PENDAL

Factsheet

Equity Strategies

December 2018

Pendal Smaller Companies Fund

Previously known as 'BT Wholesale Smaller Companies Fund'

ARSN: 089 939 328

About the Fund

The Pendal Smaller Companies Fund (**Fund**) is an actively managed portfolio investing in companies outside the top 100 listed on the Australian Stock Exchange and their equivalent on the New Zealand Stock Exchange that we believe are trading below their assessed valuation, and which we expect to grow their profits quickly.

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 Philosophy

Pendal is an active manager of smaller companies, employing a 'bottom up', valuation driven process. At the cornerstone of our investment philosophy is the view that markets are not always rational and that the inefficient market pricing of securities creates investment opportunities. This is particularly the case in smaller companies where the sector is under-researched and sentiment will often drive periods of under and over valuation.

Pendal's core investment style is an output of our Australian equities investment process. Core means we are style indifferent, we invest in both 'value' and 'growth' companies, without a predetermined 'value' or 'growth' bias.

Investment Approach

Our valuation driven process is underpinned by extensive research encompassing company visits, contact with competitors and suppliers, financial analysis and peer group comparison (both locally and internationally). Portfolios are constructed within a tight risk framework to ensure that a prudent balance is maintained between risk and reward, with the aim of maintaining consistency of investment returns.

Investment Team

The Pendal Smaller Companies Fund is managed by Pendal's highly experienced Small Caps team. The portfolio manager for the Fund is Paul Hannan who is also the head of Smaller Companies in the Equity team. Paul has over 25 years industry experience.

Portfolio characteristics

Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Number of stocks	Between 60 -90
Maximum cash weighting	20%
Ex-ante tracking error	Typically between 0% - 9%
Active single stock position	+/-5%

Risks

An investment in the Fund involves risk, including:

- **Market risk**: The risk that factors affecting one or more countries that can influence the direction and volatility of an overall market, as opposed to security-specific risks.
- **Security specific risk**: The risks associated with an individual security.
- **Liquidity risk** - The risk that an asset may not be converted to cash in a timely manner.
- **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.

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

Performance

(%)	Total Returns (post-fee)	Total Returns (pre-fee)	Benchmark Return
3 months	-15.30	-15.03	-13.70
FYTD	-14.13	-13.59	-12.75
6 months	-14.13	-13.59	-12.75
1 year (pa)	-7.44	-6.28	-8.67
2 years (pa)	4.07	5.37	4.70
3 years (pa)	3.85	5.14	7.45
5 years (pa)	6.67	8.00	5.62

Sector Allocation (as at 31 December 2018)

Energy	2.5%
Materials	13.1%
Industrials	13.3%
Consumer Discretionary	18.5%
Consumer Staples	11.5%
Health Care	6.7%
Information Technology	6.1%
Telecommunication Services	3.7%
Financials ex Property Trusts	12.8%
Property Trusts	0.6%
Cash & other	11.2%

Other Information

Fund size (as at 31 Dec 2018)	$460 million
Date of inception	December 1992
Minimum investment	$25,000
Buy-sell spread[1]	0.50% (0.25%/0.25%)
Distribution frequency	Half-yearly
APIR code	RFA0819AU

[1] 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[2]

Issuer fee[3]	1.22% pa
Estimated expense recoveries[4]	0.02% pa

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

[3] 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.

[4] This represents a reimbursement from the Fund to cover those expenses we incur in connection with the day-to-day operation of the Fund. This is an estimate based on the latest available figures. Actual expenses recovered may increase or decrease over time.

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 underperformed its benchmark over the December quarter.

Contributors

Overweight Technology One

Software and technology service company Technology One (TNE, +11.1%) posted solid FY18 results which beat consensus expectations. Net profit grew 15% while margins also increased, helped by demand for its cloud-based services from both new and existing customers. The company's UK business continues to lose money, but improving trends in the second half of FY18 underpin management's expectations that it will break even in FY19.

Underweight WorleyParsons

Engineering company WorleyParsons (WOR, -43.4%) has underperformed the market over both the quarter and in December as the oil price weakened. At the same time the company has raised capital to fund the purchase of Jacobs Engineering Group's Energy, Chemical and Resources division. This is an example of several deals across the market in 2018 which, while superficially accretive at an earnings per share level, have not been particularly well received as the market expressed concern over the long-term return to be earned form the deal.

Detractors

Overweight RCR Tomlinson

The position in RCR Tomlinson (RCR, -19.1%) was initiated in May 2017 as part of our interest in lifting exposure to domestic infrastructure, renewable energy and resources investments. We invested in RCR because it had strong engineering, procurement and construction (EPC) credentials across infrastructure, energy and renewables. Our due diligence, which included meeting with solar developers, corroborated our view that RCR is one of the higher quality EPC companies in this space. The subsequent failing of the company is nothing but disappointing. The administrators have advised us that the businesses continue operation and they expect to commence an asset sale process imminently, which will ultimately determine if any recoverable amounts are available for ordinary equity holders. However, it is too early to ascertain what the outcome will be at this stage and we have written the value of this holding to zero.

Overweight Seven Group

Seven Group (SVW, -37.3%) is well placed to benefit both from the pick-up in mining capital expenditure and the pipeline of east coast transport infrastructure via its Coates Hire and Westrac businesses. It has been weak recently on the combined effect of slowing growth in US-listed Caterpillar (CAT) (Westrac is a Caterpillar dealer) as well as caution over mining more generally. We believe the implications from CAT's result are limited, with the critical need to increase mining spending a more important factor in driving SVW's medium-term outlook. At the same time, the company is benefiting from cyclical tailwinds in other parts of its portfolio, as well as recent technology investments which are improving margins, and better capital allocation as it cleans up its corporate structure.

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.

For more information please call **1800 813 886**,
contact your key account manager or visit **pendalgroup.com**

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