PENDAL

Factsheet

Equity Strategies

March 2019

Pendal 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.

Description of Fund

This Fund is designed for investors who want the potential for long term capital growth and tax effective income, diversification across a broad range of smaller companies and industries and are prepared to accept higher variability of returns. The Fund invests primarily in companies outside the top 100 listed on the Australian Securities Exchange. The Fund may also invest in equivalent companies listed on the New Zealand Stock Exchange, hold cash and may use derivatives.

Pendal's investment process for Australian shares is based on our 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 our assessment of their long term worth and ability to outperform the market, without being restricted by a growth or value bias. Our fundamental company research focuses on valuation, franchise, management quality and risk factors (both financial and non-financial risk).

The Fund may have assets denominated in foreign currencies. This means that changes in the value of the Australian dollar relative to foreign currencies may affect the value of the assets of the Fund. The Fund's foreign currency exposure may be hedged from time to time, in whole or part.

Derivatives may be used to reduce risk and can act as a hedge against adverse movements in a particular market and/or in the underlying assets. Derivatives can also be used to gain exposure to assets and markets.

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	10.39	10.73	12.59
FYTD	-5.20	-4.32	-1.76
6 months	-6.50	-5.92	-2.83
1 year (pa)	0.49	1.74	5.78
2 years (pa)	9.10	10.46	10.29
3 years (pa)	9.34	10.69	11.40
5 years (pa)	8.40	9.75	7.97

Sector Allocation (as at 31 March 2019)

Energy	4.7%
Materials	13.0%
Industrials	12.9%
Consumer Discretionary	18.1%
Consumer Staples	9.6%
Health Care	7.7%
Information Technology	7.9%
Telecommunication Services	3.7%
Financials ex Property Trusts	9.7%
Property Trusts	2.1%
Cash & other	10.6%

Other Information

Fund size (as at 31 Mar 2019)	$502 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

As general investor sentiment improved over the March quarter, we saw the domestic small cap equity market rebound strongly. The S&P/ASX Small Ordinaries Accumulation index advanced by 12.6% over the period, outperforming its large cap counterpart by 1.7%. Despite the reporting season being less sanguine and company management teams being generally more conservative, the broad improvement in global macro influences clearly helped. Although risks remain, the market appears to be strengthening the view that we are moving towards some form of resolution in the US/China trade dispute. As such, Small Industrials (+12.7%) and Small Resources (+12.1%) both performed strongly. The market's aggregate evaluation has rebounded almost to it previous highs of 2018 and stands at 16.8x next-12-month price/earnings, an 11% premium to its five-year average.

Sector performance was somewhat bipolar over the quarter: on one side of the spectrum, Information Technology (+32.6%), Energy (+22.5%), Consumer Discretionary (+18.8%), Healthcare (+17.3%), Industrials (+16.4%) and Communication Services (+11.7%) all recorded double-digit gains; whereas heavyweight Materials (+5.3%), Real Estate (+8.4%) and Financials (+4.2%) underperformed the headline index.

Within IT, the market darlings continued higher, including Altium (ALU, +49.7%), Appen (APX, +74.0%) and Afterpay Touch (APT, +69.0%). Coming out of reporting season, strong performance from all divisions helped ALU to deliver a solid print of revenue growth for the first half. In terms of users subscription, management reaffirmed its target of 100,000 users by 2025 which helped to support sentiment. APX also delivered a strong set of results, with second-half earnings (EBITDA) 79% higher than the previous half. Improvement in efficiency and additional operating leverage continue to help APX and resulted in some broking analyst upgrades. Lastly, the losses Wisetech (WTC, +36.9%) incurred in February were quickly proven short-lived, after it announced the latest round of capital raising. In order to continue supporting its strategic inorganic growth, the international logistics service provider announced a ~$280m capital raising in March. As previously communicated by management, WTC has been expanding its geographical presence through mergers and acquisitions. This strategy has proven successful to date and as such, the capital raising was well received by the market.

Elsewhere, a rising oil price helped the Energy sector to outperform over the quarter, as it benefited the likes of Beach Energy (BPT, +53.9%) and Viva Energy (VEA, +38.8%). In addition, VEA, which distributes Shell fuel in Australia, was aided by a deal which saw it purchase the right to set the retail fuel margin at the Coles-operated petrol stations, which had been previously set by Coles management. This will result in a meaningful earnings uplift for VEA, as well as allowing it to drop the fuel price—currently at a material premium to the market—in order to win back some market share.

Consumer Staples (-3.5%) was the only sector that finished the quarter in the red. Despite the strong gains made by infant formula manufacturer Bellamy's (BAL, +51.9%) on the back of its recently launched new formula that helped to raise brand awareness, losses made by Blackmores (BKL, -23.7%) and Costa Group (CGC, -30.7%) more than offset the positives. The latter endured a tough start to the year in January after management downgraded earnings on disappointing volumes for avocados, berries and tomatoes. It was largely attributed to softer demand, although higher supply of key products and some substitution may also be playing a role. The market has de-rated the stock beyond the 10-15% hit to earnings, reflecting in part its previously high rating for an agricultural stock.

Fund performance

The Fund returned 10.39% (post-fee, pre-tax) for the quarter, underperforming its benchmark by 2.20%.

Contributors

Underweight St Barbara (SBM)

Gold miner SBM fell -28.3% for the quarter as management announced material changes in the feasibility of the Gwalia Mass Extraction project in Western Australia. The outcome is significant capex and higher operational risk than first thought as well as a delay in commissioning. This disappointed the market, despite upgraded production guidance for the company's Simberi mine in PNG. We do not hold SBM, instead gaining gold exposure via Independence Group (IGO) and Regis Resources (RRL).

Overweight Nanosonics (NAN)

Nanosonics is involved in the manufacture of devices used to disinfect ultrasound probes in hospitals. It enjoyed a strong quarter, helped by a half yearly result which came in well ahead of expectations. The company's outlook is underpinned by growth in North America as more hospitals adopt the technology. At the same time, a clinical study in Japan revealed high degrees of contamination of probes, following standard cleaning processes. This supports further demand for Nanosonic's technology.

Detractors

Overweight Eclipx Group (ECX)

ECX's trading update in March revealed significant deterioration in its Right2Drive and Gray's divisions, as well as in its core commercial and consumer leasing earnings. We had previously sold a material portion of our position following the announcement of the scheme of arrangement with McMillan Shakespeare (MMS), retaining a stake given we saw merit in the tie up. However, a trading update saw the deal fall through, and with risks emerging given a leveraged balance sheet in a tougher operating environment, we have sold out of our position.

Overweight Costa Group Holdings (CGC)

CGC downgraded earnings in January as a number of factors combined to squeeze margins, including a mix of weaker demand and rising seasonal supply, plus issues with frost in Morocco and delays to its mushroom farm expansion. We maintain our conviction in the stock, which operates in one of the higher growth food categories and is diversifying its business across more produce and geographically. It is deploying capital in an efficient way and generating high incremental returns, which adds to earnings growth but also dampens the usual cyclicality of agriculture-related stocks.

Strategy and outlook

The positions in Eclipx and Costa Group dragged; we sold out of the former as trading conditions deteriorated, however we retain our conviction in Cost Group. However, the underweight in high profile technology companies such as Afterpay Touch, Appen and Wistech dragged as they surged. This demonstrates that these stocks remain loved despite last year's volatility. We have holdings in the tech sector – and our position in Technology One was a key positive contributor - but struggle to justify the market's valuation in those three particular names.

Outside of Technology One, the holdings in Nanosonics and Breville Group did well – both were up over 50% for the quarter, as did the positions in Seven Group and IDP Education.

While March's market result was subdued, it capped a strong quarter which saw the S&P/ASX Small Ordinaries Accumulation index gain 12.6% following the volatility of late 2018. The market's aggregate evaluation has rebounded almost to it previous highs of 2018 and stands at 16.8x next-12-month price/earnings, which stands at an 11% premium to its five year average.

This is obviously not a 'cheap' market, but it is important to recognise the skews that exist below this headline number. The relatively small cohort of high growth tech stocks, for example, are trading at a 1-year forward price/earnings of 35.8x, a 113% valuation premium to the rest of the small caps market. Health care, too, stands out at 21.9x. The upshot is that there are material parts of the market which are not at demanding valuations and where compelling opportunities can be found.

The caveat is, of course, that there are also material parts of the market facing cyclical or structural headwinds. Part of the reason that tech and healthcare are priced so richly is that they are one of the few parts of the market which are offering reasonable organic growth.

That said, the small cap universe is rich with diverse and niche opportunities for us to explore. We are focused upon companies with demonstrable cash flows in parts of the market which are enjoying some form of tailwinds or which are better placed withstand the currents of subdued economic growth or business model disruption.

Examples include essential services and supplies (e.g. Bapcor and Mainfreight), infrastructure and mining services (e.g. Seven Group, Monadelphous), unique growth strategies (e.g. Webjet, Costa Group) and technology stocks which have not attracted the same valuation premium as some of their higher-profile peers (e.g. Technology One).

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

PENDAL