PENDAL

Pendal Monthly Commentary

Pendal Sustainable Future Australian Shares Portfolio

December 2022

Market commentary

Australian equities finished the year on a softer note, as central banks maintained a hawkish tone on inflation into the end of the year.

The S&P/ASX 300 fell -3.3% in December, giving back some of the gains of the previous two months. However it still finished up 9.1% for the quarter and down only -1.8% for the year. The S&P 500 fell -17.9% for the year, in contrast, highlighting the ASX's defensive qualities in this environment.

The US consumer price index (CPI - a measure of inflation) print for November was 0.2% month-on-month. This was down from 0.3% in October and was the second consecutive month where the increase was lower than consensus expectations. This, along with other signals, suggests that inflation continues to moderate.

However the US labour market remains strong and continues to concern the Federal Reserve. They need to see more slack in labour markets to calm fears about persistent wage increases driving further inflation. As a result, Chair Powell's comments following the interest rate hike in December emphasised the need to continue hiking - and to potentially keep rates high for longer than the market currently expects - until the labour market starts to soften.

Elsewhere, Beijing rolled back the zero-Covid policy. This has prompted some optimism around commodity prices on the hope that the disruptive economic effect of recurring lock-downs will end. Iron ore rose 15.7% for the month. However it is also seeing substantial near-term disruption and risks to the health system.

Every sector lost ground in December. Materials (-1.1%) held up better than the broader index on the back of higher commodity prices and optimism about the medium-term outlook for improved Chinese demand. BHP (BHP, +0.2%) held its ground, while fellow iron ore plays Rio Tinto (RIO, +6.2%) and Fortescue (FMG, +5.8%) made solid gains.

Utilities (-1.2%) also outperformed, helped by corporate actions as Origin (ORG, -1.8%) remains under a non-binding, indicative takeover offer.

Consumer Discretionary (-7.0%) fell the furthest on broad concerns over the impact of an economic slowdown in 2023. Wesfarmers (WES) was down -5.5%, Aristocrat (ALL) -12.9%) and JB Hi-Fi (JBH) -6.1%.

Industrials (-4.9%) was also among the weaker sectors. A continued hawkish tone weighed on the infrastructure names such as Transurban (TCL, -7.3%) and Atlas Arteria (ALX, -6.0%).

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 December 2022)
Sector limits	Cash 2-10%
Dividend Yield	3.86%#

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	10.42%
CBA	Commonwealth Bank of Australia	7.93%
NAB	National Australia Bank Limited	7.29%
TLS	Telstra Group Limited	6.45%
QBE	QBE Insurance Group Limited	5.07%
QAN	Qantas Airways Limited	4.91%
WBC	Westpac Banking Corporation	4.50%
MQG	Macquarie Group, Ltd.	3.87%
FMG	Fortescue Metals Group Ltd	3.61%
OZL	OZ Minerals Limited	3.57%

Source: Pendal as at 31 December 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
QAN	Qantas Airways Limited	4.38%
TLS	Telstra Group Limited	4.30%
QBE	QBE Insurance Group Limited	4.14%
CSL	CSL Limited	3.94%
OZL	OZ Minerals Limited	3.13%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Group Ltd (not held)	-10.79%
WDS	Woodside Energy Group Ltd (not held)	-3.14%
WES	Wesfarmers Limited (not held)	-2.43%
WOW	Woolworths Group Ltd (not held)	-1.91%
TCL	Transurban Group Ltd. (not held)	-1.86%

Source: Pendal as at 31 December 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	-3.86%	7.93%	10.36%	-4.86%	6.94%	8.29%
S&P/ASX 300 (TR) Index	-3.29%	9.13%	9.62%	-1.77%	5.51%	7.28%
Active return	**-0.56%**	**-1.20%**	**0.74%**	**-3.09%**	**1.42%**	**1.01%**

Source: Pendal as at 31 December 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
QBE	QBE Insurance Group Limited	0.29%
FMG	Fortescue Metals Group Ltd	0.16%
OZL	OZ Minerals Limited	0.15%
TLS	Telstra Group Limited	0.15%
NST	Northern Star Resources Ltd	0.11%

Top 5 detractors - monthly

Code	Name	Value Added
DOW	Downer EDI Limited	-0.82%
BHP	*BHP Group Ltd (not held)*	*-0.37%*
IGO	IGO Limited	-0.32%
NEC	Nine Entertainment Co. Holdings Ltd	-0.21%
ORA	Orora Ltd.	-0.08%

Top 5 contributors - 1 year

Code	Name	Value Added
QAN	Qantas Airways Limited	0.81%
QBE	QBE Insurance Group Limited	0.68%
JHX	*James Hardie Industries PLC (not held)*	*0.54%*
WES	*Wesfarmers Limited (not held)*	*0.53%*
SQ2	*Block, Inc. Shs (not held)*	*0.53%*

Top 5 detractors - 1 year

Code	Name	Value Added
BHP	*BHP Group Ltd (not held)*	*-2.66%*
XRO	Xero Limited	-1.61%
DOW	Downer EDI Limited	-1.24%
WDS	*Woodside Energy Group Ltd (not held)*	*-1.05%*
NEC	Nine Entertainment Co. Holdings Ltd	-0.96%

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

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight QBE Insurance Group (QBE, +4.4%)

Global insurer QBE maintained its recent positive momentum. It is a beneficiary of higher interest rates as it boosts returns on its investment portfolio. This tailwind was confirmed in a recent update, with fixed income yields running well ahead of consensus estimates. Revenue momentum remains strong and the stock is cheap compared to global peers.

Overweight Fortescue Metals (FG, +5.8%)

Iron ore prices rose 16.7% in December as Beijing rolled back Covid restrictions. This is likely to see significant near term economic disruption and presents a risk to health systems. Over the longer-term, it has prompted optimism that the disruptive effects of ongoing lock-downs will disappear. Iron ore miners such as Fortescue Metals, Rio Tinto and BHP outperformed as a result.

Three largest detractors

Overweight Downer (DOW, -28.2%)

Contractor DOW downgraded FY22 net profit after tax (NPAT) by ~12%. This was driven largely by weather disruption and issues with workforce management. However 3% was due to an accounting irregularity which had overstated profits on one contract. The large market reaction as driven by concern hat this could be a broader issue. The company has largely exited higher-risk, fixed-price construction contracts and believe the issue is not replicated, but is investigating. It has a good balance sheet, is buying back shares and should see a strong recovery in earnings in FY24. A strategic review could unlock further shareholder value.

Underweight BHP (BHP, +0.2%)

Iron ore prices rose 16.7% in December as Beijing rolled back Covid restrictions. This is likely to see significant near term economic disruption and presents a risk to health systems. Over the longer-term, it has prompted optimism that the disruptive effects of ongoing lock-downs will disappear. Iron ore miners such as Fortescue Metals, Rio Tinto and BHP outperformed as a result. BHP is excluded from the portfolio due to its coking coal exposure.

Overweight Oz Minerals (OZL, +1.7%)

Copper miner OZL's board has recommended the scheme of arrangement to be acquired by BHP at $28.25 a share. The deal is slated for completion in April 2023. More broadly, news that Beijing was rolling back Covid restrictions raised optimism that the disruptive effects of lockdowns would recede, helping a Chinese economic recovery over the medium term. Copper prices rose 2% over December as a result.

Overweight IGO (IGO, -12.6%)

The lithium mining sector has been under pressure since mid-November over concerns around softer Chinese demand for electric vehicles. This was exacerbated by the results of the Pilbara Minerals (PLS) December auction for lithium spodumene concentrate cargos, which saw slightly lower realised prices than in November – the first time prices have fallen in some time. This weighed on the broader sector and saw IGO give back some of the strong gains made since mid-2022.

Outlook

The portfolio underperformed in December. Downer was a notable detractor, as was the underweight in iron ore names – and particularly BHP, which is excluded from the portfolio – as Beijing changed tack on covid-zero. This offset outperformance from QBE Insurance, Oz Minerals and Telstra Group.

There are six key questions leading into 2023.

1. The persistence of inflation, which will determine how tight financial conditions need to be.
2. The scale of economic slowdown in the US and other developed markets.
3. The leverage of earnings to that downturn.
4. Whether markets have already priced in the downturn.
5. How China's economy performs as it exits covid-zero
6. Can the RBA engineer a soft landing in Australia.

Initial signs on the first three issues are positive. The first datapoints of the year suggest that inflation is lower than consensus expectations, which in turns requires less tightening, a milder downturn and a small hit to earnings.

The deceleration is wage growth is now evident. After December's pay roll print, three month annualised wage growth now stands at 4.2% and annual growth at 4.6%.

The Fed will still want to see these figures below 4%, but it is likely to lock in a 25bp rate hike in February unless we see a dramatic deterioration in CPI numbers this week,

This supports market in the near term. So too does the current outlook for China.

The consensus view has been for markets to re-test equity low points in the first quarter as earnings revisions turn negative. As a result investor positioning has been cautious, with the market braced for a poor reporting season. Ironically, this may lead to the market holding up better than expected.

That said, it is hard to see a sustained market move materially higher. The Fed is likely to rein in any substantially easing of total financial conditions – which includes equity markets. The economic downturn is still also likely, with earnings set to fall. A market multiple of 17x in the US does not provide much of a buffer to this.

It is important to note that, after persistent increases in the expected peak in Fed rates through most of 2022, the market has now stabilised at a ~5% level since October.

This coincided with the US market low and may suggest that the de-rating phase may be over, with economic downturn and the impact on earnings becoming the key issue from here.

There have been material earnings downgrades going into the US Q4 CY22 earnings season. Overall earnings per share (EPS) growth is expected to be flat year-on-year. But if the energy sector is stripped out, they are expected to be down 5%.

Usually when the market is braced for negative outcomes, it is in the price for the short term.

On the flip side, the market has held up better going into this reporting season compared to previous quarters, which suggests less scope for a relief rally.

All this is consistent with a US market trading towards the high end of recent ranges, but no break higher in short term.

The Australian market retains its defensive qualities in this environment, with China's re-opening potentially offering a further leg of support.

The portfolio has exposure to domestic defensives with predictable cash flows and strong industry positions which can protect against a weaker economic environment. Telstra is one example here. We also like companies such as Nine Entertainment where strong free cash flow is being returned to shareholders, with buybacks helping support stocks. The portfolio retains exposure to companies with pricing power supported by favourable industry structures, which can help protect margins against inflation risk. Qantas and QBE are examples of these.

We are also mindful that a new development could see a shift in policy and bond yields fall again. As a result we maintain exposure to growth stocks such as Xero and CSL, where we have good visibility on the growth opportunity and high incremental returns on invested capital.

Finally, we have selected high quality cyclical exposures. These are sensitive to the economic cycle, but are ultimately winners in their industry and provide portfolio protection against the risk of a milder economic cycle than consensus is currently pricing.

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

Buy a new position in Rio Tinto (RIO).

We are reducing the portfolio's underweight in metals via the addition of Rio Tinto (RIO).

A muted outlook for Chinese growth, driven by property sector weakness and the disruptive effect of Covid-zero, has weighed on the mining sector and on iron ore miners such as RIO in particular.

However there have been recent signals of a change in Beijing's stance. First, Covid-zero has been refined with new measures, which are seen as the first steps to winding back the policy. Second, the PBoC have announced an indefinite extension for banks to limit property and mortgage loans. This is likely to substantially ease the credit crisis in the Chinese real estate sector.

There are three large and liquid potential exposures to iron ore; BHP (BHP), Rio Tinto (RIO) and Fortescue Metals (FMG).

BHP is excluded from this portfolio given its exposure to coal. The Fund has existing exposure to iron ore via a position in Fortescue (FMG). FMG is a pure-play iron ore miner. However we are mindful of the risk to the stock in the uncertainty around Fortescue Future Industries. While the strategic imperative behind investment into lower-carbon methods of producing iron ore and steel has merit, the current lack of detail around potential return on capital is one aspect that we need to watch carefully. As a result we do not want to increase this position size at this point.

RIO is the more attractive opportunity. It was previously excluded from the Fund's universe on the basis of failures of culture and oversight stemming from the Juukan Gorge incident. Since then, we have seen progress against the specific milestones we established as a pathway to re-inclusion. These include evidence of accountability at both management and board level, with the departure of the CEO, two executives, the Chair and the appointment of a new non-executive director. We have also seen sufficient progress in greater resourcing, transparency and accountability for cultural heritage management and of a broader refreshing of corporate culture. Finally, we have seen the findings of the Parliamentary Inquiry handed down.

RIO still has further to go and we are watching the degree of support for the review of the WA Cultural heritage act in particular. However sufficient progress has been made and the company's status has returned to “investable” from 3 November 2022.

Operationally, RIO has recently turned a corner after some previous issues. Concern over Chinese and global demand has seen softer prices for iron ore, copper and alumina. Production has also tended towards the lower end of expectation in its most recent update. Nevertheless, cost control remains reasonable and supportive of decent cash flow. The stock is above a 6% dividend yield even with the recent bounce on the back of better sentiment around China.

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
128.13	231.91	-103.78

Source: ISS, Pendal holdings as at 31 December 2022. Report run on 09/01/2023 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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