

Pendal Monthly Commentary

Pendal Sustainable Future 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

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 (29 as at 31 May 2022)
Sector limits	Cash 2-10%
Dividend Yield	3.59% [#]

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	10.03%
CBA	Commonwealth Bank of Australia Ltd	7.92%
NAB	National Australia Bank Limited	7.47%
TLS	Telstra Corporation Limited	6.46%
MQG	Macquarie Group Limited	4.81%
QAN	Qantas Airways Limited	4.81%
WBC	Westpac Banking Corporation	4.58%
FMG	Fortescue Metals Group Limited	4.12%
QBE	QBE Insurance Group Limited	3.89%
DOW	Downer EDI Limited	3.57%

Source: Pendal as at 31 May 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Corporation Limited	4.39%
QAN	Qantas Airways Limited	4.33%
CSL	CSL Limited	4.13%
DOW	Downer EDI Limited	3.39%
OZL	Oz Minerals Limited	3.09%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Billiton Limited (not held)	-10.24%
WES	Wesfarmers Limited (not held)	-2.43%
RIO	Rio Tinto Limited (not held)	-1.93%
WOW	Woolworths Group Limited (not held)	-1.90%
WDS	Woodside Energy Gr Ltd (not held)	-1.31%

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 years (p.a)	Since inception (p.a.)*
Pendal Sustainable Future Australian Shares Portfolio	-3.79%	3.01%	-0.55%	2.54%	10.09%	9.97%
S&P/ASX 300 (TR) Index	-2.76%	3.08%	1.05%	4.71%	8.00%	8.44%
Active return	-1.03%	-0.06%	-1.59%	-2.17%	2.09%	1.53%

Source: Pendal as at 31 May 2022

*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
AMC	Amcor Limited	0.24%
DOW	Downer EDI Limited	0.15%
WOW	Woolworths Group Limited (not held)	0.15%
JHX	James Hardie Industries Plc (not held)	0.08%
SQ2	Block Inc Cdi Def (not held)	0.06%

Top 5 detractors - monthly

Code	Name	Value Added
BHP	BHP Billiton Limited (not held)	-0.72%
NEC	Nine Entertainment Co Ltd	-0.46%
GMG	Goodman Group	-0.16%
MQG	Macquarie Group Limited	-0.16%
BSL	Bluescope Steel Limited	-0.13%

Top 5 contributors - 1 year

Code	Name	Value Added
IGO	IGO Limited	0.84%
SQ2	Block Inc Cdi Def (not held)	0.63%
ORA	Orora Limited	0.46%
MQG	Macquarie Group Limited	0.43%
QAN	Qantas Airways Limited	0.43%

Top 5 detractors - 1 year

Code	Name	Value Added
XRO	Xero Limited	-1.21%
BHP	BHP Billiton Limited (not held)	-0.95%
NEC	Nine Entertainment Co Ltd	-0.94%
REA	REA Group Ltd	-0.50%
S32	South32 Limited (not held)	-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 Amcor (AMC, +9.4%)

Global packaging company Amcor's (AMC) quarterly result was in line with expectations. Management upgraded the expectations for the full year by a small amount. In the current environment the stock offer relatively predictable cash flow, with the ability to pass on cost pressures. It is also benefiting from volume growth in its rigids division.

Overweight Downer (DOW, +3.1%)

Downer ground higher over the month, bucking the trend of broader market weakness. It delivered a well-received investor day early in the month, which indicated that there would be no material hole in earnings despite the impact of east coast rain on the road building operation. Management also highlighted how the company is aligned to themes of decarbonisation and increased defence spending.

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.

Three largest detractors

Underweight 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 debatable, 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.

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 Goodman Group (GMG, -14.3%)

Industrial property owner and developer Goodman had a relatively turbulent month. It initially sold off on the back of Amazon's result, which reported lower online sales and pressure on costs. Amazon is a key global tenant for Goodman. GMG's own quarterly update later in May revealed a solid operating performance and management upgraded full year eps growth from 20% year-on-year to 23%. This, along with new "buy" ratings from sell-side research, saw GMG pare back some of its losses.

Outlook

The portfolio underperformed in May. The exclusion of fossil fuel exposures was a material drag on relative performance, given it was one of the few sectors to hold up reasonably well on the back of strong coal, gas and oil prices.

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 JB Hi-Fi (JBH)

Electronics retailer JB Hi-Fi (JBH) has been a long held position and strong contributor to the portfolio's performance. It remains a strong, well-managed franchise which has deftly managed the Covid period and maintains a strong competitive position.

However we are dialling down the portfolio's exposure to domestic consumer demand.

While the domestic economy remains fundamentally robust, we are also likely to see a slowing in growth as the effect of post-lockdown pent-up demand recedes and higher interest rates also take effect. Higher interest costs, in tandem with higher fuel prices, are likely to crimp disposable income.

We are also mindful that there is a mix shift taking place, as consumers spend more on services rather than goods.

JBH's earnings and revenue remain solid. However economic trends coupled with the high base effect of the Covid period may see earnings start to slow. Given all this, at this point we do not see compelling valuation upside.

As a result of the roader economic backdrop and current valuation, we are taking profits and selling JBH to zero.

The portfolio retain exposure to the rebound in domestic demand. However it is in areas which have leverage to post-lockdown trends, such as in Qantas (QAN) and Orora (ORA).

Carbon performance

The estimated weighted average carbon intensity (WACI) of the portfolio, using greenhouse gas emissions (scope 1 and 2¹) 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 CO₂e / \$M revenue)

Pendal Sustainable Future Australian Share Portfolio	ASX 300	Relative to ASX300
117.54	211.18	-93.64

Source: ISS, Pendal holdings as at 31 May 2022. Report run on 10/06/2022 using latest ISS data. 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-tcf.org/recommendations/>

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key account manager or visit pendalgroup.com

PENDAL

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