PENDAL

Pendal Monthly Commentary

Pendal Sustainable Future 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

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 (30 as at 31 August 2021)
Sector limits	Cash 2-10%
Dividend Yield	3.46%#

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	8.86%
CBA	Commonwealth Bank of Australia Ltd	6.86%
WBC	Westpac Banking Corporation	6.84%
TLS	Telstra Corporation Limited	6.24%
XRO	Xero Limited	5.31%
FMG	Fortescue Metals Group Limited	4.81%
MQG	Macquarie Group Limited	4.74%
NAB	National Australia Bank Limited	4.56%
GMG	Goodman Group	4.06%
QAN	Qantas Airways Limited	3.98%

Source: Pendal as at 31 August 2021

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
XRO	Xero Limited	4.47%
TLS	Telstra Corporation Limited	4.16%
QAN	Qantas Airways Limited	3.54%
FMG	Fortescue Metals Group Limited	3.22%
DOW	Downer EDI Limited	3.08%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Billiton Limited (not held)	-6.14%
WES	Wesfarmers Limited (not held)	-3.11%
WOW	Woolworths Group Limited (not held)	-2.42%
RIO	Rio Tinto Limited (not held)	-1.90%
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 years (p.a)	Since Inception (p.a.)*
Pendal Sustainable Future Australian Shares Portfolio	3.01%	4.86%	16.20%	29.16%	12.21%	13.22%
S&P/ASX 300 (TR) Index	2.61%	6.08%	15.13%	28.58%	10.12%	10.96%
Active return	**0.41%**	**-1.22%**	**1.07%**	**0.58%**	**2.09%**	**2.26%**

Source: Pendal as at 31 August 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
BHP	*BHP Billiton Limited (not held)*	*1.28%*
DOW	Downer EDI Limited	0.56%
RIO	*Rio Tinto Limited (not held)*	*0.30%*
QAN	Qantas Airways Limited	0.27%
XRO	Xero Limited	0.24%

Top 5 detractors - monthly

Code	Name	Value Added
FMG	Fortescue Metals Group Limited	-0.73%
APT	*Afterpay Limited (not held)*	*-0.39%*
ORA	Orora Limited	-0.19%
COH	Cochlear Limited	-0.15%
JHX	*James Hardie Industries Plc (not held)*	*-0.13%*

Top 5 contributors - 1 year

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	1.81%
ANZ	ANZ Banking Group Limited	0.92%
XRO	Xero Limited	0.90%
BSL	Bluescope Steel Limited	0.76%
NCM	*Newcrest Mining Limited (not held)*	*0.74%*

Top 5 detractors - 1 year

Code	Name	Value Added
EVN	Evolution Mining Limited	-1.28%
ALX	*Atlas Arteria (not held)*	*-1.07%*
JBH	JB Hi-Fi Limited	-1.04%
CGC	Costa Group Holdings Limited	-0.74%
CSL	CSL Limited	-0.72%

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 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 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. BHP is excluded from the portfolio due to its fossil fuel exposure.

Overweight Downer (DOW, +25.5%)

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

Underweight Rio Tinto (RIO, -10.7%)

Iron ore prices slumped during the month, driven in large part by concerns over the impact of Delta on global demand. While prices were expected to fall from previous highs, this has come through faster than most predicted. There are signs of recent stabilisation and iron ore miners are still generating strong cash flow. Operationally, results were all solid in August. Our preference remains for Fortescue in the iron ore sector.

Three largest detractors

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 during the month, driven largely by concerns about the impact of Delta on global demand. While prices were expected to fall from previous highs, this has come through faster than most predicted. There are signs of recent stabilisation. FMG provided more detail on its FFI investment, which is focused on the decarbonisation of operations. But there is still yet to be any detail on potential returns.

Underweight Afterpay (APT, +39.2%)

APT's result reflected the pressure of an increasingly competitive industry, but 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 Orora (ORA, -5.3%)

ORA delivered a decent set of results which reflected a rebound in US activity over the past six months. The Delta wave introduces some near-term risk, but management have demonstrated their ability to handle the disruption. ORA gave back some of its recent gains after the result. We still see it as attractive value at these levels.

Market outlook

The portfolio outperformed in August. It benefited from the rotation to growth via positions in Xero (XRO) and CSL (CSL). Some of the idiosyncratic opportunities such as Downer (DOW) and Telstra (TLS) also delivered well.

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 Atlas Arteria (ALX) to zero

The portfolio has sold out of its remaining position in toll road operator Atlas Arteria.

While we still see some valuation upside, this has diminished on adverse developments in France and the US.

In France, the government walked away from previous infrastructure plans that opened the door to investment opportunities and concession extensions for ALX. In the US, regulatory actions meant toll increases have been lower than expected.

There is the potential for a positive catalyst in the US if a shift in the Virginian political environment opens the way for a more benign regulatory environment. But this will be uncertain until the outcome of state elections later in the year. In the near term, the rise of the Delta variant poses uncertainty over traffic volumes in France.

The portfolio's infrastructure exposure is now focused on NextDC (NXT). This is a less traditional infrastructure play, but provides some of the same defensive characteristics for the portfolio. The outlook for NXT is underpinned by growth in demand for data centres and Australia's geographical advantages. NXT enjoys a strong competitive position in the sector.

Carbon performance

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 metrics 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.

Weighted Average Carbon Intensity (tonnes CO_2e / $M revenue)

Pendal Sustainable Future Australian Share Portfolio	ASX 300	Relative to ASX300
123.43	184.68	-61.25

Source: Pendal, ISS as at 31 August 2021, Currency: AUD

[1] Scope 1 emissions result from sources directly owned or controlled by the company. Scope 2 accounts for 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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