PENDAL

Pendal Monthly Commentary

Pendal Sustainable Future Australian Shares Portfolio

June 2022

Market commentary

The US Federal Reserve's determination to bring inflation under control is stoking fears of recession. This was exacerbated in June by a CPI print which came in slightly higher than expected and showed inflation broadening across categories.

The Fed hiked rates 75bps in June and indicated that they could do the same again in July. They are now signalling that they could end the year at 3.4%, according to the "dot plot" of expected moves. Three months ago, this figure was 1.9%.

Other central banks are striking a similarly hawkish tone with regard to the pace of rate hikes. The Reserve Bank of Australia hiked 50bps.

This saw sharp falls in equity markets, as investors start to factor in the risk of earnings downgrades. It also saw a rotation away from value and the more cyclical sectors.

Australia underperformed as a result, with the S&P/ASX 300 off -9.1%. The S&P 500 fell -8.4% and the Euro Stoxx -8.8%. However the Australian market has still outperformed over the calendar year to date.

The two largest sectors of the Australian market - which had held up well thus far - were both hit hard. Materials fared worst as commodity prices tumbled and dragged on the miners. Iron ore fell -11.9% and copper -12.6%. BHP (BHP, -7.5%) held up better than most of the other miners, which saw double digit falls. The copper and lithium miners underperformed, having been among the sector better performers previously.

Financials fell as the RBA's rate hike triggered fears of domestic recession and saw some shorting of Australian banks, particularly by international investors. ANZ (ANZ, -12.0%) held up best of the Big Four, while Westpac (WBC, -18.3) fared worst. The insurers held up much better, with QBE (QBE, +1.0%) managing a small advance.

Consumer Staples held up well as investors sought defensive pockets. Woolworths (WOW, +2.7%), Coles (COL, +1.6%) and Endeavour (EDV, +4.3%), the three largest stocks in the sector, all made gains.

Energy also outperformed and held up well despite Brent crude oil falling -6.5%, thermal coal -9.6% and natural gas -23.2%. This was largely due to strength in the newly re-christened Woodside Energy (WDS, +7.0%), the largest stock in the sector. It did well in the wake of the tie up with BHP's oil and gas assets. Other energy producers such as Santos (STO, -9.5%) were softer. The fuel retailers such as Ampol (ALD, +2.6%) and Viva Energy (VEA, +1.8%) did well on the back of recovering volumes and strong refining margins.

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 30 June 2022)
Sector limits	Cash 2-10%
Dividend Yield	4.04%#

Top 10 holdings

Code	Name	Weight
CSL-AU	CSL Limited	11.12%
CBA-AU	Commonwealth Bank of Australia	7.69%
NAB-AU	National Australia Bank Limited	7.33%
TLS-AU	Telstra Corporation Limited	6.87%
SYD-AU	Sydney Airport	4.77%
QBE-AU	QBE Insurance Group Limited	4.40%
QAN-AU	Qantas Airways Limited	4.37%
DOW-AU	Downer EDI Limited	4.32%
FMG-AU	Fortescue Metals Group Ltd	4.03%
WBC-AU	Westpac Banking Corporation	3.78%

Source: Pendal as at 30 June 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS-AU	Telstra Corporation Limited	4.64%
CSL-AU	CSL Limited	4.38%
QAN-AU	Qantas Airways Limited	4.12%
DOW-AU	Downer EDI Limited	3.55%
QBE-AU	QBE Insurance Group Limited	3.27%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP-AU	BHP Billiton Limited (not held)	-10.69%
WDS-AU	Woodside Petroleum Ltd (not held)	-2.93%
WES-AU	Wesfarmers Limited (not held)	-2.41%
WOW-AU	Woolworths Group Ltd (not held)	-2.01%
RIO-AU	Rio Tinto Limited (not held)	-1.97%

Source: Pendal as at 30 June 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	-10.72%	-13.79%	-13.79%	-9.23%	4.88%	6.73%
S&P/ASX 300 (TR) Index	-8.97%	-12.22%	-10.39%	-6.78%	3.43%	5.78%
Active return	**-1.76%**	**-1.57%**	**-3.40%**	**-2.46%**	**1.45%**	**0.95%**

Source: Pendal as at 30 June 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
TLS-AU	Telstra Corporation Limited	0.36%
CSL-AU	CSL Limited	0.33%
QBE-AU	QBE Insurance Group Limited	0.31%
AMC-AU	Amcor Ltd	0.17%
S32-AU	*South32 Ltd. (not held)*	*0.13%*

Top 5 detractors - monthly

Code	Name	Value Added
OZL-AU	OZ Minerals Limited	-0.50%
QAN-AU	Qantas Airways Limited	-0.43%
WDS-AU	*Woodside Petroleum Ltd (not held)*	*-0.40%*
IGO-AU	Independence Group NL	-0.36%
EVN-AU	Evolution Mining Limited	-0.29%

Top 5 contributors - 1 year

Code	Name	Value Added
APT-AU	*Afterpay Limited (not held)*	*0.93%*
QBE-AU	QBE Insurance Group Limited	0.58%
TLS-AU	Telstra Corporation Limited	0.56%
WES-AU	*Wesfarmers Limited (not held)*	*0.52%*
AMC-AU	Amcor Ltd	0.49%

Top 5 detractors - 1 year

Code	Name	Value Added
XRO-AU	Xero Limited	-1.24%
BHP-AU	*BHP Billiton Limited (not held)*	*-1.06%*
NEC-AU	Nine Entertainment Limited	-0.91%
WDS-AU	*Woodside Petroleum Ltd (not held)*	*-0.79%*
FMG-AU	Fortescue Metals Group Ltd	-0.44%

Source: Pendal as at 30 June 2022.
Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Telstra (TLS, -0.8%)

Telstra held up much better than the broader market in June as investors sought defensive exposure. The company announced price increases across mobile phone contracts, to take place from July. Improvement in this division underpins a more predictable outlook for the company's earnings and cash flow, which should be seen favourably in the current environment.

Overweight CSL (CSL, -1.0%)

Health care stocks tended to weather June's volatility better than some other sectors. Plasma collection in the US continues to rebound s movement restrictions roll back, helping ease some of the supply issues CSL has faced in the last two years. Demand remains strong, while there is scope for new product launches in coming halves.

Overweight QBE Insurance (QBE, +1.0%)

The insurance sector has generally outperformed in the last few months, as higher bond yields should provide a tailwind for margins. At the same time, premium pricing have been rising, helping offset rising claims inflation and structural issues posed by higher provisioning and reinsurance costs for weather-related events. QBE has done better than the domestically-focused insurers, where the market has been concerned about exposure to recent flooding events.

Three largest detractors

Overweight Oz Minerals (OZL, -26.3%)

Concern that central bank tightening could drive the US economy into recession weighed on commodity prices in June and saw the copper price come off, along with miners such as OZL. The medium term outlook for copper remains positive, underpinned by constrained supply and structural demand as part of the renewable energy thematic. However concerns over demand, coupled with input cost inflation in areas like labour, diesel and power, may weigh in the near term.

Overweight Qantas (QAN, -18.9%)

Concerns that the tightening cycle could drive the US economy into recession weighed on cyclicals in S&P 500, including on airline stocks and travel-related Australian stocks such as Qantas followed suit. A trading update from QAN late in the month Confirmed that demand remains strong. It reduced capacity in order to offset high fuel prices and continued to reduce debt ahead of schedule.

Underweight Woodside Energy (WDS, +7.0%)

Woodside Petroleum was rechristened as Woodside Energy, as part of the merger with BHP's oil and gas assets, which took place in June. The deal improves Woodside's balance sheet and offers a more diverse range of growth options. However uncertainty over which development options will be pursued - particularly the large Scarborough project - does raise questions over the company's free cash flow profile in coming years. The stock is excluded from the portfolio's investable universe due to fossil fuel exposure.

Outlook

The portfolio finished the month behind the index. Some of the more cyclical positions dragged as the market expressed concern over recession. The portfolio's holding in future-facing metals such as copper and lithium also dragged. These had been among the best-performing miners, but underperformed the mining sector in June. There was an offset from the relatively defensive exposure in telecom and health care.

We maintain a cautious near term outlook for equities. It is increasingly hard to see how the US avoids a recession from here.

First the lagged effect of inflationary pressures means we are unlikely to see much relief on this front given the fuel, food, and shelter components are still rising. This gives the Fed little room to back off hikes. Second, while overall economic activity remains reasonable, the lead indicators are deteriorating.

These include the "rule of ten" observation of mortgage rates and petrol prices - which has a good track record of predicting recessions – and falling house prices which can affect consumption. This is feeding through to a fall in the Altanta Fed's GDP tracker and other GDP forecasts rolling over.

This economic risk has implications for the market. The market is currently discounting a material drop in earnings, while the latter continue to hold up. Since 1987 we have only seen this disconnection twice, in 2002 and 2011, where markets overstated risk.

However in 2000, 2008 and 2020 the earnings caught up with the market and therein lies the risk if the US and global economy go into a recession.

Valuations in the markets other than the US - including Australia - are lower and provide some protection. But we remain wary of how the market performs as downgrades come through.

While the risk is material, this bearish scenario is not a certainty. Factors which could see a better outcome include:

- Inflation momentum slows more quickly than now expected. There are some signs of hope with higher inventory at US retailers and evidence of discounting appearing. The fall in the oil price is a very important lead if sustained.
- Labour markets loosen up sooner. We have seen announcements from the tech sector on layoffs, but collectively this is not sufficient. On the supply side perhaps inflation and the crypto bust help drive participation higher.
- Supply chains begin to ease up as China re-opens and demand softens.

Should these factors start to play out we may see the Fed swerve again and not be as aggressive on rates. It would still be unclear whether this is enough to avoid a recession; but in the market's eyes it would at least signal the depth of the downturn could be lower.

One flag which is likely to mark the low in this cycle is the passing of time. This market looks closer in nature to 2000 and 2008 where the market had to consolidate near its lows for a number of months before sentiment improved – unlike the sharp policy-driven bounce of 2020.

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," and 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

No new stocks added or sold to zero during the month.

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
113.54	227.43	-113.89

Source: ISS, Pendal holdings as at 30 June 2022. Report run on 5/07/2022 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-tcfd.org/recommendations/

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