Pendal Monthly Commentary

Pendal Australian Tax Effective Income Portfolio

March 2022

Market commentary

The S&P/ASX 300 gained 6.9% in March to end up 2.1% for the quarter and calendar year to date.

Australia is proving more resilient than overseas equity markets. This is due to a combination of a softer inflationary pulse and less need to tighten rates as well as self-sufficiency in many commodities and a higher proportionate weighting of resource companies and financials in the market than most other developed markets.

March saw ongoing conflict in the Ukraine. The situation remains unpredictable and continues to drive various second-order effects.

The key short-term issue is an exacerbation of existing supply chain issues and already tight markets in commodities. Natural gas prices rose 28% for the month, coking coal 28% and Brent crude 7%. Most metals and food prices also rose.

The US Fed hiked rates 25bps in March, accompanied by stern rhetoric from Chair Powell around the commitment to halt inflation. This prompted a view that the Fed can slow inflation without triggering a recession and saw a rally in US equities and a rebound in some growth names.

This translated to a rebound in Information technology (+11.8%), which was the best performing sector, led by Block (SQ2, +19.3%).

Commodity price strength also saw outperformance among Energy names (+10.1%) and among the miners in the Materials sector (+10.1%).

Banks (+10.0%) were also strong, as the prospect of higher bond yields is seen as supportive or margins, although there is still a question about the degree to which this tailwind is competed away.

Nevertheless, the combination of strength in banks and miners, the two largest segments of the Australian index, was enough to drive outperformance versus international equity markets.

Real Estate (+1.7%) was the worst-performing sector and Health care (+2.5%) also lagged, while still making gains.

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, while delivering a higher gross yield than the market.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15-35 (28 as at 31 March 2022)
Sector limits	A-REITS 0-30%, Cash 2-10%
Dividend Yield	4.36%[#]

Top 10 holdings

Code	Name	Weight
BHP	BHP Billiton Limited	12.20%
CBA	Commonwealth Bank of Australia Ltd	6.88%
TLS	Telstra Corporation Limited	6.41%
CSL	CSL Limited	6.36%
WBC	Westpac Banking Corporation	6.35%
NAB	National Australia Bank Limited	5.12%
MTS	Metcash Trading Limited	4.92%
ANZ	ANZ Banking Group Limited	4.77%
NEC	Nine Entertainment Co Ltd	4.72%
MQG	Macquarie Group Limited	3.61%

Source: Pendal as at 31 March 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
MTS	Metcash Trading Limited	4.73%
NEC	Nine Entertainment Co Ltd	4.53%
TLS	Telstra Corporation Limited	4.38%
QAN	Qantas Airways Limited	2.80%
WBC	Westpac Banking Corporation	2.65%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-2.49%
WOW	Woolworths Group Limited (not held)	-1.97%
RIO	Rio Tinto Limited (not held)	-1.92%
TCL	Transurban Group (not held)	-1.81%
GMG	Goodman Group (not held)	-1.69%

Source: Pendal as at 31 March 2022

[#]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	6.13%	3.99%	6.49%	14.28%	12.38%	9.90%	10.84%
S&P/ASX 300 (TR) Index	6.90%	2.08%	4.34%	15.21%	10.84%	9.38%	10.61%
Active return	**-0.77%**	**1.91%**	**2.15%**	**-0.93%**	**1.54%**	**0.52%**	**0.23%**

Source: Pendal as at 31 March 2022

*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
MTS	Metcash Trading Limited	0.15%
NEC	Nine Entertainment Co Ltd	0.10%
GMG	*Goodman Group (not held)*	*0.07%*
FMG	Fortescue Metals Group Limited	0.07%
IAG	*Insurance Group Australia (not held)*	*0.06%*

Top 5 detractors - monthly

Code	Name	Value Added
JHX	James Hardie Industries Plc	-0.25%
TLS	Telstra Corporation Limited	-0.22%
QBE	QBE Insurance Group Limited	-0.12%
QAN	Qantas Airways Limited	-0.12%
VEA	Viva Energy Group limited	-0.12%

Top 5 contributors - 1 year

Code	Name	Value Added
SQ2	*Block Inc Cdi Def (not held)*	*0.63%*
MTS	Metcash Trading Limited	0.62%
BHP	BHP Billiton Limited	0.50%
WES	*Wesfarmers Limited (not held)*	*0.36%*
TLS	Telstra Corporation Limited	0.33%

Top 5 detractors - 1 year

Code	Name	Value Added
JBH	*JB Hi-Fi Limited (not held)*	*-0.45%*
XRO	Xero Limited	-0.44%
RIO	*Rio Tinto Limited (not held)*	*-0.44%*
QAN	Qantas Airways Limited	-0.40%
ANZ	ANZ Banking Group Limited	-0.34%

Source: Pendal as at 31 March 2022

Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Metcash (MTS, +10.2%)

MTS confirmed the appointment of a new CEO in March. The company is a beneficiary of inflation via its wholesale food business, which is able to pass through inflation off a relatively stable fixed cost base. It's most recent update demonstrated a more balanced business model as well, with supermarkets now roughly half the earnings after the shift into hardware.

Overweight Nine Entertainment (NEC, +4.7%)

Nine continued to strengthen following a well received result in February which saw ~14% upgrades to FY22 net profit after tax (NPAT) and ~7% upgrades for FY23. All elements of the business are doing better than expected. Broadcast revenue is higher now than pre-Covid. The outlook for Stan looks more assured with subscriptions and average revenue per user growing. Valuation remains attractive.

Underweight Goodman Group (GMG, +3.0%)

Goodman's valuation multiple has de-rated over the year to date along with other longer-duration growth stocks. We have alternative real estate exposure in the portfolio - specifically to retail mall developer and operator Scentre Group, where we see more upside on the back of a recovery in leasing spreads and foot traffic.

Three largest detractors:

Overweight James Hardie (JHX, -9.1%)

Higher US mortgage rates have weighed on sentiment around housing-related companies such as JHX. Thus far, the company is not seeing any impact on demand. It is benefiting from the structural under-build in US housing that took place post-GFC which support favourable supply/demand dynamics.

Overweight Telstra (TLS, +2.0%)

Telstra made gains but underperformed other parts of the market as growth stocks bounced and inflation-beneficiaries outperformed. Its recent update confirmed that supportive trends in the profitability of its mobile phone segment remain in place. It is also benefiting from cost reduction. We expect these trends to continue despite the change in CEO.

Overweight QBE Insurance (QBE, +2.0%)

QBE also made gains, but lagged a market. The stock had fallen in response to a result which highlighted higher peril claims, higher costs, and claims inflation concerns which translated to a lower margin outlook for CY22 than the market was expecting. However over the stocks recovered over the course of the month, at least partly on the view that management were being very conservative in their outlook. Underlying performance is solid and the path to improved returns in on track. We remain positive stock on sub 12x PE with rate cycle in front of it.

Market outlook

There are several potential reasons for the ongoing recovery in equities. These include:

- Sentiment and positioning being too negative, leading to a technical bounce.
- A poor outlook for bonds, driving rotation to equities.
- Equity inflows remaining positive despite softer investor sentiment indicators.
- Economic growth supporting earnings, underpinning a view that the market can de-rate without a larger correction.
- A belief that the pre-requisites for economic slowdown are being put in place and that rates will not need to rise as far as Fed saying

We remain wary in the near term. The Fed needs financial conditions to tighten – and rising equities works against this objective.

Instead, we see three more likely possible scenarios than a continued strong equity market rebound.

1. The market consolidates and treads water for a few months as we gauge central bank ability to contain inflation. This would be consistent with the history of US bull markets, which shows that the third year is often lacklustre, particularly if the first two are very strong.
2. The market falls back to set new lows, reflecting falling liquidity, concerns over slower growth dragging on earnings and a lack of certainty. Slower economic growth eases inflationary pressure, allowing interest rates to peak at levels the market or Fed are currently expecting, without triggering a recession. This then enables a market recovery. In this vein, Fed Chair Powell noted that there had been similar “soft landings” in US monetary history in 1967, 1984, 1994 and 1998. Each involved the yield curve going flat, with the Fed funds rate subsequently getting cut.
3. The same as scenario 2, except we end up in recession due to policy error or as the only way inflation can be contained. History indicates that when you see oil rise more than 100% year-on-year it triggers a recession. So too does persistent inflation at current levels.

Australia is better placed than many other countries. There is less need to raise rates, allowing them to remain lower for longer. The economy is benefiting from pent-up demand as restrictions roll back. The country is larger self-sufficient in key commodities and is a beneficiary of rising prices here.

This underpins our relatively positive view of the domestic equity market. This is reinforced by the degree to which the Australian market has underperformed the S&P 500 since the GFC. While recent outperformance has been material, it is a blip on a longer-term view, which gives us confidence in the potential for further outperformance.

The portfolio underperformed in March. The cyclical recovery linked plays such as Qantas and Viva Energy underperformed; we retain strong conviction in the upside here. The underweight in banks, in Block – the largest tech stock in the index – and in lithium miners also dragged.

We remain of the view that the macroeconomic and geopolitical environment remains highly uncertain and that the shift in US monetary policy means that the market is likely to be less thematically –driven than in recent years. This places greater importance on a portfolio which is focused on managing macro risk and owns companies with visibility on earnings and the ability to deliver cash flows. This plays to the strengths of our approach.

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**