PENDAL

Pendal Monthly Commentary

Pendal Australian Shares Portfolio

July 2020

Market commentary

The S&P/ASX 300 Accumulation index (+0.6%) held up despite second-wave Covid developments in Australia and the US. Better health outcomes in comparison to the first wave – as well as the scale of policy support – were important market support factors.

Australian equities lagged the +5.1% gain in the MSCI World index due to a lower weighting in technology and higher weighting in banks.

The impact of the large-cap technology stocks has been the main difference between the performance of Australia versus the US equity market in the rebound. The key question is whether we see a sustained rotation and performance from the value part of the market. There are some initial signs of investors positioning themselves in value recovery plays in anticipation of positive news on vaccine development.

Data continues to illustrate the heavy economic impact of Covid-19. June jobs growth was much better than expected, though the unemployment rate ticked up from 7.1% to 7.4%.

The impact remains uneven. Some sectors are running stronger since Covid while others continue to languish.

Retail sales continue to benefit from an increase in disposable income from government support packages and a lack of spending alternatives such as travel.

Resources (+4.5%) gained off the back of stronger gold, copper and iron ore prices. There are signs of recovery in other commodities as demand outside China starts to improve. Materials (+5.9%) was the best-performing sector as a result.

Technology (+4.8%) was also strong as the second wave saw a defensive rotation towards growth stocks, where earnings visibility is better than in the more cyclical sectors.

An improvement in the outlook for global demand – and a depreciating US dollar – saw oil prices rise, with Brent up +4.5%. The Energy sector (-6.3%) was nevertheless the worst performer in July.

Health Care (-3.8%) also underperformed as CSL (CSL) gave back -5.9% in the month.

Portfolio overview

Australian Shares Portfolio	
Investment strategy	The strategy employs a bottom up, fundamental approach to build a diversified portfolio of Australian shares where the majority of active risk and outperformance is driven by stock selection.
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 (34 as at 31 July 2020)
Sector limits	A-REITS 0-30% Cash 2-10%
Income target	No target

Top 10 holdings

Code	Name	Weight
BHP	BHP Billiton Limited	9.25%
CSL	CSL Limited	7.84%
CBA	Commonwealth Bank of Australia Limited	5.70%
TLS	Telstra Corporation Limited	5.40%
WBC	Westpac Banking Corporation	4.57%
EVN	Evolution Mining Limited	4.26%
XRO	Xero Limited	3.74%
STO	Santos Limited	3.68%
ANZ	ANZ Banking Group Limited	3.61%
ALX	Atlas Arteria	3.47%

Source: Pendal as at 31 July 2020

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
EVN	Evolution Mining Limited	3.66%
XRO	Xero Limited	3.16%
STO	Santos Limited	3.12%
ALX	Atlas Arteria	3.10%
TLS	Telstra Corporation Limited	3.02%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-3.15%
WOW	Woolworths Group Limited (not held)	-2.91%
RIO	Rio Tinto Limited (not held)	-2.26%
NAB	National Australia Bank Limited	-1.98%
CBA	Commonwealth Bank of Australia Limited	-1.81%

Source: Pendal as at 31 July 2020

Performance

	1 month	3 month	6 month	1 year	3 year	5 year	Since inception*
Pendal Australian Shares Portfolio	-0.31%	5.85%	-13.68%	-8.17%	5.42%	5.94%	7.00%
S&P/ASX 300 (TR) Index	0.60%	7.77%	-14.20%	-9.74%	5.44%	5.23%	5.67%
Active return	**-0.92%**	**-1.92%**	**0.52%**	**1.57%**	**-0.02%**	**0.71%**	**1.33%**

Source: Pendal as at 31 July 2020
*Since Inception - 15 June 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
TLS	Telstra Corporation Limited	0.16%
EVN	Evolution Mining Limited	0.12%
SAR	Saracen Mineral Holdings Ltd	0.11%
WPL	*Woodside Petroleum Limited (not held)*	*0.10%*
JHX	James Hardie Industries Plc	0.10%

Top 5 detractors - monthly

Code	Name	Value Added
QAN	Qantas Airways Limited	-0.37%
VEA	Viva Energy Group limited	-0.25%
IAG	Insurance Group Australia	-0.22%
MND	Monadelphous Group Limited	-0.22%
GMG	*Goodman Group (not held)*	*-0.19%*

Top 5 contributors - 1 year

Code	Name	Value Added
EVN	Evolution Mining Limited	1.16%
XRO	Xero Limited	0.85%
JHX	James Hardie Industries Plc	0.83%
CSL	CSL Limited	0.80%
WPL	*Woodside Petroleum Limited (not held)*	*0.52%*

Top 5 detractors - 1 year

Code	Name	Value Added
QAN	Qantas Airways Limited	-1.08%
WES	*Wesfarmers Limited (not held)*	*-0.78%*
MND	Monadelphous Group Limited	-0.67%
NEC	Nine Entertainment Co Ltd	-0.55%
WOW	*Woolworths Group Limited (not held)*	*-0.54%*

Source: Pendal as at 31 July 2020
Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Telstra (TLS, +7.0%)

The final stages of competitive bids for the sale of Telstra's data centre assets supported the stock in July. This is part of a strategy to dispose of some $2bn worth of assets to strengthen the company's balance sheet. The final sale – for $417m to Centuria Industrial REIT – was announced in early August.

Overweight Evolution Mining (EVN, +4.1%)

A strengthening gold price supported Evolution in July. US monetary policy settings, which are likely to see lower real interest rates as inflation expectations pick up, suggest further support for the gold price. It also offers some protection in the case of a deteriorating economic outlook or heightened geopolitical risk.

Overweight Saracen (SAR +10.7%)

The stronger gold price helped Saracen Minerals. The recent acquisition of a joint venture in Western Australia's Super Pit has diversified SAR's portfolio of assets. It also offers a strong path for growth, given the company's historical ability to increase the size of a resource and extend mine life via lower unit costs compared to large multi-national miners.

Three largest detractors

Overweight Qantas (QAN, -17.0%)

The reinstatement of travel restrictions in response to the second wave of Covid cases in Victoria weighed on Qantas. Rapid cost reduction and moves to shore up the balance sheet – including the capital raise in June – mean the company has sufficient liquidity to weather an extended period of travel disruption. However this move delays the outlook for normalisation of domestic travel.

Overweight Viva Energy (VEA, -11.5%)

VEA gave back some of June's strong gains after announcing better-than-expected guidance and details of an on-market buy-back. The reimposition of travel restrictions in Victoria are likely to have an impact on retail fuel sales, which had been recovering quite well.

Overweight Insurance Australia (IAG, -11.8%)

IAG pre-announced its FY20 result, reporting net profit after tax (NPAT) would likely be less than half the FY19 result. Management was confident they won't face a flood of business interruption claims from Covid, but they did increase provisions against the knock-on effects. They will not pay a final dividend for FY20.

Market outlook

July brought a swift spread of second-wave Covid-19 infections in the US and a Victorian outbreak that led to new lockdowns. This derailed some of the more optimistic expectations for the economic outlook. It seems the virus – and the resulting restrictions – will have a social and economic impact for longer than some might have expected.

Despite this, markets have managed to hold up reasonably well. There have been two key reasons for this.

The first is the nature of the second wave. In the US, case-load numbers more than doubled from the previous peak in April but hospitalisation rates only reached the same peak levels. This suggests under-reporting of cases in April and also reflects a skew towards cases in younger people.

Mortality rates, while still tragic, were much better than April – about half the previous peak. This was due to the age skew, better treatment techniques and a broader geographical spread which allowed hospitals to cope better. These rates declined in recent weeks as the health situation showed signs of improvement.

Looking forward, we expect to see a Swedish-style outcome in the US. Cases may remain persistently high. But as long as people remain confident of avoiding a third major surge – and if acute cases continue to be better managed – activity will start ramping up, supporting markets.

It's a different situation in Australia. Reinstatement of the Victorian lockdown shows authorities are prepared to accept greater near-term economic damage to achieve effective elimination. This should ultimately allow a larger part of the economy to return to normal.

The Victorian lockdown has taken several weeks to show effects, although at this point there is little reason to fear that it won't succeed based on prior experience. Small outbreaks in NSW bear watching. But at this point swift identification and contact tracing are helping the state "hold the line" in terms of overall cases.

The second key factor supporting the markets is the ongoing scale of policy response.

The Australian federal government extended support packages and emphasised that it intends to absorb as much of the economic impact of the virus as possible. This was echoed by comments from the Reserve Bank, which believes the social costs and degradation from recession and persistent unemployment are too high to allow the normal clearing mechanism of labour and capital markets. Instead, policy makers must do everything in their power to mitigate the effects of the crisis.

This shift in thinking away from a free-market approach may be driven by considerations around the social effects of income inequality or by a view that labour markets are too rigid to react in a timely fashion to a shock of this nature. Regardless, it suggests policy makers will continue to shore up growth, which is helping support markets.

In the US, there is some risk around the negotiations of the next tranche of fiscal support. Resolution is expected. However a prolonged delay could start to hurt market sentiment.

One important aspect is that much of the policy support is designed to support the economy until a vaccine is available which can help normalise economic activity. The development of a viable vaccine remains the most important medium-term issue for the economy and markets.

Recent trials remain encouraging. However the widespread delivery of an effective vaccine is still not expected until sometime in 2021.

In light of this, we believe portfolio construction remains critical.

The high degree of uncertainty – at economic, industry and company level – means it is important for portfolios to perform across a range of outcomes. We maintain a portfolio with different kinds of exposures, rather than making a binary call on the pace of recovery.

We have recently been adding to the "policy beneficiary" segment of the portfolio, primarily through exposure to miners.

The iron ore price remains well supported, helped by very strong demand from China and supply disruption from Brazil. More recently there have been signs that other commodity prices may have troughed. We may see improvements as demand picks up in other parts of the world.

We have also been adding to the gold exposure. This play several roles in the portfolio. It provides some protection against a risk-off scenario – either driven by economic or geopolitics. It should also be well supported by policy settings in the US, which are likely to see an extended period of low real rates as inflation expectations pick up. This is typically good for real assets such as gold. Some near-term consolidation in gold is likely give the strong run, but we see it as well supported over the medium term.

Stock selection remains crucial. The latest reporting season will provide concrete data around the impact of Covid-19, but the outlook remains highly uncertain. Management quality and strategy, as well as industry structure, are key differentiating factors in this environment. Differentiating at this level – and identifying the mispricing that occurs in environments of such high uncertainty – play to the strengths of our research team.

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

Sell Rio Tinto (RIO) to zero

The portfolio is taking some profit in its iron ore position, selling Rio Tinto (RIO) to zero.

We added RIO to the portfolio as part of a diversified exposure to iron ore in December 2019, on the view that resilient steel production in China – coupled with a slower-than-expected resumption in supply from Brazil's Vale – would continue to support iron ore prices at a higher level than many expected.

The advent of Covid-19 complicated the situation, but ultimately exacerbated these underlying trends. Chinese steel production has remained high as the government stimulated the economy to help offset the negative economic effects of the pandemic. Meanwhile Brazilian iron ore production has seen a material hit from the effects of the virus.

The iron ore price has risen steadily to over US$100 per tonne as a result. Coupled with lower oil prices, a weaker AUD, and no material operational disruption from Covid-19, Australian iron ore producers were left in a sweet spot in terms of profitability.

As a result, the portfolio's iron ore position – diversified across BHP, Rio Tinto and Fortescue Metals – has been a contributor to the portfolio's outperformance in the volatile Covid-19 period.

Looking forward, we expect the iron ore price to moderate in the second half of CY20 as supply disruptions ease, although it is likely to remain at reasonable levels. Australia's iron ore miners remains in a sweet spot, with elevated profitability supporting capital return.

We are mindful that the degree of outperformance from this sector is unlikely to continue without the support of a rising iron ore price. As a result we are using this opportunity to lighten the position and consolidate the exposure into two companies – BHP and Fortescue Metals – while deploying capital into other opportunities.

Buy new position in South32 (S32)

South32 is a diversified miner with primary exposure to aluminium (47% of revenue), coal (24%) and manganese (18%). This adds to the portfolio's resource exposure while diversifying it away from iron ore.

The economy is likely to continue ramping up from its Covid-induced lows, underpinned by fiscal and monetary policy support. We expect improved economic activity to support higher prices in S32's key commodities of aluminium and alumina, manganese, zinc and metallurgical coal.

Iron ore has had a good run and stocks like Fortescue and BHP remain well supported. But signs of a rebound in other commodity prices underpin an argument for the more diversified exposure that South32 provides. S32 offers a more attractive valuation than other miners, particularly given its earnings are at cyclical lows.

There are also several positive elements to take from S32's most recent update.

Operational performance at Cannington and Illawarra – two of its biggest profit centres – was strong into the end of the most recent quarter. This suggests S32 may have overcome issues that dragged on production for several quarters. Management indicated they remain committed to the disposal of lower profitability business such as the South Africa thermal coal business – and potentially its manganese smelters. They also outlined a cost-out program focused on manganese operations and Cannington and at a corporate level.

The net effect is we see attractive upside from current levels, supported by improved operational performance and the cyclical tailwinds of higher prices for key commodities.

The key risk is that a material second wave of coronavirus infections severely delays the economic recovery. We remain mindful of this risk, which is broadly reflected in the scenario framework underpinning our portfolio construction and ensures we have other positions that help offset this outcome.

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

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