PENDAL

Factsheet

Equity Strategies

March 2020

Pendal Focus Australian Share Fund

ARSN: 113 232 812

About the Fund

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

Investment Return Objective

The Fund aims to provide a return (before fees, costs and taxes), that significantly exceeds the S&P/ASX300 (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 from a concentrated portfolio of primarily 15-30 Australian shares 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. Derivatives can also be used to gain exposure to assets and markets.

Fund Positioning

The Fund is designed to complement a conventional, core share portfolio by providing satellite exposure to selected Australian equities with the potential for performance enhancement.

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.

Other Information

Fund size (as at 31 Mar 2020)	$562 million
Date of inception	April 2005
Minimum investment	$25,000
Buy-sell spread[1] For the Fund's current buy-sell spread information, visit www.pendalgroup.com	
Distribution frequency	Half-yearly
APIR code	RFA0059AU

Investment Guidelines

Ex-ante tracking error	4.5% - 8.0%
Max absolute stock position	15%
Min/max sector position relative to index	+/- 15%
Min/Max BARRA style factors	+/- 0.5 SD
SIRA style factors	Within 1 SD
Maximum cash level	30%
Shorting	No
Borrowing	No

Performance

(%)	Total Returns		Benchmark
	(post-fee)	(pre-fee)	Return
1 month	-19.02	-18.73	-20.83
3 months	-22.43	-22.11	-23.41
FYTD	-18.10	-17.38	-20.90
6 months	-19.76	-19.22	-22.86
1 year (pa)	-11.46	-10.52	-14.53
2 years (pa)	-2.38	-1.61	-2.27
3 years (pa)	1.42	2.57	-0.59
5 years (pa)	2.91	3.99	1.39

Sector Allocation (as at 31 March 2020)

Energy	5.0%
Materials	20.6%
Industrials	13.0%
Consumer Discretionary	4.6%
Consumer Staples	3.3%
Health Care	12.4%
Information Technology	4.0%
Telecommunication Services	9.9%
Financials ex Property Trusts	17.9%
Property Trusts	1.6%
Cash & other	7.7%

Top 10 Holdings (as at 31 March 2020)

CSL Limited	10.8%
Telstra Corporation Limited	7.2%
Commonwealth Bank of Australia Ltd	5.7%
BHP Billiton Limited	5.7%
Westpac Banking Corporation	4.1%
Atlas Arteria	4.1%
Aristocrat Leisure Limited	3.8%
Evolution Mining Limited	3.6%
Amcor Limited	3.5%
Insurance Group Australia	3.3%

Management Costs[2]

Issuer fee[3]	0.75% pa
Performance fee[4]	15% x the Fund's performance (before fees) in excess of the performance hurdle.

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

[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.

[4] The Fund's performance fee is 15% of the Fund's performance in excess of the performance hurdle. The performance hurdle is the performance of the benchmark (S&P/ASX 300 (TR) Index) plus the issuer fee of 0.75% 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.
- **Concentrated portfolio risk** - The Fund's investment strategy of seeking to generate high returns by investing in a concentrated portfolio of Australian shares makes the Fund more volatile than a diversified Australian share fund.

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

Market review

The Australian equities market incurred a large selloff in March (S&P/ASX 300 Accumulation, -20.8%) amid the escalation of Covid-19 cases globally and the associated economic slowdown. The index was at one stage down by -29.3%; however it recouped some lost ground in the latter half of the month, following a significant government package to support people and the economy. The Job Keeper announcement was the most significant development for Australian equities, which helped underpin the domestic market's recovery from its lows. Lower correlations within the market suggest that investors are allocating capital more rationally, as opposed to the "sell everything" mentality earlier.

Most of the 12 GICS sectors recorded a double-digit loss, with Energy (-37.6%), Real Estate (-35.6%) and Financials (-27.7%) being the worst hit; whereas Health Care (-5.6%), Utilities (-6.7%) and Consumer Staples (-3.5%) fared better than the rest. The energy sector is finding itself under pressure in terms of both supply and demand which has seen a sharp fall in the oil price. The measures to contain Covid-19 will see a material hit to oil demand as travel is severely curtailed. At the same time, the deal to limit production between Russia and OPEC has fallen through, with both Moscow and the Saudis indicating that they will increase production from pre-agreed levels. The upshot is a materially over-supplied market and rapid falls in the oil price. At this point the excess oil production is in the order of 10 million barrels per day, which is not only keeping the oil price low but, if oil storage runs out of capacity, push it even lower. These saw the likes of Woodside Petroleum (WPL, -34.8%), Santos (STO, -49.9%) and Oil Search (-56.1%) all retreat. It is worth noting that Santos delivered a cost out and capex reduction plan designed towards the end of the month to demonstrate that they can survive with the oil price in the US$20-$30 range. This helped STO to reverse some of the early losses incurred during the month.

Real Estate did not exhibit their usual defensive characteristics amid the latest selloff. The mall operators were the hardest hit, including Scentre Group (SCG, -54.8%) and Vicinity Centres (VCX, -52.1%). This reflects the ongoing debate over leasing and who will bear the brunt of the cost for retailers who are unable to unable – or unwilling – to pay rent. Mirvac (MGR, -31.3%) and Stockland (SGP, -46.3%) also fell on fears of social distancing will hinder apartment sales.

The "big four" banks posted losses in the range of -24.4% (CBA) to -33.6% (NAB), and similarly the regional duo (BOQ, -33.2%; BEN, -29.1%). Whilst dividend yields remain attractive for now, there is an expectation that dividends are likely to cut and capital conserved in this half. A stimulus package could include some measures to allow struggling businesses to defer interest payments, and there were also concerns over funding and uncertainty over how high bad debts would rise, particularly for the regional banks.

A number of companies from the Industrials sector (-23.0%) were at the forefront of COVID-19 disruption, including Qantas Airways (QAN. -40.1%). The national carrier effectively announced that it had stopped flying and, with additional funding secured against some of their planes which will allow it to survive an extended shutdown, the focus is now on minimising the cash burn. The Australian airline industry structure is likely to re-emerge from the period in a different form, using this period to assess operations and cost bases. There are signs that some of the market concern over Virgin has stabilised, but it could look very different in the future, with scaled-back operations. Elsewhere, Sydney Airport (SYD, +24.7%) is one of those business likely to face a longer disruption than others – with the possibility that international departures may not normalise for 12 month.

Fund performance

The Fund outperformed its benchmark over the month of March.

Contributors

Overweight Metcash (MTS)

Metcash owns the IGA convenience supermarket brand and is a grocery and alcohol wholesaler into that network and others. Given this, it has a relatively defensive demand profile which is less sensitive to the effects of measures to contain Covid-19. More recently, the closure of restaurants and cafes has seen support for demand for more convenience shopping, well suited for the IGA format. At the same time, MTS and IGA have been regaining share over recent times as customers identify with the refurbished stores, extended attractive product range and competitive pricing. Overall, we expect demand to remain strong as the recent drivers will be sustained. We have lightened the exposure to MTS later in the month as it has run so hard relative to the market, but we still like its positioning as "Recession Insurance" within the portfolio and retain a position.

Underweight National Australia Bank (NAB)

Concerns over the banks centred over the potential for a material increase in bad and doubtful debts (BDDs) as a result of the economic stress of the Covid-19 containment measures. This, in turn, would weigh on bank earnings and dividends. The government and regulators have been swift in their support for banks, recognising the key role that they will play in allowing continued funding for corporate Australia. The banks have been offered cheap funding and the capital requirements have been relaxed for a period. In our view, the banks should be able to absorb a material uptick in BDDs without having to raise additional equity capital – although this does remain a risk. However it is likely that dividends will be materially cut and/or deferred in the short term. Meanwhile, lower rates continue to weigh on future margins. At this point, despite their underperformance through the recent volatility – and for a sustained period before that – we do not see a compelling argument for an overweight at this point.

Overweight Telstra (TLS)

We consider Telstra (TLS) part of the portfolio's "Recession Protection" segment and its defensive characteristics came to the fore in March, where it held up better than the market. TLS's business does not rely on face-to-face contact and, as such, is not materially affected by social distancing measures. This was emphasised by management recent re-affirmation of earnings guidance for FY20. Also, with debate around pressure on dividends in the banking sector and in other industries which are receiving government help, Telstra stands out as one large cap where dividends should remain relatively stable.

Detractors

Overweight Santos (STO)

The energy sector is finding itself under pressure in terms of both supply and demand which has seen a sharp fall in the oil price. The measures to contain Covid-19 will see a material hit to oil demand as travel is severely curtailed. At the same time, the deal to limit production between Russia and OPEC has fallen through, with both Moscow and the Saudis indicating that they will increase production from pre-agreed levels. The upshot is a materially over-supplied market and rapid falls in the oil price. This weighed on the portfolio's positions in Santos (STO) and Oil Search (OSH) – although there was some offset from not owning the largest oil energy stock in the index – Woodside (WPL) – or other energy related names such as Worley (WOR). Both of the LNG stocks in the portfolio have protection from the near term downside of oil prices through their contracts – particularly so STO where some of its contracts are inflation-linked. However, it does mean that growth plans are likely to be delayed. There is some expectation of

a new deal between Russia, the US and Saudis which may help alleviate some pressure on the supply side, however the market is likely to remain substantially over supplied until demand recovers. Nevertheless, we recognise that there is a possibility – albeit low – of a medical breakthrough and swift recovery. There is also the chance of a better-than-expected deal on oil supply. In keeping with our portfolio framework, the LNG position forms part of this "recovery insurance" segment of the portfolio, although we see no need to be overweight at this point.

Overweight Qantas (QAN)

Travel related stocks remain among the most leveraged to the containment measures enacted to control the spread of Covid-19. We retain our position in QAN as part of the "Recovery Protection" part of the portfolio. While we see the probability of a swift medical breakthrough and rapid recovery in markets as low, it still remains a possibility. As a result QAN remains in the portfolio as a hedge, as it is likely to see a rapid rebound in that event. We have confidence in QAN's ability to remain solvent through an extended shutdown. They have moved rapidly to cut costs and have secured funding backed against part of their fleet, most of which is fully owned rather than leased. Domestic flights are also a far larger driver of earnings than international, with the former likely to resume sooner than the latter. We also believe that QAN is likely to emerge in a stronger competitive position post the economic disruption.

Overweight Atlas Arteria (ALX)

Atlas Arteria (ALX) – which operates toll roads in Europe and the US – initially outperformed the market in the early stages of the Covid-19-linked volatility, but came off mid-month, before partly rebounding late in March. The company announced that travel restrictions had significantly affected traffic volumes in late March in both its French and US toll roads. Management have emphasised that they are well-placed in terms of balance sheet liquidity to withstand a period of lower traffic, however they have taken the decision to suspend guidance for its 1H 2020 distribution until it has more clarity on the scale of the impact. There is material degree of uncertainty in terms of how long containment measures remain in place and how they are rolled back, complicated by the fact that ALX operates in various international jurisdictions. Nevertheless, the stock's response appeared to be pricing in an extreme and – in our view unlikely - scenario in terms of the length of disruption.

Outlook

Market uncertainty is being driven, ultimately, by that fact that no-one knows how long containment measures are likely to last or the scale of the damage that will be inflicted upon the economy.

Each week brings better clarity on two key inputs, the first is the spread of infection. There are signs that the curves – the daily percentage increase in new confirmed cases – are flattening in Europe. The US remains the largest source of new infections, although the spread is quite uneven. In Australia, at this point, the percentage of new case growth has dropped from above 20% in March to below 5% today.

The key point is that containment measures appear to be working. Risk remains; and questions over whether secondary outbreaks occur when measures are lifted. Nevertheless, particularly in the domestic context, this gives the government a degree of control over how and when measures are rolled back.

The second key input is the scale of policy measure to help alleviate the structural damage to the economy and help underpin a rebound. This has been unprecedented. In Australia, the total fiscal support is now above 10% of GDP.

It is important to remember that the economic impact will still be very negative. At this point the technical unemployment rate could still reach 10% - but without Job Keeper that could have been nearer to 15%. There is also the question of how the economy looks once we start to roll back measures.

Nevertheless, this package helps reduce the worst-case scenario in terms of unemployment and structural damage to the economy, better positioning it for a rebound. It also signals the government's intent to do whatever it takes.

There are clear signals that we have gone through a liquidation phase of indiscriminate selling. This partly reflects the liquidity of equities and people selling what they can. It also reflects the impact of passive investment. Now the market is appearing to be in a more rational phase – correlations within the market have fallen, suggesting that investors are being more discerning.

All this has helped improve recent market sentiment. Nevertheless, we remain cautious and expect that we trade sideways in a "sawtooth" pattern of high volatility for a period.

This is partly to do with the sticker shock of economic data that will emerging coming weeks and day. We are also mindful that we are yet to see the data around corporate earnings. It is simply too early, with too many unknowns, for the market to try and quantify the scale of earnings fall. As it does so, there could be further volatility.

We are also starting to see capital calls coming through. While the most leveraged companies are tapping the markets early given more immediate stress, there are also signs of better quality companies with seemingly less imperative seeking to obtain a capital buffer at reasonable prices. We expect that the steady flow of cash calls within will absorb some liquidity and have a limiting effect on any near-term market gains.

No-one knows how the health crisis will playout or what the ultimate economic impact will be. We focus on those things that we can control.

We can think through possible scenarios –as outlined in last month's commentary - and position the portfolio to weather the most likely outcomes, while have some insurance against less probable – but still possible – scenarios.

We are also speaking to companies. In this environment, understanding company management, capital positions, and industry structures intimately is paramount. This plays to the strengths of our large and experience team.

We have been reviewing the portfolio companies to assess risk to the balance sheet or cash flow. We are also doing a secondary deep stress test for worsening trading conditions to assess each company's ability to weather the storm without deeply discounted capital raisings.

Within the context of the portfolio framework outlined last month:

- We have added to some of the *Recession Protection* companies – such as gold miner Evolution Mining (EVN). Metcash (MTS) had a strong run and we reduced the exposure towards the end of the month, although we continue to like its position.
- We have been adding to positions in *High Quality Defensives*, which are less sensitive to the current disruption – companies such as Telstra (TLS) and CSL (CSL)
- We also lifted the exposure early in the month to *Policy Beneficiaries* – primarily in iron ore, but also in James Hardie (JHX). Chinese demand for steel remains resilient and will be underpinned by a construction-focused stimulus. However we also remain watchful of the effect of reduced steel demand form Europe and the US.
- We are keeping a close watch on the *Long Term Franchise Winners*. Companies such as JB Hi-Fi (JBH) and Nine Entertainment (NEC) are offering some attractive opportunities on a longer-term view. It is interesting to note that the lines are blurring between some of these companies and *Policy Beneficiaries* – as recent strength in JBH and NEC last week was linked to policy moves.

- We remain cautious on the *Recovery Insurance* names – seeing it as too early to add materially to our exposure here. It is important to remember that history shows us that market leadership in a rebound does not tend to come from those stocks which have fallen the most. After a plunge they often have something of a dead cat bounce. However they can then flat-line for a period as there is often some structural factor which needs to be overcome – we only need to look at the long path to recovery of some technology stocks post-2000 for examples of this. So we need to be careful on this front. The crucial element here is understanding the balance sheet and liquidity position in the event of a prolonged disruption.

On area for consideration – across all parts of the portfolio – is a company's domestic versus overseas exposure. This could prove to be an increasingly material factor if we start to see a larger divergence in the outlook for infection rates and faster ability to normalise in Australia versus other parts of the world.

In this environment, active portfolio construction and risk management is crucial. The ability to weigh risks, recognize the mis-priced opportunities and provide a clear and disciplined framework to account for an uncertain range of possible outcomes has paid dividends thus far. We believe will continue to do so as the current crisis unfolds and the path to recovery becomes clear.

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

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