Pendal Monthly Commentary

Pendal Sustainable Future 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

Sustainable Future Australian Shares Portfolio	
Investment strategy	Pendal's investment process for Australian shares is based on its core investment style and aims to add value through active stock selection and fundamental company research. Pendal's core investment style is to select stocks based on its assessment of their long term worth and ability to outperform the market, without being restricted by a growth or value bias. Pendal's fundamental company research focuses on valuation, franchise, management quality and risk factors (both financial and non-financial risk)
Investment objectives	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 August 2023)
Sector limits	Australian Shares, 65 - 98%, Australian Property 0 - 30%, Cash 2 - 5%
Dividend Yield	3.51%#

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	9.89%
CBA	Commonwealth Bank of Australia	6.88%
TLS	Telstra Group Limited	6.37%
NAB	National Australia Bank Limited	5.64%
QBE	QBE Insurance Group Limited	5.21%
RIO	Rio Tinto Limited	5.01%
GMG	Goodman Group	4.20%
QAN	Qantas Airways Limited	4.13%
WBC	Westpac Banking Corporation	3.90%
MQG	Macquarie Group, Ltd.	3.80%

Source: Pendal as at 31 August 2023

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Group Limited	4.28%
QBE	QBE Insurance Group Limited	4.20%
CSL	CSL Limited	3.94%
QAN	Qantas Airways Limited	3.65%
RIO	Rio Tinto Limited	3.12%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Group Ltd (not held)	-10.25%
WDS	Woodside Energy Group Ltd (not held)	-3.17%
WES	Wesfarmers Limited (not held)	-2.76%
WOW	Woolworths Group Ltd (not held)	-2.10%
TCL	Transurban Group Ltd. (not held)	-1.84%

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 Sustainable Future Australian Shares Portfolio	-0.42%	3.41%	4.47%	9.53%	10.54%	8.13%	8.89%
S&P/ASX 300 (TR) Index	-0.76%	3.88%	2.87%	8.96%	10.51%	6.99%	7.62%
Active return	**0.34%**	**-0.47%**	**1.59%**	**0.57%**	**0.03%**	**1.13%**	**1.27%**

Source: Pendal as at 31 August 2023
*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
GMG	Goodman Group	0.31%
JHX	James Hardie Industries PLC	0.19%
BHP	*BHP Group Ltd (not held)*	*0.18%*
NXT	Nextdc Limited	0.15%
RMD	*Resmed Inc (not held)*	*0.14%*

Top 5 detractors - monthly

Code	Name	Value Added
QAN	Qantas Airways Limited	-0.35%
WES	*Wesfarmers Limited (not held)*	*-0.29%*
CGC	Costa Group Holdings Ltd.	-0.19%
QBE	QBE Insurance Group Limited	-0.15%
ILU	Iluka Resources Limited	-0.14%

Top 5 contributors - 1 year

Code	Name	Value Added
XRO	Xero Limited	0.71%
QBE	QBE Insurance Group Limited	0.70%
NST	Northern Star Resources Ltd	0.61%
FMG	Fortescue Metals Group Ltd	0.44%
GMG	Goodman Group	0.43%

Top 5 detractors - 1 year

Code	Name	Value Added
BHP	*BHP Group Ltd (not held)*	*-1.16%*
DOW	Downer EDI Limited	-0.76%
CSL	CSL Limited	-0.58%
WDS	*Woodside Energy Group Ltd (not held)*	*-0.46%*
SCG	*Scentre Group (not held)*	*-0.43%*

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 Goodman Group (GMG, +13.73%)

GMG's FY23 result broadly beat management guidance but was in line with consensus expectations. Increased earnings from investment and new developments partially offset lower management fees. Management flagged a $30bn-plus development opportunity in data centres, which effectively doubles their five-year logistics development pipeline. This, along with confirmation that their core rent growth is increasing, saw the stock re-rate.

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.

Underweight BHP (BHP, -2.52%)

BHP's FY23 result was largely in ln with consensus. Like most other mining companies, it is flagging higher capex driven largely by inflation. This may leave net debt at the higher end of BHP's target range and serve to limit dividends over the next couple of years. BHP is excluded from the portfolio on the basis of its exposure to coal.

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 Costa Group (CGC, -13.90%)

Costa noted a decline in trading conditions late in FY23, with a deterioration in the quality of citrus late in the season and softer demand for tomatoes. This announcement coincides with private equity group Paine Schwartz Partners continuing its due diligence of the Costa assets following a prior $3.54 non-binding offer for the group. The stock has sold off given higher uncertainty as to whether a deal proceeds or gets repriced.

Performance and outlook

The portfolio ended the month ahead of the index. There were positive contributions from the growth exposures in Goodman Group (GMG), NextDC (NXT) and Cochlear (COH) as well as from cyclical James Hardie (JHX). The largest detraction came from Qantas (QAN).

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.

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
126.19	165.49	-39.30

Source: ISS, Pendal holdings as at 31 August 2023. Report run on 06/09/2023 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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