Pendal Monthly Commentary

Pendal Sustainable Future Australian Shares 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

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 (28 as at 31 October 2022)
Sector limits	Cash 2-10%
Dividend Yield	3.74%#

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	10.31%
CBA	Commonwealth Bank of Australia	8.63%
NAB	National Australia Bank Limited	7.98%
TLS	Telstra Group Limited	6.44%
QAN	Qantas Airways Limited	4.85%
WBC	Westpac Banking Corporation	4.30%
QBE	QBE Insurance Group Limited	4.29%
IGO	IGO Limited	4.08%
MQG	Macquarie Group, Ltd.	3.99%
DOW	Downer EDI Limited	3.17%

Source: Pendal as at 31 October 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
QAN	Qantas Airways Limited	4.32%
TLS	Telstra Group Limited	4.27%
CSL	CSL Limited	3.86%
IGO	IGO Limited	3.59%
QBE	QBE Insurance Group Limited	3.43%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Group Ltd (not held)	-9.03%
WDS	Woodside Energy Group Ltd (not held)	-3.26%
WES	Wesfarmers Limited (not held)	-2.46%
TCL	Transurban Group Ltd. (not held)	-1.94%
WOW	Woolworths Group Ltd (not held)	-1.91%

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 years (p.a)	Since inception (p.a.)*
Pendal Sustainable Future Australian Shares Portfolio	6.31%	1.49%	-6.62%	-4.07%	7.08%	8.25%
S&P/ASX 300 (TR) Index	5.96%	0.46%	-5.77%	-2.61%	4.86%	6.84%
Active return	**0.34%**	**1.03%**	**-0.85%**	**-1.47%**	**2.22%**	**1.40%**

Source: Pendal as at 31 October 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
BHP	*BHP Group Ltd (not held)*	*0.89%*
QAN	Qantas Airways Limited	0.46%
RIO	*Rio Tinto Limited (not held)*	*0.20%*
IGO	IGO Limited	0.19%
NAB	National Australia Bank Limited	0.19%

Top 5 detractors - monthly

Code	Name	Value Added
FMG	Fortescue Metals Group Ltd	-0.43%
OZL	OZ Minerals Limited	-0.38%
CSL	CSL Limited	-0.32%
DOW	Downer EDI Limited	-0.27%
WDS	*Woodside Energy Group Ltd (not held)*	*-0.24%*

Top 5 contributors - 1 year

Code	Name	Value Added
IGO	IGO Limited	1.19%
SQ2	*Block, Inc. Shs (not held)*	*1.00%*
QAN	Qantas Airways Limited	0.50%
NAB	National Australia Bank Limited	0.48%
TLS	Telstra Group Limited	0.41%

Top 5 detractors - 1 year

Code	Name	Value Added
XRO	Xero Limited	-1.62%
BHP	*BHP Group Ltd (not held)*	*-1.58%*
WDS	*Woodside Energy Group Ltd (not held)*	*-1.10%*
DOW	Downer EDI Limited	-0.88%
NEC	Nine Entertainment Co. Holdings Limited	-0.55%

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

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Underweight BHP (BHP, -3.0%)

The outlook for growth in the Chinese property sector - and the economy ore broadly - remains muted with nothing from the National People's Congress to suggest a change in path. Iron ore prices have continued to weaken as a result. This weighed on BHP, which is excluded from the portfolio due to its coking coal exposure.

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 benefited from not owning Rio Tinto (RIO).

Three largest detractors

Overweight Fortescue Metals (FMG, -12.6%)

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 Fortescue Metals. While the Chinese economic outlook is likely to remain muted until zero Covid is rolled back, FMG remains a strong source of cash flow in the portfolio and is offering a dividend yield above 8%.

Overweight Oz Minerals (OZL, -6.3%)

Softer sentiment around China also weighed on the copper miners such as Oz Minerals. However there is still a strong expectation that BHP may return with an improved takeover offer, having made a bid of $25 per share in early August, which the OZL board rejected.

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.

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 to zero in Transurban (TCL).

We are further reducing the portfolio's bond sensitivity in an environment where the Federal Reserve is maintaining a policy of aggressive rate hikes, at the same time that we do not yet have a clear indication of the pace at which inflation is slowing.

Despite its sensitivity to increase in interest rates, toll-road developer and operator Transurban (TCL) has held up relatively well compared to the broader market and to other traditional rate sensitives such as REITs, over the course of the last twelve months.

At the same time, Transurban's fundamentals are less attractive at the margin. Its full-year dividend disappointed, partly as a result of higher than expected operating cost growth. The latter is expected to increase further into FY23, while cost inflation also reduces the economics of potential development opportunities.

Given the combination of recent relative performance, an environment in which bond-sensitive stocks look vulnerable, and a less attractive fundamental outlook, we see better opportunities emerging and have liquidated this position as a result.

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
106.95	235.01	-128.06

Source: ISS, Pendal holdings as at 31 October 2022. Report run on 10/11/2022 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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