PENDAL

Pendal Monthly Commentary

Pendal Sustainable Future Australian Shares Portfolio

February 2024

Market commentary

Australian equities bounced around in February before ultimately rallying into the month's end and posting a 0.98% gain for the month (S&P/ASX 300).

The broad underlying picture of disinflation opening the way to rate cuts in 2024 remains in place.

However some stronger than expected economic and inflation data in the US have tempered previous expectations around the timing and scale of rate cuts.

In Australia the RBA kept rates on hold. Governor Bullock noted that inflation remains too high, but that recent developments are encouraging. She also noted that the CPI will not necessarily need to be back within the 2-3% target range before the first cut.

The outlook from Australian earnings season was slightly better than average, with 28% of stocks seeing EPS upgrades for FY24 – versus a long-term average of 22%. 33% saw downgrades, just under the long-term average for 34%.

The consensus FY24 earnings-per-share outlook for the ASX 200 remains unchanged following reporting season, with slight upgrades for banks and industrials offsetting slight downgrades for resources.

Information technology (+19.70%) was the stand-out sector, helped by good results from NextDC (NXT, +25.89%) and Wisetech (WTC, +29.44%), a takeover bid for Altium (ALU, +30.41%) and a well-received investor day from Xero (XRO, +14.91%).

Consumer Discretionary (+9.74%) also outperformed as the revenue environment for retailers remains better than expected, while they are also generally maintaining good control of costs. Wesfarmers (WES, +16.22%) beat expectations on the back of Kmart, while JB Hi-Fi (JBH, +10.37%) benefited from stronger than expected margins at The Good Guys.

Energy (-5.94%) underperformed. Woodside Energy (WDS, -6.33%) and Santos (STO, -6.38%) announced that they would not pursue potentially merger talks any further, introducing an element of uncertainty into the outlook for both companies.

Materials (-4.80%) also lagged as continued caution over the outlook for the Chinese economy weighed on the price of iron ore (-11.7%). This weighed on BHP (CHP, -7.07%), Rio Tinto (RIO, -6.88%) and Fortescue (FMG, -9.61%) despite all three delivering reasonable results.

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 29 February 2024)
Sector limits	Australian Shares, 65 - 98%, Australian Property 0 - 30%, Cash 2 - 5%
Dividend Yield	3.30%#

Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	9.97%
CBA	Commonwealth Bank of Australia	6.72%
NAB	National Australia Bank Limited	6.27%
TLS	Telstra Group Limited	6.12%
RIO	Rio Tinto Limited	6.11%
QBE	QBE Insurance Group Limited	5.15%
GMG	Goodman Group	4.95%
WBC	Westpac Banking Corporation	4.71%
MQG	Macquarie Group, Ltd.	3.84%
XRO	Xero Limited	3.70%

Source: Pendal as at 29 February 2024

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Group Limited	4.24%
RIO	Rio Tinto Limited	4.16%
CSL	CSL Limited	4.11%
QBE	QBE Insurance Group Limited	4.05%
QAN	Qantas Airways Limited	3.30%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Group Ltd (not held)	-9.45%
WES	Wesfarmers Limited (not held)	-3.21%
WDS	Woodside Energy Group Ltd (not held)	-2.45%
TCL	Transurban Group Ltd. (not held)	-1.77%
WOW	Woolworths Group Ltd (not held)	-1.69%

Source: Pendal as at 29 February 2024

#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	1.43%	11.08%	8.63%	13.44%	9.68%	10.76%	9.66%
S&P/ASX 300 (TR) Index	0.98%	9.46%	7.44%	10.50%	9.08%	8.60%	8.28%
Active return	**0.44%**	**1.62%**	**1.19%**	**2.94%**	**0.60%**	**2.16%**	**1.38%**

Source: Pendal as at 29 February 2024
*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)*	*0.83%*
NXT	Nextdc Limited	0.40%
GMG	Goodman Group	0.38%
XRO	Xero Limited	0.36%
QBE	QBE Insurance Group Limited	0.31%

Top 5 detractors - monthly

Code	Name	Value Added
WES	*Wesfarmers Limited (not held)*	*-0.43%*
RIO	Rio Tinto Limited	-0.35%
QAN	Qantas Airways Limited	-0.32%
CSL	CSL Limited	-0.26%
FMG	Fortescue Ltd	-0.24%

Top 5 contributors - 1 year

Code	Name	Value Added
XRO	Xero Limited	0.94%
GMG	Goodman Group	0.87%
DOW	Downer EDI Limited	0.85%
NXT	Nextdc Limited	0.85%
JHX	James Hardie Industries PLC	0.82%

Top 5 detractors - 1 year

Code	Name	Value Added
QAN	Qantas Airways Limited	-1.28%
LTM	Arcadium Lithium Plc	-1.17%
ORA	Orora Ltd.	-0.87%
WES	*Wesfarmers Limited (not held)*	*-0.82%*
ILU	Iluka Resources Limited	-0.61%

Source: Pendal as at 29 February 2024.
Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Underweight BHP (BHP, -7.07%)

The iron ore price fell -11.7% in February as the market remains cautious on the economic outlook for China. This weighed on the major miners. BHP's H1 FY24 result was largely in-line with expectations with most divisions performing well. The interim dividend was slightly ahead of expectations, but the payout ratio continues to decline as the requirement for capex builds. Earlier in the month the company wrote down its Australian nickel operations and idled the smelter while it reviews the operations.

Overweight NextDC (NXT, +25.89%)

Data centre operator NXT delivered a result that included less of a step-up in costs and capex than had been feared, resulting in earnings that beat expectations. There was no change to full year revenue and earnings guidance, which still looks on the conservative side, in our view. NXT's strong development pipeline drew attention, with strong demand from enterprise, hyperscale cloud and Generative AI. We remain positive on the long-term outlook for NXT with a strong competitive position and inventory available at an important point in the cycle.

Overweight Goodman Group (GMG, +16.80%)

GMG beat consensus 1H FY24 earnings by 13%, driven by recognition of embedded profits across their land banks. The company is increasingly focussed on GMG's data centre developments, where the total pipeline of projects was increased and the timing of delivery brought forward. Data centres now accounts for 37% of GMG's work in progress. Meanwhile, operating metrics for industrial remains robust. Softer cap rates and negative revaluations are resetting operating businesses for future growth.

Three largest detractors

Underweight Wesfarmers (WES, +16.22%)

WES grew group EBIT by 1.4% and EPS 3% for 1H FY24, beating expectations mainly due to strength in Kmart. It will be difficult for Kmart to sustain recent margin strength in our view. Other retail businesses such as Bunnings and OfficeWorks were well managed in a period of high wage inflation and sub-2% revenue growth.

Overweight Rio Tinto (RIO, -6.88%)

The iron ore price fell -11.7% in February as the market remains cautious on the economic outlook for China. This weighed on the major miners and dragged on the position in RIO, although there was some offset from the underweight in BHP (BHP). RIO beat expectations for its interim dividend by 5%, with the rest of its result largely in-line with expectations. The business is tracking well, growing earnings at 2-3% p.a., paying out the top end of the dividend policy and with a solid balance sheet.

Overweight Qantas (QAN, -7.73%)

QAN delivered profit before tax (PBT) of $1,245 for 1H FY24, a touch under consensus expectations at $1,259. The result demonstrated that demand and market share are not deteriorating and fundamental conditions remain supportive of structurally higher levels of profitability post-Covid. Management flagged seasonal headwinds for 2H FY24, which drove ~8% downgrades. However we believe this does not fully account for some offsetting factors such as fuel and capacity growth. FY25 should see a marked improvement in margins versus FY24 in our view.

Outlook

The economic backdrop remains reasonably benign for markets, although we remain mindful of still material risks.

US inflation continues to trend in the right direction, which opens the door to rate cuts at some stage. February did see some inflation data points that were higher than expected. The message from the Fed is that the path to lower inflation is unlikely to be linear and that the overall trend remains in the right direction.

At the same time, the US economy is holding up relatively well. This is important as it means the Fed can afford to sit on its hands and wait for confirmation that inflation is indeed being brought under control.

If we start to see a material deceleration in the economy, it would risk an earnings recession which could drag on markets. It could force the Fed into cutting rates sooner than they otherwise would.

At the other end of the spectrum, there is also the risk that inflation remains stubborn high or even rebounds. This could also drag on markets, which continue to price in cuts for 2024, even if the number of expected cuts has been reduced in recent weeks.

For the moment, though, inflation is on the right path and the economy is holding up well.

Likewise in Australia, earnings season is telling us the economy is OK. There is the odd pocket of softness but generally trends are continuing as before.

Industrial and tech companies are doing better, while large consumer-facing companies are wary of delivering a message which is too positive, for fear of a media backlash.

Aggregate ASX 200 earnings are expected to fall -4.2% in total for FY24, with some strength in industrials offsetting weakness in resources and banks. However at this point the market seems content to look through near-term weakness, which has seen a market valuation re-rating drive recent equity gains.

This re-rating has come in anticipation of the economy avoiding recession and the eventuation of rate cuts. We note that conditions remain benign and that there is still plenty of cash to be deployed in markets. This suggests that markets can continue to grind higher. However we are mindful that some of the valuation buffer has been removed if we do start to see a downturn in fundamentals.

Looking forward to FY25, consensus currently expects 2.8% EPS growth, with continued strength in Industrials and an improved – albeit still negative – outcome for the banks and resources.

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
102.75	105.25	-2.50

Source: ISS, Pendal holdings as at 29 February 2024. Report run on 12/03/2024 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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