened 27bps. The worst-performing were telecoms and real estate which widened 83 and 68bps respectively. Semi-government bonds also underperformed, widening 21bps to commonwealth government bonds.

Fund performance

Fund Returns as at 31 March 2020

Returns (After Fees %)	3M	6M	1Y	2Y	3Y	5Y	7Y	10 Y
Pendal Enhanced Cash	-0.15	0.29	1.41	1.88	2.21	2.35	2.61	3.64
Bloomberg AusBond Bank 0+Y TR AUD	0.26	0.49	1.23	1.62	1.66	1.83	2.09	2.79
Excess Returns	**-0.41**	**-0.20**	**0.18**	**0.25**	**0.55**	**0.52**	**0.52**	**0.85**

The portfolio delivered a total return of -0.42% for March and -0.15% for the March quarter (after fees).Pleasingly we have recovered half of this drawdown during the month of April. While we are incredibly disappointed at returning negative performance, we are happy to have limited negative returns by actively de-risking the fund during the quarter. As you can see in the table above, the fund has still delivered solid returns over all time frames in excess of the benchmark as well.

Our credit exposures in financials, industrials, infrastructure and utilities all detracted from performance as their spreads widened. The short credit iTraxx position added to performance, acting as a hedge against the credit losses.

We continued to de-risk the portfolio on the back of the uncertainty related to the coronavirus. Activity included buying protection (short credit risk) on the Australian iTraxx which positively contributed to performance. We also sold financials while increasing our cash weight.

Portfolio positioning

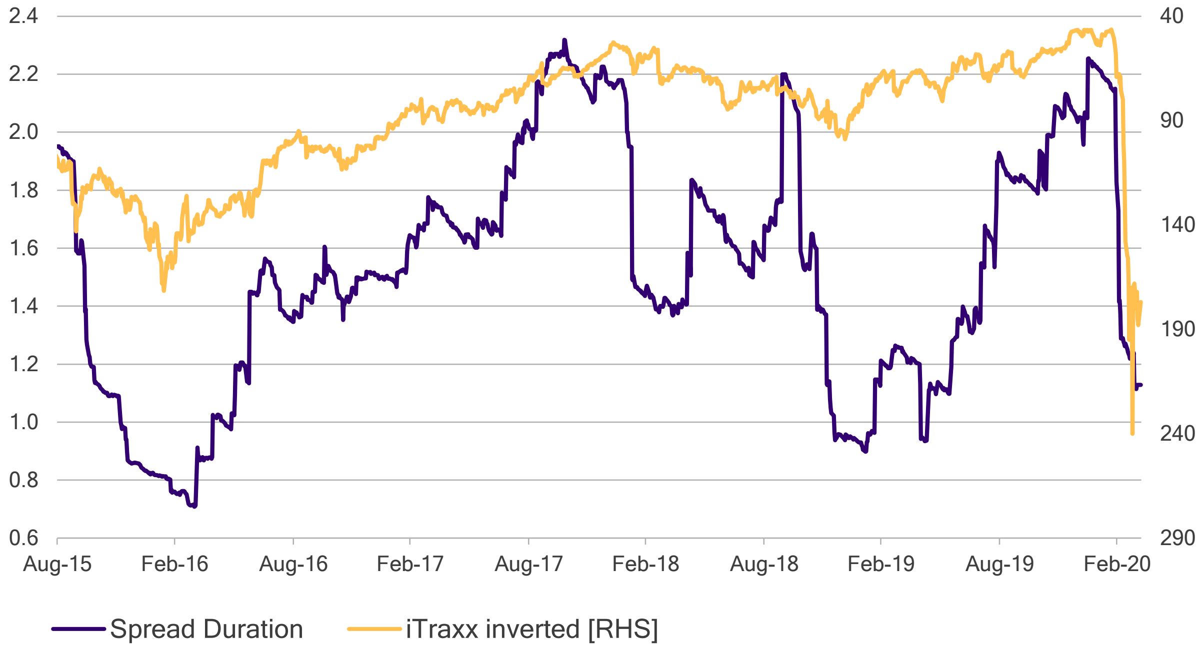
The fund de-risked leading into the market downturn as risks started to increase around the virus's impact on economic growth and subsequent credit spreads. During the last week of February and early March we sold some more physical securities (mainly senior bank paper) and then took some iTraxx protection to reduce our credit risk (from 2.25yrs to 1.2yrs).

We also increased our cash holdings when we sold down securities – and had over 48% of the fund in cash securities at the end of March.

In the chart below you can see how we actively de-risk the portfolio when we get concerned on the outlook for credit spreads increasing.

The iTraxx on the chart represents this credit risk as it's a representative of a basket of the largest corporate issuers in Australia. The line is inverted – as it goes down it shows the increase in credit spreads (and decrease in credit prices). The blue line represents the Enhanced Cash Fund exposure to credit as measured by the spread duration. As the line goes down, credit risk is reduced in the fund.

Chart one: Pendal Enhanced Cash Fund Credit Risk vs Index

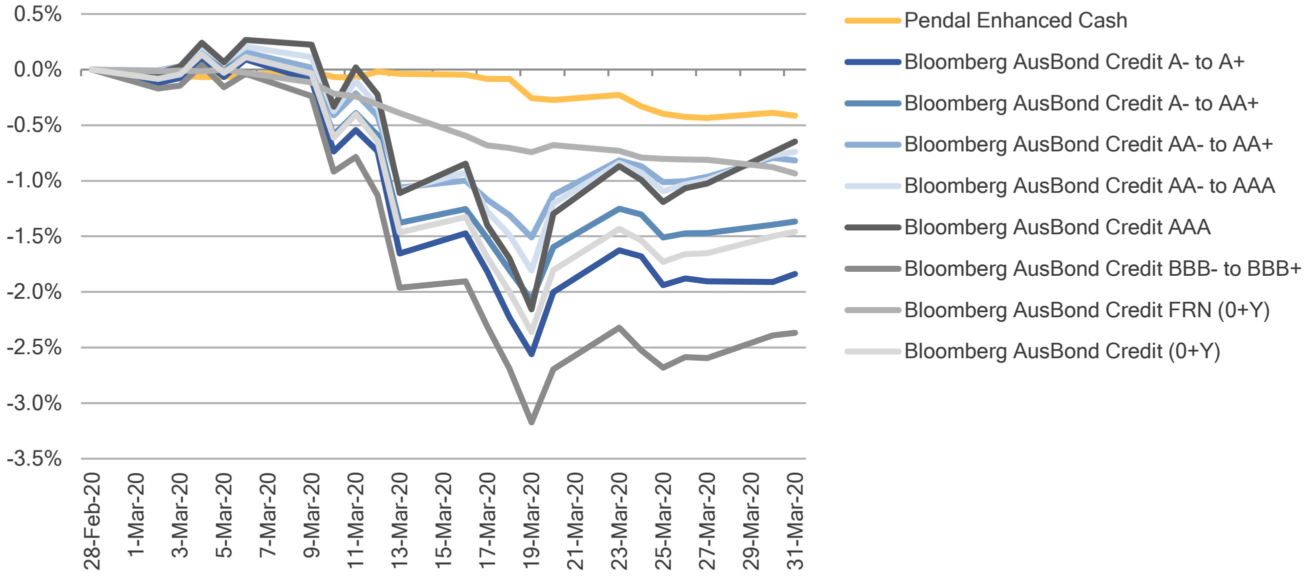


Source: Pendal, Bloomberg

If we review various credit spreads during the month we can see in the chart below that all credit indices from AAA to BBB were negative. The Enhanced Cash Fund mantains a AA average credit rating. As you can see below, the lower the credit rating, the larger the negative return.

The active reduction of credit risk as well as higher quality ratings helped reduce drawdowns for the enhanced cash fund.

Chart two: Pendal Enhanced Cash Fund Returns over March vs Credit Index returns



Source: FE Analytics, After fees.

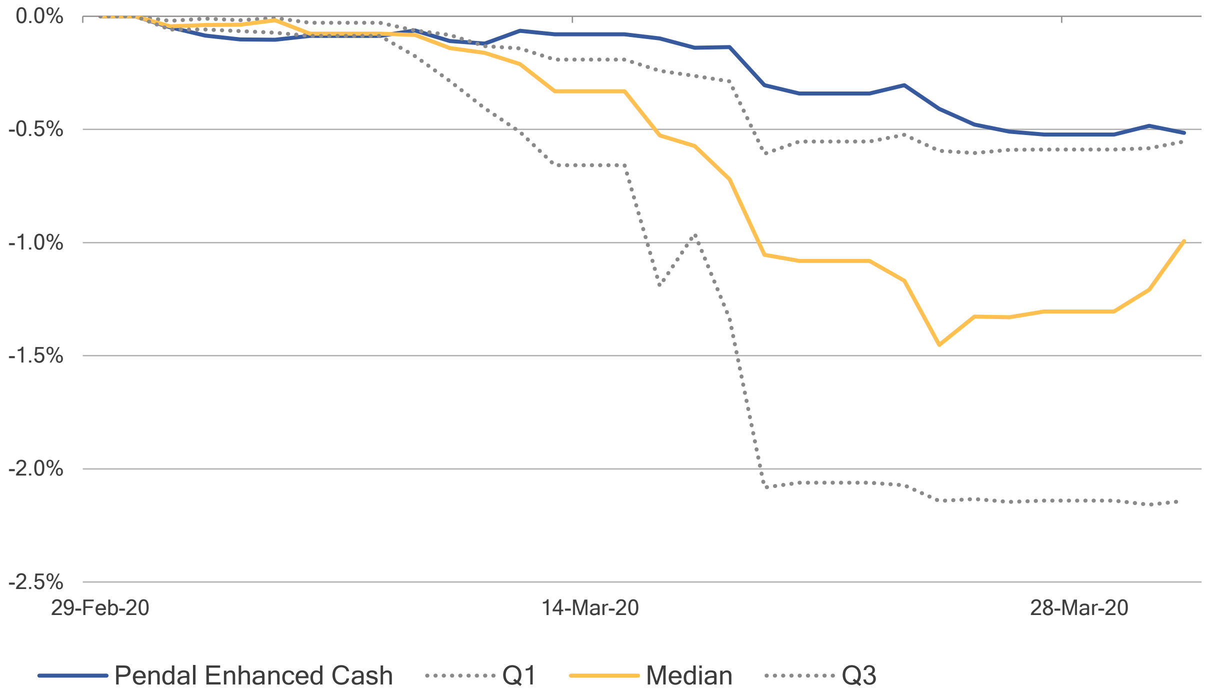
Index/ Fund Name	1m return
Pendal Enhanced Cash TR in AU	-0.42
Index : Bloomberg AusBond Credit AAA TR in AU	-0.65
Index : Bloomberg AusBond Credit AA to AAA TR in AU	-0.74
Index : Bloomberg AusBond Credit AA to AA+ TR in AU	-0.82
Index : Bloomberg AusBond Credit FRN 0+ Years TR in AU	-0.94
Index : Bloomberg AusBond Credit A to AA+ TR in AU	-1.37
Index : Bloomberg AusBond Credit 0+ Years TR in AU	-1.46
Index : Bloomberg AusBond Credit A to A+ TR in AU	-1.84
Index : Bloomberg AusBond Credit BBB to BBB+ TR in AU	-2.37

Peer relative returns

From a peer relative perspective, the Enhanced Cash Fund performed in line with the top quartile of returns. This showcases its defensive characteristics again – as it has done in previous credit spread widening events. This can be seen in the chart below where we have cushioned the fall in returns relative to median and lower quartile managers.

All funds look very similar in the enhanced cash space during benign market environments. But when volatility increases and credit spreads move wider, we realise the level of risk in these strategies. As credit markets become stressed they also tend to become less liquid and the price for selling securities widens quickly.

Chart three: Pendal Enhanced Cash Fund Performance vs Peers March 2020



Source: Morningstar, After fees.

Current positioning and outlook

The portfolio has a running yield currently as at 30 April 2020 of 1.29% – around 0.75% above bank bill rates. It has a current credit spread duration of 1.54yrs and modified duration of 0.16yrs.

The portfolio maintained its credit protection heading into April. But we removed it mid-month as the credit outlook became less concerning and we felt risk sentiment improving.

The credit securities we do maintain in the portfolio are of a high quality (AA average) with an average maturity of around two years. We feel very comfortable continuing to own these securities and we will wait for opportunities to increase any exposure.

Global factors continue to offer the greatest guidance to domestic credit spreads. In this respect, the spread of COVID-19 has emerged as an over-riding driver of short-term risk sentiment. We remain wary that the path and evolution of the virus across the globe is rapidly evolving and remains uncertain.

Over the longer-term, we expect loose monetary policy settings to be supportive for risk assets. Policy easing in previous years had been the most significant driver of tighter spreads.

Significant fiscal responses have also been witnessed and we expect additional government spending to be announced with magnitudes depending on the escalation of the outbreak.

For global corporates the extent of the impact on revenue, supply chains and earnings is yet to be quantified. Most companies have issued profit warnings and we expect this to continue until there is greater clarity on the virus's impact.

Overall the COVID-19 outbreak remains a fluid and fast-evolving situation with an unknown outlook. While we expect a negative impact to economic growth and corporate earnings, the extent of that impact and how much will be mitigated by policymaker responses is unknown.

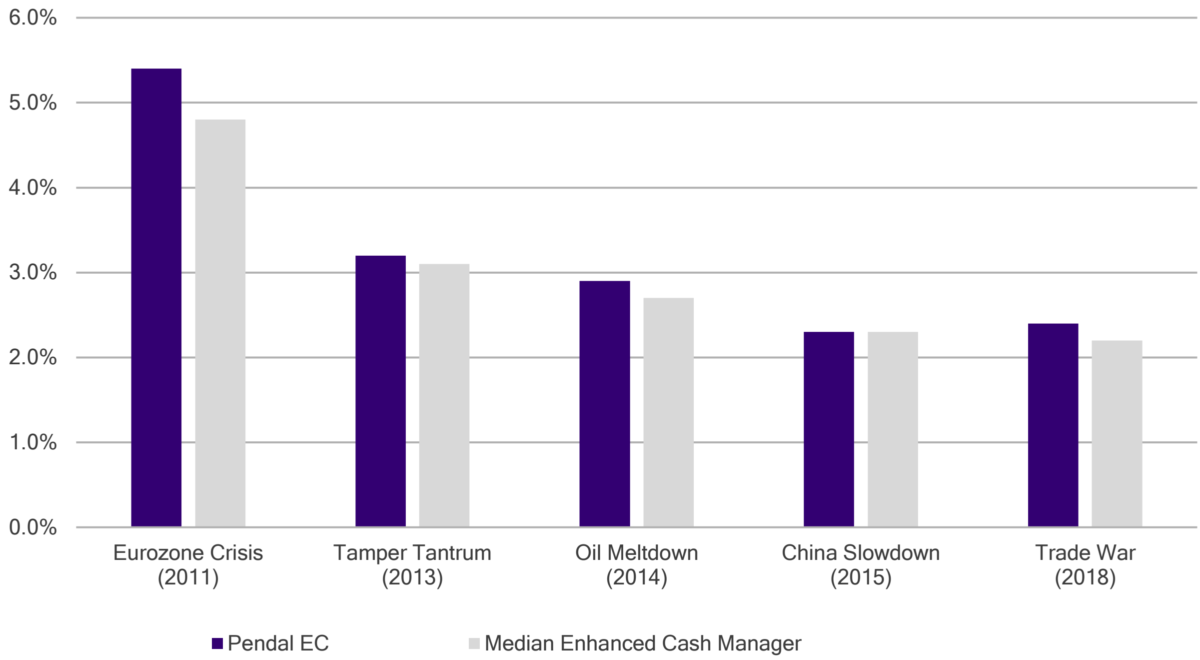
We will continue to closely scrutinise relevant developments and assess the potential ramifications as they occur. Over the longer-term, policy measures should be supportive for risk sentiment. However, in the near-term we prefer to adopt a cautious stance.

Fund Performance Outlook

When we look at prior periods of spread-widening similar to the past four-to-six weeks, we can see strong excess returns as markets stabilise and credit spreads come back in. Our ability to de-risk and then re-risk supports a limiting in drawdowns and participation in the upside.

In the table below you can see examples of this occurring over the past 10 years. It shows how the fund has delivered strong excess returns after these periods. In the chart this is highlighted by the top-quartile rolling 12-month returns in excess of bank bills.

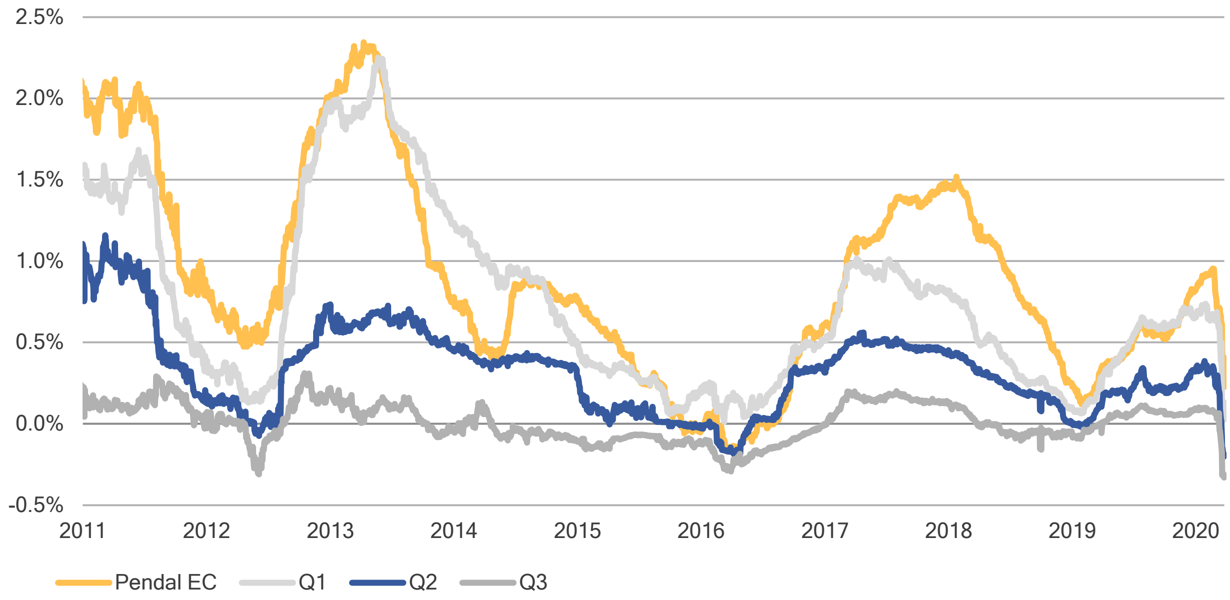
Chart four: Pendal Enhanced Cash Fund performance during stressed environments



Source: Morningstar, Bloomberg

	Eurozone Crisis (2011)	Tamper Tantrum (2013)	Oil Meltdown (2014)	China Slowdown (2015)	Trade War (2018)
Start Date	31/05/2011	31/05/2013	30/06/2014	30/06/2015	31/03/2018
EC Return (Excess)	5.4% (+0.6%)	3.2% (+0.5%)	2.9% (+0.3%)	2.3% (+0.0%)	2.4% (+0.4%)
Median Return (Excess)	4.8% (-0.1%)	3.1% (+0.4%)	2.7% (+0.1%)	2.3% (+0.0%)	2.2% (+0.2%)
EC Worst Drawdown	-0.15%	-0.09%	-0.02%	-0.07%	-0.03%
Aust. IG Spread Range	140bps	50bps	30bps	100bps	50bps

Chart five: Pendal Enhanced Cash Fund Rolling 12m Excess Returns over Bank Bills vs Peers



Source: Bloomberg, Morningstar, custom enhanced cash universe (net of fees)

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