

Pendal Monthly Commentary

Pendal Australian Tax Effective Income Portfolio

August 2021

Market commentary

The equity market continued to grind higher in August despite 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 cyclical 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 its 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 Tax Effective 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.
Investment objective	The objective of the Model Portfolio is to outperform the S&P/ASX300 (TR) Index on a rolling 3 year period by 3% per annum, while delivering a higher gross yield than the market.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15-35 (27 as at 31 August 2021)
Sector limits	A-REITS 0-30%, Cash 2-10%
Dividend Yield	4.65% [#]

Top 10 holdings

Code	Name	Weight
BHP	BHP Billiton Limited	9.82%
CBA	Commonwealth Bank of Australia Ltd	7.84%
WBC	Westpac Banking Corporation	7.09%
TLS	Telstra Corporation Limited	7.08%
CSL	CSL Limited	7.08%
ANZ	ANZ Banking Group Limited	5.65%
MTS	Metcash Trading Limited	4.64%
NEC	Nine Entertainment Co Ltd	4.55%
NAB	National Australia Bank Limited	3.39%
QAN	Qantas Airways Limited	3.31%

Source: Pendal as at 31 August 2021

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Corporation Limited	4.99%
MTS	Metcash Trading Limited	4.45%
NEC	Nine Entertainment Co Ltd	4.37%
BHP	BHP Billiton Limited	3.67%
QAN	Qantas Airways Limited	2.87%

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%
TCL	Transurban Group (not held)	-1.78%
GMG	Goodman Group (not held)	-1.78%
APT	Afterpay Limited (not held)	-1.46%

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 (p.a.)	5 year (p.a.)	Since Inception (p.a.)*
Pendal Australian Tax Effective Income Portfolio	1.13%	2.50%	12.13%	31.38%	10.37%	11.31%	11.07%
S&P/ASX 300 (TR) Index	2.61%	6.08%	15.13%	28.58%	10.12%	11.05%	11.26%
Active return	-1.48%	-3.58%	-3.00%	2.80%	0.25%	0.26%	-0.20%

Source: Pendal as at 31 August 2021

*Since Inception - 14 September 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
DOW	Downer EDI Limited	0.24%
QAN	Qantas Airways Limited	0.22%
JHX	James Hardie Industries Plc	0.21%
AMC	Amcor Limited	0.17%
WES	Wesfarmers Limited (not held)	0.15%

Top 5 contributors - 1 year

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	1.66%
<i>NCM</i>	<i>Newcrest Mining Limited (not held)</i>	<i>0.74%</i>
MTS	Metcash Trading Limited	0.70%
<i>A2M</i>	<i>The A2 Milk Company Limited (not held)</i>	<i>0.69%</i>
JHX	James Hardie Industries Plc	0.64%

Source: Pendal as at 31 August 2021

Underweight positions are in italics.

Top 5 detractors - monthly

Code	Name	Value Added
BHP	BHP Billiton Limited	-0.75%
<i>APT</i>	<i>Afterpay Limited (not held)</i>	<i>-0.39%</i>
FMG	Fortescue Metals Group Limited	-0.25%
NEC	Nine Entertainment Co Ltd	-0.17%
STO	Santos Limited	-0.16%

Top 5 detractors - 1 year

Code	Name	Value Added
EVN	Evolution Mining Limited	-1.30%
JBH	JB Hi-Fi Limited	-0.82%
STO	Santos Limited	-0.46%
ALX	Atlas Arteria	-0.42%
MND	Monadelphous Group Limited	-0.41%

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

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.

Overweight James Hardie (JHX, +16.0%)

JHX benefited from robust volume performance in US housing. This was realised in JHX's 1Q22 results with better-than-expected earnings and an upgrade of FY22 earnings guidance. This has been driven by a strong outlook for the US renovation and repair market, underpinned by low rates, increased demand from post-pandemic driven work-from-home preferences and an undersupply of new homes.

Three largest detractors:

Overweight BHP (BHP, -14.7%).

BHP delivered a strong operational result and dividend, but broader weakness in iron ore prices and the proposal to collapse its dual listing dragged the stock down in August. BHP is generating enormous free cash flow even at these lower iron ore prices and was on a near 10% dividend yield at month's end. The market appears to have largely priced in the implied reduction in premium for the Australian listing that would come from 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 Fortescue Metals (FMG, -15.7%)

Fortescue delivered a strong operational result and is generating enormous cash flow, funding material returns to shareholders. However iron ore prices slumped, driven largely by Delta concerns. Prices were expected to fall from previous highs, but this has come through faster than most predicted. FMG provided more detail on its FFI investment, which is focused on the decarbonisation of operations. There is yet to be any detail on potential returns.

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 and/or stocks sold to zero during the month

No new stocks added or sold to zero during the month.

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

PENDAL

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