Pendal Monthly Commentary

Pendal Australian Specialised Retirement Income 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 ad 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 Dexus (DXS, -6.2%) also off.

Portfolio overview

Australian Specialised Retirement Income 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. **Higher turnover:** Takes advantage of lack of tax implications to pursue shorter-term opportunities
Investment objective	The objective of the Model Portfolio is to outperform the S&P/ASX 300 (TR) Index on a rolling 3 year period.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15-35 (29 as at 31 May 2022)
Sector limits	A-REITS 0-30%, Cash 2-10%
Dividend Yield	4.78%#

Top 10 holdings

Code	Name	Weight
BHP	BHP Billiton Limited	12.51%
CSL	CSL Limited	8.01%
CBA	Commonwealth Bank of Australia Ltd	6.72%
TLS	Telstra Corporation Limited	6.37%
WBC	Westpac Banking Corporation	6.22%
NAB	National Australia Bank Limited	6.09%
STO	Santos Limited	4.62%
S32	South32 Limited	3.96%
MTS	Metcash Trading Limited	3.77%
QAN	Qantas Airways Limited	3.42%

Source: Pendal as at 31 May 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Corporation Limited	4.30%
MTS	Metcash Trading Limited	3.58%
STO	Santos Limited	3.49%
QAN	Qantas Airways Limited	2.94%
S32	South32 Limited	2.91%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-2.43%
TCL	Transurban Group (not held)	-2.00%
RIO	Rio Tinto Limited (not held)	-1.93%
WOW	Woolworths Group Limited (not held)	-1.90%
GMG AE	Goodman Group (not held)	-1.58%

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 Specialised Retirement Income Portfolio	-1.52%	3.63%	4.32%	4.24%	9.50%	9.68%	9.55%
S&P/ASX 300 (TR) Index	-2.76%	3.08%	1.05%	4.71%	8.00%	8.97%	8.86%
Active return	**1.23%**	**0.55%**	**3.28%**	**-0.48%**	**1.50%**	**0.70%**	**0.69%**

Source: Pendal as at 31 May 2022

*Since Inception - 20 August 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
GMG	*Goodman Group (not held)*	*0.21%*
S32	South32 Limited	0.21%
WBC	Westpac Banking Corporation	0.16%
WOW	*Woolworths Group Limited (not held)*	*0.15%*
STO	Santos Limited	0.15%

Top 5 detractors - monthly

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	-0.50%
MTS	Metcash Trading Limited	-0.31%
JHX	James Hardie Industries Plc	-0.18%
RIO	*Rio Tinto Limited (not held)*	*-0.08%*
CBA	*Commonwealth Bank of Australia Ltd*	*-0.07%*

Top 5 contributors - 1 year

Code	Name	Value Added
MTS	Metcash Trading Limited	0.96%
S32	South32 Limited	0.80%
SQ2	*Block Inc Cdi Def (not held)*	*0.63%*
BHP	BHP Billiton Limited	0.53%
VEA	Viva Energy Group limited	0.48%

Top 5 detractors - 1 year

Code	Name	Value Added
NEC	Nine Entertainment Co Ltd	-1.01%
EVN	Evolution Mining Limited	-0.73%
XRO	Xero Limited	-0.68%
DHG	Domain Holdings Aust Ltd	-0.48%
WBC	Westpac Banking Corporation	-0.46%

Source: Pendal as at 31 May 2022

Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

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 South32 (S32, +4.8%)
Diversified miner S32 delivered a well-received update which confirmed decent operational momentum. There were also updates on development opportunities in the US, with the Hermosa Taylor zine-lead-silver project entering a feasibility study. There is also the possibility that the Hermosa-Clark manganese project being fast-tracked, given the alignment with US strategic supply chain priorities.

Overweight Westpac (WBC, +2.6%)
Westpac's results were better than many feared with pre-provision operating profit beating consensus expectations by ~5%. This was driven largely by improvements on costs. Management gave little in terms of the specific benefit from higher rates on margins, however margins at the end of the period were better than the market had been forecasting.

Three largest detractors:

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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.

Market 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

Add new position in Orora (ORA).

ORA manufactures glass bottles and cans for beverages in Australia and distributes a range of packaging formats in the US. Around three quarters of revenue derives from the US, while the bulk of the remainder comes from Australia.

ORA is fundamentally a relatively defensive industrial, given it operates in packaging. Most importantly in the current inflationary environment, it is demonstrating the ability to pass on increases in input costs, thereby defending margins.

Many of ORA's US customers were hit hard by Covid and it is benefiting from the rebound in demand. Its material exposure to food and beverage service means it is also aligned with the mix shift in demand from goods to services. Recent updates have confirmed it is beating expectations on revenue. The bottom line is also benefiting from a material degree of fixed cost taken out during Covid. The company is also focused on "value over volume" in the US, shifting away from or repricing less profitable customers which has further scope to improve margins.

Its Australian business has been affected by the Chinese ban on wine exports, which reduced bottle demand for its customers in the wine industry. Management have identified several opportunities to replace volumes lost in the wine industry with other businesses in Australia. In particular, they are targeting customers who are using more expensive, imported bottles where ORA can offer a very competitive proposition. This is lower margin, however helps fill the gap in earnings. Recent updates suggest that this is coming through, allowing Australian earnings to remain flat. There is also additional opportunities for growth in aluminium cans. Strong demand for cans, driven by changing customer preferences, has led to ORA announcing the construction of two new canning lines, underpinned by customer contracts. Tight supply and demand also reduces competitive risk, providing a good environment for long-term contract renewals with customers.

ORA has a strong balance sheet and generates a very attractive cash flow yield. The company is on reasonable valuation given a supportive macro backdrop. It is still well below its historical P/E relative to Industrials.

On the sustainability front, ORA is participating in and growing the circular economy. It is a major player in the conversion and reuse of recycled glass in Australia and has been expanding its scope in this regard. It is also demonstrating progress towards environmental targets with regard to renewable energy usage, waste to landfill reduction and water efficiency.

As a result, we are seeing a good opportunity to add a high quality defensive industrial with good pricing power and decent sustainability credentials to the portfolio.

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**

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