Pendal Australian Share Fund

ARSN: 089 935 964

Factsheet

Equity Strategies

March 2020

About the Fund

The Pendal Australian Share Fund (**Fund**) is an actively managed portfolio of Australian shares.

Investment Return Objective

The Fund aims to provide a return (before fees, costs and taxes) that exceeds the S&P/ASX 300 (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 Australian companies and industries and are prepared to accept higher variability of returns. The Fund may also 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).

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. Derivative can also be used to gain exposure to assets and markets.

Investment Team

Pendal's nineteen member Equity team is one of the largest in the Australian fund's management industry. The portfolio manager for the Fund is Crispin Murray, who has more than 28 years' industry experience. Crispin is also Head of Equity.

Investment Guidelines

Ex-ante (forward looking) tracking error	2.0% - 6.0%
Min/max stock position	+/-4%
Min/max sector position	+/-8%

Other Information

Fund size (as at 31 Mar 2020)	$861 million
Date of inception	September 1992
Minimum investment	$25,000
Buy-sell spread[1] For the Fund's current buy-sell spread information, visit www.pendalgroup.com	
Distribution frequency	Quarterly
APIR code	RFA0818AU

[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]	0.79% 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.

Performance

(%)	Total Returns (post-fee)	Total Returns (pre-fee)	Benchmark Return
1 month	-19.80	-19.75	-20.83
3 months	-22.85	-22.70	-23.41
FYTD	-19.43	-18.95	-20.90
6 months	-20.92	-20.61	-22.86
1 year (pa)	-13.95	-13.26	-14.53
2 years (pa)	-3.57	-2.80	-2.27
3 years (pa)	-0.02	0.78	-0.59
5 years (pa)	1.31	2.12	1.39

Sector Allocation (as at 31 March 2020)

Energy	5.2%
Materials	21.7%
Industrials	9.3%
Consumer Discretionary	4.7%
Consumer Staples	5.0%
Health Care	13.1%
Information Technology	3.8%
Telecommunication Services	7.7%
Financials ex Property Trusts	20.5%
Property Trusts	4.7%
Cash & other	4.3%

Top 10 Holdings (as at 31 March 2020)

CSL Limited	10.8%
Commonwealth Bank of Australia Ltd	6.2%
Telstra Corporation Limited	6.1%
BHP Billiton Limited	5.5%
Westpac Banking Corporation	3.6%
ANZ Banking Group Limited	3.1%
Insurance Group Australia	3.0%
Aristocrat Leisure Limited	2.8%
Amcor Limited	2.8%
Rio Tinto Limited	2.6%

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.

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

Market review

The Australian equities market had its worst quarter over March since the 1987 Market Crash. Amid the escalation of Covid-19 cases globally and the associated economic slowdown, the S&P/ASX 300 Accumulation index initially declined by as much as -36.2% from its peak, before recouping some of the losses in late March following the introduction of a significant government package to support people and the economy. The index finished the quarter -23.4% lower. The Job Keeper announcement was the most significant development for Australian equities, which helped underpin the domestic market's recovery from its lows. Lower correlations within the market suggest that investors started to allocate capital more rationally, as opposed to the "sell everything" mentality earlier.

Energy (-48.2%) was the hardest hit sector over the period, as it found itself under pressure in terms of both supply and demand. The measures to contain Covid-19 will see a material hit to oil demand as travel is severely curtailed. At the same time, the deal to limit production between Russia and OPEC has fallen through, with both Moscow and the Saudis indicating that they will increase production from pre-agreed levels. The upshot is a materially over-supplied market and rapid falls in the oil price. At this point the excess oil production is in the order of 10 million barrels per day, which is not only keeping the oil price low but, if oil storage runs out of capacity, push it even lower. Against this backdrop, sector heavyweights include Woodside Petroleum (WPL, -45.6%), Santos (STO, -57.8%) as well as Origin Energy (ORG, -47.1%) all lost approximately half of their equity market value over the quarter. It is worth noting that Santos delivered a cost out and capex reduction plan designed towards the end of March to demonstrate that they can survive with the oil price in the US$20-$30 range. This helped STO to reverse some of the early losses incurred.

Following the Energy sector, Real Estate (-34.8%), Consumer Discretionary (-30.0%) as well as Industrials (-28.2%) all underperformed the headline index. Most of their poor underperformance could be attributed to COVID-19 disruption and the negative earnings impact from the subsequent boarder closures and the social distancing restrictions imposed. Amongst all, shopping mall operators and property developers such as Scentre Group (SCG, -57.9%), Vicinity Centres (VCX, -58.4%), Stockland (SGP, -45.2%) as well as Lendlease Group (LLC, -40.5%) lost their conventional bond-proxy defensiveness over fears that social distancing restrictions will dent their near-term earnings. Similarly, national carrier Qantas Airways (QAN. -53.4%) sold off after effectively announcing that it had stopped flying. With additional funding secured against some of their planes which will allow it to survive an extended shutdown, the focus is now on minimising the cash burn for QAN. The Australian airline industry structure is likely to re-emerge from the period in a different form, using this period to assess operations and cost bases. There are signs that some of the market concern over Virgin has stabilised, but it could look very different in the future, with scaled-back operations.

Elsewhere, the "big four" banks posted losses in the range of -20.9% (CBA) to -32.3% (NAB), and similarly the regional duo (BOQ, -31.0%; BEN, -33.3%). Whilst dividend yields appear very attractive for the cohort following the recent price drops, there is an expectation that dividends are likely to cut and capital conserved in this half, given the scale of policy support and relief measures being provided by banks. There were also concerns over funding and uncertainty over how high bad debts would rise, particularly for the regional banks. On the other hand, the iron ore miners held up well during the recent market turmoils, as the iron ore price remained resilient on the back of supply disruption and stimulus efforts in China. As such, Fortescue Metals (FMG) was up by 1.3% over the quarter; whilst Rio Tinto (RIO, -12.4%) also outperformed the broad market.

Fund performance

The Fund outperformed its benchmark over the March quarter.

Contributors

Overweight Metcash (MTS)

Metcash owns the IGA convenience supermarket brand and is a grocery and alcohol wholesaler into that network and others. Given this, it has a relatively defensive demand profile which is less sensitive to the effects of measures to contain Covid-19. More recently, the closure of restaurants and cafes has seen support for demand for more convenience shopping, well suited for the IGA format. At the same time, MTS and IGA have been regaining share over recent times as customers identify with the refurbished stores, extended attractive product range and competitive pricing. Overall, we expect demand to remain strong as the recent drivers will be sustained. We have lightened the exposure to MTS later in the month as it has run so hard relative to the market, but we still like its positioning as "Recession Insurance" within the portfolio and retain a position.

Overweight CSL (CSL)

CSL (CSL) maintained a strong run into the start of the year and then held up relatively well during the volatility of the last six weeks. Its business is unlikely to see a material impact on demand as a result of the Covid-19 outbreak and as such has been rewarded for its defensive characteristics in a volatile period. There is likely to be some impact on supply of plasma due to the effect of COvid-19, although at this point it remains deemed as essential service in the US. However higher unemployment rates are also likely to encourage donation rates. We regard CSL as part of the "high quality defensive" part of the portfolio.

Underweight Woodside Petroleum (WPL)

The energy sector is finding itself under pressure in terms of both supply and demand which has seen a sharp fall in the oil price. The measures to contain Covid-19 will see a material hit to oil demand as travel is severely curtailed. At the same time, the deal to limit production between Russia and OPEC has fallen through, with both Moscow and the Saudis indicating that they will increase production from pre-agreed levels. The upshot is a materially over-supplied market and rapid falls in the oil price. This weighed on the portfolio's positions in Santos (STO) and Oil Search (OSH) – although there was some offset from not owning the largest oil energy stock in the index – Woodside (WPL) – or other energy related names such as Worley (WOR). We have had a preference for STO and OSH based on a superior growth profile (STO) and material undervaluation and ability to monetise assets (OSH).

Detractors

Overweight Qantas (QAN)

Travel related stocks remain among the most leveraged to the containment measures enacted to control the spread of Covid-19. We retain our position in QAN as part of the "Recovery Protection" part of the portfolio. While we see the probability of a swift medical breakthrough and rapid recovery in markets as low, it still remains a possibility. As a result QAN remains in the portfolio as a hedge, as it is likely to see a rapid rebound in that event. We have confidence in QAN's ability to remain solvent through an extended shutdown. They have moved rapidly to cut costs and have secured funding backed against part of their fleet, most of which is fully owned rather than leased. Domestic flights are also a far larger driver of earnings than international, with the former likely to resume sooner than the latter. We also believe that QAN is likely to emerge in a stronger competitive position post the economic disruption.

Overweight Santos (STO)

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Overweight Oil Search (OSH)

The energy sector is finding itself under pressure in terms of both supply and demand which has seen a sharp fall in the oil price. The measures to contain Covid-19 will see a material hit to oil demand as travel is severely curtailed. At the same time, the deal to limit production between Russia and OPEC has fallen through, with both Moscow and the Saudis indicating that they will increase production from pre-agreed levels. The upshot is a materially over-supplied market and rapid falls in the oil price. This weighed on the portfolio's positions in Santos (STO) and Oil Search (OSH) – although there was some offset from not owning the largest oil energy stock in the index – Woodside (WPL) – or other energy related names such as Worley (WOR). We have had a preference for STO and OSH based on a superior growth profile (STO) and material undervaluation and ability to monetise assets (OSH). Both of the LNG stocks in the portfolio have protection from the near term downside of oil prices through their contracts – particularly so STO where some of its contracts are inflation-linked. However it does mean that growth plans are likely to be delayed. There is some expectation of a new deal between Russia, the US and Saudis which may help alleviate some pressure on the supply side, however the market is likely to remain substantially over supplied until demand recovers. Nevertheless, we recognise that there is a possibility – albeit low – of a medical breakthrough and swift recovery. There is also the chance of a better-than-expected deal on oil supply. In keeping with our portfolio framework, the LNG position forms part of this "recovery insurance" segment of the portfolio, although we see no need to be overweight at this point.

Outlook

Market uncertainty is being driven, ultimately, by that fact that no-one knows how long containment measures are likely to last or the scale of the damage that will be inflicted upon the economy.

Each week brings better clarity on two key inputs, the first is the spread of infection. There are signs that the curves – the daily percentage increase in new confirmed cases – are flattening in Europe. The US remains the largest source of new infections, although the spread is quite uneven. In Australia, at this point, the percentage of new case growth has dropped from above 20% in March to below 5% today.

The key point is that containment measures appear to be working. Risk remains; and questions over whether secondary outbreaks occur when measures are lifted. Nevertheless, particularly in the domestic context, this gives the government a degree of control over how and when measures are rolled back.

The second key input is the scale of policy measure to help alleviate the structural damage to the economy and help underpin a rebound. This has been unprecedented. In Australia, the total fiscal support is now above 10% of GDP.

It is important to remember that the economic impact will still be very negative. At this point the technical unemployment rate could still reach 10% - but without Job Keeper that could have been nearer to 15%. There is also the question of how the economy looks once we start to roll back measures.

Nevertheless, this package helps reduce the worst-case scenario in terms of unemployment and structural damage to the economy, better positioning it for a rebound. It also signals the government's intent to do whatever it takes.

There are clear signals that we have gone through a liquidation phase of indiscriminate selling. This partly reflects the liquidity of equities and people selling what they can. It also reflects the impact of passive investment. Now the market is appearing to be in a more rational phase – correlations within the market have fallen, suggesting that investors are being more discerning.

All this has helped improve recent market sentiment. Nevertheless, we remain cautious and expect that we trade sideways in a "sawtooth" pattern of high volatility for a period.

This is partly to do with the sticker shock of economic data that will emerging coming weeks and day. We are also mindful that we are yet to see the data around corporate earnings. It is simply too early, with too many unknowns, for the market to try and quantify the scale of earnings fall. As it does so, there could be further volatility.

We are also starting to see capital calls coming through. While the most leveraged companies are tapping the markets early given more immediate stress, there are also signs of better quality companies with seemingly less imperative seeking to obtain a capital buffer at reasonable prices. We expect that the steady flow of cash calls within will absorb some liquidity and have a limiting effect on any near-term market gains.

No-one knows how the health crisis will playout or what the ultimate economic impact will be. We focus on those things that we can control.

We can think through possible scenarios –as outlined in last month's commentary - and position the portfolio to weather the most likely outcomes, while have some insurance against less probable – but still possible – scenarios.

We are also speaking to companies. In this environment, understanding company management, capital positions, and industry structures intimately is paramount. This plays to the strengths of our large and experience team.

We have been reviewing the portfolio companies to assess risk to the balance sheet or cash flow. We are also doing a secondary deep stress test for worsening trading conditions to assess each company's ability to weather the storm without deeply discounted capital raisings.

Within the context of the portfolio framework outlined last month:

- We have added to some of the *Recession Protection* companies – such as gold miner Evolution Mining (EVN). Metcash (MTS) had a strong run and we reduced the exposure towards the end of the month, although we continue to like its position.
- We have been adding to positions in *High Quality Defensives*, which are less sensitive to the current disruption – companies such as Telstra (TLS) and CSL (CSL)
- We also lifted the exposure early in the month to *Policy Beneficiaries* – primarily in iron ore, but also in James Hardie (JHX). Chinese demand for steel remains resilient and will be underpinned by a construction-focused stimulus. However we also remain watchful of the effect of reduced steel demand form Europe and the US.
- We are keeping a close watch on the *Long Term Franchise Winners*. Companies such as JB Hi-Fi (JBH) and Nine Entertainment (NEC) are offering some attractive opportunities on a longer-term view. It is interesting to note that the lines are blurring between some of these companies and *Policy Beneficiaries* – as recent strength in JBH and NEC last week was linked to policy moves.
- We remain cautious on the *Recovery Insurance* names – seeing it as too early to add materially to our exposure here. It is important to remember that history shows us that market leadership in a rebound does not tend to come from those stocks which have fallen the most. After a plunge they often have something of a dead cat bounce. However they can then flat-line for a period as there is often some structural factor which needs to be overcome – we only need to look at the long path to recovery of some technology stocks post-2000 for examples of this. So we need to be careful on this front. The crucial element here is understanding the balance sheet and liquidity position in the event of a prolonged disruption.

On area for consideration – across all parts of the portfolio – is a company's domestic versus overseas exposure. This could prove to be an increasingly material factor if we start to see a larger divergence in the outlook for infection rates and faster ability to normalise in Australia versus other parts of the world.

In this environment, active portfolio construction and risk management is crucial. The ability to weigh risks, recognize the mis-priced opportunities and provide a clear and disciplined framework to account for an uncertain range of possible outcomes has paid dividends thus far. We believe will continue to do so as the current crisis unfolds and the path to recovery becomes clear.

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

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