Pendal Monthly Commentary

Pendal Sustainable Future 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

Sustainable Future Australian Shares Portfolio	
Investment strategy	To deliver outperformance relative to the benchmark before fees over a rolling five year period by investing in companies which Pendal has identified as having leading financial, ethical and sustainability characteristics.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15-40 (29 as at 31 March 2021)
Sector limits	Cash 2-10%
Dividend Yield	3.47%#

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	8.63%
ANZ	ANZ Banking Group Limited	6.82%
WBC	Westpac Banking Corporation	6.63%
CBA	Commonwealth Bank of Australia Ltd	6.11%
TLS	Telstra Corporation Limited	5.76%
FMG	Fortescue Metals Group Limited	5.12%
MQG	Macquarie Group Limited	4.86%
XRO	Xero Limited	4.51%
QAN	Qantas Airways Limited	4.45%
NEC	Nine Entertainment Co Ltd	4.40%

Source: Pendal as at 31 March 2021

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
NEC	Nine Entertainment Co Ltd	4.19%
QAN	Qantas Airways Limited	3.96%
XRO	Xero Limited	3.74%
TLS	Telstra Corporation Limited	3.72%
AMC	Amcor Limited	3.59%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Billiton Limited (not held)	-6.75%
WES	Wesfarmers Limited (not held)	-3.02%
WOW	Woolworths Group Limited (not held)	-2.62%
RIO	Rio Tinto Limited (not held)	-2.08%
CBA	Commonwealth Bank of Australia Ltd	-1.62%

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	Since Inception (p.a.)*
Pendal Sustainable Future Australian Shares Portfolio	3.96%	3.80%	18.64%	39.07%	10.85%
S&P/ASX 300 (TR) Index	2.30%	4.15%	18.51%	38.34%	8.03%
Active return	**1.67%**	**-0.35%**	**0.13%**	**0.73%**	**2.81%**

Source: Pendal as at 31 March 2021
*Since Inception - 16 June 2018
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
BHP	*BHP Billiton Limited (not held)*	*0.56%*
JBH	JB Hi-Fi Limited	0.48%
TLS	Telstra Corporation Limited	0.28%
RIO	*Rio Tinto Limited (not held)*	*0.28%*
BSL	Bluescope Steel Limited	0.27%

Top 5 detractors - monthly

Code	Name	Value Added
FMG	Fortescue Metals Group Limited	-0.57%
NEC	Nine Entertainment Co Ltd	-0.18%
IGO	IGO Limited	-0.17%
WES	*Wesfarmers Limited (not held)*	*-0.14%*
ALL	*Aristocrat Leisure Limited (not held)*	*-0.11%*

Top 5 contributors - 1 year

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	3.52%
FMG	Fortescue Metals Group Limited	2.71%
JBH	JB Hi-Fi Limited	1.87%
XRO	Xero Limited	1.60%
ANZ	ANZ Banking Group Limited	1.01%

Top 5 detractors - 1 year

Code	Name	Value Added
IAG	*Insurance Group Australia (not held)*	*-1.63%*
BHP	*BHP Billiton Limited (not held)*	*-1.54%*
CSL	CSL Limited	-1.52%
ALX	Atlas Arteria	-1.17%
APT	*Afterpay Limited (not held)*	*-1.14%*

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 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.

Overweight JB Hi-Fi (JBH, +19.3%)

JBH delivered strong gains in March after underperforming in February despite a strong half-year earnings results and an update that emphasised strong trading conditions. We are mindful that sales momentum is likely to slow at some point, as more options for discretionary spending become available and the company starts to cycle strong numbers from last year. But at this point we continue to see JBH as the most attractive exposure to the retail sector.

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 Fortescue Metals (FMG, -11.7%)

The iron ore miners underperformed in March as the iron ore price came off. US dollar strength weighed 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 miners with pathway for further earnings upgrades. Strong cash flow is being channelled back to shareholders.

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.

Overweight IGO (IGO, -10.7%)

Speculation of additional supply in China weighed on the nickel price in March. This dragged on IGO, which mines nickel. The supply threat comes from China's Tsingshan, which announced a supply agreement to electric vehicle (EV) battery makers using low-quality nickel which requires a highly polluting process. The demand and detail is yet to be seen. We are mindful that IGO has a diverse exposure to EV demand via nickel, copper and lithium.

Market outlook

The portfolio outperformed in March, with a diverse collection of contributors. Re-opening stocks such as BlueScope (BSL) made solid contributions. More defensive holdings such as Amcor (AMC) 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 along with 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 we can't see a correction or consolidation. But it's 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 will present as 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 current stance of no rate hikes before 2023.

There is an interesting trade developing in 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

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 current earnings from the United States and the balance from Australia and Asia.

The company is benefiting from external tailwinds as the construction cycle picks up in the US and Australia, plus improvements in its structure and costs under new management. It is also displaying improving sustainability credentials.

In Australia revenue declined 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 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. Although volumes should stabilise after recent contract wins this may continue to be a modest drag.

Nevertheless, market expectations here have been re-based, lowering scope for disappointment.

New management has focused on pulling out costs, improving the 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.

BLD's strategy includes a focus on shifting from energy and resource-intensive products to more sustainable products.

This includes a concrete product that uses half the cement of traditional products. (Cement is a big source of carbon emissions in the concrete production chain). The process has no impact on the concrete's structural performance and has been used in projects such as Crown Sydney and Barangaroo South.

BLD has also developed an asphalt product that includes materials such as glass, plastic, tyres and old road pavement among others. This reduces landfill and the need for raw materials in asphalt. The product has been used in a number of road projects across Australia.

Carbon Footprint

The estimated weighted average carbon intensity (WACI) of the portfolio, using greenhouse gas emissions (scope 1 and 21) data supplied by ISS and weighted by the size of our holding in each company, is shown in the table below. In other words, this provides an indication of a portfolio's exposure to carbon intensive companies. We also compare this to the weighted average emissions for the companies in the aggregated ASX300 index.

We caution that there are limitations of using carbon footprinting measures as an indicator of a portfolio's overall exposure to climate-related risks. For example, not all companies report their emissions data and hence some of the below analysis includes estimates. Also, it does not include scope 3 emissions. Further, portfolio carbon analysis does not capture exposure to physical climate-related risks, or the unique transition risks some companies within the portfolio face. Nevertheless, the WACI metric is recommended by the Task Force on Climate-related Financial Disclosures (TCFD)2, noting it supports greater comparability of investor reporting.

Carbon Intensity (tonnes CO2e / $M sales)

Pendal Sustainable Future Australian Share Portfolio	ASX 300	Relative to ASX300
108.54	166.26	-57.72

Source: Pendal, ISS as at 31 March 2021

*As of 28 February 2021, Pendal changed carbon providers from MSCI ESG Research LLC to Institutional Shareholder Services (Australia) Pty Ltd. As such, the change may result in variations in previously reported weighted average carbon intensity in the portfolio holdings of the Fund as well as its underlying carbon data.

[1] Scope 1 emissions result from sources directly owned or controlled by the company. Scope 2 accounts for GHG emissions from the generation of purchased electricity consumed by the company. Scope 3 emissions result from activities not directly owned or controlled by the company but are associated with its operation such as business travel, waste management, commuting, and the use of sold products and services. https://ghgprotocol.org/sites/default/files/standards/ghg-protocol-revised.pdf

[2] *Recommendations of the Task Force on Climate-Related Financial Disclosures, June 2017* https://www.fsb-tcfd.org/recommendations/

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