Pendal MidCap Fund

ARSN: 130 466 581

Factsheet

Equity Strategies

July 2019

About the Fund

The Pendal MidCap Fund (**Fund**) is an actively managed portfolio of Australian mid cap shares.

Investment Return Objective

The Fund aims to provide a return (before fees, costs and taxes) that exceeds the Pendal MidCap Custom Index over the medium to long term. The suggested investment timeframe is five years or more.

Description of Fund

This Fund is designed for investors who want the potential for long term capital growth and tax effective income from a portfolio of primarily 40-60 Australian mid cap shares and are prepared to accept higher variability of returns. Pendal defines the mid cap universe to include companies ranked between 51 and 150 of the S&P/ASX 200 Index. The Fund may also invest in equivalent companies listed on the New Zealand Stock Exchange, hold cash and may use derivatives.

Pendal's investment process for Australian shares is based on our core investment style and aims to add value through active stock selection and fundamental company research. Pendal's core investment style is to select stocks based on our assessment of their long term worth and ability to outperform the market, without being restricted by a growth or value bias. Our fundamental company research focuses on valuation, franchise, management quality and risk factors (both financial and non-financial risk).

The Fund may have assets denominated in foreign currencies. This means that changes in the value of the Australian dollar relative to foreign currencies may affect the value of the assets of the Fund. The Fund's foreign currency exposure may be hedged from time to time, in whole or part.

Derivatives may be used to reduce risk and can act as a hedge against adverse movements in a particular market and/or in the underlying assets. Derivatives can also be used to gain exposure to assets and markets.

Investment Team

Pendal's Equity team is headed up by Crispin Murray who has extensive experience and a strong record in equities research. Andrew Waddington is the portfolio manager for the Fund.

A combination of the Australian equities large cap and small cap teams' research is used to construct the Pendal MidCap Fund.

Investment Guidelines

Investable universe	ASX and NZX listed and soon to be listed companies, generally with a market capitalisation of A$0.5 billion to A$5 billion; derivatives; cash
Investment ranges	Australian shares 80 - 100% New Zealand shares 0 - 10% Cash 0 - 20%
Ex-ante tracking error	3 – 8%
Number of stocks	Typically 40 – 60
Absolute stock position	15%
Maximum active stock position	+/- 5%[1]
Maximum active sector position relative to index	+/- 10%[1]

[1] compared to benchmark.

Performance

(%)	Total Returns (post-fee)	(pre-fee)	Benchmark Return
1 month	4.39	4.47	5.00
3 months	6.32	6.56	5.63
6 months	14.40	14.90	14.97
1 year (pa)	2.08	3.00	6.79
3 years (pa)	10.61	11.89	10.45
5 years (pa)	12.25	13.62	12.12
7 years (pa)	15.09	16.76	13.59
10 years (pa)	12.38	14.21	9.80
Since Inception (pa)	10.28	12.40	6.36

Sector Allocation (as at 31 July 2019)

Energy	5.0%
Materials	18.4%
Industrials	14.5%
Consumer Discretionary	10.4%
Consumer Staples	6.6%
Health Care	5.7%
Information Technology	8.4%
Telecommunication Services	10.7%
Financials ex Property Trusts	4.1%
Property Trusts	2.4%
Cash & other	13.8%

Top 10 Holdings (as at 31 July 2019)

Xero Limited	5.5%
Nine Entertainment Co Ltd	5.4%
JB Hi-Fi Limited	4.3%
Metcash Trading Limited	4.0%
Resmed Inc	3.7%
Northern Star Resources	3.6%
Seven Group Holdings Ltd	3.5%
Monadelphous Group Limited	3.2%
Bendigo & Adelaide Bank Limited	3.1%
Regis Resources Limited	2.9%

Other Information

Fund size (as at 31 Jul 2019)	$513 million
Date of inception	June 2008
Minimum investment	$25,000
Buy-sell spread[2]	0.50% (0.25%/0.25%)
Distribution frequency	Quarterly
APIR code	BTA0313AU

[2] The buy-sell spread represents transaction costs incurred whenever you invest or withdraw funds, and may vary from time to time without notice.

Management Costs[3]

Issuer fee[4]	0.90% p.a.
Performance fee[5]	20% x the Fund's performance (before fees) in excess of the performance hurdle

[3] You should refer to the latest Product Disclosure Statement for full details of fees and other costs you may be charged.

[4] This is the fee we charge for overseeing the operations of the Fund and managing the assets of the Fund. The Issuer fee is paid from the assets of the Fund and is reflected in the unit price of your investment.

[5] The Fund's performance fee is 20% of the Fund's performance in excess of the performance hurdle. The performance hurdle is the performance of the benchmark (Pendal MidCap Custom Index) plus the issuer fee of 0.90% pa. If a performance fee is payable, it is charged in addition to the issuer fee. The fee is calculated each Business Day based on the investment performance and value of the Fund on that day. If we are entitled to a performance fee, it is paid to us as at 30 June each year.

Risks

An investment in the Fund involves risk, including:

- **Market risk**: The risk that factors affecting one or more countries that can influence the direction and volatility of an overall market, as opposed to security-specific risks.
- **Security specific risk**: The risks associated with an individual security.

Please read the Fund's Product Disclosure Statement (**PDS**) for a detailed explanation of each of these risks.

Market review

Performance for the Australian share market was strong in July, with the larger cap S&P/ASX 100 Accumulation index adding +2.8%, whereas the Small Ordinaries index was also +4.5% higher. The large cap iron ore miners all retreated despite a 10% gain in the commodity price: Brazil's Vale has been successful in bringing around one-third of its shuttered production back on line, following the shut-downs that occurred after the tragic tailings dam disaster earlier in the year. It will take Vale's production between 60 and 90 days to find its way back into the market – and it is still a long way short of previous production. The iron ore price has subsided from its highs and an increase in trade friction may prompt further volatility. In contrast, the gold miners continued to outperform, although return from the precious metal was somewhat muted (+2%). The ongoing decline in long-term bond yields, coupled with elevated geopolitical uncertainties has seen investors continue the rotation into safe haven asset. The S&P/ASX 51-150 Accumulation index finished July 5% higher.

Nine of the 11 GICS sectors, for the 51-150 index recorded gains over the month, with Industrials (-0.2%) and Utilities (-3.7%) being the exceptions. Within the former, infrastructure company Atlas Arteria (ALX, +4.5%) was the largest performance contributor to the sector; although it underperformed the headline index. ALX released its 2Q19 traffic data that was down -2.1% over the quarter for the group. Part of the negative comps was attributable to a strong second quarter last year; whereas Dulles Greenway (DG) in particular experienced its ninth consecutive period of declines with traffic down - 2.6%. More than offsetting ALX's gains, CIMIC (CIM, -18.0%) recorded a double-digit loss. The company saw a backlash to its quarterly update, with the market concerned over weaker cash flows. CIM has been under some pressure from an institutional short-seller, who noted the use of "reverse-factoring" arrangements as an accounting tool which can potentially help improve the optics on working capital. The practice, which involves using third-party institutions to honour accounts payable, then repaying the institution, may prove to be a niche issue in the upcoming reporting season if its use is wider spread.

On the other side of the tally board, Materials (+5.2%) contributed the most to the headline index return; whereas Consumer Staples (+13.7%) recorded the largest absolute gains in July. As mentioned above, gold miners including Evolution Mining (EVN, +15.1%), Northern Star (NST, +11.7%) and St. Barbara (SBM, +25.9%) helped lift the sector. Offsetting some of their gains, mineral sand miner Iluka (ILU, -10.7%) and building materials manufacturer Adelaide Brighton (ABC, -12.4%) were the largest detractors from sector performance. Exposure to iron ore via royalties impacted on Iluka, however it was the soft patch in its core zircon market revealed in a disappointing quarterly update which saw it sell off by investors. At the same time, Adelaide Brighton downgraded its full year guidance. In doing so it confirmed a trend first flagged by CIMIC that the pipeline of infrastructure work has proved slower than expected. Several of the domestic construction-related names have had bounces post-election. However there are signs now that the underlying environment has not improved.

Turning to Consumer Staples, a2 Milk (A2M, +23.6%) was the best performing stock in July. The market darling continued to run high despite its elevated stock valuation - trading at 36x FY1 P/E after the recent run. The company has put through retail price increases lately, boosting investor's confidence that the infant formula manufacturer will continue to beating earnings expectations. Following A2M, Metcash (MTS, +12.5%) was also amongst the top performance contributors to the sector. The stock rose on the back of improved sentiment, as the proposed demerger from Woolworths of its hospitality group provided a positive read-through for MTS. Metcash runs three lines of businesses: Food, Liquor and Hardware and is currently trading at ~7x EV/EBITDA. Whilst it is not a perfect like-for-like comparison, the implied multiple of Bunnings from Coles; and that of Endeavour Group from WOW help to provide some benchmark pricing for Metcash's Hardware and Liquor businesses. As such, it suggests that Metcash's Food business, which has been operating in a challenging environment is clearly undervalued at 5x EV/EBITDA.

Fund performance

The Fund made strong gains in July, driven by a good mix of stocks. Several of the companies which we believe are doing a good job of responding to disruptive pressure - JB Hi-Fi, Nine Entertainment and Metcash - all had strong months. Our growth exposure - via Xero and ResMed - also outperformed. However the Fund did lag the market's gains. This was due primarily to the underweights in A2 Milk and in Magellan.

Contributors

Overweight JB Hi-Fi

Domestic cyclicals enjoyed a rally throughout July, including our long-term holding JB Hi-Fi (JBH, +16.4%). We continue to like the company on a medium term view. It is one of the best-managed franchises in Australia – and one which is doing a good job of navigating the changes in industry structure brought about by online retail. It is also well placed to benefit from pressure on smaller competitors and has the ability to drive better returns via an improvement in the operational performance of its Good Guys business. That said, we are mindful that there are signs that broad domestic demand has remained subdued post-election. The combination of recent rate cuts, tax cuts and the potential for further fiscal stimulus could help revive a soft environment, however the risk is that near-term softness leads to disappointing outlooks for the domestic consumer over the near term.

Does not hold CIMIC

CIMIC (CIM, -18.0%) saw a backlash to its quarterly update, with the market concerned over weaker cash flows. CIM has been under some pressure from an institutional short-seller, who noted the use of "reverse-factoring" arrangements as an accounting tool which can potentially help improve the optics on working capital. The practice, which involves using third-party institutions to honour accounts payable, then repaying the institution, may prove to be a niche issue in the upcoming reporting season if its use is wider spread.

Detractors

Underweight a2 Milk

a2 Milk (A2M, +23.6%) was the best performing Consumer Staples stock in July. The market darling continued to run high despite its elevated stock valuation - trading at 36x FY1 P/E after the recent run. The company has put through retail price increases lately, boosting investor's confidence that the infant formula manufacturer will continue to beating earnings expectations.

Does not hold Magellan

A rising market, strong fund performance as well as positive FUM inflows have in conjunction propelled the share price of Magellan (MFG, +21.3%) to all-time highs. The fund manager reported its June FUM update in early July, where the net inflows of $488m were split ~25/75 between retail and institutional. We do not own MFG, and it dragged on relative performance.

Strategy and outlook

Leading into reporting season, we have seen a soft patch as tighter lending standards and already high levels of household debt are feeding through to in terms of domestic consumer demand. This has weighed on some of the domestic cyclicals in the midcap space.

There are two broad views of the current environment. One states that data signals a continuing slow down in the global economy, which will lead to recession. The other is that we are likely to see a policy response, which will help support both the economy and also the equity market. We subscribe to the latter.

Domestically we are seeing a version of this debate play out. The Coalition Federal government has set its stall out on maintaining a fiscal surplus - whereas arguably this is the one year where we need fiscal stimulus, given moribund growth and diminishing utility of monetary policy. The means are there, in the form of the windfall of iron ore royalties, as well as government borrowing costs at less than 1%. What's more any more pressure on depositors – seeing term deposit rates likely going to 1.3% - is likely to prompt a political backlash.

As a result, we remains mindful that any signs that the deterioration in domestic demand is bottoming out may prompt a re-rating of the domestic cyclicals, many of which are at relatively low valuations.

We retain exposure to bond-sensitive stocks in both the growth sector (Xero, ResMed, REA Group) and the more traditional defensive yield sector (Atlas Arteria).

The resource sector has been volatile in recent weeks, as the expectation of a resumption in Brazilian production, coupled with concerns over China, has seen the iron ore price fall from its highs of early July. The portfolio has minimal direct exposure to iron ore. Instead, we have positions in mining service companies Seven Group and Monadelphous. We see the earnings outlook for these companies as linked to the volume of fleet maintenance and production replacement that the miners must undertake in coming years. As such, we consider them far less sensitive to shifts in commodity prices.

For more information please call 1800 813 886,
contact your key account manager or visit pendalgroup.com

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