Pendal Monthly Commentary

Pendal Australian Shares Portfolio

August 2021

Market commentary

The equity market continued to grind higher in August despite challenges posed by the spread of the Delta Covid variant.

Paradoxically we are in an environment where the constraint on growth from Delta supports markets, since it means policy remains easier for longer.

The S&P/ASX 300 gained 2.61% for the month. The S&P/ASX Small Ordinaries was up 4.98% and S&P/ASX 300 A-REIT index gained 6.38%.

Economic data confirmed Delta's impact on economic growth. Broadly speaking this encouraged a rotation away from cyclicals towards growth and some defensive stocks during the month.

Delta is driving greater near-term uncertainty about demand for some of the more cyclical stocks. It also supports the idea that monetary policy will remain loose, underpinning valuations for long-duration growth stocks.

Technology (+16.2%) led the market on the back of the rotation to growth. This was despite the fact that results in the sector were not as strong as the price action might imply. Wisetech (WTC, +57.0%) was the best-performing stock in the ASX 100 for the month.

Afterpay's (APT, +39.2%) result reflected the pressure of an increasingly competitive industry, though Square's takeover offer rendered this result moot. Until the deal completes APT trades as a geared play on Square's roll-out of alternative payment platforms rather than a pure buy-now-pay-later exposure. As a result there is probably less risk, although valuations are still rich.

We saw a recovery in some of the stocks hardest hit by the lockdown such as Qantas (QAN, +10.9%), Scentre Group (SCG, +12.6%) and Seek (SEK, +11.2%).

Here outlook statements helped the market to start dimensioning near-term risks. In several instances management was able to demonstrate that activity in 4Q FY21 – which was largely Covid-unaffected – was better than expected. This underpins confidence in the strength of a demand rebound when restrictions are rolled back. An accelerated vaccination rate in NSW also played a role.

The S&P/ASX 300 Resources index dropped 8.37%. This was driven in part by falling commodity prices and was exacerbated by BHP's proposal to collapse the company's dual listing. Operationally, results were generally fine in the sector.

On balance, reporting season was probably more positive than most expected. There was heightened uncertainty in the outlook given the impact of Delta, but confidence in the degree of underlying demand. Corporate confidence was also reflected in the large volume of M&A activity taking place. The degree to which ESG factors are driving changes in corporate strategy is also notable.

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 (31 as at 31 August 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	9.53%
CSL	CSL Limited	8.17%
WBC	Westpac Banking Corporation	6.65%
TLS	Telstra Corporation Limited	6.29%
CBA	Commonwealth Bank of Australia Ltd	6.26%
XRO	Xero Limited	5.04%
ANZ	ANZ Banking Group Limited	4.80%
QAN	Qantas Airways Limited	4.06%
ALL	Aristocrat Leisure Limited	3.47%
JHX	James Hardie Industries Plc	3.39%

Source: Pendal as at 31 August 2021

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
XRO	Xero Limited	4.20%
TLS	Telstra Corporation Limited	4.20%
QAN	Qantas Airways Limited	3.62%
BHP	BHP Billiton Limited	3.39%
MTS	Metcash Trading Limited	3.14%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-3.11%
WOW	Woolworths Group Limited (not held)	-2.42%
NAB	National Australia Bank Limited	-2.16%
RIO	Rio Tinto Limited (not held)	-1.90%
CBA	Commonwealth Bank of Australia Ltd	-1.86%

Source: Pendal as at 31 August 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	2.14%	3.40%	14.21%	31.80%	10.87%	12.33%	11.18%
S&P/ASX 300 (TR) Index	2.61%	6.08%	15.13%	28.58%	10.12%	11.05%	9.50%
Active return	**-0.47%**	**-2.68%**	**-0.92%**	**3.21%**	**0.75%**	**1.28%**	**1.68%**

Source: Pendal as at 31 August 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)*	*0.30%*
DOW	Downer EDI Limited	0.30%
QAN	Qantas Airways Limited	0.28%
JHX	James Hardie Industries Plc	0.28%
XRO	Xero Limited	0.22%

Top 5 detractors - monthly

Code	Name	Value Added
BHP	BHP Billiton Limited	-0.71%
APT	*Afterpay Limited (not held)*	*-0.39%*
STO	Santos Limited	-0.24%
WTC	*Wisetech Global Limited (not held)*	*-0.12%*
WOW	*Woolworths Group Limited (not held)*	*-0.12%*

Top 5 contributors - 1 year

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	1.21%
JHX	James Hardie Industries Plc	0.99%
XRO	Xero Limited	0.84%
NCM	*Newcrest Mining Limited (not held)*	*0.74%*
A2M	*The A2 Milk Company Limited (not held)*	*0.70%*

Top 5 detractors - 1 year

Code	Name	Value Added
EVN	Evolution Mining Limited	-1.60%
STO	Santos Limited	-0.81%
NAB	*National Australia Bank Limited*	*-0.70%*
ALX	Atlas Arteria	-0.64%
CBA	*Commonwealth Bank of Australia Ltd*	*-0.46%*

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

Stock-specific drivers of monthly performance relative to benchmark

Three largest contributors

Underweight Rio Tinto (RIO, -10.7%)

Iron ore prices slumped during the month, driven largely by concerns over the impact of Delta on global demand. Prices were expected to fall from previous highs, but this came through faster than most predicted. There are signs of recent stabilisation and iron ore miners are still generating strong cash flow. Operationally, results were solid in August. Our preference remains for Fortescue and BHP over Rio Tinto.

Overweight Downer (DOW, +25.5%)

Downer delivered a strong result that reflected the benefits of its strategic shift away from mining services to a less capital-intensive, urban services-focused model. Covid remains a drag on some of its hospitality-related contracts, but other parts of the business are showing strong momentum. Transport returned to strong growth following a weak previous half.

Overweight Qantas (QAN, +10.9%)

While travel restrictions continue to weigh on the near-term outlook for QAN, the market was reassured by the strength of the June quarter, which was largely unaffected by domestic restrictions. Management was able to demonstrate very strong results in that period and a material reduction in debt. This suggests a strong rebound in demand as restrictions roll off.

Three largest detractors

Overweight BHP (BHP, -14.7%).

While BHP delivered a strong operational result and dividend, broader weakness in iron ore prices and the proposal to collapse its dual listing dragged the stock down in August. The company is generating enormous free cash flow even at these lower iron ore prices and was on a near 10% dividend yield at the month's end. The market appears to have largely priced in the implied reduction in premium for the Australian listing that would come as a result of removing the London listing.

Underweight Afterpay (APT, +39.2%)

APT's result reflected the pressure of an increasingly competitive industry, though Square's takeover offer rendered this result moot. Until the deal completes APT trades as a geared play on Square's roll-out of alternative payment platforms rather than a pure buy-now-pay-later exposure. As a result there is probably less risk, although valuations are still rich.

Overweight Santos (STO, -5.0%)

STO's results were largely in line with consensus. It continued to display strong cost control and its dividend came in higher than expected with a 49% pay-out ratio. However concerns over global growth weighed on the oil price and the energy sector more broadly. A proposed tie up with Oil Search (OSH) makes strategic sense, delivering scale, some synergies and unlocking some of the discount in the OSH assets.

Market outlook

The portfolio finished behind the index in August. Several key positions delivered strong results and performance during reporting season. But this was offset by the drag from not owning Afterpay (APT) which came under takeover offer – and by the position in BHP. Softer iron ore prices weighed on the latter. This was exacerbated by a proposal to collapse the dual listing structure, creating a near-term overhang for the share price.

There were four key themes to highlight from reporting season:

1) **Rising fears of a slowing global economy**. This led to underperformance in the mining and energy sectors.
2) **Elevated merger and acquisition (M&A) activity**. This year has already broken through previous highs in terms of the dollar value of M&A activity with four months left to run. This reflects strong confidence in board rooms.
3) **Confidence in a demand rebound**. Management teams pointed to a better-than-expected June quarter (before restrictions were imposed) as evidence of strong underlying demand when the economy re-opens.
4) **ESG as a major factor in corporate strategy**. This was evident in BHP's (BHP) shift out of oil and gas; moves by Woodside (WPL) and Santos (STO) to create scale to de-risk and become more cash-generative; detail around Fortescue's (FMG) FFI project; and BlueScope (BSL) flagging the need to invest in decarbonisation.

This month is likely to see peak Covid case numbers in NSW based on vaccination trends. The key question is how restrictions are rolled back. Hospital bed capacity is a key factor in this decision, especially in states with lower per capita intensive care unit (ICU) capacity.

One key outcome of reporting season was the degree of confidence in underlying domestic demand once restrictions roll back. This was underpinned by the strong level of activity in the June quarter, which was largely unencumbered by domestic restrictions. As a result the market seemed prepared to look through near-term uncertainty about the specifics of the re-opening plan. This was supportive of some the portfolio's more Covid-sensitive stocks during reporting season.

Overseas there are signs the Delta wave in the US may be plateauing, though not yet rolling over. It is important to note empirical evidence that vaccines have waning efficacy in terms of preventing infection. But their ability to prevent severe consequences and alleviate pressure on hospital systems seems persistent.

The overseas Delta wave is having an impact on economic recovery, which is showing up in weaker-than-expected US data. In particular new job growth in the service sector has tailed off.

At this point an announcement on tapering in November – to commence in December – seems most likely. The Fed has signalled that Quantitative Easing (QE) tapering and rate rises are not linked. That is, that the latter does not necessarily follow the former immediately.

This has largely quashed fears about an early commencement of QE tapering. At the same time softer growth and recent hits to popularity have raised speculation of adjustments to US fiscal policy, to reduce the effect of the 2022 fiscal cliff. At this point, policy remains very supportive for equities.

New stocks added or stocks sold to zero during the month

Sell to zero in Tabcorp (TAH)

We are selling the position in wagering and lotteries company Tabcorp (TAH). It has done well for the portfolio since its addition in April 2020, making a material contribution to outperformance.

Movement restrictions and lockdowns had an effect on its retail wagering business. However we saw significant valuation upside based on the strength of its lotteries business, which has proved largely immune to the effects of Covid.

This value began to be realised in Q4 2020, when speculation around potential buyers for the wagering business emerged. This was followed by a bid from British gaming group Entain in early 2021. Indicative bids from Apollo Management and Betmakers and a revised bid from Entain saw further share price appreciation.

At this point the board has not recommended either bid to shareholders. Instead, management are working to demerge the wagering business to unlock further value in the lotteries segment. TAH cited uncertainty around whether a sale to either bidder would pass regulatory and industry hurdles as a key factor in this decision.

Disentangling the lotteries and wagering businesses will take time. It is a process that would also be required in the event of a sale.

At this point TAH has realised much of our expected upside. While a sale or demerger of the wagering business is likely to unlock further value, we expect it would take time to play out. In the interim we see better opportunities to put this capital to work. As a result we are selling and taking profits in TAH.

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