PENDAL

Pendal Monthly Commentary

Pendal Australian Tax Effective Income 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 Tax Effective 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 focuses on both capital growth and delivering higher than market yield with a particular consideration for CGT.
Investment objective	To deliver outperformance relative to the benchmark after fees on a rolling three year period while delivering a higher gross yield than the market.
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	4.11%#

Top 10 holdings

Code	Name	Weight
BHP	BHP Group Ltd	11.98%
CSL	CSL Limited	7.94%
CBA	Commonwealth Bank of Australia	7.23%
TLS	Telstra Group Limited	6.31%
NAB	National Australia Bank Limited	5.78%
WBC	Westpac Banking Corporation	4.65%
STO	Santos Limited	4.08%
MTS	Metcash Limited	3.93%
QBE	QBE Insurance Group Limited	3.81%
QAN	Qantas Airways Limited	3.58%

Source: Pendal as at 31 August 2023

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Group Limited	4.22%
MTS	Metcash Limited	3.77%
QAN	Qantas Airways Limited	3.10%
NEC	Nine Entertainment Co. Holdings Limited	3.06%
STO	Santos Limited	2.94%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES	Wesfarmers Limited (not held)	-2.76%
WOW	Woolworths Group Ltd (not held)	-2.10%
RIO	Rio Tinto Limited (not held)	-1.89%
TCL	Transurban Group Ltd. (not held)	-1.84%
NCM	Newcrest Mining Limited (not held)	-1.05%

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 Tax Effective Income Portfolio	-0.93%	3.54%	2.85%	8.43%	12.14%	7.62%	9.15%
S&P/ASX 300 (TR) Index	-0.76%	3.88%	2.87%	8.96%	10.51%	6.99%	8.99%
Active return	**-0.17%**	**-0.34%**	**-0.02%**	**-0.53%**	**1.63%**	**0.63%**	**0.16%**

Source: Pendal as at 31 August 2023

*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
MTS	Metcash Limited	0.16%
RMD	*Resmed Inc (not held)*	*0.14%*
TCL	*Transurban Group Ltd. (not held)*	*0.13%*
WTC	*Wisetech Global Ltd. (not held)*	*0.12%*
COL	*Coles Group Ltd. (not held)*	*0.11%*

Top 5 detractors - monthly

Code	Name	Value Added
QAN	Qantas Airways Limited	-0.30%
WES	*Wesfarmers Limited (not held)*	*-0.29%*
S32	South32 Ltd.	-0.17%
TLS	Telstra Group Limited	-0.14%
COH	*Cochlear Limited (not held)*	*-0.10%*

Top 5 contributors - 1 year

Code	Name	Value Added
QBE	QBE Insurance Group Limited	0.47%
XRO	Xero Limited	0.39%
JHX	James Hardie Industries PLC	0.34%
NXT	Nextdc Limited	0.30%
ASX	*ASX Limited (not held)*	*0.24%*

Top 5 detractors - 1 year

Code	Name	Value Added
MTS	Metcash Limited	-0.57%
DOW	Downer EDI Limited	-0.52%
MIN	Mineral Resources Limited	-0.38%
CSL	CSL Limited	-0.35%
NCM	*Newcrest Mining Limited (not held)*	*-0.32%*

Source: Pendal as at 31 August 2023

Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Metcash (MTS, +3.61%)

It was a quiet month of newsflow for Metcash, which reported in June. The stock held up in a softer market. We remain attracted to MTS" defensive characteristics, forming part of the portfolio which we would expect to outperform if we see the economic environment begin to deteriorate. At a stock level, we believe the market is underestimating the degree to which MTS can retain some of the market share gains made during the Covid period.

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.

Three largest detractors

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.

Overweight South32 (S32, -12.37%)

Headline financials were in-line with expectations but free cash flow was relatively soft and looks set to remains so in FY24, with capex higher at both Illawarra and Sierra Gorda. Higher cost guidance and lowered production guidance at Illawarra and Brazil Aluminium saw earnings downgrades. S32's valuation remains undemanding and it is among our preferred positions within the mining sector, although we remains moderately underweight the sector as a whole.

Performance and outlook

The portfolio ended the month slightly behind the index. There were positive contributions to relative performance from not owning several underperforming stocks, including ResMed, Transurban, Wisetech and Coles. Holdings in Metcash, James Hardie and NextDC also made positive contributions.

This was offset by a detraction from positions in Qantas, South32 and Telstra and from not owning Wesfamers and Cochlear.

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-geared 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

No new stocks added or sold to zero during the month.

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

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