

Pendal Monthly Commentary

Pendal Australian Shares Portfolio

May 2022

Market commentary

Equity markets endured a volatile month as people grappled with the interplay between inflation, a hawkish Fed and the potential risk of a US recession.

China was also forefront of mind. Adherence to Covid zero policy continues to weigh on economic momentum and we saw GDP growth expectations generally reined in. Beijing announced several policy initiatives during the month to help support growth. However there is debate over the degree to which it will bolster the economic outlook.

The S&P/ASX 300 fell -2.76% in May. There was a degree of catching-up to other markets, with Australia underperforming other major developed equity markets. That said, Australian equities remain well ahead of the US and European equities over the calendar year to date.

Value stocks continued to outperform growth, broadly speaking, as the Fed maintained a hawkish line on the pace of monetary policy and the desire to return rates to a "neutral" setting as quickly as possible.

This was reflected in sector performance.

Materials did best, as the most of the miners managed gains despite uncertainty around Chinese demand and softer iron ore (-4.2%) and copper (-3.3%) prices. Heavyweights BHP (BHP, +4.3%), Rio Tinto (RIO, +1.4%) and South32 (S32, +4.8%) all rose, with only specialised iron ore producer Fortescue Metals (FMG, -7.0%) bucking this trend. Defensive exposures such as Amcor (AMC, +9.5%) also tended to outperform within the sector.

Energy also outperformed on the back of strong gains in thermal coal (+30.7%), Brent crude oil (+12.3%) and natural gas (+23.8%). Woodside Energy (WDS, -4.5%), rechristened following the merger with BHP's oil and gas assets, ended the month down. However this was offset by Santos (STO, +2.5%), coal miner Whitehaven (WHC, +7.3%) and several of the smaller oil and gas plays.

Technology was hardest hit on softer trends in tech in the US and hawkish monetary policy. Computershare (CPU, -8.4%) - now the largest tech stock in the index - was off despite being a beneficiary of rising interest rates. Elsewhere Block (SQ2, -13.2%), Xero (XRO, -7.3%) and Wisetech (TWC, -7.0%) were also weak.

Real Estate also underperformed. Heavyweight industrial property name Goodman (GMG, -14.3%) fell in response to indications that demand from Amazon - a key client for logistical property - may be moderating. However weakness was broad-based, with Scentre (SCG, -4.0%) and Dexs (DXS, -6.2%) also off.

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 (33 as at 31 May 2022)
Sector limits	A-REITS 0-30% Cash 2-10%
Dividend Yield	4.29% [#]
Income target	No target

Top 10 holdings

Code	Name	Weight
BHP	BHP Billiton Limited	12.25%
CSL	CSL Limited	7.80%
STO	Santos Limited	6.53%
TLS	Telstra Corporation Limited	6.31%
CBA	Commonwealth Bank of Australia Ltd	6.06%
WBC	Westpac Banking Corporation	5.29%
QAN	Qantas Airways Limited	4.62%
NAB	National Australia Bank Limited	3.99%
XRO	Xero Limited	3.54%
MTS	Metcash Trading Limited	2.90%

Source: Pendal as at 31 May 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
STO	Santos Limited	5.39%
TLS	Telstra Corporation Limited	4.25%
QAN	Qantas Airways Limited	4.15%
XRO	Xero Limited	3.01%
MTS	Metcash Trading Limited	2.71%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-2.43%
ANZ	ANZ Banking Group Limited (not held)	-2.10%
CBA	Commonwealth Bank of Australia Ltd	-2.02%
TCL	Transurban Group (not held)	-2.00%
RIO	Rio Tinto Limited (not held)	-1.93%

Source: Pendal as at 31 May 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 Shares Portfolio	-1.50%	3.01%	2.87%	4.15%	9.95%	10.55%	10.04%
S&P/ASX 300 (TR) Index	-2.76%	3.08%	1.05%	4.71%	8.00%	8.97%	8.24%
Active return	1.26%	-0.07%	1.82%	-0.56%	1.95%	1.58%	1.80%

Source: Pendal as at 31 May 2022

*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
STO	Santos Limited	0.27%
<i>WOW</i>	<i>Woolworths Group Limited (not held)</i>	<i>0.15%</i>
BHP	BHP Billiton Limited	0.13%
DOW	Downer EDI Limited	0.10%
S32	South32 Limited	0.10%

Top 5 contributors - 1 year

Code	Name	Value Added
S32	South32 Limited	1.02%
STO	Santos Limited	0.88%
MTS	Metcash Trading Limited	0.71%
<i>SQ2</i>	<i>Block Inc Cdi Def (not held)</i>	<i>0.63%</i>
BHP	BHP Billiton Limited	0.55%

Source: Pendal as at 31 May 2022

Underweight positions are in italics.

Top 5 detractors - monthly

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	-0.40%
MTS	Metcash Trading Limited	-0.20%
JHX	James Hardie Industries Plc	-0.20%
XRO	Xero Limited	-0.15%
<i>RIO</i>	<i>Rio Tinto Limited (not held)</i>	<i>-0.08%</i>

Top 5 detractors - 1 year

Code	Name	Value Added
XRO	Xero Limited	-1.63%
NEC	Nine Entertainment Co Ltd	-0.79%
<i>FMG</i>	<i>Fortescue Metals Group Ltd (not held)</i>	<i>-0.64%</i>
EVN	Evolution Mining Limited	-0.53%
JHX	James Hardie Industries Plc	-0.50%

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Santos (STO, +2.5%)

Stronger oil and gas prices continued to support Santos (STO). Its joint venture with State Gas was also named as the preferred tenderer for two new gas exploration areas in Queensland. The sites are adjacent to existing Santos assets and it would be the operator under the proposal. Santos remains our preferred energy exposure, with disciplined cost control and an attractive pipeline of development opportunities.

Underweight Woolworths (WOW, -10.0%)

Disappointing updates from US broad-line retailers such as Walmart and Target weighed on Australian retailers. In the US, increased freight costs are putting pressure on margins at the same time that there is a mix shift in consumption from goods to services. There are also signs of consumers "trading down" to lower-margin private label goods due to pressure on income. This is seen as a potential risk for Australia and weighed on Woolworths (WOW), among others.

Overweight BHP (BHP, +4.3%)

Beijing announced several policy initiatives to try and underpin economic growth in the face of the challenge from lockdowns and the Covid zero approach. While the efficacy may be debateable, signs of an effort to stimulate growth provided some relief to the mining sector. Woodside's shareholders also approved merger with BHP's oil and gas portfolio into the newly christened Woodside Energy (WDS). BHP still retains a fossil fuel exposure via coking coal.

Three largest detractors

Overweight Nine Entertainment (NEC, -18.2%)

Nine reiterated their FY guidance during the month and we still see some room for upgrade. The company sees no signs of advertising demand slowing at this point and viewership ratings remain strong for the free-to-air division. However the market seems to be bracketing this in the consumer discretionary camp as it sold off on broader concerns over the cycle. The stock looks cheap, particularly when the value of the stake in Domain is backed out.

Overweight Metcash (MTS, -10.0%)

Broader weakness around consumer staples dragged on Metcash. This, in turn, reflects the headwinds being felt by US retailers such as Target and Walmart. We see MTS as relatively defensive in an Australian context, with the added element of strong pricing power.

Overweight James Hardie (JHX, -12.1%)

James Hardie delivered a decent FY22 result during the month and reaffirmed FY23 guidance despite the headwinds facing the US housing market. While US new home sales were down 26% year-on-year in May, JHX has a two year backlog of orders, underpinning expected volumes. JHX also has material exposure to the repair and remodelling market, which is not tied to mortgage rates.

Outlook

The portfolio outperformed in May. Its commodity exposures did well, including Santos (STO), South32 (S32) and BHP (BHP). Downer (DOW) also had a good month.

We believe we are in something of a holding pattern for now. Rate expectations have shifted materially. Whether they will moderate or go higher still will be determined by the economy over the next three months. It's just too early to call.

Looking in turn at the "book-end" scenarios of a soft-landing or a recession:

1) The path to a soft landing.

- Building inventories mean consumer price rises ease off.
- Chinese re-opening eases product supply, also helping inflation.
- Wages ease as a lack of stimulus means companies no longer need to pay up to induce workers to return. Companies begin to stop hiring and even lay off workers. Tesla and Amazon's recent comments are pertinent in this regard.
- Commodity prices stop rising.
- As a result, the Fed do not need to go harder than what is already priced in the forward curve

2) The path to recession.

- Inflation remains resilient as the economy doesn't slow sufficiently.
- Companies continue to catch up to the cost impost they are wearing.
- Housing costs keep rising.
- The labour market stays tight as service jobs continue to recover, workers seek compensation for higher prices and so wage growth doesn't slow.
- Supply shortages combined with the return of China continue to underpin higher commodity prices.
- This leads to the Fed being forced to remain hawkish and trigger a recession.

The path should become more apparent in coming months. The issue for markets remains that central bankers will want to be seen to be hawkish until it is clear inflation is beaten, which will not help sentiment.

The risk-reward at this point favours caution, as the Fed still cannot afford for financial conditions to loosen - which would be the case if equities rallied too far.

The key caveat is that Australian equities remain well placed in this environment and continue to hold up better than global equities.

This is a challenging environment for portfolio construction, however we believe it plays to the strength of our approach.

Our strategy is underpinned by:

- Identifying mis-priced stocks by "anticipating change."
- Building a portfolio that manages thematic risk and is primarily dependent on stock-specific alpha - rather than a particular macro pathway or outcome - to perform.

Both elements can be seen in the way we approach portfolio construction in this environment. We have a range of thematic exposures, such that performance is not dependent on a particular outcome or pathway in terms of the key macroeconomic uncertainties currently at play.

Within this framework, we are finding stocks which have a company-specific aspect which can support valuation and/or drive outperformance. A key element of this at the moment is an emphasis on pricing power and of cash flow that has resilience even if we do see economic momentum start to slow.

New stocks added and/or stocks sold to zero during the month

Sell to zero in Tabcorp (TAH), retain new stock in The Lottery Corporation (TLC).

Tabcorp's management have delivered the previously-flagged separation of the company's lotteries business from its wagering, media and gaming business. Lotteries and Keno have been demerged into a new listed entity, The Lottery Corporation (TLC).

We have elected to retain the portfolio's holding in TLC, received as part of this transaction, and sell the position in TAH. We have a strong preference for the competitive position and growth outlook for the lotteries business over the more challenged wagering division retained by TAH.

TLC owns long-dated lottery concessions in Australia, with major licences not expiring until 2050 and 2072. It enjoys strong scale benefits and barriers to entry from owning all major Australian lottery and instant scratch licenses.

The demerged company offers characteristics similar to infrastructure stocks; a relatively defensive revenue stream and low capital intensity which leads to higher degree of visibility on earnings and cash flow. This is likely to be appealing to many investors in the current macro environment. The stock is also trading on an attractive valuation relative to other infrastructure companies with these attributes.

The demerger will allow management to focus on growth, where they have a strong track record in growing market share through product innovation. In this vein there are opportunities to drive structural margin expansion via increased penetration in the digital space, which offers lower fixed costs and higher margins.

All this underpins an attractive earnings outlook and the potential for a valuation re-rating.

We also consider lotteries to be the most socially responsible form of gambling, due to high tax return to Government and relatively low incidence of problem gambling.

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

PENDAL

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