Pendal Monthly Commentary

Pendal Sustainable Future 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

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 (31 as at 30 June 2021)
Sector limits	Cash 2-10%
Dividend Yield	3.47%[#]

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	7.84%
CBA	Commonwealth Bank of Australia Ltd	7.12%
WBC	Westpac Banking Corporation	7.11%
TLS	Telstra Corporation Limited	5.93%
FMG	Fortescue Metals Group Limited	5.56%
ANZ	ANZ Banking Group Limited	5.41%
MQG	Macquarie Group Limited	4.63%
XRO	Xero Limited	4.55%
NAB	National Australia Bank Limited	3.90%
GMG AE	Goodman Group	3.86%

Source: Pendal as at 30 June 2021

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Corporation Limited	3.82%
XRO	Xero Limited	3.77%
FMG	Fortescue Metals Group Limited	3.74%
NEC	Nine Entertainment Co Ltd	3.49%
QAN	Qantas Airways Limited	3.37%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Billiton Limited (not held)	-6.73%
WES	Wesfarmers Limited (not held)	-3.15%
WOW	Woolworths Group Limited (not held)	-2.27%
RIO	Rio Tinto Limited (not held)	-2.21%
APT	Afterpay Limited (not held)	-1.32%

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	Since Inception (p.a.)*
Pendal Sustainable Future Australian Shares Portfolio	0.86%	7.50%	11.59%	29.86%	12.56%
S&P/ASX 300 (TR) Index	2.25%	8.48%	12.98%	28.49%	10.26%
Active return	**-1.40%**	**-0.98%**	**-1.40%**	**1.36%**	**2.30%**

Source: Pendal as at 30 June 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
TLS	Telstra Corporation Limited	0.17%
COH	Cochlear Limited	0.17%
GMG AE	Goodman Group	0.15%
NCM	*Newcrest Mining Limited (not held)*	*0.14%*
HLS	Healius Limited	0.11%

Top 5 detractors - monthly

Code	Name	Value added
OZL	Oz Minerals Limited	-0.29%
APT	*Afterpay Limited (not held)*	*-0.26%*
EVN	Evolution Mining Limited	-0.17%
NEC	Nine Entertainment Co Ltd	-0.15%
NST	Northern Star Resources	-0.14%

Top 5 contributors - 1 year

Code	Name	Value added
NEC	Nine Entertainment Co Ltd	2.95%
FMG	Fortescue Metals Group Limited	2.16%
XRO	Xero Limited	0.97%
ANZ	ANZ Banking Group Limited	0.86%
A2M	*The A2 Milk Company Limited (not held)*	*0.80%*

Top 5 detractors - 1 year

Code	Name	Value added
ALX	Atlas Arteria	-1.26%
EVN	Evolution Mining Limited	-1.22%
CSL	CSL Limited	-0.92%
BHP	*BHP Billiton Limited (not held)*	*-0.87%*
NST	Northern Star Resources	-0.84%

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 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 the plan to unlock value is coming to fruition. Half the proceeds will be returned to shareholders, with the remainder to pay down debt.

Overweight Cochlear (COH, +10.9%)

COH continues to benefit from improving volumes in patient demand for implants. COH's product continues to be regarded as the best in the market and it is winning share from competitors. The company's strong operating momentum led to consensus earnings upgrades in June.

Overweight Goodman Group (GMG, +9.7%)

Goodman continues to benefit from strong demand for industrial property, driven in part by a trend to online shopping which is driving demand for logistics and industrial space. GMG gave an operational update for Q3 and reaffirmed estimated full-year operating profit of $1.2 billion.

Three largest detractors

Overweight Oz Minerals (OZL, -11.1%)

The Fed's shift in signalling saw a rotation away from inflation-linked plays, where the market had been concentrated. This includes copper miner such as OZL. We continue to see supportive fundamental demand and supply drivers for the copper price. Longer-term, the shift in focus to renewable energy and power sources is supportive for copper demand.

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 the 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.

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.

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.

NXT is regarded as a beneficiary of the trend to digitalisation which has been accelerated by Covid. It 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 – including technology stocks like NXT – towards value stocks and cyclicals. This has been driven by the 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, driven by the strong thematic tailwind of falling bond yields, which reflected a broad low-growth environment.

This tailwind for growth has probably disappeared. Nevertheless, we believe it is important to retain growth exposure in the portfolio.

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 some 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 data creation and use. 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 the opportunity 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 that 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 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 are mindful that data centres, while an integral component of the development of Australia's economy, are highly energy intensive. We are looking at NXT's approach to identifying, measuring and monitoring key issues and driving improvement. We regard NXT's approach to sustainability as demonstrable, credible and leading within its industry.

NXT is pursuing a number of policies and initiatives to drive continuous improvement in energy use. The company has aggressive targets for conversion to renewable energy sources. Its M1 data centre has a rooftop solar array and the company is assessing the potential for similar arrangements at other data centres. It is also looking at off-site renewable power generation.

For now the company remains reliant on the traditional grid but has a strong focus on energy efficiency. Its M1 and S1 data centres in Melbourne and Sydney are both rated as 5-star (out of a possible 6) by NABERS, the national rating system which measures the environmental performance of a building. They are the highest-rated data centres in the country. NXT also leads its industry in terms of Power Usage Effectiveness, an internationally accepted metric of energy use efficiency.

It is 100% carbon neutral at a corporate level and is rolling out a program to allow customers to offset emissions. It has policies in place to minimise contribution to landfill and maximise water use efficiency.

Carbon Footprint

The estimated weighted average carbon intensity (WACI) of the portfolio, using greenhouse gas emissions (scope 1 and 2[1]) 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 CO_2e / $M sales)

Pendal Sustainable Future Australian Share Portfolio	ASX 300	Relative to ASX300
123.09	175.19	-52.1

Source: Pendal, ISS as at 30 June 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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