# Pendal Monthly Commentary

## Pendal Australian Tax Effective Income Portfolio

October 2022

## Market commentary

Australian equities rebounded in October with the S&P/ASX 300 up 6.0%.

There was some see-sawing during the month as the market grappled to interpret successive data prints from the US.

However ultimately equity markets were driven by the expectation that the Fed would respond to slowing growth and some signs of financial market strain with a "pivot" away from its hawkish path. The extremely bearish positioning on investors post the recent sell-off also played a role.

China's National People's Congress saw President Xi installed for a third term - and the degree to which he has quelled potential factional opposition caught most by surprise. The initial inference is that policies such as Covid zero and less appetite to use traditional stimulus to support the economy remain in place.

Gains were largely broad-based, with only Consumer Staples (-0.16%) and Materials (-0.18%) losing ground - and only marginally so.

Financials (+12.1%) was the best performing sector, driven by the banks, which are demonstrating the benefits of higher rates for net interest margins in their most recent updates. Insurers are also beneficiaries and also did well in October.

Real Estate (+9.3%) enjoyed relief after a torrid run, on the hope that a milder pace of rates hikes might see a headwind recede. Index heavyweight Goodman Group (GMG) was up 7.7%. The retail malls also continued to do relatively well, with Scentre Group (SCG) up 14.2% and Vicinity (VCX) up 12.1%. However the market continue to express more doubt around the outlook for office with Dexus (DXS) only gaining 0.5%.

The miners weighed on Materials as the outlook for Chinese growth - and for the property sector in particular, remains muted. BHP (BHP) fell -3.0%, Rio Tinto (RIO) -5.6% and Fortescue Metals (FMG) -12.6%. The lithium sector surged apace, with Pilbara Minerals (PLS) up 11.6%,

Consumer Staples underperformed as investors were less defensive. Woolworths (WOW) fell -2.7% and Coles (COL) - 0.6%. Metcash (MTS, +5.9%) bucked the trend.

### Portfolio overview

| Australian Tax Effective Portfolio | |
|---|---|
| Investment strategy | **Dual focus:** Deliver tax-effective capital & grossed-up income.<br>**Broad hunting ground:** Core approach, drawing ideas from across the market cap spectrum.<br>**Income focus:** Greater exposure to stocks with high grossed-up yield & dividend sustainability. |
| Investment objective | The objective of the Model Portfolio is to outperform the S&P/ASX300 (TR) Index on a rolling 3 year period, while delivering a higher gross yield than the market. |
| Benchmark | S&P/ASX 300 (TR) Index |
| Number of stocks | 15-35 (30 as at 31 October 2022) |
| Sector limits | A-REITS 0-30%, Cash 2-10% |
| Dividend Yield | 4.91%# |

### Top 10 holdings

| Code | Name | Weight |
|---|---|---|
| BHP | BHP Group Ltd | 10.69% |
| CSL | CSL Limited | 8.52% |
| NAB | National Australia Bank Limited | 7.04% |
| CBA | Commonwealth Bank of Australia | 6.95% |
| TLS | Telstra Group Limited | 6.63% |
| WBC | Westpac Banking Corporation | 5.96% |
| STO | Santos Limited | 5.18% |
| QAN | Qantas Airways Limited | 3.73% |
| MTS | Metcash Limited | 3.69% |
| QBE | QBE Insurance Group Limited | 3.37% |

Source: Pendal as at 31 October 2022

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

| Code | Name | Weight |
|---|---|---|
| TLS | Telstra Group Limited | 4.47% |
| STO | Santos Limited | 3.95% |
| MTS | Metcash Limited | 3.50% |
| QAN | Qantas Airways Limited | 3.20% |
| NEC | Nine Entertainment Co. Holdings Ltd | 2.97% |

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

| Code | Name | Weight |
|---|---|---|
| WES | Wesfarmers Limited (not held) | -2.46% |
| TCL | Transurban Group Ltd. (not held) | -1.94% |
| WOW | Woolworths Group Ltd (not held) | -1.91% |
| ANZ | Australia and New Zealand Banking Group Limited | -1.71% |
| CBA | Commonwealth Bank of Australia | -1.58% |

Source: Pendal as at 31 October 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 Tax Effective Income Portfolio | 5.95% | 1.96% | -5.26% | 0.50% | 7.09% | 7.65% | 9.05% |
| S&P/ASX 300 (TR) Index | 5.96% | 0.46% | -5.77% | -2.61% | 4.86% | 7.23% | 8.66% |
| **Active return** | **-0.02%** | **1.50%** | **0.51%** | **3.11%** | **2.23%** | **0.42%** | **0.39%** |

Source: Pendal as at 31 October 2022
*Since Inception - 14 September 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 | 0.30% |
| *RIO* | *Rio Tinto Limited (not held)* | *0.20%* |
| WBC | Westpac Banking Corporation | 0.19% |
| *WOW* | *Woolworths Group Ltd (not held)* | *0.18%* |
| NAB | National Australia Bank Limited | 0.13% |

### Top 5 detractors - monthly

| Code | Name | Value Added |
|---|---|---|
| TLS | Telstra Group Limited | -0.19% |
| CSL | CSL Limited | -0.17% |
| BHP | BHP Group Ltd | -0.16% |
| DOW | Downer EDI Limited | -0.14% |
| S32 | South32 Ltd. | -0.14% |

### Top 5 contributors - 1 year

| Code | Name | Value Added |
|---|---|---|
| BHP | BHP Group Ltd | 1.20% |
| *SQ2* | *Block, Inc. Shs (not held)* | *1.01%* |
| VEA | Viva Energy Group Ltd. | 0.45% |
| MTS | Metcash Limited | 0.43% |
| TLS | Telstra Group Limited | 0.42% |

### Top 5 detractors - 1 year

| Code | Name | Value Added |
|---|---|---|
| XRO | Xero Limited | -0.89% |
| JHX | James Hardie Industries | -0.74% |
| WDS | Woodside Energy Group Ltd | -0.66% |
| NEC | Nine Entertainment Co. Holdings Limited | -0.62% |
| DOW | Downer EDI Limited | -0.50% |

Source: Pendal as at 31 October 2022
*Underweight positions are in italics.*

# Stock specific drivers of monthly performance relative to benchmark

## Three largest contributors

**Overweight Qantas (QAN, +16.3%)**
QAN flagged that it expected underlying profit before tax in H1 FY23 between $1.2-$1.3bn, versus consensus expectations of ~$500m. It continues to rebound faster than the market expected. Business travel revenue is over 100% of pre-Covid levels and leisure revenue is ~130%. Group international capacity is expected to grow form 61% of pre-Covid in !h23 to 77% in 2H23, assisted by new planes coming on line.

**Underweight Rio Tinto (RIO, -5.6%)**
The lack of any meaningful change in policy direction from the Chinese National People's Congress weighed on sentiment in the commodity space. At this point Beijing appears unlikely to roll out any material stimulus measures or change to the Covid zero policy, with the economic outlook for the property sector and the broader economy remaining muted as a result. The portfolio is underweight in iron ore.

**Overweight Westpac (WBC, +16.8%)**
The bank sector is enjoying tailwinds from higher interest rates, which is feeding through to higher net interest margins, a trend confirmed by recent updates from the sector. Westpac was the best-performed of the major banks, which in part reflects a larger previous de-rating. Going forward investors will be watching to see how sustained this tailwind is, while also keeping a close eye on the cost profile.

## Three largest detractors:

**Overweight Telstra (TLS, +1.8%)**
As a more defensive exposure, Telstra underperformed as sentiment took a more positive turn. We continue to see the market in something of a holding pattern, with sentiment oscillating. We continue to see Telstra as in important defensive exposure in the event that the economy takes a material downturn as a result of tighter monetary policy. At the same time, it is benefiting from a return to profitability in the mobile phone segment.

**Overweight CSL (CSL, -1.6%)**
CSL gave back some of its recent strong gains, although it was recovering into the end of the month. The update on the recently acquired Vifor business at its strategy day was well received. We continue to see the recovery in plasma supply as a decent tailwind for CDL, while an upcoming new product cycle can provide further upside catalysts.

**Overweight BHP (BHP, -3.0%)**
The expectation that zero-Covid and lack of stimulus will continue to weigh on the Chinese economy - and on the property sector - continued to cool sentiment in the iron ore space and weigh on BHP.

# Market outlook

The market continues to oscillate between two potential scenarios.

At the benign end is the view that inflation continues to trend down, allowing the Fed to achieve its target rate and then start cutting rates towards the end of 2023. This results in a mild economic downturn and limited effect on earnings. In this scenario, further equity market downside is also limited.

The more bearish scenario is one where inflation remains stubbornly higher than the Fed wants, meaning that rates remain higher for longer. This, in turn, means a deeper recession and a significant earnings drop. In this scenario, the earnings effect takes markets a leg lower.

At the moment, the market seems to be bouncing between these poles, depending on the latest data prints or interpretation of statements from central banks. As a result, we see markets operating in a trading range for the time being.

The medium term market outlook remains dependent on the degree of economic downturn and the impact that has on earnings.

There is some debate about the degree of leverage earnings will have to the downturn. Historically, recessions have led to a 20% fall in earnings, on average. However this is often in a low inflation environment, when nominal GDP (a proxy for corporate revenue) is low.

In this instance, the bulls argue that there are three factors which may mitigate earnings decline;

1. Companies will benefit from higher nominal growth supporting revenue, helping cover fixed costs.
2. Materials and energy companies will see continued strong earnings, given lack of supply.
3. The potential re-opening of China may offset weakness in Europe and the US.

This degree of earnings leverage remains to be seen. However it is fair to say we are in a different type of cycle than those investors have grown used to.

The portfolio's performance is not predicated on which of these two scenarios wins out. If inflation remains high, prompting fear of higher-for-longer rates, it has exposure to domestic defensives and to companies with strong pricing power. If, on the other hand, the earnings outcome is milder than many fear, then the exposure to high quality cyclicals is expected to do well.

We continue to look for companies which combine the desired thematic exposures with a fundamental company-specific story that can provide an additional level of valuation support. Strong cash flow generation and the return of capital to shareholders remains attractive attributes in this environment.

We also remain mindful that the Australian equity market is relatively defensive in a global context. The combination of less inflationary pressure – particularly in wages, higher household savings, a more dovish central banks, strong terms of trade and the index construction have also seen the ASX hold up better than global peers.

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

**Sell Evolution Mining (EVN) to zero and buy a new position in Northern Star Resources (NST)**

We are shifting the portfolio's exposure to gold miners via the sale of Evolution (EVN) and a new stake in Northern Star (NST).

Gold mining exposure plays a defensive role in the portfolio. 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.

We are seeing some fundamental pressure come through on the gold mining sector. Companies 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.

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. At the same time, EVN has reduced its guidance on expected production. It has announced that the expansion of its Mungari project in Western Australia will be delayed due to the higher cost environment. It also 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.

NST is not immune from increased cost pressure, however it is taking steps to manage this, such as scaling down more marginal operations.

A key distinction between the EVN and NST is the outlook for cash flow. NST has completed the expansion of its Pogo asset in Alaska, which now offers a clean operational outlook, EVN is still facing ongoing challenges at Red Lake.

One result is that EVN is unlikely to be generating material free cash flow in the next few years, in contrast to NST, which should be generating sizable amounts. NST also has a stronger balance sheet than EVN. The $300m on-market buyback from NST indicates that management will be returning capital to shareholders.

This is also translating to a higher current dividend yield for NST versus EVN.

Given this combination of factors, we are switching out gold exposure from EVN to NST.

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.

**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 and lithium for other producers.

The key attraction at this point is MIN's lithium business; it is one of Australia's largest producers of the mineral spodumene, one of two key sources of lithium (the other being brine pools, more common in South America).

Since 2017, MIN has been producing and shipping lithium ore from its West Australian projects at Mt Marion and Wodgina, the latter being one of the largest hard rock lithium deposits in the world.

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. Recent policies in China, the US and EU to support the EV market have sent lithium prices soaring, as supply struggles to match demand.

We believe the market is underappreciating potential earnings growth in this area as MIN looks to extracts a greater share of the lithium value chain. It is expanding both its Wodgina and Mt Marion operations, in conjunction with its joint venture partners Albemarle and Ganfeng.

The next step is to produce lithium hydroxide, the final product used in EV batteries, historically processed in China. Again in JV with Albermarle, MIN is constructing what is expected to be one of the world's largest lithium production facilities at Kemerton, capable of producing lithium hydroxide. It is also looking at building additional hydroxide production, with the goal to have sufficient capacity to fully convert its spodumene.

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 our research suggests consensus estimates for MIN underappreciate the scope for earnings uplift from the production of higher margin lithium hydroxide.

There are additional tailwinds for MIN beyond this margin uplift. One is increased spodumene production, with further expansions at both Mt Marion and Wodgina possible.

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.

MIN is currently on a 5.1% dividend yield.

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