PENDAL

Pendal Monthly Commentary

Pendal Australian Specialised Retirement Income 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 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 (33 as at 31 July 2020)
Sector limits	A-REITS 0-30%, Cash 2-10%

Top 10 holdings

Code	Name	Weight
BHP	BHP Billiton Limited	9.48%
CSL	CSL Limited	7.13%
CBA	Commonwealth Bank of Australia Limited	6.89%
TLS	Telstra Corporation Limited	5.79%
WBC	Westpac Banking Corporation	4.66%
ANZ	ANZ Banking Group Limited	4.10%
EVN	Evolution Mining Limited	3.86%
MTS	Metcash Trading Limited	3.51%
ALX	Atlas Arteria	3.48%
FMG	Fortescue Metals Group Limited	3.18%

Source: Pendal as at 31 July 2020

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Corporation Limited	3.41%
MTS	Metcash Trading Limited	3.35%
EVN	Evolution Mining Limited	3.26%
ALX	Atlas Arteria	3.11%
BHP	BHP Billiton Limited	3.03%

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%
NCM	Newcrest Mining Limited (not held)	-1.70%
GMG	Goodman Group (not held)	-1.64%
WPL	Woodside Petroleum Limited (not held)	-1.14%

Source: Pendal as at 31 July 2020

Performance

	1 month	3 month	6 month	1 year	3 year	Since inception*
Pendal Australian Specialised Retirement Income Portfolio	-0.07%	5.91%	-14.11%	-8.89%	4.46%	6.25%
S&P/ASX 300 (TR) Index	0.60%	7.77%	-14.20%	-9.74%	5.44%	6.41%
Active return	**-0.67%**	**-1.86%**	**0.09%**	**0.85%**	**-0.98%**	**-0.16%**

Source: Pendal as at 31 July 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
FMG	Fortescue Metals Group Limited	0.28%
TLS	Telstra Corporation Limited	0.20%
EVN	Evolution Mining Limited	0.11%
WPL	*Woodside Petroleum Limited (not held)*	*0.10%*
AMP	*AMP Limited (not held)*	*0.08%*

Top 5 detractors - monthly

Code	Name	Value Added
QAN	Qantas Airways Limited	-0.41%
IAG	Insurance Group Australia	-0.29%
MND	Monadelphous Group Limited	-0.23%
VEA	Viva Energy Group limited	-0.21%
GMG	*Goodman Group (not held)*	*-0.19%*

Top 5 contributors - 1 year

Code	Name	Value Added
FMG	Fortescue Metals Group Limited	1.08%
EVN	Evolution Mining Limited	0.99%
MTS	Metcash Trading Limited	0.82%
XRO	Xero Limited	0.70%
JHX	James Hardie Industries Plc	0.65%

Top 5 detractors - 1 year

Code	Name	Value Added
QAN	Qantas Airways Limited	-1.20%
WES	*Wesfarmers Limited (not held)*	*-0.78%*
MND	Monadelphous Group Limited	-0.70%
IAG	Insurance Group Australia	-0.66%
NEC	Nine Entertainment Co Ltd	-0.63%

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 Fortescue Metals (FMG, +25.7%)

Fortescue continued to do well on the back of strengthening iron ore prices due to much stronger-than-expected Chinese demand and disrupted supply from Brazil. Late in the month FMG announced it had exceeded the upper end of production guidance for FY20.

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.

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 Insurance Australia (IAG, -11.8%)

IAG pre-announced its FY20 result, reporting net profit after tax (NPAT) would likely be less than half that of FY19. 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.

Overweight Monadelphous (MND, -11.7%)

There was little in the way of stock-specific news for mining service contractor Monadelphous in July. It has underperformed the broader market since mid-June, diverging from the strong performance of the iron ore miners. Over the medium term the strength in the miners should translate to a continued strong pipeline of work for MND. We believe this disconnection in performance should reverse.

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.

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

No stocks added or sold to zero during the month.

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

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