Pendal Monthly Commentary

Pendal Sustainable Future 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

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 August 2022)
Sector limits	Cash 2-10%
Dividend Yield	3.71%#

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	10.73%
CBA	Commonwealth Bank of Australia	7.58%
NAB	National Australia Bank Limited	7.49%
TLS	Telstra Corporation Limited	6.48%
MQG	Macquarie Group, Ltd.	4.99%
QAN	Qantas Airways Limited	4.75%
DOW	Downer EDI Limited	3.95%
FMG	Fortescue Metals Group Ltd	3.87%
WBC	Westpac Banking Corporation	3.83%
QBE	QBE Insurance Group Limited	3.61%

Source: Pendal as at 31 August 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Corporation Limited	4.31%
QAN	Qantas Airways Limited	4.28%
CSL	CSL Limited	4.07%
DOW	Downer EDI Limited	3.79%
IGO	IGO Limited	3.14%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Group Ltd (not held)	-9.67%
WDS	Woodside Energy Group Ltd (not held)	-3.04%
WES	Wesfarmers Limited (not held)	-2.51%
WOW	Woolworths Group Ltd (not held)	-2.06%
RIO	Rio Tinto Limited (not held)	-1.65%

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 years (p.a)	Since inception (p.a.)*
Pendal Sustainable Future Australian Shares Portfolio	2.11%	-2.36%	0.58%	-4.52%	7.63%	8.74%
S&P/ASX 300 (TR) Index	1.18%	-2.41%	0.59%	-3.67%	5.64%	7.31%
Active return	**0.93%**	**0.05%**	**-0.01%**	**-0.86%**	**1.99%**	**1.44%**

Source: Pendal as at 31 August 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
OZL	OZ Minerals Limited	0.78%
QAN	Qantas Airways Limited	0.58%
IGO	IGO Limited	0.54%
NEC	Nine Entertainment Co. Holdings Limited	0.14%
TLS	Telstra Corporation Limited	0.13%

Top 5 detractors - monthly

Code	Name	Value Added
BHP	*BHP Group Ltd (not held)*	*-0.35%*
DOW	Downer EDI Limited	-0.32%
NXT	Nextdc Limited	-0.22%
ORA	Orora Ltd.	-0.19%
WDS	*Woodside Energy Group Ltd (not held)*	*-0.17%*

Top 5 contributors - 1 year

Code	Name	Value Added
SQ2	*Block, Inc. Shs (not held)*	*1.08%*
IGO	IGO Limited	0.77%
TLS	Telstra Corporation Limited	0.48%
NAB	National Australia Bank Limited	0.35%
JHX	*James Hardie Industries (not held)*	*0.33%*

Top 5 detractors - 1 year

Code	Name	Value Added
XRO	Xero Limited	-1.43%
WDS	*Woodside Energy Group Ltd (not held)*	*-0.96%*
BHP	*BHP Group Ltd (not held)*	*-0.91%*
DOW	Downer EDI Limited	-0.55%
BSL	Bluescope Steel Limited	-0.47%

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 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 but left the door open to further negotiation.

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 IGO (IGO, +21.7%)

IGO has transitioned to a "future-facing" metals operations. Following the investment of its gold mine, it is now exposed to nickel, copper, cobalt and lithium. It was the latter which drove the stock in August, driven by stronger prices and the broader EV-thematic. Its FY22 results were in line with expectations, as most headline earnings were pre-released in July.

Three largest detractors

Underweight BHP (BHP, +5.0%)

BHP delivered a good result, slightly beating consensus expectations for revenue, net profit after tax, and the dividend. The latter was well-received in the light of BHP's bid for Oz Minerals. Costs are expected to be up in FY23, but remains under control. Medium term capex was also increased, with a material proportion earmarked for decarbonisation. It also increased guidance for iron ore production. The portfolio does not hold BHP due to its exposure to coal.

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 particaurly 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 the month. There were strong contributions from the "future-facing" commodity exposures such as Oz Minerals (copper), IGO (copper and lithium), and Iluka (minerals sands and rare earths). In addition, well-received results from some of the portfolio's higher-conviction overweights such as Qantas (QAN) and Nine Entertainment (NEC) were beneficial.

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 Evolution Mining (EVN) to zero.

We are reducing and consolidating the portfolio's exposure to gold miners via the sale of Evolution (EVN) and an increase in the existing position in Northern Star (NST).

EVN has been held as part of a diversified exposure to gold within the portfolio's more defensive segment. The scale of macro uncertainty has meant elevated risks of sharp downturns in investor sentiment and geopolitical shocks. Gold exposure is specifically useful in this regard, as we saw when gold miners held up well amid the market volatility in the initial stages of the Russian invasion of Ukraine.

Gold still plays this role in the portfolio. But there is increasing fundamental pressure on the sector. Gold miners are seeing sharp increases in the cost of key inputs such as power, diesel and labour. At the same time, the gold price has been largely range-bound over the last two years and has been softening since March. The gold price remains at much higher levels than pre-2020, which is supportive. However without an offset of higher gold prices, the miners are seeing a margin squeeze.

This squeeze is leading to earnings downgrades, such as that recently announced by EVN. There are also issues in terms of expected production. It has announced that the expansion of its Mungari project in Western Australia will be delayed due to the higher cost environment. At the same time it faces technical challenges at its Red Lake mine in Canada. Management are confident of addressing these, but it has pushed out the expected timeframe of expected volume expansion. As a result, EVN is also seeing reductions in production volume guidance.

As a result of all this, we are consolidating the portfolio's gold position in NST. NST is not immune from increased cost pressure, however it is taking steps to manage this, such as scaling down more marginal operations. It also offers a cleaner operational outlook than EVN, having completed the expansion of its Pogo asset in Alaska.

At this point, we have greater confidence in NST's growth profile given on-going challenges at Red Lake. NST also has a stronger balance sheet than EVN.

This trade results in a small reduction in the overall exposure to gold, which reflects the increased risk to margins. However we also hold a position in the oil and gas sector which helps offset some of the cost headwinds to the gold miners.

Overall, we still see a role for gold in the portfolio as a hedge against macroeconomic – and particularly geopolitical - risk. This plays an important role in our approach to managing risk and building a portfolio which is driven by company-specific insight, rather than a call on macro or thematic outcomes. This approach has served us well in recent years and is, we think, very important in the current environment of elevated uncertainty.

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
112.99	234.48	-121.49

Source: ISS, Pendal holdings as at 31 August 2022. Report run on 07/09/2022 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/

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

PENDAL