

Pendal Monthly Commentary

Pendal Australian Shares Portfolio

August 2023

Market commentary

The S&P/ASX 300 gave up much of its July rally over the first half of August.

However a softer-than-expected CPI inflation print in Australia, coupled with several US indicators that eased some concerns about excessive economic growth, saw some of the concern around further rate hikes recede.

Equities rebounded into the month's end as a result. The S&P/ASX 300 ended down -0.76% for August.

A recent softer-than-expected US employment report is seen as supporting the view that the Fed does not need to hike rates again.

The market is now pricing in a 94% chance that Fed holds rates steady in September and 65% chance of a hold in November too.

The consensus view is firmly that of a soft landing, goldilocks scenario playing out in the US.

Australian earnings season was largely in-line with expectations with earnings revisions no larger than normal. It painted a picture of an economy that remains in good shape with very little evidence of slowdown.

Broadly speaking, cyclicals generally performed better than defensives. In some instances, the former's earnings declined but held up better than the market feared.

There was larger dispersion within sectors than across them. This indicates a market where stock specifics are exerting a great influence on performance than was the case twelve months ago.

Consumer Discretionary (+5.80%) did best, partly reflecting the theme of cyclicals holding up better than the market feared. Wesfarmers (WES, +10.60%), Aristocrat (ALL, +3.99%), JB Hi-Fi (JBH, +2.61%) and Domino's Pizza (DMP, +10.99%) outperformed in this regard.

Real Estate (1.53%) also outperformed the index, largely as the result of a well-received result from index heavyweight Goodman Group (GMG, +13.73%), where the market likes the data-centre development opportunity.

The small Utilities (-3.85%) sector was the largest underperformer, dragged down by APA Group (APA, -10.10%), where lower dividend guidance and an equity issuance to fund an acquisition weighed on the result. AGL Energy (AGL) fell -7.13%.

Consumer Staples (-3.14%) also underperformed. Woolworths (WOW, +0.23%) held the line but Coles (COL, -10.56%) disappointed as theft proved a large drag in the half.

Portfolio overview

Australian Shares Portfolio	
Investment strategy	Pendal employs a bottom up, fundamental approach to build a diversified portfolio of Australian shares where the majority of active risk and outperformance is driven by stock selection. The portfolio will focus primarily on capital growth.
Investment objective	To deliver outperformance relative to the benchmark after fees over a rolling three year period.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15 - 35 (29 as at 31 August 2023)
Sector limits	Australian Shares 60 - 98% Australian Property 0 - 30% Cash 2 - 10%
Dividend Yield	3.44% [#]
Income target	No target

Top 10 holdings

Code	Name	Weight
BHP	BHP Group Ltd	11.25%
CSL	CSL Limited	8.65%
STO	Santos Limited	7.13%
CBA	Commonwealth Bank of Australia	6.02%
TLS	Telstra Group Limited	5.85%
NAB	National Australia Bank Limited	5.71%
WBC	Westpac Banking Corporation	4.94%
XRO	Xero Limited	4.79%
QAN	Qantas Airways Limited	4.25%
QBE	QBE Insurance Group Limited	3.73%

Source: Pendal as at 31 August 2023

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
STO	Santos Limited	5.99%
XRO	Xero Limited	4.00%
QAN	Qantas Airways Limited	3.77%
TLS	Telstra Group Limited	3.76%
QBE	QBE Insurance Group Limited	2.73%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
ANZ	ANZ Group Holdings Limited (not held)	-3.43%
WDS	Woodside Energy Group Ltd (not held)	-3.17%
WES	Wesfarmers Limited (not held)	-2.76%
WOW	Woolworths Group Ltd (not held)	-2.10%
RIO	Rio Tinto Limited (not held)	-1.89%

Source: Pendal as at 31 August 2023

[#]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 Shares Portfolio	-1.09%	2.82%	3.82%	9.38%	11.90%	7.70%	9.17%
S&P/ASX 300 (TR) Index	-0.76%	3.88%	2.87%	8.96%	10.51%	6.99%	7.75%
Active return	-0.32%	-1.05%	0.95%	0.42%	1.39%	0.71%	1.42%

Source: Pendal as at 31 August 2023

*Since Inception - 15 June 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
<i>RMD</i>	<i>Resmed Inc (not held)</i>	<i>0.14%</i>
<i>TCL</i>	<i>Transurban Group Ltd. (not held)</i>	<i>0.13%</i>
JHX	James Hardie Industries PLC	0.13%
<i>WTC</i>	<i>Wisetech Global Ltd. (not held)</i>	<i>0.12%</i>
XRO	Xero Limited	0.12%

Top 5 contributors - 1 year

Code	Name	Value Added
XRO	Xero Limited	1.16%
QBE	QBE Insurance Group Limited	0.43%
NST	Northern Star Resources Ltd	0.38%
JHX	James Hardie Industries PLC	0.37%
<i>ASX</i>	<i>ASX Limited (not held)</i>	<i>0.24%</i>

Source: Pendal as at 31 August 2023

Underweight positions are in italics.

Top 5 detractors - monthly

Code	Name	Value Added
JDO	Judo Capital Holdings Limited	-0.37%
QAN	Qantas Airways Limited	-0.36%
<i>WES</i>	<i>Wesfarmers Limited (not held)</i>	<i>-0.29%</i>
S32	South32 Ltd.	-0.18%
TLS	Telstra Group Limited	-0.12%

Top 5 detractors - 1 year

Code	Name	Value Added
S32	South32 Ltd.	-0.48%
<i>WDS</i>	<i>Woodside Energy Group Ltd (not held)</i>	<i>-0.46%</i>
STO	Santos Limited	-0.46%
CSL	CSL Limited	-0.37%
JDO	Judo Capital Holdings Limited	-0.36%

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Underweight ResMed (RMD, -24.03%)

ResMed delivered a decent set of numbers with strong revenue growth, although margins came in softer than expected. There is a view that the stock has come under pressure in response to the rise in use of semaglutide medications to treat obesity, a condition often associated with the sleep apnea that RMD products seek to treat. There are signs that RMD stock is being sold short in response to this thematic effect.

Underweight Transurban (TCL, -7.53%)

Historically, Transurban tends not trade too much on its results given its defensive earnings profile. However a 6% EBITDA (earnings before interest, tax, depreciation and amortisation) miss in 2H23 on weaker Sydney traffic - combined with the sell off in defensive stocks - saw TCL underperform over the month.

Overweight James Hardie Industries (JHX, +7.01%)

James Hardie's 1Q24 EBIT (earnings before interest and tax) beat expectations by 12% and management provided positive guidance for 2Q24, with the company benefiting from a surprisingly strong recovery in new home construction demand in the US. Combined with easing input costs this is driving positive operating leverage, with margins returning towards peak levels.

Three largest detractors

Overweight Judo Capital Holdings (JDO, -32.60%)

Judo's results were largely in-line with guidance and consensus. But the outlook disappointed, with suggestions of a sharp drop in FY24 margins as JDO replaces the portion of its funding that comes from the Term Funding Facility with more expensive deposits. The resulting uncertainty shook market confidence, although management remains adamant that it remains on track for its target scale metrics and that it can continue funding growth through short term disruptions.

Overweight Qantas (QAN, -9.49%)

QAN delivered profit before tax in-line with guidance and ~\$1bn higher than any twelve-month period prior to Covid. Net debt is almost half pre-Covid levels. Despite this, the company came under intense media scrutiny for a number of issues including unused flight credits and legal action from the ACCC. The challenges of ramping up capacity have resulted in poor customer service and QAN failing to get the balance right. It has announced the early departure of the CEO and steps to address the issues with customer service. The current valuation implies that cost out, improved industry structure, strong loyalty business and shift in consumer spending trends will largely unwind. We believe this will not be the case.

Underweight Wesfarmers (WES, +10.60%)

WES delivered solid results, in line with consensus, with underlying EBIT growth of 13% in FY23. The retail businesses continue to hold up well at elevated levels. Kmart had a strong 2H unlike key competitor Big W. There was limited detail on the outlook, although sales trends into FY24 remain reasonable. The chemicals business is expected to have a material reversal in EBIT next year driven by falling commodity prices and high gas input costs. We see the stock as fully-valued given muted earnings-per-share (EPS) growth and uncertainties around the outlook for retail sales.

Performance and outlook

The portfolio ended the month behind the index. There were positive contributions from the growth exposures in Xero (XRO), Goodman Group (GMG), NextDC (NXT) and Pro Medicus (PME) as well as from defensive Metcash (MTS) and cyclical James Hardie (JHX). However this was more than offset by the drag from Qantas (QAN), Judo (JDO) and South32 (S32) as well as not owning Wesfarmers (WES).

The global disinflation story continues. This is supportive for markets as we currently appear to be close to the end of the tightening cycle and economic growth in the US and Australia remains largely intact.

The consensus view is firmly that of a soft landing, goldilocks scenario in the US.

Extrapolating current data, it looks like the US is on track to deliver a very solid quarter of GDP growth, with the Atlanta Fed's GDPNow measure at 5.6% growth. The market takes a more nuanced view, believing that strength in the consumer cannot be sustained with a wave of headwinds due to bite.

Whilst real personal spending growth has continued to run hotter than expected, upcoming headwinds associated with a lower savings rate, resumption of student loan repayments and run down of pandemic excess savings would suggest that such strong personal consumption growth should not be sustained into 4Q.

But this does raise the concern that a stronger than expected economy may override the improving trends in inflation and wages, leading to further uncertainty in rates and at the Fed.

This would be counter to the soft landing scenario which is now being priced into the market and which recent data has supported.

In China, we are seeing a drip feeding of policies and support for markets, with concerns around housing, leverage, shadow banking and capital flight still in focus.

Beijing has delivered a number of easing measures to support the property sector, consumption and currency. It is a positive step in the right direction but more is needed.

In Australia, the underlying theme is the economy seems fine and earnings are largely holding up for industrials.

While there are pockets of weakness in certain retail categories, these are outweighed by positive signals in travel, commercial demand and building materials.

One emerging theme was the sharp increase in interest costs in response to higher rates. This remains a key area to watch for the higher-gear companies - particularly where slowing revenue growth may lead to operating de-leverage.

However there are no signs of recession and, with rates on hold, it is hard to see what would trigger one.

The only issue is at some point inflation trends may force RBA to re-evaluate, but that remains a little way off.

In sum, the combination of slowing inflation and economic resilience is a good one - but it remains too soon to declare victory, in our view. Uncertainties remain about the lagged effect of monetary policy as various other supportive factors recede. Also inflation, while falling, may settle at a higher rate than central banks are comfortable with, prompting further rate hikes.

As a result we retain the balance in our portfolio construction, with a mix of defensives, cyclicals, growth stocks, capital returners and stocks that retain good pricing power.

We observe that 12-month sector dispersion over 12-month stock dispersion has fallen sharply over 2023, after rising for much of 2022. This suggests the re-emergence of stock-specific factors as a key driver of performance, which we believe plays to the strengths of our approach.

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

Sell to zero in Domain Group (DHG)

We are taking advantage of a strong run over the calendar year-to-date to sell the position in Domain Group.

Domain offers a range of property-related services. The “Domain” online residential platform is the best known. However it also owns a print and online media advertising franchise and a number of services to agents to help generate leads and manage inspections as well as providing market data and research.

The speed and scale of interest rate hikes in 2022 has provided a challenging backdrop for the housing market, with DHG flagging that new listings had declined 9.5% year-on-year in the first half of FY23.

The company has been able to offset some of this revenue via product pricing and “depth penetration,” which is the degree to which agents will adopt more premium products. While this has led to some pressure on margins, it has been primarily macro factors - the poor sentiment around the housing market and falling house prices as well as a broader de-rating of growth stocks - which dragged on the stock for much of 2022.

However the stock has rallied strong and is up 50.80% year to date (as at end July 2023), helped by an attractive valuation starting point and the view that house price declines had reached a nadir and would start to recover.

The listing environment is improving, however it is unclear whether this will plateau for a period or develop into a material rebound. There are still a number of competing factors in the economy, including the lagged effect of monetary tightening, which are at play here.

We continue to see DHG as a good quality growth company which is executing well on its innovation strategy.

However given good performance year to date, reduced valuation upside and uncertainty over the cyclical backdrop, we are taking the opportunity to close out this position.

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

PENDAL

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