PENDAL

Pendal Monthly Commentary

Pendal Australian Shares Portfolio

June 2021

Market commentary

There was a marked rotation away from cyclicals and value towards growth in June.

The S&P/ASX 300 gained 2.25% for the month.

The rotation was a response to a perceived shift in the US Federal Reserve's stance. While the Fed did not move rates or adjust Quantitative Easing in its June meeting, it did signal that it remained focused on potential inflationary pressures and would tighten if required.

There was a shift in the median expectation of rate hikes – from zero to two expected hikes by the end of 2023. This was a shot across the bow and a clear signal that the Fed was not complacent on the inflation risk.

The market had been concentrated on assets viewed as inflation beneficiaries. This shift in sentiment saw a flattening of the Treasury yield curve and a rotation back to other parts of the market such as growth and defensive stocks.

Information technology (+12.4%) was the best-performing sector as a result. It was led by a 27.4% gain from Afterpay (APT), which is the largest tech stock in the index and typically the most leveraged to shifts in sentiment towards growth stocks.

Health care (+2.1%) is typically considered a growth sector. Several health care stocks saw strong gains, but the sector as a whole was held back by heavyweight CSL (CSL, -1.7%) which was impacted by an adverse regulatory ruling in the US.

Financials (-0.18%) was the only sector to lose ground. It was dragged down by a 1.33% drop in banks as expectations for an increase in nominal bond yields (a driver of bank profitability) moderated.

Materials (+0.07%) lagged. This was largely driven by weakness in the gold mining stocks – again in response to a more moderate view of inflation risk.

June capped a 28.49% gain for the full financial year, the strongest year since 2006. Gains in FY21 have been driven by a recovery in earnings associated with economic re-opening.

The best performing sub-sectors have been those most leveraged to this theme, including deep cyclical sectors such as steel, building materials and gaming.

Defensive sectors such as infrastructure, utilities and gold miners were the worst performers.

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 (33 as at 30 June 2021)
Sector limits	A-REITS 0-30% Cash 2-10%
Dividend yield	3.95%#
Income target	No target

Top 10 holdings

Code	Name	Weight
BHP	BHP Billiton Limited	10.02%
CSL	CSL Limited	7.27%
WBC	Westpac Banking Corporation	6.82%
CBA	Commonwealth Bank of Australia Ltd	6.01%
TLS	Telstra Corporation Limited	5.84%
ANZ	ANZ Banking Group Limited	4.98%
XRO	Xero Limited	4.27%
QAN	Qantas Airways Limited	3.81%
STO	Santos Limited	3.67%
ALL	Aristocrat Leisure Limited	3.36%

Source: Pendal as at 30 June 2021

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Corporation Limited	3.73%
XRO	Xero Limited	3.49%
QAN	Qantas Airways Limited	3.40%
BHP	BHP Billiton Limited	3.29%
MTS	Metcash Trading Limited	3.15%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-3.15%
NAB	National Australia Bank Limited	-2.50%
CBA	Commonwealth Bank of Australia Ltd	-2.33%
WOW	Woolworths Group Limited (not held)	-2.27%
RIO	Rio Tinto Limited (not held)	-2.21%

Source: Pendal as at 30 June 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	0.83%	7.89%	14.16%	32.82%	10.61%	12.96%	11.05%
S&P/ASX 300 (TR) Index	2.25%	8.48%	12.98%	28.49%	9.76%	11.25%	9.12%
Active return	**-1.42%**	**-0.59%**	**1.18%**	**4.32%**	**0.85%**	**1.71%**	**1.93%**

Source: Pendal as at 30 June 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
MTS	Metcash Trading Limited	0.30%
TLS	Telstra Corporation Limited	0.17%
NCM	*Newcrest Mining Limited (not held)*	*0.14%*
NAB	*National Australia Bank Limited*	*0.13%*
STO	Santos Limited	0.07%

Top 5 detractors - monthly

Code	Name	Value Added
EVN	Evolution Mining Limited	-0.31%
APT	*Afterpay Limited (not held)*	*-0.26%*
WES	*Wesfarmers Limited (not held)*	*-0.13%*
NST	Northern Star Resources	-0.13%
NEC	Nine Entertainment Co Ltd	-0.12%

Top 5 contributors - 1 year

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	2.05%
JHX	James Hardie Industries Plc	0.87%
XRO	Xero Limited	0.82%
A2M	*The A2 Milk Company Limited (not held)*	*0.81%*
NCM	*Newcrest Mining Limited (not held)*	*0.73%*

Top 5 detractors - 1 year

Code	Name	Value Added
EVN	Evolution Mining Limited	-1.53%
ALX	Atlas Arteria	-0.87%
APT	*Afterpay Limited (not held)*	*-0.55%*
NAB	*National Australia Bank Limited*	*-0.53%*
CSL	CSL Limited	-0.53%

Source: Pendal as at 30 June 2021 | Underweight positions are in italics.

Stock-specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Metcash (MTS, +12.7%)

Metcash delivered a well-received full year result. It delivered revenue growth in food, liquor and hardware divisions. Margins in food were disappointing, though it appears to be holding market share gains. Hardware was stronger than expected. Combined with liquor this segment is now bigger than the food business. Management announced a share buy-back, signalling confidence in the outlook.

Overweight Telstra (TLS, +6.8%)

TLS announced the sale of a 49% stake in its mobile phone tower network to a consortium of superannuation funds. The price was higher than most expected and at a premium to TLS's valuation multiple, demonstrating that the plan to unlock value is coming to fruition. Half the proceeds will be returned to shareholders, with the remainder to pay down debt.

Underweight Newcrest Mining (NCM, -10.7%)

A shift in the Fed's signalling curbed any expectations of rampant inflation and weighed on inflation beneficiaries such as gold miners. The portfolio retains an exposure to gold. It serves as a "risk off" hedge in the case of a material downturn in market sentiment. The medium-term debate about inflation is yet to be resolved. Evolution (EVN) and Northern Star (NST) are our preferred exposures given relatively attractive growth profiles and cost control compared to Newcrest (NCM), the biggest gold miner in the index.

Three largest detractors

Overweight Evolution Mining (EVN, -16.8%)

A shift in the Fed's signalling curbed any expectations of rampant inflation and weighed on inflation beneficiaries such as gold miners. The portfolio retains an exposure to gold. It serves as a "risk off" hedge in the case of a material downturn in market sentiment. The medium-term debate about inflation is yet to be resolved. Evolution (EVN) and Northern Star (NST) are our preferred exposure given relatively attractive growth profiles and cost control. The drag from this exposure was offset to a degree by not owning Newcrest (NCM), the largest gold miner in the index.

Underweight Afterpay (APT, +27.4%)

APT benefited from the rotation to growth. This was augmented by the announcement of a new "shop anywhere" option in the US and an increase in price for a small segment of PayPal's BNPL customer base. We see material competitive intensity for APT, coupled with higher costs, which are not reflected in the valuation. XRO remains our preferred growth exposure.

Underweight Wesfarmers (WES, +6.7%)

Wesfarmers outperformed in the latter half of the month as the market rotated away from inflation-linked beneficiaries and back to other parts of the market. We prefer other domestic exposures. Metcash, for example, offers exposure to the same trends as WES's Bunnings franchise at a much more attractive valuation multiple.

Market outlook

The portfolio lagged the market's gain in June. The strength of the rebound in growth stocks reflected the degree to which the market was concentrated in inflation beneficiaries such as commodities and was short other parts of the market.

The portfolio's growth exposure through stocks such as Xero (XRO) did well. Not owning Afterpay (APT) – the largest and most leveraged growth trade – dragged. A number of the portfolio's cyclical exposures are also exposed to the domestic re-opening trade, notably Qantas (QAN). These came off late in the month as lock-downs took effect.

Debate on inflation remains the key macro issue. The Fed has signalled it is factoring the risk of higher-than-expected inflation into deliberations. This reinforces a view that it is not as potentially reckless as some had feared.

The counter argument is that that the Fed does not have the degree of control it believes it has – given the combined degree of fiscal and monetary stimulus. But this will not be apparent for some time.

There are clear bottlenecks driving wage pressure in some parts of the US economy. This is despite a material slack in labour capacity. There are 5.5 million fewer people working now than pre-Covid.

Recent data on US house prices – now growing at their fastest rate in 30 years – is a reminder of the wealth effects created by current policies. This can drive medium-term inflationary forces.

There are also suggestions temporary factors driving inflation may have peaked in May and should halve by November. This means that even if the inflation thesis is correct, it will be hard to detect in the next few months.

Combined with on-going Quantitative Easing this could keep bonds range-bound in the next few months and prevent a dramatic rotation back to value in equity markets.

This reinforces the importance of building a portfolio which is not driven by a particular path in terms of inflationary expectations. We continue to maintain both growth and value exposures in the portfolio. The crucial element is finding companies that also have a company-specific angle to support the stock even if the macro environment is not beneficial.

Heightened uncertainty in the market means there is still a high degree of mispricing, in our view. This means it is a good environment to look for company-specific opportunities.

At this point the market is largely looking through recent lock-downs in Australia, although several re-opening beneficiaries have been hit. Lockdowns and effective contact tracing suggest this outbreak should be containable in weeks rather than months. This is certainly the view reflected in markets.

Other parts of the world are re-opening, prompting a local debate about our path to normalisation. At some point there will need to be a leap of faith, allowing a degree of Covid in the community on the premise that it won't lead to poor health outcomes.

The maths around target immunity levels for domestic re-opening is a function of variant transmissibility, vaccine effectiveness and vaccine penetration.

Delta's greater infectiousness has raised the required threshold of immunity. The shift to greater use of Pfizer should help. We may also see an acceleration in the timing of second doses.

We suspect the trigger may be availability of vaccine for anyone who wants it, rather than a specified proportion of the population vaccinated. Either way, this is unlikely to arrive before the fourth quarter of 2021. A full re-opening of international borders is likely to be delayed into 2022.

We continue to watch the UK carefully as a possible test case, where new case numbers continue to climb sharply, but hospitalisations remains subdued.

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

Buy a new position in NextDC (NXT)

NextDC (NXT) operates 11 data centres including facilities in Sydney, Melbourne, Brisbane, Perth and Canberra.

It has been regarded as a beneficiary of the digitalisation trend accelerated by Covid. NXT delivered strong performance in 2020 during the initial downturn and into the policy-driven rebound.

Since November 2020 we have seen a rotation in equity markets away from growth companies and beneficiaries of lockdown (including technology stocks like NXT) towards value stocks and cyclicals. This has been driven by an outlook of economic recovery on the back of re-opening and vaccinations. NXT has pulled back from its highs since this point and has underperformed the market.

Growth stocks have outperformed for most of the last ten years. They were driven by a strong thematic tailwind of falling bond yields, which reflected a broad low-growth environment. This tailwind for growth has probably disappeared.

We believe it is important to retain growth exposure in the portfolio. But we differentiate between speculative and high-quality growth stocks. We believe the latter – with manageable debt and visibility of earnings – can continue to perform despite a less-supportive macro environment.

NXT fits this bill. It is a high-quality growth company, coupled with infrastructure-like characteristics.

Our research suggests NXT can deliver multiple years of compounding double-digit revenue and earnings growth.

This is underpinned by several factors.

First, NXT has a strong competitive position in a stable, rational and growing market. It has a well-established ecosystem and strong partnerships with customers such as Amazon, Google, IBM and Microsoft. This aids customer retention and helps attract new partners.

Second, it is aligned with the secular trend of greater creation and use of data. In particular, the appetite for companies to store data in off-premise centres with multiple tenants is growing. This is driven by issues around cyber-security, regulation and opportunities offered by networking across the cloud.

Third, Australia is particularly well positioned from a global geopolitical perspective for data centre development. This is reflected in favourable demand for increased capacity in Sydney, Melbourne and increasingly Perth. Sydney is the 15th biggest market for data centre capacity in the world and has the fourth largest pipeline of development.

NXT is doing a good job of capitalising on these beneficial trends.

FY20 was a record year for new contracts. We are mindful there can be some "lumpiness" in NXT's financial profile, with large wins followed by periods of digestion. But we are confident in the long-term growth profile, underpinned by demand for current demand for data centres and potentially augmented by a shift into overseas markets.

As a result we are confident in using the stock's recent pullback as an opportunity to establish a position.

We have funded this by trimming some of the portfolio's positions that have done well on the re-opening theme, including Nine (NEC) and Tabcorp (TAH).

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

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