PENDAL

Pendal Monthly Commentary

Pendal Australian Specialised Retirement Income Portfolio

January 2020

Market commentary

The market staged a strong start to 2020, with the S&P/ASX 300 Accumulation index gaining +4.9% in January.

However with Resources up only +0.65% and Financials (+4.7%) somewhat in-line with the market, the gains were concentrated in a narrow part of the market – particularly Health Care (+12.0%), Information Technology (+10.2%) and Consumer Staples (+7.8%).

This rotation away from cyclicals – and towards bond-sensitive defensive and growth stocks – is a reversal of the prevailing theme of the last quarter and reflects a cautious turn in investor sentiment in recent weeks. Coronavirus has played a role in this, but even prior to this uncertainty there had been some weaker signals on global growth.

People are now looking for further monetary easing to support the global economy, with a further 50bps of rate cuts currently priced into the bond market. US 10-year bond yields contracted 41bps to 1.51% over the month, while their Australian equivalents came in 42bps lower to 0.95%.

Elsewhere the combination of bushfires and the coronavirus – and the potential effects on travel and tourism – hit a raft of stocks including Flight Centre (FLT, -10.8%), Qantas (QAN, -9.9%), Star Entertainment (SGR, -9.1%) and Sydney Airport (SYD, -3.1%). The underperformance of global cyclicals such as BlueScope Steel (BSL, -5.4%) and Alumina (AWC, -5.2%) indicates broader uncertainties over the global economy.

The list of better performing stocks looks like a carbon copy of 1H 2019 and reflects a more negative bent in sentiment and lower bond yields. Afterpay Touch (APT) was up 31.7%, while fellow technology stocks Altium (ALU, +14.7%), Appen (APX, +12.9%), Wisetech (WTC, 7.1%) and Xero (XRO, +7.0%) also outperformed.

Health care, the other key growth sector, was also strong. ResMed (RMD) was up +14.4% and CSL (CSL) +13.2%.

Portfolio overview

Australian Specialised Retirement Income Portfolio	
Investment strategy	**Dual focus:** Deliver tax-effective capital & grossed-up income. **Broad hunting ground:** Core approach, drawing ideas from across the market cap spectrum. **Income focus:** Greater exposure to stocks with high grossed-up yield & dividend sustainability. **Higher turnover:** Takes advantage of lack of tax implications to pursue shorter-term opportunities
Investment objective	The objective of the Model Portfolio is to outperform the S&P/ASX 300 (TR) Index on a rolling 3 year period by 3% per annum.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15-35 (29 as at 31 January 2020)
Sector limits	A-REITS 0-30%, Cash 2-10%

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	9.32%
CBA	Commonwealth Bank of Australia Ltd	8.10%
BHP	BHP Billiton Limited	7.24%
TLS	Telstra Corporation Limited	6.00%
WBC	Westpac Banking Corporation	4.74%
QAN	Qantas Airways Limited	4.30%
STO	Santos Limited	4.28%
MQG	Macquarie Group Limited	4.11%
ANZ	ANZ Banking Group Limited	3.77%
NEC	Nine Entertainment Co Ltd	3.35%

Source: Pendal as at 31 January 2020

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
QAN	Qantas Airways Limited	3.80%
TLS	Telstra Corporation Limited	3.64%
STO	Santos Limited	3.49%
NEC	Nine Entertainment Co Ltd	3.20%
MTS	Metcash Trading Limited	3.20%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WOW	Woolworths Group Limited (not held)	-2.85%
WES	Wesfarmers Limited (not held)	-2.66%
WPL	Woodside Petroleum Limited (not held)	-1.68%
GMG AE	Goodman Group (not held)	-1.24%
NCM	Newcrest Mining Limited (not held)	-1.17%

Source: Pendal as at 31 January 2020

Performance

	1 month	3 month	6 month	1 year	2 Year	3 Year	Since Inception*
Pendal Australian Specialised Retirement Income Portfolio	4.01%	6.60%	6.08%	25.25%	10.83%	11.85%	10.69%
S&P/ASX 300 (TR) Index	4.89%	6.03%	5.20%	24.99%	12.40%	12.39%	10.90%
Active return	**-0.88%**	**0.56%**	**0.88%**	**0.27%**	**-1.57%**	**-0.54%**	**-0.21%**

Source: Pendal as at 31 January 2020

*Since Inception - 20 August 2015

Performance returns are pre-fee. Investors should contact their platform provider for applicable fee rates.

Past performance is not a reliable indicator of future performance

Top 5 contributors - monthly

Code	Name	Value Added
TWE	*Treasury Wine Estates Limited (not held)*	*0.16%*
CSL	CSL Limited	0.15%
TLS	Telstra Corporation Limited	0.12%
NCM	*Newcrest Mining Limited (not held)*	*0.09%*
JHX	James Hardie Industries Plc	0.09%

Top 5 detractors - monthly

Code	Name	Value Added
QAN	Qantas Airways Limited	-0.64%
WOW	*Woolworths Group Ltd (not held)*	*-0.28%*
IAG	Insurance Group Australia	-0.27%
VEA	Viva Energy Group limited	-0.20%
EVN	Evolution Mining Limited	-0.11%

Top 5 contributors - 1 year

Code	Name	Value Added
XRO	Xero Limited	0.80%
JHX	James Hardie Industries Plc	0.63%
CSL	CSL Limited	0.62%
JBH	*JB Hi-Fi Limited (not held)*	*0.58%*
STO	Santos Limited	0.39%

Top 5 detractors - 1 year

Code	Name	Value Added
WHC	*Whitehaven Coal Limited (not held)*	*-0.96%*
S32	*South32 Limited (not held)*	*-0.68%*
WES	*Wesfarmers Limited (not held)*	*-0.59%*
VEA	Viva Energy Group limited	-0.55%
WOW	*Woolworths Group Ltd (not held)*	*-0.53%*

Source: Pendal as at 31 January 2020

Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Underweight Treasury Wines (TWE, -19.8%)

Treasury Wine Estates released its results early and shifted full-year earnings growth expectations from 15-20% down to 5-10%. Management cited a squeeze on its bulk wine business in the US, which is seeing rising costs from Australian grapes, while stronger competition is limiting its ability to pass the costs on.

Overweight CSL (CSL, +13.2%)

CSL continues to benefit from a shortage in plasma supply in the US. More efficient use of blood in surgery has meant the Red Cross, which supplies 25% of the market, has not been growing collections. Meanwhile demand for immunoglobulin products sourced from blood plasma has been growing in the mid-to-high single digits each year. CSL has benefited from the twin tailwinds of higher US prices, as well as a mix shift as it supplies more product into the US.

Overweight Telstra (TLS, +8.5%)

Telstra quickly regained the ground it lost in December, helped by recent broker upgrades. We believe TLS continues to turn the corner, helped by better cost control and signs of stability emerging in the domestic mobile phone market.

Three largest detractors:

Overweight Qantas (QAN, -9.9%)

QAN was hit along with a raft of other travel and tourism related stocks on concern over the impact of the 2019-nCov virus (coronavirus) on demand. While there is likely to be some impact, we are mindful QAN is well placed to adjust capacity in response to any sustained downturn in volumes, given the stable domestic structure.

Underweight Woolworths (WOW, +15.7%)

Consumer staples such as Woolworths (WOW, +15.7%) and Coles (COL, +11.5%) benefited from a more defensive investor mindset. We believe valuations in both look stretched, given low single-digit earnings growth. Our preference remains for Metcash (MTS, +2.0%), which is valued at a historically wide discount to WOW and which has greater leverage to the shift in grocery price inflation.

Overweight Insurance Australia Group (IAG, -7.6%)

Insurance Australia (IAG) downgraded its expected insurance margins from 14.5-16.5% versus previous guidance of 16-18%. This followed a review of natural perils claims, prompted by a 2019 hailstorm. Underlying operations remain decent and the industry structure remains supportive in terms of its ability to price risk. A one-off remediation charge also exacerbated the downgrade.

Market outlook

- The coronavirus has quickly replaced trade at the nexus of uncertainty over the outlook for Chinese economic growth The rate at which infection rates are developing – and whether it is slowing – is a key factor in trying to gauge the length and scale of the ultimate impact. Near term the focus will be on how China returns to work following the extended Lunar new year holiday.
- In China manufacturing may start to ramp up faster than construction, as the latter relies more on migrant labour which may be impacted by travel restrictions. The market is working through the implications for commodity demand. There are also questions over the impact on regional and global supply chains, with stories emerging of some auto plants experiencing issues as they run short of components.
- This issue is likely to have implications for a swathe of Australian industries and companies. The effect on commodity demand is front and centre for the resources sector – and extends beyond the first-order implications for iron ore demand. For example, CNOOC, China's largest buyer of LNG, has declared force majeure and stated it is unable to take delivery of some contracted LNG shipments due to the impact of coronavirus. This could ultimately lead to gas originally intended for export finding its way into the Australian domestic east coast market, putting pressure on prices and on domestic gas suppliers.
- There are also likely to be impacts on companies that sell to Chinese consumers. Treasury Wine Estate, for example, downgraded in January on a weaker outlook for the US business. However the effects of any hit to demand in China or disruption in distribution are yet to flow through.
- As always there will be industries, companies and management teams better placed to deal with these issues than others. Some industries will be able to make adjustments. Airlines such as Qantas, for example, have the ability to react to weaker demand for flights via reduced capacity. For the miners, in contrast, mined ore not bought by Chinese steel plants sits as unsold inventory.
- The outlook for China is just one factor the market must think through as we enter reporting season. Across the Pacific, data from the US provided a brighter counterpoint to concerns over China as monthly employment came in much stronger-than-expected. We believe the US economy remains in reasonable shape. This is important because the effects of any Chinese demand shock will take place against a US economy which has some momentum, rather than one hovering at stall speed.
- The domestic economy remains patchy, however we are mindful that any signs of an improvement- perhaps in response to government stimulus – may see a sharp rebound in lowly-rated cyclicals. This rebound may be enhanced by the degree of valuation dispersion between cyclicals and growth stocks.

New stocks added and/or stocks sold to zero during the month

Sell to zero in Suncorp (SUN)

Suncorp Group is a Queensland-based conglomerate with operations spanning banking, general insurance and life insurance.

Recent updates have generally been better than the market expected. But there is no denying headwinds remains stiff, with little sign of margin improvement in the insurance or banking divisions.

The key factor for the stock's outlook is whether the company can deliver on management commitments to lift the underlying insurance margin from about 10% in FY20 to 12% in coming years.

Our recent analysis suggests this will be difficult, given 1) the company's primary strategic focus is shifting to market share, 2) the cost-out program has ended, 3) interest rates (and therefore investment income) remain under pressure and 4) SUN previously hinted at scope to reduce reinsurance cover, but the fires and hail of recent weeks underscore the importance of retaining strong levels of protection.

We believe diminished confidence in SUN's ability to deliver on margin targets will weigh on earnings and the company's ability to re-rate. As such, we are closing this position and rotating the capital into other opportunities.

For more information contact your
key account manager or visit **pendalgroup.com**

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