Pendal Focus Australian Share Fund update

June 1, 2020

Key observations

We are very optimistic about the opportunities emerging in this environment. Uncertainty creates mis-pricing, which creates opportunity. Today we have heightened uncertainty at three levels:

- **Economic:** How quickly does the economy recover and to what level? What are the risks of disappointment?
- **Industry:** How prolonged is the cyclical effect? What structural changes have emerged or accelerated? How is the structure changing?
- **Company:** What is management's strategy to deal with this environment? Is it credible and effective?

We are mindful of the potential for investors to latch onto obvious themes. At this point, despite the recent surge, overall market positioning remains very bearish in expectation of a material pullback.

Ironically, this can make a major sell-off less likely. It is important to be looking at the economy and at companies – but also to be thinking about how the market is positioned.

There are a range of possible scenarios on the health and economic fronts, along with second-order effects not yet visible. It is not the time to take a binary view of the environment. We continue to use our scenario framework, positioning for the likelier scenarios while maintaining protection in case of better or worse outcomes.

This market is incredibly volatile, with big swings. Even this week over two days we saw a swift rotation from growth to value. This emphasises the importance of our approach of focusing on stock-specific drivers and not taking huge thematic or sector positions in this environment.

This approach continues to help performance.

The fund performed better than the index in the downturn and has also outperformed in the rebound. Over 12 months it is now down -2.69% (post fees) versus the S&P/ASX 300's -6.95% return.

Net-of-fee performance as at May 26, 2020

	Market trough (24/3/20) to date	Market peak (21/2/20) to date	2020 YTD	12m to date
Pendal Focus	29.34	-14.82	-9.84	-2.69
S&P/ASX 300 TR	27.95	-18.33	-12.35	-6.95
Active	*1.38*	*3.51*	*2.51*	*4.26*

Source: Morningstar - May 26, 2020

Drivers of performance

Recent data in some industries has been better than many feared, helping several of our positions.

Traffic in France is recovering faster than expected (Atlas Arteria, ALX). US housing has held up better than expected (James Hardie, JHX). Optimism that the Australian economy may recover faster than many feared has helped Seven Group (SVW).

There has been a material rotation in markets in recent weeks, away from defensives that had previously outperformed, towards more cyclical names.

Our underweight in Woolworths (WOW) and Coles (COL) has helped, while our preferred supermarket Metcash (MTS) outperformed the market over the month so far.

Gold has continued to do well, helping our position in Evolution (EVN). A continued recovery in the oil prices –helped by some constraint in supply and optimism on demand – also helped our position in Santos (STO).

Changes in position

The market is optimistic at the pace of recovery as restrictions are rolled back. But we don't yet know the level to which it will recover in the near term. It seems unlikely we will return quickly to 100 per cent of previous aggregate economic capacity.

Different industries will walk a different path. Some such as tourism and entertainment may only return to 80 per cent or less of previous capacity.

Other industries can quickly return to 100 per cent or even beyond. There seems to be resurgence in car traffic, for example, as people remain wary of public transport. This has implications for car sales and manufacturing, steel and infrastructure.

We are spending a lot of examining the outlook for different industries and marrying that up with valuation. An industry may be slower to recover – but that does not mean there isn't opportunity. An industry that may recover to 80 per cent, but is priced for recovery to 60 per cent, can be an interesting prospect.

We have seen mispricing in the insurance industry, which has underperformed amid worries about the scope for COVID-19 claims – particularly related to business interruption. Our research suggests these concerns are overdone. There may be some exposure, but not as much as the market is implying. As a result we have been adding to insurers.

We have also added to iron ore miners in recent weeks. Supply disruption in Brazil is leading to shortage of certain blends and supporting prices. This is likely to be a temporary factor and demands a close watch. However at this point the miners remain in a sweet spot given a weak AUD and historically low oil price.

We have added to our domestically-focused recovery plays via Downer (DOW). There has been some impact to DOW's business from shut-downs in New Zealand and in some of its education and entertainment contracts. But the bulk of its business has remained resilient. The stock did well in May on better sentiment towards a recovery.

We maintain our balanced portfolio exposure, positioned for what we see as the probable outcomes, while also owning stocks that will do well in the event of a materially worse – or better – outcome.

Recession protection	Quality defensives	Policy beneficiaries	Franchise winners	Recovery hedges
Evolution MINING	xero	FMG	ARISTOCRAT	Santos
amcor	CSL	SGH	JamesHardie	QANTAS
TELSTRA	IAG Insurance Australia Group	JB HI-FI	Nine entertainment co.	Tabcorp
			atlasArteria	Downer

Source: Pendal, companies

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

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