Pendal Monthly Commentary

Pendal Australian Shares Portfolio

March 2021

Market commentary

The S&P/ASX 300 gained 2.3% in March. The market shrugged off concerns over another surge in US Covid cases, the high-profile collapse of a highly-levered hedge fund and underlying inflation concerns leading to interest rate increases.

At this point the prospect of a spectacular surge in stimulus-fuelled growth in the US is dominating sentiment and driving equities higher.

The market continues to grapple with a contradiction between the outlook for very strong economic growth in the US versus the Fed's stated intention of avoiding rate rises until 2023.

Scepticism that the Fed can maintain this stance is reflected in rising bond rates. The US 10-year Treasury yield rose 28bps in March. Australian 10-year bond yields fell 9bps, having already increased markedly in February.

The risk is that a sell-off in bonds becomes disorderly, driving yields higher and choking off the growth pulse.

However at this point inflationary pressure – particularly in wages – is not an issue in aggregate.

The US dollar continues to gently strengthen against most major currencies, backed by a strong outlook for growth.

This has been weighing on the price for commodities such as iron ore, which fell 5% for the month. Materials (-3.1%) was the weakest sector as a result, dragged down by the large cap miners.

Technology (-2.7%) also fell, although this was largely the result of a 15.1% fall in Afterpay (APT), the biggest stock in the sector. Other larger tech stocks such as Xero (XRO, +6.8%) and Computershare (CPU, +14.5%) rose.

Utilities (+6.8%) was the strongest sector, closely followed by Consumer Discretionary (+6.7%).

The latter continues to benefit from improving expectations or economic re-opening and ore activity as a vaccine becomes available.

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 (32 as at 31 March 2021)
Sector limits	A-REITS 0-30% Cash 2-10%
Dividend Yield	3.82%#
Income target	No target

Top 10 holdings

Code	Name	Weight
BHP	BHP Billiton Limited	10.49%
CSL	CSL Limited	6.89%
WBC	Westpac Banking Corporation	6.56%
ANZ	ANZ Banking Group Limited	5.81%
CBA	Commonwealth Bank of Australia Ltd	5.59%
TLS	Telstra Corporation Limited	5.29%
XRO	Xero Limited	4.25%
QAN	Qantas Airways Limited	4.05%
JHX	James Hardie Industries Plc	3.62%
STO	Santos Limited	3.53%

Source: Pendal as at 31 March 2021

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Billiton Limited	3.73%
QAN	Qantas Airways Limited	3.57%
XRO	Xero Limited	3.48%
NEC	Nine Entertainment Co Ltd	3.28%
TLS	Telstra Corporation Limited	3.24%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-3.02%
NAB	National Australia Bank Limited	-2.66%
WOW	Woolworths Group Limited (not held)	-2.62%
CBA	Commonwealth Bank of Australia Ltd	-2.14%
RIO	Rio Tinto Limited (not held)	-2.08%

Source: Pendal as at 31 March 2021

#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	3.23%	5.81%	22.46%	43.07%	10.42%	11.69%	10.10%
S&P/ASX 300 (TR) Index	2.30%	4.15%	18.51%	38.34%	9.72%	10.31%	8.00%
Active return	**0.93%**	**1.66%**	**3.95%**	**4.74%**	**0.70%**	**1.38%**	**2.10%**

Source: Pendal as at 31 March 2021 | *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
RIO	*Rio Tinto Limited (not held)*	*0.27%*
APT	*Afterpay Limited (not held)*	*0.25%*
TLS	Telstra Corporation Limited	0.24%
MTS	Metcash Trading Limited	0.20%
XRO	Xero Limited	0.18%

Top 5 detractors - monthly

Code	Name	Value Added
BHP	BHP Billiton Limited	-0.30%
WES	*Wesfarmers Limited (not held)*	*-0.14%*
NEC	Nine Entertainment Co Ltd	-0.13%
STO	Santos Limited	-0.12%
MND	Monadelphous Group Limited	-0.11%

Top 5 contributors - 1 year

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	2.42%
STO	Santos Limited	1.52%
JHX	James Hardie Industries Plc	1.43%
XRO	Xero Limited	1.36%
SVW	Seven Group Holdings Ltd	1.32%

Top 5 detractors - 1 year

Code	Name	Value Added
APT	*Afterpay Limited (not held)*	*-1.16%*
IAG	*Insurance Group Australia (not held)*	*-1.00%*
CSL	CSL Limited	-0.89%
ALX	Atlas Arteria	-0.78%
TLS	Telstra Corporation Limited	-0.72%

Source: Pendal as at 31 March 2021

Underweight positions are in italics.

Stock-specific drivers of monthly performance relative to benchmark

Three largest contributors

Underweight Rio Tinto (RIO, -9.2%)

The iron ore miners underperformed in March as the iron ore price came off, with US dollar strength weighing broadly on commodities. We retain a positive outlook for iron ore, underpinned by a resumption in demand outside China. The price is likely to moderate over the year. But we expect it to settle at a point higher than consensus expectations, leaving the miners with pathway for further earnings upgrades. Strong cash flow is being channelled back to shareholders. Our preference is for BHP over RIO.

Underweight Afterpay (APT, -15.1%)

Higher bond yields have been a headwind for growth stocks generally because they increase the discount rate used for valuation. Meanwhile a rash of new listings and entrants in the IPO space has emphasised the increasingly competitive nature of the buy-now-pay-later (BNPL) sector. We believe the likely impact on costs and margins has not been reflected in valuations for APT. Hence we prefer other tech growth names such as Xero (XRO).

Overweight Telstra (TLS, +10.4%)

The market welcomed the announcement of a legal restructure of TLS into three entities. Two parts will own and operate physical assets such as mobile towers and data exchanges. The third will own and operate its service offering. This allows the company to extract value via the full or partial sale of infrastructure assets.

Three largest detractors

Overweight BHP (BHP, -5.4%)

The iron ore miners underperformed in March as the iron ore price came off, with US dollar strength weighing broadly on commodities. We retain a positive outlook for iron ore, underpinned by a resumption in demand outside China. The price is likely to moderate over the year. But we expect it to settle at a point higher than consensus expectations, leaving the miners with pathway for further earnings upgrades. Strong cash flow is being channelled back to shareholders. Our preference is for BHP over RIO.

Underweight Wesfarmers (WES, +7.0%)

Conglomerate WES has benefited from improved sentiment towards retail plays such as its Bunnings, Kmart and Target franchises on the back of economic re-opening. It also has exposure to lithium, which has also been well supported on the electric vehicle thematic. We do not hold WES in the portfolio.

Overweight Nine Entertainment (NEC, -1.9%)

NEC gave back some of its recent gains, following strong momentum in the wake of deals for payments from online platforms that use its content. We maintain a positive outlook for NEC. Advertising revenues are picking up post-Covid. The company has taken out a material amount of costs, increasing its leverage to rising revenue.

Market outlook

The portfolio outperformed in March with a diverse collection of contributors. Re-opening stocks such as Aristocrat (ALL), Crown (CWN) and Tabcorp (TAH) all made solid contributions. But more defensive holdings such as Metcash (MTS) and Telstra (TLS) also did well, as did our preferred tech growth name Xero (XRO).

The rise in US Covid cases presents a risk. Localised outbreaks have seen case numbers increase and hospitalisations tick up. There is a risk of restrictions resuming in some places. But at this point the market is looking through this and focusing instead on a huge surge in economic growth.

A couple of quarters of extremely strong growth are likely to result from large-scale stimulus pushed through by the Biden administration and re-opening as the vaccination program accelerates. This, coupled with accommodative monetary policy and a market awash with liquidity, is likely to remain supportive for equities.

Market breadth also remains a favourable factor. Almost 95% of stocks in the S&P500 are above their 200-day moving average. This is more than at any point since May 2013.

This does not mean that we can't see a correction or consolidation. But it makes it less likely we are at a market top. Narrower and narrower market breadth tends to be a sign of extended markets – and we are clearly not at that point.

Inflation remains the key risk that can de-rail markets. There are signs of inflationary pressure in specific areas in supply chains. The issues is how quickly – and to what degree – this flows through to wages.

The link to wage inflation has not been present for 20 years and we are a long way from employment capacity. As a result we do not think inflation is a key issue in the near term. Nevertheless, this remains an important factor to watch. Should the economic rebound continue at the likely pace of the next couple of quarters, it will become harder for the Fed to maintain its stance of no rate hikes before 2023.

There is an interesting trade developing within the broad rotation from value to growth.

Within growth, large-cap tech stocks are outperforming smaller, more speculative names for the first time since April last year. It is important to remain mindful that today's market is not just a case of simply "buy value, sell growth".

Plenty of value companies are structurally challenged. There are also signs of a divergence between profitable growth companies with strong cash flow versus the longer duration, more speculative names. This is reflected in our preference for Xero, among others, in the growth part of the portfolio.

New stocks added or stocks sold to zero during the month

Sell to zero in Ampol (ALD); buy a new position in Boral (BLD)

We added exposure to the portfolio's recovery-aligned segment via a new position in Boral (BLD).

BLD makes construction and building materials including concrete, bricks, plasterboard, timber, cement and asphalt. It also operates quarries and provides construction-related logistics. Headquartered in Sydney, BLD derives roughly 40% of its earnings from the United States. The balance comes from Australia and Asia.

Boral is benefiting from external tailwinds as the construction cycle picks up in the US and Australia, plus improvements in the company's structure and costs under new management.

In Australia, revenue had been declining in recent years as a softer housing market affected demand for building products. Delays in the infrastructure pipeline also weighed on demand for cement. Both these elements should turn a corner into FY22.

Low interest rates and home builder grants have prompted a surge in demand for detached housing. Meanwhile federal and state governments are focused on infrastructure as central to post-Covid stimulus packages. Improved volumes and potentially better pricing – coupled with recent cost reductions – should see decent operating leverage in BLD's Australian segment.

The key risk is additional supply as a result of the Gunlake cement import terminal. At this point we think cyclical uplift and cost reduction should offset this negative impact. But this is a risk to watch.

Low rates are also driving strength in US housing demand, which has been exacerbated by a decade-long structural underbuild in housing.

We saw this momentum coming through in BLD's most recent result, where its building products divisions came in well ahead of consensus expectations.

BLD also produces fly ash in the US – a substitute for cement created from the by-product of energy production. This division has been under margin pressure. Volumes should stabilise after recent contract wins, but this may continue as a modest drag. Nevertheless, market expectations here have been re-based, lowering scope for disappointment.

New management has focused on pulling out costs, improving leverage to higher-volume demand. Management has also focused on simplifying the business. The gypsum production business has been sold and the US building products business is up for sale at a favourable point in the cycle.

Capital proceeds from this, combined with further cyclical tailwinds, can help realise what we see as attractive valuation upside.

This addition has been funded by the sale of Ampol (ALD).

ALD provided a degree of exposure to economic recovery via an improvement in fuel volumes as traffic picked up. There is potential for a further leg as demand for air travel resumes. But this has been complicated by exposure to refining where margins have collapsed and uncertainty over corporate actions.

ALD came under takeover offer from global conglomerate Aliment Couche-Tard, but the deal fell through. ALD retains some corporate appeal but another suitor does not appear imminent.

We prefer Viva Energy (VEA) and retain this in the portfolio. However at this point we see greater alignment with recovery and reopening via Boral. Hence we are selling ALD to zero.

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