

## Pendal Monthly Commentary

### Pendal Australian Shares Portfolio

August 2022

#### Market commentary

Australia's reporting season took place against the backdrop of some sharp shifts in macro expectations and market sentiment.

The S&P/ASX 300 initially carried its upward momentum into August on the back of expectations of a more dovish cant to Fed monetary policy. Various Fed spokespeople continued to pour cold water on the notion of an imminent pivot to less hawkish policy. This was then confirmed by a short and direct speech by Chair Powell at Jackson Hole, where he reminded all of the singular focus on bring down inflation even at the cost of pain to households and business.

This saw a reversal in equity markets. The S&P/ASX 300 ended up 1.2%. However it was one of the few equity markets to remain in the black. The S&P500 was down -4.2% for the month.

A reasonably benign results season helped bolster the local market. FY22 results were broadly in line with historical averages in terms of revisions. FY22 delivered 23% EPS growth, driven by 38% EPS growth in resources. Bank EPS rose 15% as bad debt charges fell and Industrial EPS was up 7%.

Importantly, the feared plunge in earnings is not evident at this point. Looking forward, consensus now expects market EPS to grow 3% in FY23. This is essentially unchanged over the last month.

Resource EPS are expected to fall 3%. Industrials are expected to grow 9%. This is down from 11% a month ago, but still looks optimistic, in our view.

Energy (+7.8%) performed best in August. Brent crude came off -12.3% on some hope of a deal to return Iranian volumes to markets - although OPEC+ has subsequently indicated that they may reduce supply in response. However natural gas (+7.2%) and thermal coal (+4.2%) continued to strengthen. Woodside Energy (WDS\_ gained 7.1% and Santos (STO) +9.7%.

Materials (+4.5%) also outperformed. BHP (BHP, +5.0%) and South32 (S32, +8.9%) were the stand-outs among the majors, while lithium plays such as Mineral Resources (MIN, +19.0%) and Pilbara Minerals (PLS, +31.8%) continued to surge on the EV thematic.

Real Estate (-3.3%) was the weakest sector on broad-based declines. Goodman Group (GMG), the largest stock in the sector, gave up -5.0%. Scentre Group (SCG, +4.0%), which owns and operates the Westfield malls in Australia and New Zealand was one of very few property stocks to buck the trend.

Consumer Staples (-1.7%) also fell. The market expressed concern that the relative safe haven of supermarkets such as Woolworths (WOW, -2.4%) and Coles (COL, -6.4%) may not be as defensive as expected as results showed the impact of higher costs.

#### 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.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15-35 (32 as at 31 August 2022)
Sector limits	A-REITS 0-30% Cash 2-10%
Dividend Yield	4.21%#
Income target	No target

#### Top 10 holdings

Code	Name	Weight
BHP	BHP Group Ltd	11.13%
CSL	CSL Limited	8.77%
STO	Santos Limited	7.35%
TLS	Telstra Corporation Limited	6.69%
CBA	Commonwealth Bank of Australia	5.87%
NAB	National Australia Bank Limited	5.25%
WBC	Westpac Banking Corporation	4.96%
QAN	Qantas Airways Limited	4.82%
XRO	Xero Limited	4.08%
MQG	Macquarie Group, Ltd.	3.13%

Source: Pendal as at 31 August 2022

#### Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
STO	Santos Limited	6.22%
TLS	Telstra Corporation Limited	4.53%
QAN	Qantas Airways Limited	4.35%
XRO	Xero Limited	3.55%
MTS	Metcash Limited	2.68%

#### Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WDS	Woodside Energy Group Ltd (not held)	-3.04%
WES	Wesfarmers Limited (not held)	-2.51%
ANZ	Australia and New Zealand Banking Group Limited	-2.17%
WOW	Woolworths Group Ltd (not held)	-2.06%
TCL	Transurban Group Ltd. (not held)	-2.02%

Source: Pendal as at 31 August 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	2.02%	6.47%	-3.50%	-0.60%	-2.80%	7.70%	8.99%
S&P/ASX 300 (TR) Index	1.18%	7.20%	-2.41%	0.59%	-3.67%	5.64%	8.24%
<b>Active return</b>	<b>0.84%</b>	<b>-0.73%</b>	<b>-1.09%</b>	<b>-1.19%</b>	<b>0.87%</b>	<b>2.06%</b>	<b>0.75%</b>

Source: Pendal as at 31 August 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
QAN	Qantas Airways Limited	0.56%
STO	Santos Limited	0.50%
TLS	Telstra Corporation Limited	0.14%
VEA	Viva Energy Group Ltd.	0.13%
NEC	Nine Entertainment Co. Holdings Limited	0.12%

### Top 5 contributors - 1 year

Code	Name	Value Added
STO	Santos Limited	1.38%
<i>SQ2</i>	<i>Block, Inc. Shs (not held)</i>	<i>1.08%</i>
S32	South32 Ltd.	0.80%
BHP	BHP Group Ltd	0.76%
VEA	Viva Energy Group Ltd.	0.55%

Source: Pendal as at 31 August 2022

Underweight positions are in italics.

### Top 5 detractors - monthly

Code	Name	Value Added
XRO	Xero Limited	-0.26%
<i>WDS</i>	<i>Woodside Energy Group Ltd (not held)</i>	<i>-0.22%</i>
NXT	Nextdc Limited	-0.16%
DOW	Downer EDI Limited	-0.14%
JHX	James Hardie Industries	-0.11%

### Top 5 detractors - 1 year

Code	Name	Value Added
XRO	Xero Limited	-1.78%
JHX	James Hardie Industries	-0.85%
<i>WDS</i>	<i>Woodside Energy Group Ltd (not held)</i>	<i>-0.82%</i>
JDO	Judo Capital Holdings Limited	-0.52%
<i>FMG</i>	<i>Fortescue Metals Group Ltd (not held)</i>	<i>-0.44%</i>

## Stock specific drivers of monthly performance relative to benchmark

### Three largest contributors

#### Overweight Qantas (QAN, +16.7%)

QAN's current run rate suggests returning to pre-Covid EBITDA in FY23, restoring profitability far faster than many expected. The cost impost from fuel is being managed via the combination of ticket prices and higher yields on flights. It is reducing domestic capacity by 10% in 1H FY23 in order to manage for fuel as well as improve operational reliability. Strong FY22 cash flow has seen the debt fall to below pre-Covid levels, allowing a surprise 400m buyback.

#### Overweight Santos (STO, +9.7%)

There was a mixed reaction to STO's result on the day. Operationally it was decent and showed continued strong cost control. However there was some disappointment with the degree of capital management given the cash flow. Management flagged the intention to go ahead with the Pikka oil project in Alaska and deferment of Dorado project in Australia. Nevertheless, STO continues to perform well, is developing an attractive portfolio of assets and benefits from strong energy prices.

### Three largest detractors

#### Overweight Xero (XRO, -5.6%)

XRO did not report - it has a March year-end. It sold off along with other growth stocks in response to the shift in bond yields expectations following fed Chair Powell's Jackson Hole speech. Management maintained FY23 guidance at the AGM in August. We continue to see a material growth opportunity in the UK's Making Tax Digital initiative and there are indications that the company is gaining headway in improving average revenue per user (ARPU) in its overseas markets.

#### Underweight Woodside (WDS, 7.0%)

Woodside Energy delivered a strong result with tailwinds from strong commodity prices, although profitability missed expectations once adjusted for an asset sales. It rose along with the rest of the energy sector as supply disruptions continue to support energy prices. The underweight dragged, but there was an offset from the position in Santos (STO), our preferred energy exposure.

**Overweight Telstra (TLS, +4.2%)**

Telstra delivered a solid result, in line with expectations. The mobile phone and infrastructure segment now contribute over 80% of earnings and are growing at ~5% per annum. There was a muted reaction on the day, as the company lowered the midpoint of guidance for FY23, possibly to reflect a more uncertain economic outlook. However overall the story is one of a company which has return to a steady source of mid-single digit growth and capital return, emphasised by a small increase in the dividend in this result.

**Overweight NextDC (NXT, -11.0%)**

The broad sell-off in growth stocks saw data centre operator NXT give back recent gains. This was despite a solid result for FY22 and revenue guidance for FY23 ahead of consensus. NXT is bringing on additional capacity in FY23 and is particularly well positioned in Sydney, where it is one of the few providers with capacity in a very tight market. We see the company as attractively valued in that the downside is protected by a real asset base while there is significant upside from rolling out planned capacity.

## Outlook

The portfolio outperformed over August. Most of the portfolio's highest conviction overweights made strong contributions. Qantas (QAN) and Nine Entertainment (NEC) both delivered well-received results. Supportive energy prices helped Santos (STO), while Viva Energy (VEA) accelerated its refining dividend given a strong environment. The largest drag came from the growth exposure as expectations around monetary policy shifted around. Xero (XRO) and NextDC (NXT) both dragged.

The outlook for the market remains somewhat binary, with two very different paths forward.

The positive scenario is that the combined effect of diminishing supply chain pressures, slowing labour demand and rising labour participation allows the Fed to avoid raising rates too far. Recent US employment data is pointing in the right direction – the question is whether it shifts far enough to satisfy the Fed.

In this more benign environment, softer inflation requires only a moderate economic slowdown and we do not see a sharp drop in earnings. Equity risk premiums fall along with the outlook for interest rates.

In this scenario we may have seen close to the market lows already and can start to see a recovery.

In the second, more negative scenario, inflation remains embedded at too high a level, potentially due to stubborn wage growth or high energy prices. Combined with the European power crisis and ongoing lockdowns in China, it forces central banks to raise rates into a global economic slowdown.

Such an environment may induce some form of additional financial shock, further exacerbating the downturn and market pessimism. Earnings take a leg down and we see the market put in new lows.

It is too early to call the direction in which we head. All eyes will be on September's CPI print and the Fed meeting later in the month.

In the meantime, we expect the market to remain in something of a holding pattern.

We also continue to note the total financial conditions index feedback loop, where too big a rise in equities starts to work counter to the Fed's goals and leads to a hawkish shift in their messaging. This emphasises that the Fed will need to see inflation and the economy much softer before it is comfortable with a sustained rise in equities.

In this context, while not positioning the fund for a specific outcome, we are retaining a more defensive tilt and skew towards larger stocks and those delivering capital return to shareholders.

The latter was a key observation from reporting season; the market is rewarding companies that can demonstrate purchasing power and which are returning capital.

We continue to see the Australian market as relative defensive in this environment. It benefits from less inflationary pressure, a higher level of household saving to call upon, the ability to increase immigration to drive labour supply and housing demand, favourable terms of trade that underpin government revenue, and a relatively good fiscal position.

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

**Sell to zero in Woodside Energy (WDS) and Amcor (AMC).**

**Buy a new position in Mineral Resources (MIN).**

We have added a new position in diversified miner Mineral Resources (MIN) which owns iron ore, lithium and gas assets in Western Australia. It also has a mining services business which processes iron ore for other producers.

The key attraction is MIN's lithium business, where MIN has been one of Australia's largest producers of the mineral spodumene, one of two key sources of lithium (the other being brine pools).

The lithium space benefits from structural tailwinds in terms of demand, given increasing political and regulatory support for battery technology, clean energy and electric vehicles.

We believe the market is underappreciating potential earnings growth in this area as MIN looks to extract a greater share of the lithium value chain as it increases the proportion of spodumene processed into lithium hydroxide in-house. At this point, our research suggests consensus estimates for MIN underappreciate the scope for lithium hydroxide production

There are some potential execution risks to further in-house processing capacity. The ability to secure capacity and the cost involved need to be watched.

However there are additional tailwinds for MIN. One is increased spodumene production, with volumes ramping up as both the Mt Marion and Wodgina mines are expanded.

Another is the potential from the gas business. MIN has the largest discovery in the Perth basin, although further appraisal wells are needed. In an ever tightening gas market, this discovery provides huge optionality.

We are more cautious on MIN's iron ore business given the high cost of existing operations and uncertainty around the timeline for the proposed iron ore production centre JV at Ashburton. However, we do not believe these risks are material enough to offset the upside potential of the lithium business.

We have funded this through the sale of the stake in Woodside Energy (WDS), which was acquired due to our holding in BHP (BHP) as the latter sold its oil and gas assets to Woodside.

We also liquidated packaging company Amcor (AMC). AMC has outperformed strongly but now the valuation is looking stretched, with multiples at peak levels relative to its own history and to peer companies.

AMC's end demand has proved very resilient and the pass-through of rising input costs has also been excellent. However there are some risks to FY23 earnings, with many global packaging companies starting to show a slowdown or decline in volumes. AMC also faces headwinds from a weaker EUR and rising interest rates, given a large amount of floating rate debt.

With the stock trading at peak valuations and with some modest earnings risk we believe it is an appropriate time to exit the position in this portfolio in favour of more preferred defensive exposures.

#### **Buy new position in Star Entertainment (SGR)**

The Star Entertainment Group (SGR) owns and operates the Star Sydney, the Star Gold Coast, and Treasury Brisbane casinos.

It offers an example of a company facing material negativity and headwinds, but where we believe the market is pricing in too negative an outcome, particularly given a supportive operating environment and an inflection point in terms of capex and cash flow.

SGR faces significant challenges from ongoing regulatory inquiries and the opening of a competing tables-only casino in Sydney. However following material underperformance, we believe the share price is now overreacting to the negative impacts from these two challenges.

At the same time, our research suggests that the share price is underestimating the benefit from the strong trading environment and likely improvements in the free cash flow profile.

Gaming revenue is historically less sensitive to economic cycles, which is important in the current environment of uncertainty around the economic outlook as rates increase. There was some concern that a normalisation of consumer activity post-lockdown - and in particular the return of travel as an alternative - would see a material hit to casino gaming revenue. This has not been the case, with revenues remaining resilient, potentially helped by new customers and players reallocating spend from other casino activities towards gaming.

The company has also been investing in the relocation of its Brisbane casino to Queen's Wharf. This is now winding down, with the casino slated to move into its new premises in 2023.

The combination of reduced capex and a beneficial trading environment should support strong cash flow, helping rapidly pay down the debt incurred during Covid. In combination with an attractive valuation, which we believe over-estimates the impact of regulatory and competitive headwinds, we see a good opportunity to establish a position in a relatively defensive source of earnings and cash flow.

#### **Sell to zero in Iluka (ILU)**

We are reducing the portfolio's exposure to commodities via the sale of Iluka Resources, which produces mineral sands such as zircon and titanium dioxide. It has also recently been moving into rare earths.

ILU enjoys structural tailwinds from the transition to a less carbon intensive economy, where both mineral sands and rare earths have a role to play in more efficient production methods and energy storage. The political imperative to diversify rare earth production, which has been historically dominated by China, also offers opportunity.

However we are mindful of the cyclical risk of softer demand and commodity pricing. The Chinese economy remains under pressure, weighed down by weakness in the housing sector. The policy response from Beijing thus far seems focused on stemming further falls, rather than attempting genuine stimulus. At the same time, the high interest rate

regime in the US is specifically designed to slow growth and bring inflation under control. This is also a headwind for commodity demand.

We are starting to see this feed through to pricing. Tronox, a large US-based mineral sands producer, has flagged continued demand weakness in both the US and Europe. It also noted declining titanium dioxide prices in China, a key source of end demand. Zircon prices have also fallen in China and are expected to weaken further into Q4.

At the same time rare earth prices are also falling. Neodymium-Praseodymium, used in magnets among other applications, has dropped from a decade high of US\$175/kg in February to below US\$110/kg. We expect pricing to remain around US\$100/kg given healthy supply growth in China following recent quota increases.

ILU continues to deliver operationally and we like the company's strategic direction. However given the nearer term cyclical headwinds, it is no longer among our highest-conviction ideas and as a result we have sold to zero in this portfolio.

For more information contact your key account manager or visit [pendalgroup.com](https://pendalgroup.com)

**PENDAL**

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