PENDAL

Pendal Monthly Commentary

Pendal Australian Specialised Retirement Income 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 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 (30 as at 31 August 2022)
Sector limits	A-REITS 0-30%, Cash 2-10%
Dividend Yield	4.76%#

Top 10 holdings

Code	Name	Weight
BHP	BHP Group Ltd	12.14%
CSL	CSL Limited	8.94%
TLS	Telstra Corporation Limited	6.73%
NAB	National Australia Bank Limited	6.66%
CBA	Commonwealth Bank of Australia	6.49%
WBC	Westpac Banking Corporation	5.35%
STO	Santos Limited	5.33%
MTS	Metcash Limited	3.72%
QAN	Qantas Airways Limited	3.41%
S32	South32 Ltd.	3.40%

Source: Pendal as at 31 August 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Corporation Limited	4.56%
STO	Santos Limited	4.20%
MTS	Metcash Limited	3.53%
NEC	Nine Entertainment Co. Limited	3.18%
QAN	Qantas Airways Limited	2.93%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-2.51%
WOW	Woolworths Group Ltd (not held)	-2.06%
TCL	Transurban Group Ltd. (not held)	-2.02%
RIO	Rio Tinto Limited (not held)	-1.65%
GMG	Goodman Group (not held)	-1.57%

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 Specialised Retirement Income Portfolio	2.16%	-3.21%	0.30%	-1.74%	7.57%	8.57%	8.69%
S&P/ASX 300 (TR) Index	1.18%	-2.41%	0.59%	-3.67%	5.64%	8.24%	8.16%
Active return	**0.98%**	**-0.80%**	**-0.29%**	**1.93%**	**1.93%**	**0.33%**	**0.53%**

Source: Pendal as at 31 August 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
QAN	Qantas Airways Limited	0.40%
STO	Santos Limited	0.35%
S32	South32 Ltd.	0.18%
VEA	Viva Energy Group Ltd.	0.18%
NEC	Nine Entertainment Co. Limited	0.15%

Top 5 detractors - monthly

Code	Name	Value Added
DOW	Downer EDI Limited	-0.18%
NXT	Nextdc Limited	-0.14%
OZL	*OZ Minerals Limited (not held)*	*-0.11%*
PLS	*Pilbara Minerals Limited (not held)*	*-0.10%*
EVN	*Evolution Mining Limited (not held)*	*-0.10%*

Top 5 contributors - 1 year

Code	Name	Value Added
SQ2	*Block, Inc. Shs (not held)*	*1.08%*
STO	Santos Limited	0.91%
BHP	BHP Group Ltd	0.72%
VEA	Viva Energy Group Ltd.	0.58%
TLS	Telstra Corporation Limited	0.49%

Top 5 detractors - 1 year

Code	Name	Value Added
JHX	James Hardie Industries	-0.78%
XRO	Xero Limited	-0.77%
WDS	Woodside Energy Group Ltd	-0.70%
EVN	*Evolution Mining Limited (not held)*	*-0.46%*
NEC	Nine Entertainment Co. Limited	-0.38%

Source: Pendal as at 31 August 2022

Underweight positions are in italics.

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.

Overweight South32 (S32, +8.9%)

South32 delivered a solid set of financial results and extended their buyback. Management are guiding to lightly higher costs, which led to some downgrades to consensus FY23 numbers. However it remains supported by strength in the coal price and remains one of the cheaper base metal miners.

Three largest detractors:

Overweight Downer (DOW, -6.3%)

DOW has completed its transformation away from mining and construction towards urban services. Its FY22 result was good and ahead of expectations in a challenging environment. However its guidance for FY23 was slightly behind the consensus expectations. It also disappointed those looking for more return of capital to shareholders following the divestment phase.

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.

Underweight Oz Minerals (OZL, +36.6%)

Copper miner OZL came under a non-binding indicative takeover proposal from BHP. The all-cash offer of $25 per share came at a 32.1% premium to the prior closing price. OZL's board have rejected the initial offer.

Market 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 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

Buy new position in Suncorp (SUN)

Suncorp Group Limited is a Queensland based conglomerate with operations spanning Banking, General Insurance and Life Insurance.

We are increasingly constructive on the insurance sector. The market has been focused on risks around storm activity and inflation. These issues are real, but in our view, more than offset by rising interest rates, higher pricing, internal cost out initiatives and discounted valuations. The portfolio has an existing position in QBE (QBE), however a strong case can now be made for SUN, which was sold off heavily following recent floods.

After three years of share price weakness SUN started to find its feet in 2022. Underwriting margins stopped falling, confidence in the outlook improved given efficiency targets, and interest rates started to rise.

It was looking encouraging until floods struck south eastern Queensland and Northern NSW in Q1 2022. The market's concern is that SUN will need to pay more for reinsurance and also need to lift peril budgets. However this now appears largely reflected in consensus, which is already allowing for a 1% margin headwind on perils. Historically the budget has tended not to move by more than 1%, with room for insurers to argue conditions will improve.

The other hot topic is emerging claims inflation. This is already coming through home and motor supply chains, and will become a risk to liability classes as wages rise. However this is not a problem if passed on via price.

With regard to pricing, premiums have been increasing across the sector to reflect claims inflation and higher budgets for catastrophes. At this point we expect the industry to remain rationale in terms of price.

We see the recently announced deal to sell SUN's banking arm to ANZ – while still awaiting regulatory approval – as a further positive. The proposed price seems fair and in line with the markets' expectations, once SUN's estimation of transaction and legacy costs are factored in. Most importantly, SUN has been at a structurally lower valuation to the insurance sector due to the bank. Its removal provides scope for a re-rating as a pure-play insurer. Given the other positive aspects of our thesis, we expect it to close this discount to peers.

An additional benefit is the likely increased focus on addressing the challenges of climate change, a key issue for insurers. Management have stated that SUN will focus on working with governments to help build resilience to major weather events. There are also several specific commitments, made in conjunction with ANZ, to various sustainability-linked initiatives in Queensland.

SUN should also benefit from high rates. Investment portfolio will be marked lower in upcoming results (given higher corporate spreads and lower equities). However once that subsides, margins should benefit from the pickup in running yields.

At this point be believe that consensus expectations do not reflect the full extent of the tailwinds that SUN will receive from higher bond yields. At the same time that SUN is benefiting from both cyclical and company-specific tailwinds, valuation is also undemanding in a historical context. It is trading on a 6.4% dividend yield.

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

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