Pendal Smaller Companies Fund

ARSN: 089 939 328

Factsheet

Equity Strategies

June 2020

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	24.72	25.11	23.90
FYTD	-3.08	-1.88	-5.67
6 months	-4.81	-4.23	-9.21
1 year (pa)	-3.08	-1.88	-5.67
2 years (pa)	-3.30	-2.10	-1.95
3 years (pa)	5.38	6.70	6.10
5 years (pa)	7.26	8.60	7.90

Sector Allocation (as at 30 June 2020)

Energy	3.1%
Materials	13.5%
Industrials	14.1%
Consumer Discretionary	19.1%
Consumer Staples	7.3%
Health Care	6.1%
Information Technology	12.1%
Telecommunication Services	3.7%
Financials ex Property Trusts	10.6%
Property Trusts	5.7%
Cash & other	4.7%

Other Information

Fund size (as at 30 Jun 2020)	$373 million
Date of inception	December 1992
Minimum investment	$25,000
Buy-sell spread[1] For the Fund's current buy-sell spread information, visit www.pendalgroup.com	
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

Unlike its larger cap counterpart, the S&P/ASX Small Ordinaries Accumulation Index lost momentum in June. It recorded a loss of -2.0%, underperforming the S&P/ASX 100 by -5.0% over the month. Nevertheless, the small cap rebound since the Covid trough on 23 March has seen the index record a double digit gain of +23.9% over the quarter; and it is now down -9.2% for the calendar year to date.

This came despite some wobbles late in June as the market expressed some concern over the rise in cases in the US as it rolled back restrictions. There was strong rotation from growth and defensives to value and more cyclical stocks during the quarter as confidence around the economy improved – although this rotation stalled late in the period. Economic data continued to reflect the material blows inflicted by the shutdown. However in most respects it is not as bad as many as expected – while the rebound in activity and confidence indicators has also been sharp.

Sector performance over the quarter was generally strong, with the inception of Consumer Staples (+0.9%). Whilst the abundant liquidity from central banks have been supportive for the equity market in general, investors remain concerned on the negative impact on consumers. Sector heavyweight Metcash (MTS, -13.7%) was the largest drag on the sector. The company delivered its FY20 results in June. The key factor, in terms of their underlying position, was that there are continued signs that IGA's loss of share in recent years has stabilised and is turning. While there were indications of this pre-Covid, the trend has been helped by a return to more localised shopping in recent months. This comes soon after MTS had revamped formats in many IFAs and reduced prices, with the result that people returning to IGAs during March and April have liked the experience. MTS saw a bump in revenues during Covid, however this did not feed through to earnings, which was disappointing but consistent with a recent update from Woolworths. Supermarkets were forced to take on additional costs – such as extra shifts - to meet the surge in demand, offsetting revenue gains.

Outside Consumer Staples, sector performance was broadly strong in absolute terms; although IT (+20.3%), Industrials (+19.5%), Real Estate (+16.8%), and Communication Services (+17.2%) underperformed the market. Amongst all, some of the standout underperformers included Nufarm (NUF, -19.8%), Navigator Global (NGI, -48.5%) and Phoslock (PET, -40.2%). NUF provided a trading update for 4Q20 where uncertainties around the negative impact from Covid disruption remained great. The company generates ~40% of its group EBIT from Europe, which was the hardest hit region through the pandemic. The dwindling demand within the region is set to weight on the company's short-term earnings. Similarly, PET, which is a global water technology company that engages in the manufacture and sale of environmental solutions also provided an update to the market in June. The company effectively reduced their revenue guidance for FY2020 to $30-40m, Management lowered short-term revenue expectations for the remaining six months of the year as they become more cautious that some projects might expect delays, particularly in China and the US due to new outbreaks of Covid-19.

On the other side of the ledger, the two-stock sector, Utilities (+124.4%) recorded the largest absolute gains, as both stocks within rallied strongly. Infigen Energy (IFN, +121.2%) received a takeover offer from UAC Energy and it was subsequently outbid by an offer from Iberdrola Renewables, the world's largest wind power company. The latest bid valued Infigen at A$0.89 a share, and was recommended by the IFN Board. The potential deal is still subject to the FIRB approval, and Iberdrola needs 50% of the shareholder's approval. That said, with its ~20% stake and the approval from the IFN's largest shareholder, it is already over the 40% mark. Amaysim (AYS, +73.0%) also recorded strong gains as investors reacted favourably to its mobile subscriber acquisition contract. AYS is set to acquire ~77k subscribers from OVO Mobile for a maximum consideration of $15.8m; and the transaction is expected to complete imminently. This will see bring the company's recurring mobile subscriber base to over 820k and a total subscriber base of 1.17m.

Fund performance

The Fund outperformed the benchmark over the June quarter.

Contributors

Underweight Metcash

Metcash delivered its FY20 results in June. The key factor, in terms of their underlying position, was that there are continued signs that IGA's loss of share in recent years has stabilised and is turning. While there were indications of this pre-Covid, the trend has been helped by a return to more localised shopping in recent months. This comes soon after MTS had revamped formats in many IFAs and reduced prices, with the result that people returning to IGAs during March and April have liked the experience. MTS saw a bump in revenues during Covid, however this did not feed through to earnings, which was disappointing but consistent with a recent update from Woolworths. Supermarkets were forced to take on additional costs – such as extra shifts - to meet the surge in demand, offsetting revenue gains.

Overweight AUB Group

AUB Group - formerly known as Austbrokers – made a strong contribution to relative performance. The stock continued to gain in the wake of a trading update in April, which revealed strong growth in quarterly NPAT versus the previous year.

Detractors

Overweight Invocare

Funeral operator Invocare (IVC) has seen an impact on its business as a result of social distancing requirements which limited attendees at funerals, resulting in less revenue per service. While the balance sheet was in good shape, management chose to raise capital in April to accelerate its capex programme for improvement of its venues while they were underutilised. It also provides more powder for acquisitions. We see this as good use of capital and participated in the raise.

Overweight Charter Hall Long Wale REIT

Small cap REITs lagged the market over the quarter. Ongoing concern around rental income from small-to-medium enterprises (SMEs), who may qualify for rental abatements and deferments under the new national code, weighed on the sector. CLW remains our preferred property exposure. Its key tenants include the government. Telstra and long weighted average lease expiry (WALE) retail tenants such as petrol stations. The average lease expiry of 14.9 years and quality of the tenants provides a relatively attractive visibility on earnings.

Strategy and outlook

The small cap index fell away in the last couple of weeks of June on concerns over the impact of a potential second wave of Covid-19.

The portfolio held up better than the market, helped by the exposure to gold as well as constructive updates from some of the retail positions.

Macro level uncertainty remains elevated. The economic rebound as restrictions roll off has generally beaten expectations. Coupled with supportive data and strong policy support, it has driven a rapid bounce in equity markets.

However on the other hand, while second wave clusters in China and Germany appear to have been contained, cases continue to rise in the US. This in itself is not causing economic issues at this point. However the fear is that we will see a re-run of March/April, with cases leading to stress on hospitals and ICUs and a surge in mortality. This would likely be a material setback for market sentiment and confidence.

As China and Germany have demonstrated, a replay of April - in terms of case-loads, hospitalisations and mortality – is not a foregone conclusion. Today's situation is different from then in several important ways.

1. The outbreaks are in less densely populated areas than New York
2. The age profile of new cases is a lot lower this time – an average of 20 years younger.
3. There is substantially more testing. This may result in worse-looking numbers but does mean that the problem is being identified earlier than in April
4. There is more physical distancing and use of face masks – despite well-publicised incidents to the contrary.
5. Knowledge of how to treat the virus is far better now. Previously, treatment had focused on the lungs, which are now believed to be more symptomatic in nature. Instead, treatment is now focused more on anti-inflammatories, with better outcomes as a result.

If the US is able to successfully deal with this wave without reimposing broad-based restriction or a severe spike in mortality, then it should bolster market confidence. Nevertheless, this issue comes with material risk for sentiment and potential consequences for markets in the near term.

We continue to take a balanced approach to the portfolio's exposure, give the range of possible paths forward in terms of coronavirus and the economic recovery. We have added to some positions leveraged to domestic recovery in recent weeks – including CSR (CSR) and Healius (HLS). However we still retain a strong core of more defensive positions – including gold and some agricultural companies – which should benefit the portfolio if we start to see economic momentum fade.

At this point it appears the worst case scenario has been avoided and the Australia has been reasonably successful in suppressing Covid-19, paving the way to a resumption in domestic economic activity.

However there will be divergences between industries in terms of the degree to which they recover. Some will only partially recover, while others may get back to previous capacity – or more – in relatively quick time. The uncertainty here – and mis-pricing that results – coupled with the divergence in responses to the crisis at a company level, is driving material opportunity for active management.

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

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