PENDAL

Pendal Monthly Commentary

Pendal Australian Specialised Retirement Income Portfolio

May 2021

Market commentary

The S&P/ASX 300 gained 2.3% in May, much of it in the last week after a somewhat choppy month.

The key development was concrete evidence of inflation coming through in the US. The April consumer price index (CPI) was up 3% year-on-year and +0.92% versus March. This was stronger than expected.

This prompted some volatility in equity markets on fears that strong inflation would force central banks to raise rates sooner than planned, potentially choking off growth.

However central banks moved quickly to characterise current price spikes as transitory – receding once we pass through an initial phase of pent-up demand and current supply chain bottlenecks are addressed.

For the moment, this has satisfied markets. There was a rotation back to value and cyclicals which reflects confidence that near-term rate rises are off the cards. Late in the month the Fed was able to signal that they were "thinking about thinking about" Quantitative Easing tapering, without upsetting markets.

Elsewhere, there was some volatility in commodities and cryptocurrency markets as the Chinese government flagged high prices as an issue and warned against speculation.

The federal budget reflected an expansionary mindset now dominating Western governments. This is in contrast to the mantra of austerity and balanced budgets that dominated in the wake of the GFC.

Financials (+5.7%) was the best performing sector as the banks delivered updates that emphasised a more benign environment. Rising nominal bond yields eased margin pressure. The absence of a surge in bankruptcies means they are in a strong capital position. Cyclical Consumer Discretionaries (+3.2%) also outperformed.

Technology (-9.1%) underperformed as leadership shifted away from growth stocks. Heavyweight Afterpay (APT) fell 21.1% over the month. It faced headwinds from competition, reduced online purchasing and a thematic rotation away from growth.

Utilities (-6.6%) also fell, led by AGL Energy (-9.1%).

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 (28 as at 31 May 2021)
Sector limits	A-REITS 0-30%, Cash 2-10%
Dividend Yield	4.14%#

Top 10 holdings

Code	Name	Weight
BHP	BHP Billiton Limited	10.56%
WBC	Westpac Banking Corporation	8.60%
CSL	CSL Limited	6.96%
ANZ	ANZ Banking Group Limited	6.92%
CBA	Commonwealth Bank of Australia Ltd	6.72%
TLS	Telstra Corporation Limited	6.02%
NEC	Nine Entertainment Co Ltd	4.68%
MTS	Metcash Trading Limited	4.06%
FMG	Fortescue Metals Group Limited	3.10%
STO	Santos Limited	3.08%

Source: Pendal as at 31 May 2021

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
NEC	Nine Entertainment Co Ltd	4.47%
TLS	Telstra Corporation Limited	4.01%
WBC	Westpac Banking Corporation	3.94%
MTS	Metcash Trading Limited	3.89%
BHP	BHP Billiton Limited	3.80%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-3.01%
WOW	Woolworths Group Limited (not held)	-2.53%
NAB	National Australia Bank Limited	-2.22%
TCL	Transurban Group (not held)	-1.82%
CBA	Commonwealth Bank of Australia Ltd	-1.78%

Source: Pendal as at 31 May 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	Since inception*
Pendal Australian Specialised Retirement Income Portfolio	2.93%	9.28%	14.92%	33.56%	11.38%	10.49%
S&P/ASX 300 (TR) Index	2.31%	8.53%	11.95%	28.72%	10.09%	9.59%
Active return	**0.62%**	**0.75%**	**2.96%**	**4.84%**	**1.29%**	**0.90%**

Source: Pendal as at 31 May 2021
*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
APT	*Afterpay Limited (not held)*	*0.32%*
EVN	Evolution Mining Limited	0.29%
WBC	Westpac Banking Corporation	0.19%
ALL	Aristocrat Leisure Limited	0.13%
TWE	Treasury Wine Estates Limited	0.09%

Top 5 detractors - monthly

Code	Name	Value added
MND	Monadelphous Group Limited	-0.32%
QAN	Qantas Airways Limited	-0.20%
XRO	Xero Limited	-0.17%
CBA	*Commonwealth Bank of Australia Ltd*	*-0.15%*
STO	Santos Limited	-0.14%

Top 5 contributors - 1 year

Code	Name	Value added
NEC	Nine Entertainment Co Ltd	2.35%
A2M	*The A2 Milk Company Ltd (not held)*	*0.80%*
FMG	Fortescue Metals Group Limited	0.63%
TAH	Tabcorp Holdings Limited	0.58%
JHX	James Hardie Industries Plc	0.55%

Top 5 detractors - 1 year

Code	Name	Value added
EVN	Evolution Mining Limited	-1.28%
ALX	Atlas Arteria	-1.04%
IAG	*Insurance Group Australia (not held)*	*-0.80%*
NAB	*National Australia Bank Limited*	*-0.56%*
MND	Monadelphous Group Limited	-0.53%

Source: Pendal as at 31 May 2021
Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Underweight Afterpay (APT, -21.1%)

Afterpay sold off along with most of the tech sector as leadership shifted away from growth to value and cyclicals. We see a role for quality growth stocks in the portfolio despite a less supportive macro backdrop. We continue to see APT as over-valued due to lower online spending as economies re-open and pressure on margins from competition.

Overweight Evolution Mining (EVN, +16.9%)

There was a rally in the gold price as inflation expectations rose, which fed through to miners such as EVN. EVN is among our preferred gold exposures given its relatively low cost base and growth opportunities in Canadian assets.

Overweight Westpac (WBC, +8.2%)

Westpac's result demonstrated that the environment continues to improve for banks. Capital positions are strong since provisions made against a sharp increase in bad debts have not been needed. Higher nominal bond yields have also helped alleviate some margin pressure. Westpac has more scope to materially reduce costs than its peers and its management has indicated a strategy to do so.

Three largest detractors:

Overweight Monadelphous (MND, -22.5%)

Mining services company MND gave back the gains it made after April's news that it had settled out of court with Rio Tinto over liability for the Cape Lambert fire. The company continues to win new contracts and has a strong pipeline, but the market is focused on near-term pressure from higher labour costs on margins.

Overweight Qantas (QAN, -4.9%)

Covid outbreaks in Sydney and Melbourne weighed on travel stocks including QAN. The increasingly complex situation overseas has pushed back expectations of international travel. Australia's vaccination program should support the domestic market, which is more important to QAN's outlook.

Overweight Xero (XRO, -6.3%)

XRO sold off with a rotation away from growth, but it held up better than most of its peers. The market was initially disappointed in its half-year earnings, although it recovered from a post-result fall. The UK's drive to push small business systems and accounting onto the cloud – which was a factor in the success of Australia's JobKeeper – provides an attractive growth pathway for XRO.

Market outlook

The portfolio outperformed in May, helped by exposure to re-opening plays in Australia and the US. Several of the best performers were drawn from cyclical and value parts of the portfolio, in line with a broad rotation in the market.

Some of the growth names underperformed, notably Xero (XRO). But it held up better than other tech growth names. Not owning companies like Afterpay offset this drag on relative performance.

The gold price saw some relief as inflation expectations rose, driving the positions in Evolution (EVN) and Northern Stare (NST). The rest of the mining and resource sector tended to underperform.

The portfolio is broadly neutral on resources, but some interesting opportunities are emerging.

Recent commodity price weakness has been driven mainly by the view that slowing Chinese credit growth and effort by Beijing to curb speculation will drag prices down. However this view perhaps understates the demand side of the equation.

The Chinese economy recovery has been highly leveraged to exports, which have been running hot on pent-up Western demand. Applying the brakes to credit growth can help temper overall economic momentum. But it may not have as much of an effect on demand for exports, which is a key driver of commodity prices.

There is the additional factor that commodity demand from the rest of the world is also now coming through, potentially exacerbated by stimulus spending programs. This may moderate the effect of Chinese efforts to ease commodity prices.

We are mindful of some recent developments in the energy space. Renewed global Covid outbreaks and the potential for additional Iranian supply weighed on the oil price recently.

But several events are likely to constrain medium-term supply. This includes a ruling in the Netherlands that Shell must expand its plan to cut emissions; the election of new directors to Exxon's board; and the International Energy Agency's roadmap to net-zero by 2050. These are all indicators of an environment in which investment in new fossil fuel projects will become increasingly hard. As production rates decline at an accelerating rate (due to the proportion of shale energy in the mix) this is all supportive of much stronger energy prices in the medium term.

These are two of the macro factors we are considering in the portfolio's current construction. We also continue to monitor inflationary expectations, policy settings and recent Covid outbreaks in various parts of the world.

We are still reasonably sanguine on the outlook for Australian equities in the current environment. However a high degree of macro uncertainty emphasises the importance of maintaining a portfolio that can adapt to swift change in the underlying environment.

New stocks added or stocks sold to zero during the month

Buy new position in Treasury Wine Estates (TWE)

Sell to zero in Seven Group (SVW)

We added a new position in Treasury Wine Estates (TWE) to the portfolio. TWE is one of the world's biggest wine groups. It sources wine and grapes from around the world and sells into more than 70 countries.

TWE has largely not participated in the post-Covid rebound. Its key challenge has been dealing with the loss of the Chinese market. We see some pieces falling into place that suggest TWE, under a new management team, is turning a corner. Coupled with market expectations that have rebased to a low level, this suggests material potential upside.

TWE has been one of the major victims of tension between China and Australia. Sales to China and Hong Kong were a key part of TWE's market, particularly in the luxury segment. The region accounted for 32% of the Group's EBIT in FY19 and was expected to be 44% in FY22. Instead, an effective 177% tariff on Australian wines all but destroyed this market for TWE. This led to a surplus of Australian red wine that would otherwise have been sold in China.

Meanwhile TWE's North American business suffered from an oversupply of commercial wine which saw its earnings in that market halve in FY19.

As a result TWE's stock was down some 48% from its 2018 high.

Its recent results reflected the combination of these challenges. However from this nadir, we believe that signs of a turnaround are emerging under a new management team.

Oversupply of wine in the US market has been resolved due to vine removals and very strong volume growth in retail channels in 2020 through Covid lockdowns. Wildfires also had a major negative impact on the Californian harvest in 2020. Inventories of Napa Cabernet fell 50% year-on-year. This was reflected in a material improvement in margins in the US in 1H FY21, with more expected to come.

Against this backdrop TWE has been showing evidence of success in its US "premiumisation" strategy. The company is generating value and price growth for its portfolio above the market trend.

The key risk and area of uncertainty is how TWE re-allocates volumes that would otherwise have been sold into China. Key measures here include reallocation of brands such as Penfolds to other markets (including Australia and rest of Asia) and accelerated investment in sales and marketing in these countries.

Prospects for the success of this reallocation strategy are good given the strength of the Penfolds brand and TWE's marketing and distribution capabilities in these markets. This is against the backdrop of a strong consumer environment.

Initial indications are positive, though this is the major factor to watch in coming halves. Impact on margin will be a key focus.

TWE has a strong portfolio of brands and largely unmatched scale in an environment of strong consumer spending. Cyclically, demand should remain supported by the broad theme of re-opening as people start dining out again.

Management is demonstrating a coherent strategy to deal with the near-term challenge of losing a major customer for one of its products. There is risk here around execution, timing and the impact on margins. But current valuation does not reflect a high degree of expectation, implying downside support if the recovery takes longer than expected.

This position has been funded via the sale of the position in Seven Group (SVW).

SVW has been a strong performer for the portfolio over the past year. The Westrac franchise remained resilient during the Covid downturn, supported by demand for commodities. The Coates business has also been aligned with the shift in sentiment towards recovery and re-opening in recent months.

Following its run, SVW has hit our valuation target. Risk and uncertainty around capital allocation increased in recent times as it acquired partial stakes in other ASX-listed companies. As a result we have booked our gains in this position and rotated to TWE, where we see more attractive risk/reward.

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

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