Pendal Sustainable Diversified Funds Update

April 17, 2020

Pendal's sustainable diversified funds employ a proven, long-term approach to responsible investing. The funds benefit from the well-resourced capabilities of our dedicated multi-asset and Environmental, Social and Governance (ESG) capabilities. While there is significant focus on the impact of COVID-19 right now, our sustainable funds continue to focus on the environmental and social issues we are all becoming engaged with.

A common criticism of sustainable strategies is they underperform their non-sustainable counterparts. However over the past quarter and year our sustainable diversified strategies have been in the top quartile of performers across their risk profiles in both sustainable and mostly non-sustainable strategies. This has been driven by a combination of the active strategies outlined below.

Pleasingly, this performance has occurred in down-markets – meaning we have reduced the drawdown relative to our peers. This is in line with our philosophy that a smoother investment journey is important for client wealth creation and well-being. With this in mind we actively consider downside risk in all aspects of portfolio construction.

Returns as at 31 March 2020	3M	6M	1Y	3Y	5Y	10Y
Pendal Sustainable Conservative Benchmark	-3.81	-3.64	0.72	3.49	3.14	5.09
Pendal Sustainable Conservative Fund	-5.15	-4.91	-1.15	1.69	1.60	3.88
Quartile	2	2	2	3	3	2

Returns (After Fees %)	3M	6M	1Y	3Y	5Y	10Y
Pendal Sustainable Balanced Fund Benchmark	-11.02	-9.77	-3.22	3.72	4.13	7.10
Pendal Sustainable Balanced Fund	-13.03	-11.21	-5.92	1.10	1.93	5.54
Quartile	2	2	2	3	3	3

Sources: Financial Express, Pendal after fees.

The key benefit of diversified funds is the mixing together of assets that behave differently in different market environments. While no one could have predicted recent events, portfolio construction for the Pendal strategies has always focused on seeking the most appropriate mix of assets classes and strategies to deliver the best risk/return outcomes within recommended investment timeframes.

While the strategies have large exposure to equities as long-term drivers of growth, we also balance these assets with other strategies including government bonds and alternatives.

The funds have had reasonable exposure to government bonds and alternative assets. In the previous 12 months this dragged on returns as riskier assets such as high-yield credit, property and equities had very strong returns.

However during the recent market downturn these asset classes did not fall as much as riskier asset classes. This helped reduce drawdown in our portfolios. This can be seen in returns for March and in the period since the equity markets started to fall. The strategies had smaller drawdowns relative to equities in these timeframes.

In March our alternatives strategies delivered a return of -4.8% while and our government bond strategies returned -0.2% and 1.44%. This was not enough to offset the larger equity markets falls but it acted to reduce the impact.

Our active asset allocation approach also helps deal with market volatility. This looks at short-term market movements as well as medium-term market valuations. By slightly tilting the portfolio around our long-term strategic asset allocation we can obtain a smoother ride for our investors and take advantage of short-term noise in markets.

Over the past four-to-six weeks the portfolio has shifted. In February we were initially tilting towards taking short-term protection against rising volatility, taking extra exposure to bonds, increasing gold exposures and selectively shorting more expensive US equity markets. In March we have been adding additional equity exposures into areas that now appear to be better value when considered over a medium-time frame of three-to-five years.

In March the active asset allocation contributed about 0.2% to portfolio returns. While not large, the risk taken to generate these returns is commensurate. Over the longer term these small incremental returns – especially during down markets – can contribute meaningfully.

The other element of Pendal's diversified funds has been the active management within each asset class. In the sustainable funds this has the additional emphasis on ESG outcomes alongside financial returns.

As part of our ongoing commitment to ensuring that the fund's investment aligns with our investors, we made some changes to our active asset allocation process in recent months.

In early February we replaced Dax futures in our active asset allocation program with Stoxx 600 ESG-X futures. The new contract better reflects the values expressed by the fund and its investors. We are monitoring other markets with a view to making similar changes as new futures contracts become available, while meeting our strict liquidity requirements.

The performance of our asset class strategies against the broader peer groups has been interesting. We have seen strong active returns over the last few months and over the last year from three of our four active asset class strategies.

The Sustainable Australian share fund, Sustainable Australian and Global Fixed income funds all outperformed their benchmarks and peer median manager returns.

The Sustainable Australian Fixed Income Fund and the Sustainable Global Fixed Income Fund were top-quartile performers for the three months (as well as 12 months) to end of March. It's an excellent result considering this is when you need your defensive managers to perform.

Performance has been driven by strong stock selection in sustainable companies such as CSL as well as not owning oil companies or Westpac bank. A large exposure to government bonds helped outperformance, along with a large holding in impact bonds which have outperformed relative to corporate credit securities.

The focus has shifted from some of the bigger issues a few months ago such as climate change and governance issues with companies. But the impacts of COVID 19 should see a further emphasis on ESG factors as companies and governments respond to the health crisis, humanitarian issues and the need to stimulate economies.

Solutions under discussion domestically and globally include projects designed to improve social and environmental issues. This could involve public and private sectors working together to achieve the United Nations' Sustainable Development Goals (SDGs). Issuing green and social bonds might provide an opportunity to finance these investments.

Our sustainable Australian fixed income fund now has more than 40% of its capital dedicated to these investments and is always on the lookout for new projects. You can see in the table below how our social and impact bonds map to these SDG goals.

	1 No Poverty	2 Zero Hunger	3 Good Health and Well-being	4 Quality Education	5 Gender Equality	6 Clean Water and Sanitation	7 Affordable and Clean Energy	8 Decent Work and Economic Growth	9 Industry, Innovation and Infrastructure	10 Reduced Inequalities	11 Sustainable Cities and Communities	12 Responsible Consumption and Production	13 Climate Action
Australian Catholic University Sustainable Bond			✓	✓				✓			✓		✓
ANZ Green Bond							✓				✓	✓	✓
NAB Climate Bond							✓				✓	✓	✓
NAB Social Bond - Gender Equality					✓			✓		✓			
National Green RMBS						✓	✓				✓	✓	✓
Westpac Climate Bond							✓				✓	✓	✓
EIB Climate Awareness Bond							✓				✓	✓	✓
IFC Social Bond	✓	✓	✓	✓	✓					✓			
IBRD Green Bond						✓	✓		✓			✓	✓
ADB Green Bond							✓				✓		✓
Macq. Uni Sustainable Bond			✓	✓		✓	✓	✓	✓	✓	✓	✓	✓
Treasury Corp. of Vic. Green Bond							✓		✓		✓	✓	✓
NSW TCorp Green Bond						✓			✓		✓	✓	✓
NSW TCorp Sustainability Bond				✓		✓			✓	✓	✓	✓	✓
National Housing Finance Bond	✓									✓	✓		
IADB EYE Social Bond				✓				✓					
Woolworths Green Bond							✓				✓		✓
Aquasure Vic Desalination						✓							
Mitsubishi UFJ Green							✓				✓		
CBA Climate Bond							✓				✓	✓	✓

Source: https://sustainabledevelopment.un.org/sdgs
Note these are 13 of the 17 total SDGs, the others are: Life Below Water, Life on Land, Peace and Justice Strong Institutions, Partnerships to achieve the Goal

The key to diversification is ensuring a constant rebalancing of portfolios to our strategic asset allocation – a process we have been following consistently in recent months as markets have fallen. This form of dollar cost averaging adds incremental returns over the long run.

We have also been actively looking for opportunities to invest in undervalued assets that give us a better probability of achieving our long-term return objectives. It's always difficult to invest in very volatile markets, but a disciplined and methodological approach helps take some of the emotion out of the investment equation. Our approach to rebalancing during recent large falls sees us buying equity markets as they get cheaper.

It is difficult to make a call on whether markets have bottomed or not. But we know cheap markets generally generate above-average returns over the medium term – and therefore provide investors with a margin of safety when they do buy an asset. We selectively added to global equities in March as certain regions and sectors became very attractive from a medium-term perspective.

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