Pendal Australian Share Fund

ARSN: 089 935 964

Factsheet

Equity Strategies

February 2020

About the Fund

The Pendal Australian Share Fund (**Fund**) is an actively managed portfolio of Australian shares.

Investment Return Objective

The Fund aims to provide a return (before fees, costs and taxes) that exceeds the S&P/ASX 300 (TR) 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, diversification across a broad range of Australian companies and industries and are prepared to accept higher variability of returns. The Fund may also 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).

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. Derivative can also be used to gain exposure to assets and markets.

Investment Team

Pendal's nineteen member Equity team is one of the largest in the Australian fund's management industry. The portfolio manager for the Fund is Crispin Murray, who has more than 28 years' industry experience. Crispin is also Head of Equity.

Investment Guidelines

Ex-ante (forward looking) tracking error	2.0% - 6.0%
Min/max stock position	+/-4%
Min/max sector position	+/-8%

Other Information

Fund size (as at 29 Feb 2020)	$1,101 million
Date of inception	September 1992
Minimum investment	$25,000
Buy-sell spread[1]	0.50% (0.25%/0.25%)
Distribution frequency	Quarterly
APIR code	RFA0818AU

[1] 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[2]

Issuer fee[3]	0.79% pa

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

[3] 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.

Performance

(%)	Total Returns (post-fee)	Total Returns (pre-fee)	Benchmark Return
1 month	-7.59	-7.53	-7.76
3 months	-5.60	-5.41	-5.22
FYTD	0.47	1.00	-0.09
6 months	0.57	0.97	-0.71
1 year (pa)	8.10	8.98	8.75
2 years (pa)	5.68	6.52	7.77
3 years (pa)	8.80	9.68	8.62
5 years (pa)	5.99	6.84	6.23

Sector Allocation (as at 29 February 2020)

Energy	7.4%
Materials	17.5%
Industrials	11.6%
Consumer Discretionary	5.3%
Consumer Staples	3.5%
Health Care	11.9%
Information Technology	3.1%
Telecommunication Services	7.2%
Financials ex Property Trusts	25.6%
Property Trusts	4.3%
Cash & other	2.6%

Top 10 Holdings (as at 29 February 2020)

CSL Limited	9.6%
Commonwealth Bank of Australia Ltd	7.0%
BHP Billiton Limited	5.2%
Telstra Corporation Limited	5.2%
ANZ Banking Group Limited	4.8%
Westpac Banking Corporation	4.3%
Qantas Airways Limited	3.5%
Transurban Group	3.2%
Macquarie Group Limited	3.1%
Aristocrat Leisure Limited	3.0%

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

Australian equities, as measured by the S&P/ASX 300 Accumulation index fell by -7.8% over February, amid growing concerns of Covid-19 becoming a pandemic. US 10 year bond yields dropped from 1.52% to 1.14% while Australian 10 year government bonds fell from 0.95% to 0.82% as investors turned risk-averse. Resources (-13.2%) were hit the hardest, whilst Industrials (-6.4%) held up relatively better.

In terms of sector performance, a broad market de-rating weighed across the board and Information Technology (-16.2%) retreated the most on that basis. Link (LNK, -31.0%) played a role in this, however the WAAAX stocks also underperformed. Afterpay (APT) gave up -14.0%, Xero (XRO) -13.9% and Wisetech (WTC) -39.7%. WTC delivered another half of profit growth, but slashed its full year earnings guidance as the effect of Chinese production closures feeds through into global supply chains and logistics. WTC is now down -55.9% from its high point in September 2019.

Elsewhere, cyclical sectors such as Energy (-17.4%), Consumer Discretionary (-8.7%) and Materials (-11.7%) underperformed; and the traditional defensives of Utilities (-4.0%) and Real Estate (-4.5%) held up best, while still losing ground.

There were only 8 stocks in the ASX 100 that held their ground and recorded a gain over the month, including Cleanaway Waste Management (CWY, +11.3%), Evolution Mining (EVN, +10.6%), Northern Star Resources (NST, +6.8%) and a2 Milk (A2M, +6.3%). CWY defied market concerns to post a 6.8% increase in underlying EBIT and 15.2% gain in underlying NPAT. It has been an eventful year for CWY as it digests several recent acquisitions and flagged further capex, however it delivered an increased dividend and increased its guidance for the second half of FY20; and was well received by the market. Similarly, A2M reported a great set of results, with EPS growing by +22% to 25.3c, beating market consensus.

Turning to the other side of the spectrum, Rio Tinto (RIO, -11.6%) delivered in-line with the market's expectation in terms of earnings. Management maintained the recently lowered guidance on production, which reflects weather-related outages in the Pilbarra. Costs were also up in both the copper and iron ore portfolios. However the key facet was that its dividend was lower than expected – it also disappointed some segments of the market who were looking for another special dividend. The miners have increasingly become a major source of dividend income in the past few years. While this does help provide a degree of stock support, it also raises the risk of disappointment when the market is uncertain over the outlook for the dividend.

Bluescope Steel (BSL, -16.6%) delivered a good half but, like so many other companies, now faces an increasingly uncertain outlook for the next half given the effect of Covid-19. BSL faces headwinds in terms of volumes - given a reduction in production activity in China – but also on steel spreads as the price of coal and iron ore has held up relatively well in relation to the steel price.

Flight Centre (FLT, -17.0%) was another which delivered a reasonable half given a soft domestic environment, with revenue growth of 11%. However this was swamped by the cautious outlook, with management indicating that the full year effect from Covid-19 could be up to $200m.

Plumbing supplies manufacturer Reliance Worldwide (RWC, -24.9%) came under pressure as profits fell 20% for the half, even as revenue remains flat. It is facing stiff competition in the US as retailers have begun to offer their own private label versions of RWC products, putting pressure on pricing and margins.

Lastly, Ramsay Health Care (RHC, -14.1%) is at an interesting juncture. The result demonstrated that trends are improving in its key overseas markets. Tariff trends are now positive in France, while it is starting to see an increase in volumes in the UK – following a tough period – which may now provide scope to improve on price. While the result may have put these issues to bed, the focus is now on Australia. Group revenue ex-Europe grew at 4.8%, and there are signs that it has gone through the worst in terms of declining volumes. It has also recontracted with Bupa, removing some uncertainty over pricing. However it does remain locked in negotiation with Medibank, having come off contract in 1HFY20. This will be a key area to watch in coming months, although RHC is well positioned in these negotiations given its strong market position.

Fund performance

The Fund marginally outperformed the benchmark over the month of February.

Contributors

Does not hold Woodside Petroleum

Underperformance from the energy was largely thematic in February as concerns over the demand effect of Chinese shutdowns has weighed on the oil price; Brent crude has fallen from US$68bbl to US$56bbl (-17.8%) over the year to date, dragging down the oil/LNG producers. We do not own Woodside Petroleum (WPL), which added to relative performance.

Overweight CSL

Uncertainty drove bond yields lower, which helped support some of the portfolio's key bond-sensitive exposures. Growth stock CSL (CSL) was helped by a combination of decent results and the bond yield thematic. The combination of strong demand in growth and constrained supply drove a strong result for CSL, with 11% revenue growth slightly ahead of consensus. Management upgraded FY20 profit guidance. Low bond yields continue to support growth stocks like CSL and we are mindful of its valuation premium to history; although there is a degree of support for CSL compared to peers in the strong fundamentals and the scale and visibility on growth that it enjoys.

Overweight Atlas Arteria

In terms of defensive yield for the fund, the overweight in Atlas Arteria (ALX) was among the strongest contributors. ALX delivered a well-received result, growing underlying profit by 9% for the full year and delivering a better-than-expected 20% growth in dividends. Consensus earnings were revised up by 5% for FY21. That said, the thematic effect was also a material driver as bond yields fell. ALX offers defensive yield exposure without either the near-term challenges that Transurban (TCL) faces in terms of project delays, or the exposure to travel disruption that comes with Sydney Airport (SYD).

Detractors

Overweight Santos

Underperformance from the energy was largely thematic in February as concerns over the demand effect of Chinese shutdowns has weighed on the oil price; Brent crude has fallen from US$68bbl to US$56bbl (-17.8%) over the year to date, dragging down the oil/LNG producers. The outcome of half-yearly results from Santos was muted, given previous trading updates. STO remains well positioned in the sector with a significant part of its portfolio geared not to oil price, but local CPI linked contracts and a low cost base enabling it to continue to generate free cash flow at low oil prices.

Overweight Oil Search

Underperformance from the energy was largely thematic in February as concerns over the demand effect of Chinese shutdowns has weighed on the oil price; Brent crude has fallen from US$68bbl to US$56bbl (-17.8%) over the year to date, dragging down the oil/LNG producers. Also weighing on the share price of Oil Search (OSH), negotiations with the PNG government over the Papua LNG project broke down. The market's valuation now implies that neither this project – nor development of its Alaskan assets – will take place. We think this outcome is unlikely.

Overweight Qantas

QAN's result was well received by the market, however the stock has been volatile given its exposure to the effects of Covid-19. Here, management do have some tools to help mitigate the effect on demand. Management have indicated that they will cut capacity further, by 2.3% in domestic and 3.8% in international, helped by the acceleration of scheduled aircraft maintenance. There will also be some partial offset from lower fuel costs given a weaker oil price. At this point, management have guided to a 2H20 EBIT impact of $100-$150m. Given the broadening of the virus' spread the near term earnings consequences may be higher, but this needs to be viewed in the context of the company's strong balance sheet and the supportive industry structure with Virgin (VAH) remaining financially challenged. The strength of QAN market position was reflected in a better than expected H1 result, profits down 1% vs pcp in a period which affected by softer domestic demand and Hong Kong protests. Sequential quarterly improvements in revenue per average seat kilometer (RASK) over the half demonstrate the beneficial effect of QAN's ability to manage capacity to offset headwinds. Capital management is a key part of our thesis and remains intact. QAN is on track to return another $350m to shareholders for the next half, including a $150m buyback.

Outlook

On Covid-19 the focus is on China (ex-Hubei province), Singapore and Taiwan – which were among the first countries affected and thus guiding expectations elsewhere in the world. In these countries containment measures have focused on delaying the virus's spread and extending peak infections over a period long enough to enable medical infrastructure to cope with demand.

The trade-off has been a virtual economic shutdown for an extended period. If other governments follow this lead, the question becomes how long and severe is the downturn in each country – and how effectively can governments stimulate to plug the gap.

If these countries can successfully normalise economic activity without a spike in infections, then it suggests that the hit may be short term and potentially manageable with stimulus. One key question will be the strength of behavioural factors – will stimulus be able to outweigh the effect of "social distancing" as people look to reduce interactions with others.

We can look at the way forward in terms of four broad scenarios.

1) **Worst case is a widespread global pandemic**, provoking a sustained global recession, zero rates, unconventional policy responses and further material falls (>20%) in the equity market. We think this is a low probability outcome.

2) **Rolling outbreaks globally**, prompting short-term economic downturns of 2-4% followed by quick recovery. Policy responses could include zero rates and targeted fiscal stimulus. This scenario could see further markets falls – potentially of up to ~10% - but a bounce back by the year's end.

3) **A milder outbreak** – with containment measures and the Northern hemisphere Spring curtailing the spread. This could see a short-term slowdown, with rate cuts and limited fiscal stimulus. The market may already have seen its lows if this is the case, with a good chance of a 10-20% bounce.

4) **A quick resolution** driven by a medical breakthrough. This could see economic acceleration, a reversal in rate cuts, bonds falling sharply and a 20%+ rally in equities. Like the negative extreme, we see this as a low probability outcome.

It is in uncertain situations such as this – with a degree of binary outcomes – that portfolio construction becomes critical. We are positioning the portfolio to weather the more likely outcomes – scenarios (2) and (3) - and to take advantage of the buying opportunities that have emerged. However we also need to be mindful of protecting it in the case of one of the more extreme scenarios – positive or negative - playing out. In this context, the portfolio's key positions can be considered as follows:

1) **Recession insurance.** We want stocks with the potential to hold up well if economic conditions deteriorate. We have some gold exposure – and also hold positions in bond-sensitives that should do well if sentiment worsens. In terms of the traditional defensives it is important to be selective. We want to hold A-REITs backed by good assets with low gearing, avoiding those with a high exposure to consumer discretionaries. In infrastructure, it is also important to recognise that in some stocks traditional correlations to bond yields may be swamped by fundamental factors.

2) **Buying opportunities** in good businesses which are unlikely to see a structural deterioration, but which have been sold down on the risk-off trade. Here, we want companies which are well positioned in terms of balance sheets and competitive position to withstand a slowdown and which look attractively valued on a two to three year view.

3) **Beneficiaries of fiscal stimulus.** While central banks have already moved to cut rates, governments are also increasingly expected to inject stimulus to help companies and the economy bridge the expected slowdown. We think the iron ore miners would benefit from stimulus in China, while domestically we see certain retailers as well positioned to benefit from government spending to support the economy.

4) **Resolution insurance.** There are several stocks which we would expect to surge quickly on any sign of slowing infection rates or a medical breakthrough. These include the travel-related stocks and certain specific oil/LNG plays.

5) **Areas to remain cautious near-term.** If this was just a short-term hit to demand then the sharp drop in the oil price might make energy look more interesting, however the break between Russia and OPEC on production cuts over the weekend has complicated the issue. If we are entering a grab for share – with some signs that Russia is looking to put pressure on the US shale industry - then the risks here are elevated relative to other commodities. We also remain cautious on the banks. Dividend yields remain attractive, but additional rate cuts just bring further margin pressure to bear. A stimulus package could also include some measures to allow struggling businesses to defer interest payments – although there is speculation that such a measure may include the quid pro quo of cheap funding for the banks.

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

PENDAL