PENDAL

Factsheet

Equity Strategies

December 2018

Pendal MicroCap Opportunities Fund

Previously known as 'BT Wholesale MicroCap Opportunities Fund'

ARSN: 118 585 354

About the Fund

The Pendal MicroCap Opportunities Fund (**Fund**) is a portfolio of stocks in the rapidly expanding and highly diversified micro cap sector. The universe includes more than 1,100 companies listed on the ASX and NZX with a market capitalisation of between $5 million and $150 million.

Investors should be aware that due to the characteristics of micro cap companies there is some additional risk involved in investing in the Fund compared to a conventional Australian equities fund.

Investment Return Objective

The Fund aims to provide a return (before fees, costs and taxes) that exceeds the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term. The suggested investment timeframe is five years or more.

Investment Strategy

The Fund is actively managed employing a bottom up valuation process. The investment strategy will follow the same investment philosophy and process as is used in the Pendal Australian Smaller Companies Fund.

Investment Philosophy

At the cornerstone of Pendal's investment philosophy is the view that markets are not always rational and the inefficient market pricing of securities creates investment opportunities. This is particularly the case in micro caps where the sector is under-researched and sentiment will often drive periods of under-valuation and over-valuation. This reflects our belief that in the absence of structural change security prices will revert to their intrinsic value through the course of an investment cycle.

As with Pendal's other Australian equity portfolios, the Fund will be managed in a way that is style indifferent, it will be invested in both 'value' and 'growth' companies, without a predetermined 'value' or 'growth' bias.

Investment Team

The Pendal MicroCap Opportunities Fund is managed by Pendal's highly experienced Small Cap team. The Fund is managed by Paul Hannan, Head of Smaller Companies and Noel Webster, Portfolio Manager in the Equity team. Paul and Noel have over 50 years of investment experience between them and are supported by a highly experienced Small Cap team.

Portfolio Characteristics

Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Number of stocks	Between 40 - 60
Maximum cash weighting[1]	25%
Ex-ante (forward looking) tracking error[2]	5 - 20%
Maximum absolute stock position	10% (5% for developing companies)
Maximum ownership of any company	15%
Shorting	No
Borrowing	No

[1] We may hold higher levels of cash following large applications or if suitable investment opportunities cannot be identified.

[2] The Fund is measured against the S&P/ASX Small Ordinaries Accumulation Index, which is a widely used measure of the performance of micro cap funds. Only a portion of the index will comprise companies with a market capitalisation of less than $150m and as a result the Fund's ex-ante tracking error is expected to vary more widely than the tracking error for most other types of active Australian share funds.

Performance

(%)	Total Returns		Benchmark
	(post-fee)	(pre-fee)	Return
3 months	-12.27	-11.87	-13.70
FYTD	-8.42	-7.73	-12.75
6 months	-8.42	-7.73	-12.75
1 year (pa)	-7.64	-6.40	-8.67
2 years (pa)	6.95	8.71	4.70
3 years (pa)	9.23	10.93	7.45
5 years (pa)	14.08	17.56	5.62

Sector Allocation (as at 31 December 2018)

Energy	3.2%
Materials	11.8%
Industrials	12.3%
Consumer Discretionary	11.3%
Consumer Staples	3.6%
Information Technology	16.3%
Telecommunication Services	2.8%
Financials ex Property Trusts	5.7%
Property Trusts	5.5%
Cash & other	27.5%

Other Information

Fund size (as at 31 Dec 2018)	$314 million
Date of inception	March 2006
Minimum investment	$25,000
Buy-sell spread[3]	0.70% (0.35%/0.35%)
Distribution frequency	Yearly
APIR code	RFA0061AU

[3] The buy-sell spread represents transaction costs incurred whenever you invest or withdraw funds, and may vary from time to time without notice.

Management Costs[4]

Issuer fee[5]	1.20% pa
Performance fee[6]	20% of the Fund's performance in excess of the performance hurdle.

[4] You should refer to the latest Product Disclosure Statement for full details of fees and other costs you may be charged.

[5] This is the fee we charge for overseeing the operations of the Fund and managing the assets of the Fund. The Issuer fee is paid from the assets of the Fund and is reflected in the unit price of your investment.

[6] The Fund's performance fee is 20% of the Fund's performance in excess of the performance hurdle. The performance hurdle is the performance of the benchmark (S&P/ASX Small Ordinaries Accumulation Index) plus the issuer fee of 1.20% pa. If a performance fee is payable, it is charged in addition to the issuer fee. The fee is calculated each Business Day based on the investment performance and value of the Fund on that day. If we are entitled to a performance fee, it is paid to us as at 30 June each year.

Risks

An investment in the Fund involves risk, including:

- **Market risk** - The risk associated with factors that can influence the direction and volatility of an overall market, as opposed to security-specific risks. These factors can affect one country or a number of countries.
- **Security specific risk** - The risk associated with an individual asset.
- **Currency risk -** Currency exchange rate fluctuation risk arising from investing across multiple countries.
- **Interest rate risk -** The risk associated with adverse changes in asset prices as a result of interest rate movements.
- **Credit risk –** The risk of an issuing entity defaulting on its obligation to pay interest/principal when due
- **Derivative risk –** The risk arising from use of derivatives to manage exposures to investment markets.
- **Small company risk –** Shares in smaller companies may trade less frequently and in smaller volumes and may experience greater price volatility than shares in larger companies.
- **Illiquidity risk -** This is the risk that an investment may not be easily converted into cash with little or no loss of capital and minimum delay, because of either inadequate market depth or disruptions in the market place.

Please read the Fund's Product Disclosure Statement (**PDS**) for a detailed explanation of each of these risks.

Market review

Similar to its large cap counterpart, the S&P/ASX Small Ordinaries Accumulation Index lost ground in the December quarter, edging 13.7% lower. We saw the final quarter of 2018 completely wipe out gains from the two previous quarters, resulting in a total loss of 8.7% for the Index over the year, where Small Industrials (-6.5%) outperformed Small Resources (-16.0%). The Index now trades on a one-year forward price/earnings valuation multiple of 14.6x, representing a 3% discount to its five-year average.

The global macro environment remains challenging. What started as a year of expected synchronised global growth ended up with US-China trade tensions, further Fed tightening to the extent that the market is fearful of potential policy mis-steps, a tightening domestic credit market, and geopolitical uncertainties stemming from the eurozone.

All of the 11 GICS sectors finished the quarter in the red, with the exception of the more defensive Real Estate (+1.7%) sector. The sector's strong performance was largely led by gains from sector heavyweight, Shopping Centres Australasia (SCP, +9.2%). SCP bought 10 malls from Vicinity Centres (VCX, +2.2%) in early October, which led to a 3.8% increase to SCP's FY19 guidance and was well received by the market. Offsetting some of SCP's contributions, Aveo (AOG, -20.8%) was the largest detractor from sector performance. Management at the retirement village operator downgraded the company's FY19 sales targets, while also failing to confirm earnings guidance due to sales volumes uncertainty.

Other sectors that outperformed the headline index, despite recording a loss-making quarter include Materials (-6.1%) and Consumer Staples (-6.6%); whilst the performance of Financials (-13.7%) was in line with the index. Within Materials, the outstanding performance of the gold miners contributed the most in line with the risk-off sentiment which typically leads a revival of the gold price. The precious metal was trading at US$1284.7/oz at December end, compared to the $1196.2/oz it was trading at the quarter beginning. This helped to support the share price of gold miners in general, including the likes of Saracen Mineral (SAR, +57.1%), St. Barbara (SBM, +34.7%), and Regis Resources (RRL, +29.8%). SAR in particular reached a record quarterly production during its third quarter, although guidance for the full financial year was maintained. Offsetting some of these gains, lithium miner Pilbara Minerals (PLS, -30.6%) posted double-digit losses over the quarter, where most of it was incurred in December. Peer miner Galaxy Resources (GXY, -12.9%) reported lower pricing in the December quarter, attributed to weakening market conditions in China which clearly weighed on PLS.

Stock performance within Consumer Staples was also mixed over the quarter, with Graincorp (GNC, +17.3%) and Asaleo (AHY, +26.2%) both recording strong gains on the back of potential corporate actions: Asaleo managed to lock in a deal to sell its loss-making Australian Consumer Tissue business at a price that exceeded market expectations. Management noted the proceeds will be deployed towards paying down debt and the company will be able to focus more on its core personal care products. Gains from GNC came from a non-binding indicative acquisition proposal from Long-Term Asset Partners, at $10.42/share. On the other side of the tally board, BWX (-56.1%) was the worst performing stock within the sector. Management now expects FY19 normalised earnings (EBITDA) to be in the range of $27 - 32m, representing a 27% downgrade from that of FY18 and management's previous guidance. A combination of soft market conditions in China and a loss of sales momentum in the US was cited as the culprit.

Lastly, Energy (-28.9%) was the worst performing sector over the quarter in both absolute terms and as a performance detractor for the headline index. Whilst a plunging oil price, which traded 38% lower over the last quarter clearly weighed on Beach Energy (BPT, -37.1%); Engineering company WorleyParsons (WOR, -44.5%) was the largest detractor from sector performance. The company raised capital to fund the purchase of Jacobs Engineering Group's Energy, Chemical and Resources division, which was not well received by the market.

Fund performance

The Fund outperformed its benchmark over the December quarter. Key contributors to performance were overweight positions in Johns Lyng Group, Vista Group International and Elixinol Global, and an underweight position in WorleyParsons. Key detractors from performance were overweight positions in National Tyre & Wheel Limited, Adairs Limited and Gtn Limited.

Strategy and outlook

Both the December month and quarter were volatile in the small cap market. We are in an environment of elevated macro uncertainty which, in combination with the persistent withdrawal of market liquidity as various central banks wind back quantitative easing and credit growth slows, is driving sharp swings in the Small Ordinaries and across the market more broadly.

The market has been focused on two issues; the risks to growth from the Fed over-tightening of interest rates and from trade friction between the US and China. The market has been in a more upbeat mood on both these issues in recent weeks. However, uncertainties remain and any disappointing developments here could see the market re-rest its December lows. At the same time, data suggests that both the Chinese and European economies continue to soften. The outcomes here are difficult to predict.

In our view, the key takeaway is investors must remain mindful of a higher than usual macro risk and position portfolios accordingly.

The recent falls have been broad-based. The withdrawal of market liquidity is clearly having an effect on the elevated rating of growth stocks which had done well earlier in the year. This is evident in the small companies market through the underperformance of previous market darlings such as Afterpay Touch (APT). At the same time, a weaker oil price and concerns over slowing Chinese demand have weighed on the resource sector, including the producers and the contractors who service them. However, beyond this there were very few parts of the market which have proved immune to selling over the quarter.

At this point, the broad earnings outlook remains relatively stable and it has been a valuation de-rating driving market falls. We think the domestic economy remains in reasonable shape, supported by growth in jobs, in wages, and by the boost to discretionary budgets from lower fuel and utility prices. Small caps in particular harbour pockets of good growth in Australia, particularly in areas such as agriculture, tourism, education and mining services. Given this view, the sentiment driven nature of recent falls can throw up opportunities. For example, we believe the outlook for mining services looks attractive as miners start to spend on long-delayed and much-needed replacement production and equipment maintenance.

Australian equities bounced back in late December from what looked to be on oversold level. While sentiment has improved, we remain relatively cautious on the near term outlook for the broad market given the macro uncertainty. The P/E de-rating has returned the Small Ordinaries Index to 14.8x next-12-month (NTM) P/E. Several of the growth names remain on relatively demanding valuations given the excess market liquidity which has been partly responsible for driving growth stock outperformance is now declining. However, other parts of the market are looking good value. While lower liquidity may act as a market headwind, it does mean that stock-specific factors assume increased prominence in determining returns and should see greater dispersion within the market. This environment plays to our strength as active stock pickers. Even as we counsel some caution on the broad market in the near term, we have been buying specific stocks where we think the sentiment-driven sell off has created material mis-pricing, given our view on the earning outlook.