Pendal Monthly Commentary

Pendal Australian Shares Portfolio

November 2020

Market commentary

The S&P/ASX 300 posted its best month since 1988 in November – a gain of 10.2%.

Good news on the vaccine front – coupled with the prospect of a more predictable policy environment and a reasonable earnings season in the US – drove improvement in sentiment.

Investors seemed content to look through the latest Covid surge in the northern hemisphere and the risk of further lockdowns.

Resources (+10.7%) rebounded strongly for the month and marginally outperformed Industrials (+10.1%) as confidence in the economic recovery continued to drive commodity price gains.

Copper was up 11.7% and is well above pre-Covid levels. Brent Crude gained 29% for the month. Gold fell 4.9% as investors saw reduced need for portfolio insurance.

There was something of a catch-up trade in November – stocks and sectors that have generally lagged this year did well.

Energy (+28.2%) was the best-performing sector, driven by a rebound in the oil price.

Financials (+16.1%) were also strong. Updates from the major banks suggested bad and doubtful debts were tracking towards the more benign end of expectations, leaving capital in a strong position. Margins remain under pressure from low rates and strong competition, but all in all the updates were well received.

The more defensive sectors generally underperformed.

Consumer staples (-0.66%) was the only sector to go backwards, experiencing the twin impacts of a rotation away from defensives and a hit to Treasury Wines (TWE, -6.3%) as China imposed tariffs on Australian wine.

Utilities (+1.5%) and Health Care (+2.9%) lagged the market.

Technology growth stocks were generally muted.

The sector rose 4.1% but the portfolio's preferred position, Xero (XRO), was up 20.3% following a good result.

Subscriber growth in Xero's more mature markets of Australia and New Zealand suggest a post-Covid shift in mentality towards the importance of cloud-based administration for businesses.

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 30 November 2020)
Sector limits	A-REITS 0-30% Cash 2-10%
Dividend Yield	3.26%#
Income target	No target

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	8.78%
BHP	BHP Billiton Limited	8.68%
CBA	Commonwealth Bank of Australia Ltd	5.51%
TLS	Telstra Corporation Limited	4.71%
WBC	Westpac Banking Corporation	4.66%
ANZ	ANZ Banking Group Limited	4.50%
XRO	Xero Limited	4.26%
JHX	James Hardie Industries Plc	3.85%
QAN	Qantas Airways Limited	3.64%
NEC	Nine Entertainment Co Ltd	3.28%

Source: Pendal as at 30 November 2020

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
XRO	Xero Limited	3.44%
NEC	Nine Entertainment Co Ltd	3.10%
QAN	Qantas Airways Limited	3.09%
JHX	James Hardie Industries Plc	2.92%
TLS	Telstra Corporation Limited	2.77%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-2.99%
WOW	Woolworths Group Limited (not held)	-2.49%
NAB	National Australia Bank Limited	-2.42%
RIO	Rio Tinto Limited (not held)	-2.00%
CBA	Commonwealth Bank of Australia Ltd	-1.95%

Source: Pendal as at 30 November 2020

#The Portfolio's dividend yield represents the weighted average 12-month forward-looking dividend yield of the portfolio holdings (excluding cash), as at the date of the Factsheet. Each individual security's dividend yield is calculated using market consensus Dividend Per Share (DPS) before tax and franking credits, collated by Pendal and divided by the closing market price of the security as at the date of the Factsheet. The portfolio dividend yield therefore is only an estimate, and does not reflect the actual returns of the Fund, which will be affected by market movements in the price of individual securities, the returns on other assets such as cash holdings and variances of individual security's actual dividends from the forecasted DPS.

Performance

	1 month	3 month	6 month	1 year	3 Year	5 Year	Since Inception*
Pendal Australian Shares Portfolio	11.60%	10.93%	16.10%	1.61%	8.07%	10.03%	9.31%
S&P/ASX 300 (TR) Index	10.23%	8.27%	14.98%	-1.62%	7.05%	9.13%	7.45%
Active return	**1.38%**	**2.65%**	**1.12%**	**3.23%**	**1.01%**	**0.90%**	**1.87%**

Source: Pendal as at 30 November 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
QAN	Qantas Airways Limited	0.49%
STO	Santos Limited	0.44%
WOW	*Woolworths Group Limited (not held)*	*0.38%*
XRO	Xero Limited	0.32%
MND	Monadelphous Group Limited	0.28%

Top 5 detractors - monthly

Code	Name	Value Added
EVN	Evolution Mining Limited	-0.67%
NAB	*National Australia Bank Limited*	*-0.34%*
MTS	Metcash Trading Limited	-0.31%
SAR	Saracen Mineral Holdings Ltd	-0.30%
WPL	*Woodside Petroleum Ltd (not held)*	*-0.17%*

Top 5 contributors - 1 year

Code	Name	Value Added
XRO	Xero Limited	1.49%
NEC	Nine Entertainment Co Ltd	0.91%
EVN	Evolution Mining Limited	0.87%
JHX	James Hardie Industries Plc	0.77%
SVW	Seven Group Holdings Ltd	0.54%

Top 5 detractors - 1 year

Code	Name	Value Added
QAN	Qantas Airways Limited	-1.18%
STO	Santos Limited	-0.83%
APT	*Afterpay Limited (not held)*	*-0.75%*
WES	*Wesfarmers Limited (not held)*	*-0.58%*
IAG	Insurance Group Australia	-0.58%

Source: Pendal as at 30 November 2020

Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Qantas (QAN, +28.4%)

An easing of restrictions on interstate travel opened the way for QAN to start ramping up its domestic operations. While QAN has now returned close to its pre-Covid enterprise value, we see the opportunity for further upside with a material beneficial effect on working capital as operations normalise.

Overweight Santos (STO, +30.2%)

The surging oil price proved a strong tailwind for energy producers, including STO – our preferred holding in the space. STO has done a strong job of managing costs over the last few years and through the Covid period. It also has the most attractive portfolio of potential growth opportunities.

Underweight Woolworths (WOW, -3.1%)

Defensive consumer staples companies underperformed, including Woolworths and our preferred position in Metcash (MTS, +0.0%), as investor sentiment improved. We continue to see upside in MTS. Its supermarket is on an improving trajectory after several years of self-help, while its hardware and liquor segments continue to perform well.

Three largest detractors

Overweight Evolution Mining (EVN, -10.3%)

The gold price sold off as sentiment improved – along with gold miners such as EVN. We still see an important place for gold exposure in the portfolio. It is a hedge against a downturn in sentiment – particularly with the Covid surge in the US and Europe. It could also perform well if we see an environment of negative real interest rates as inflation expectations increase but nominal rate remain low.

Underweight National Australia Bank (NAB, +24.8%)

The portfolio is underweight the Big Four banks. The sector is tracking towards a better outcome than many feared. But we are mindful that challenges remain – in particular a headwind of low rates and pressure on margins as well as limited ability to reduce costs.

Overweight Metcash (MTS, +0.0%)

Defensive consumer staples companies underperformed, including Woolworths and our preferred position in Metcash (MTS, +0.0%), as investor sentiment improved. We continue to see upside in MTS. Its supermarket is on an improving trajectory as a result of several years of self-help, while its hardware and liquor segments continue to perform well.

Market outlook

The S&P/ASX 300 gained 10.23% in November – its best monthly return since March 1988. It was also a good month for the portfolio, which outperformed.

While improved sentiment toward US politics and vaccines drove markets, the move was supercharged by two surprises.

First, contrary to consensus expectations, there was no “Blue Wave” of change in US politics. The presidential race was very close and the Senate looks set to remain in Republican hands. This would leave the US with a far more moderate – and market-friendly – government than many expected. That said, we continue to watch the lead up to the Georgia Senate run-off with interest.

Second, on the vaccine front efficacy rates of around 95% reported by Modern and Pfizer were far higher than most expected.

These positive surprises – along with several negative ones which occurred in 2020 – emphasise the importance we place on building a robust portfolio. This has been the bedrock of the portfolio’s performance this year.

Our approach is to has been to keep different types of stocks in the portfolio – positions that could perform under a number of different scenarios. We then use our insight into companies to choose the best stocks to own. These were the companies where we saw relatively limited downside and potential for large upside gains.

Our performance in the market’s plunge was driven by defensive holdings such as Metcash (MTS) and Telstra (TLS); high-quality growth names such as CSL (CSL); and portfolio insurance provided by gold miners such as Evolution (EVN).

Performance in November was driven by a different part of the portfolio – cyclical, recovery-linked exposures such as Qantas (QAN), Santos (STO) and Monadelphous (MND).

At times this year the growth exposure has worked well – for example CSL and Xero (XRO). At other times it was the policy beneficiaries such as Fortescue Mining (FMG), JB Hi-Fi (JBH) and Atlas Arteria (ALX).

We did well as the market recognised the value offered in long-term winners such as Aristocrat (ALL), James Hardie (JHX) and Nine Entertainment (NEC).

The recent strong run may mean we are in for a period of consolidation, though not necessary any sort of material pull-back.

The risk of prolonged recession has receded. Policy-makers remain in the mindset of “whatever it takes” with policy settings supporting the economy and markets.

The world is in a better place than many feared in March. The economic rebound has been strong, helped by a surge in monetary and fiscal policy support. Strong industrial production in the US is helping offset weaker activity in services. Vaccines are on the horizon. The world is getting better at living with the virus and mitigating its economic damage.

Nevertheless, risks remain. The northern hemisphere Covid surge has led to renewed lockdowns and an impact on real-time economic activity. There is a great deal of complexity around the vaccines. How soon and how widespread will they be deployed? How quickly will we return to normal? Geopolitical risk – particularly in the relationship between China and Australia – is higher than usual.

The upshot is that we believe our balanced approach remains as valid now as it did earlier in the year.

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

Sell to zero in Ramsay Health Care (RHC) and add a new position in Crown Resorts (CWN) to the portfolio.

We are adjusting exposure to the portfolio segment aligned with the reopening of the domestic economy – selling out of Ramsay Health Care (RHC) and building a new position in Crown Resorts (CWN).

The portfolio has held RHC since January 2019. During that time it has broadly benefited from greater efficiencies in its domestic business and an improvement in its overseas units. Uncertainty peaked more recently as elective surgeries were deferred due to Covid.

However government funding put a floor under the cash burn. There has also been an expectation RHC would benefit from a normalisation of elective surgery volumes as the domestic impact of Covid abated. As we stand today, there are signs of this coming through, though perhaps more slowly than the market expected.

While we expect this trend to continue playing out, we are seeing greater upside emerging in CWN. Hence we are rotating out of this position.

CWN owns and operates two integrated resorts in Australia – Crown Melbourne and Crown Perth. It is also developing the Crown Sydney Hotel Resort and has smaller interests in other overseas and digital businesses.

Despite strength in other domestic-economy exposed stocks, CWN has underperformed the market and experienced severe valuation multiple compression. This is due to multiple recent regulatory investigations into the company – including a NSW probe into Crown Sydney and uncertainty over Melbourne's extended lockdown.

We see these issues as short-term in nature, with a pathway to resolution. We believe the current price does not reflect the long-term value of CWN's high-quality casino assets and the company's free cash flow profile, which will improve dramatically as Crown Sydney is completed.

We have incorporated the likely outcome of the NSW inquiry into our valuation. There is a very strong possibility Crown will be deemed an unsuitable licensee when regulators publish their report on February 1. However we also see scope for the regulator to allow CWN to address this through a series of measures, most of which are already underway. This is likely to drive further management, board and ownership changes.

In our view we could also see a delayed opening, a ban on junkets for overseas players and higher compliance and regulatory costs. A substantial fine from AUSTRAC is also on the cards. Ultimately, all this should pave the way for the opening of the Sydney asset.

This regulatory risk remains a focus. But we believe this is skewed to the upside given the share price already reflects the valuation impact of a permanent loss of the Sydney licence.

More broadly, CWN's governance issues are high profile and hurting sentiment towards the stock. On the other side of the inquiry report and consequent actions, the company is very likely to adopt best practice in these areas and undertake management and ownership changes. As a result, we believe a rapid turnaround in CWN's governance profile is likely.

Beyond this, CWN's Melbourne and Perth casino assets are long-term monopolies with highly predictable medium-term earnings. These should benefit from a gradual lifting of restrictions around domestic travel and social distancing. The soon-to-be-completed Sydney asset should ultimately be an additional growth driver.

The company as a whole will move ex-capex from the end of FY21 and generate a strong free cash flow yield. The attractiveness of these kinds of assets has only increased as bond yields have declined.

As a result we see a compelling opportunity to add exposure to the domestic reopening theme part of the portfolio.

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

PENDAL