PENDAL

Factsheet

Equity Strategies

June 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 (TR) 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 26 years industry experience.

Portfolio characteristics

Benchmark	S&P/ASX Small Ordinaries (TR) 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	1.77	2.09	3.75
FYTD	-3.53	-2.32	1.92
6 months	12.35	13.04	16.81
1 year (pa)	-3.53	-2.32	1.92
2 years (pa)	9.89	11.26	12.53
3 years (pa)	8.42	9.77	10.66
5 years (pa)	9.19	10.56	9.26

Sector Allocation (as at 30 June 2019)

Energy	4.4%
Materials	12.0%
Industrials	14.7%
Consumer Discretionary	18.2%
Consumer Staples	10.2%
Health Care	7.4%
Information Technology	8.2%
Telecommunication Services	4.2%
Financials ex Property Trusts	10.8%
Property Trusts	3.7%
Cash & other	6.2%

Other Information

Fund size (as at 30 Jun 2019)	$489 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

There was some performance divergence between the S&P/ASX Small Ordinaries Accumulation Index and its large cap counterpart, the S&P/ASX 100 Accumulation Index over the quarter. The former index finished the period +3.7% higher, whilst underperforming the latter by 4.8%. The small cap universe did not benefit as much from the boost of the miners; whilst weakness among some of the larger index-weights also detracted from relative performance.

Small Resources (-2.3%) finished the quarter in the red. Whilst the Gold miners (+5.5%) performed strongly as the precious metal is fetching multi-year high prices; it was more than offset by the Diversified miners (-7.4%). Rising concerns that demand from China for lithium ore could deteriorate further weighed on investor sentiment for Pilbara Minerals (PLS, -31.0%) and Galaxy Resources (GXY, -44.4%); whereas Aurelia Metals (AMI, -44.4%) missed market expectation on both volume and All-In-Sustainable-Costs for 3Q19. Offsetting some of the losses, Lynas Corporation (LYC) advanced by +23.0%. The rare earth miner was one of the few beneficiaries from intensifying Sino-US trade tensions, with speculation China could strangle global rare earth supplies in retaliation to the latest round of tariffs imposed by the Trump administration. Management also outlined a $500m growth program that will be self-funded.

Also weighing on Resources, Energy (-4.4%) recorded losses over the June quarter. Global oil price, which had been volatile over the period is starting to stabilise somewhat, finishing the quarter at US$65/bbl; down from US$68/bbl at March end - it was fetching $75/bbl and $60/bbt at the highs/lows during the period. Global supply could become tight again given the OPEC+ has decided to extend existing production curtailment. Within the sector, Viva Energy (VEA, -13.9%), which supplies more than 50% of all fuel used in Victoria, and is the sole distributor of Shell-branded fuel in Australia was the largest performance detractor. The refiner margin, which has always been volatile, has been at the downside lately. In addition, VEA's Retail business update in April revealed that lower retail fuel margins on the back of the rising oil prices, and the lag in passing these on to end customers is going to hit the earnings harder than expected.

Elsewhere, Consumer Staples (-6.4%) posted the largest sector loss over the quarter, mainly ascribed to the poor performance of Costa Group (CGC, -21.4%) and Graincorp (GNC, -13.2%). In May, CGC delivered a guidance downgrade that disappointed the market. The company disappointed on a number of fronts, including a later-than-usual blueberries harvest from its Moroccan acreage which brings the product into competition with Spanish suppliers, putting pressure on prices. At the same time, CGC has experienced issues with the quality of its raspberry crop and the discovery of a fruit fly at its NSW citrus farms which could see an increase in costs as fruit is shipped elsewhere for storage and packing. There was also some pressure on costs for its mushroom produce. Conversely, crop grower GNC released its first-half results, where earnings (EBITDA) for the period dropped by 78% year-on-year despite a 25% increase in sales. The persistent east coast drought conditions continue to weigh on the Grains division whereas margin compression was evident in both the malt and oils businesses. The market also remains sceptical about management's commentary around the proposed spin-off of the malts business towards the end of 2019. In contrast, Select Harvests (SHV, +21.4%) reported some strong numbers for its 1H19 results, driven by the best almond crop yield in 6 years and it was well received by market.

On the other side of the tally board, Industrials (+15.9%), Health Care (+14.3%) both recorded double-digit gains over the period; followed by Financials (+9.4%) and Information Technology (+8.4%). Nearmap (NEA, +34.5%), Austal (ASB, +51.6%) and Bingo Industries (BIN, +47.7%) led the gainers within Industrials. NEA is a provider for location intelligence services, with high resolution and timely aerial imagery. Deploying a Software-as-a-Service (SaaS) business model, investors are currently giving Management great credibility in their ability to scale up the business, with continuous market expansion in the US.

Fund performance

The Fund underperformed its benchmark over the June quarter end.

Contributors

Overweight Austal

Austal is a shipbuilder specialising in defence and commercial vessels. It benefited from inclusion in the S&P/ASX 200 index during the month as well as steady supportive newsflow. A modification of its existing contract to provide the design and construction for two fast transport vessels for the US Navy was announced in late April. This comes on the back of several recent contract wins to build ships and service contracts for the US Navy and the expectation that it is in a good position to win further work, given the withdrawal of a key competitor.

Overweight AP Eagers

A softer domestic economy has dragged on car sales, which has had a negative impact on operational performance of car yard owner AP Eagers. However the market has welcomed the news of a proposed merger with Automotive Holdings Group (AHG). The combined group will have just over 10% market share of the national new car dealership market. The deal offer significant synergies and fits well on a geographical basis given AHG is primarily west-coast focused and AP Eagers on the east.

Detractors

Overweight AUB

Insurance services company AUB Group delivered a soft set of earnings, driving ear term underperformance. While the underlying insurance cycle remains supportive, some of this has been offset in the near term by changes in iCare (formerly WorkCoverNSW) which have led to a transitory slowdown in referrals. We expect a recovery in earnings for the Rrelevant division in FY20. More broadly, the company raised ~$142m in November 2018 to position them to take advantage of M&A opportunities. In the near term the dilution from the capital raise has weighed on the stock. In the medium term we expect the company to continue to allocate capital efficiently into M&A, driving shareholder value.

Underweight NIB Holdings

The Coalition’s surprise victory in the Federal election sent NIB soaring. Labor’s proposed policies included mandatory caps on annual health insurance premium increases. The stock has bounced on the removal of this threat. Our underweight position dragged on performance.

Strategy and outlook

A positive June capped a strong first half to 2019 for the Australian small cap equity sector, which has staged a rapid rebound from the sell-off in late 2018. The S&P/ASX Small Ordinaries is up +0.9% for the month, +3.8% for the quarter and +16.8% for the first half.

Smaller companies have underperformed the larger end of the index over 2019 to date. This has been driven by strength in the iron ore sector, dominated by the big three of Rio Tinto, BHP and Fortescue Metals. At the same time the conclusion to the Royal Commission, coupled with an improvement in sentiment towards the housing sector, has seen the “big four” banks outperform.

Nevertheless, smaller companies have delivered strong absolute returns over the last half in aggregate, although performance has been mixed at a sector level. Information technology is up +43.7% calendar year to date, led by software-as-a-service companies Wisetech and Appen. This high-profile growth cohort continues to perform well and this quarter Altium joined Xero and Afterpay in the ASX 100, leaving the Small Ordinaries.

Consumer staples, in contrast, are down -9.7% over the half. This reflects a combination of challenges including concern over the domestic supermarket sector (Metcash), uncertainty around Chinese growth (Blackmores) and company-specific issues at other companies such as Costa Group and Graincorp.

The portfolio lagged the index over the quarter. Austal has been a sustained strong performer, while auto dealership AP Eagers has also done well as it looks to merge with rival Automotive Holdings Group. However this was offset by the drag from AUB Group and the underweight in NIB Holdings – the latter continuing to outperform following the Coalition’s election victory which removes the probability of near term caps on health insurance premiums.

Looking forward, we continue to see a challenging environment in domestic cyclicals on the back of tighter bank lending and softer house prices, which is showing up in weaker new car sales, media advertising and general retail. That said, government efforts to stimulate demand should provide some degree of support.

Elsewhere in small caps, a weak Australian dollar is supporting offshore earnings and helping those companies with niche growth opportunities in technology, health care and education.

Lower interest rates in Australia and elsewhere is providing further fuel for the growth parts of the market. There are valid opportunities here with some valuation support, however there are also stocks where we believe that valuation has run ahead of reasonable levels and the market is being less discerning between the quality of these companies. While several of the more popular technology stocks have now left the index, finding attractively-priced growth remains a challenge for small cap investors.

As always, we retain our valuation discipline and look to have a diverse range of ideas within the portfolio. Our favoured tech stock remains Technology One. Elsewhere, the Fund’s largest positions also include mining services (Seven Group), logistics (Mainfreight) and quality stocks with defensive earnings such as INvocare and Ryman Healthcare.

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

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