Pendal Australian Equity

Quarterly Investment Option Update

30 June 2022

Aim and Strategy

To provide a return (before fees, costs and taxes) that exceeds the S&P/ASX 300 (TR) Index over the medium to long term. It is an actively managed portfolio of Australian shares that has the potential for long-term capital growth and tax effective income and offers diversification across a broad range of Australian companies and industries.

This strategy may also hold cash and may use derivatives for managing market exposure. The investment manager's process for Australian shares is based on a core investment style and aims to add value through active stock selection and fundamental company research which focuses on four key factors: valuation, financial risk, franchise and management quality.

Investment Option Performance

To view the latest investment performances for each product please visit amp.com.au/performance

Investment Option Overview

Investment Category	Australian Shares
Suggested Investment timeframe	5 years
Relative risk rating	7 / Very High
Investment style	Core
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Australian Shares	100	94.12
Cash	0	5.88

Sector Allocation	%
Cash & Short Term	5.88
Consumer Discretionary	5.08
Consumer Staple	4.47
Energy	10.19
Financials x Prop Trusts	24.80
Health Care	9.13
Industrials	5.56
Information Technology	5.21
Materials	21.73
Real Estate Investment Trusts	2.15
Communication Services	8.82
Utilities	0.00
Futures	-3.02

Top Holdings	%
BHP Billiton Limited	12.62
CSL Limited	8.74
Telstra Corporation Limited	6.15
Commonwealth Bank of Australia Limited	5.89
Santos Limited	5.00
Westpac Banking Corporation	4.58
National Australia Bank Limited	4.50
Qantas Airways Limited	3.90
Xero Limited	3.43
QBE Insurance Group Limited	3.38

Investment Option Commentary

The Fund outperformed the index over the June quarter.

Key contributors

Overweight Viva Energy (VEA, +23.0%)

Fuel retailer VEA continues to benefit from the post-lockdown rebound in demand as car and airline travel picks up. At the same time, it is benefiting from very strong refining margins, with regional refining running near full capacity. The company released a strong quarterly update, with a 9% increase in total sales volume over the same period last year despite dealing with logistical issues and restrictions caused by the recent floods.

Overweight QBE Insurance (QBE, +5.7%)

The insurance sector has generally outperformed in the last few months, as higher bond yields should provide a tailwind for margins. At the same time, premium pricing have been rising, helping offset rising claims inflation and structural issues posed by higher provisioning and reinsurance costs for weather-related events. QBE has done better than the domestically-focused insurers, where the market has been concerned about exposure to recent flooding events.

Key detractors

Overweight Nine Entertainment (NEC, -38.6%)

Nine was dragged down with other cyclicals as the market expressed concern that a tightening cycle could result in recession. The company is seeing no signs of slowing in demand for advertising and its free to air television rating remain strong. It was also less of a Covid beneficiary than other domestic cyclicals, so does not have to contend with the slowdown from a higher base. Pendal sees good value at 9.0x consensus next twelve month earnings and an 8.0% dividend yield.

Overweight Xero (XRO, -25.1%)

Xero's stock price came under pressure in Q2, along with the broader growth cohort. The Fund maintains conviction in Xero's fundamental outlook. It continues to invest in overseas growth opportunities at very high rates of incremental return on capital. At the same time, the more mature Australia and New Zealand businesses continue to perform well. The valuation is nearing a point where very little growth in subscribers or revenue is priced in.

Market Commentary

There was a persistent undercurrent of concern over stubborn inflation and tightening interest rates throughout the period.

This boiled over in June as the Fed hiked rates 75bps and indicated that they could do the same again in July. They are now signalling that they could end the year at 3.4%, according to the "dot plot" of expected moves. Three months ago, this figure was 1.9%.

Other central banks have adopted a similarly hawkish tone. The Reserve Bank of Australia hiked 50bps in June.

All this triggered concerns that central banks would drive economies into recession, rather than the desired soft landing, in the quest to tame inflation.

Most of the damage to equity markets was done in June. It also saw rotation from value, which had outperformed in April and May, as investors start to factor in the risk of earnings downgrades.

The S&P/ASX 300 fell -12.7% over the quarter. It underperformed in June as financials and resources were hit hard. However Australia held up better than the S&P 500 (-16.4%) for the quarter and has outperformed over the calendar year to date.

Information technology was the worst performing sector over the quarter as higher rates and bond yields weighed on valuations for long duration growth stocks. This was exacerbated by some cautious and disappointing updates from some US tech companies.

Higher bond yields also weighed on Real Estate. Heavyweight industrial property name Goodman (GMG) fell in response to indications that demand from Amazon – a key client for logistical property – may be moderating. However the sector as a whole continues to see resilient sales in the retail sector and continued strong demand for industrial property.

Utilities held up best. This is in part reflects the sector's defensive characteristics, but also the degree of corporate activity, with a consortium of Brookfield and Grok Ventures launching a takeover bid for AGL Energy (AGL).

Energy also remained in the black for the quarter. Energy prices took a tumble in June on recession concerns, but were still up considerably for the quarter in response to constrained supply. Brent crude was up 6.4%, natural gas +18.4% and thermal coal +49.0%.

Outlook

Pendal maintains a cautious near term outlook for equities. It is increasingly hard to see how the US avoids a recession from here.

First the lagged effect of inflationary pressures means the market is unlikely to see much relief on this front given the fuel, food, and shelter components are still rising. This gives the Fed little room to back off hikes. Second, while overall economic activity remains reasonable, the lead indicators are deteriorating.

These include the "rule of ten" observation of mortgage rates and petrol prices - which has a good track record of predicting recessions – and falling house prices which can affect consumption. This is feeding through to a fall in the Altanta Fed's GDP tracker and other GDP forecasts rolling over.

This economic risk has implications for the market. The market is currently discounting a material drop in earnings, while the latter continue to hold up. Since 1987 the market has only seen this disconnection twice, in 2002 and 2011, where markets overstated risk.

However in 2000, 2008 and 2020 the earnings caught up with the market and therein lies the risk if the US and global economy go into a recession.

Valuations in the markets other than the US - including Australia - are lower and provide some protection. But Pendal remains wary of how the market performs as downgrades come through.

While the risk is material, this bearish scenario is not a certainty. Factors which could see a better outcome include:

- Inflation momentum slows more quickly than now expected. There are some signs of hope with higher inventory at US retailers and evidence of discounting appearing. The fall in the oil price is a very important lead if sustained.
- Labour markets loosen up sooner. The market has seen announcements from the tech sector on layoffs, but collectively this is not sufficient. On the supply side perhaps inflation and the crypto bust help drive participation higher.
- Supply chains begin to ease up as China re-opens and demand softens.

Should these factors start to play out the market may see the Fed swerve again and not be as aggressive on rates. It would still be unclear whether this is enough to avoid a recession; but in the market's eyes it would at least signal the depth of the downturn could be lower.

One flag which is likely to mark the low in this cycle is the passing of time. This market looks closer in nature to 2000 and 2008 where the market had to consolidate near its lows for a number of months before sentiment improved – unlike the sharp policy-driven bounce of 2020.

This is a challenging environment for portfolio construction, however Pendal believes it plays to the strength of our approach.

The strategy is underpinned by identifying mis-priced stocks by "anticipating change," and building a portfolio that manages thematic risk and is primarily dependent on stock-specific alpha – rather than a particular macro pathway or outcome – to perform.

Both elements can be seen in the way Pendal approaches portfolio construction in this environment. Pendal has a range of thematic exposures, such that performance is not dependent on a particular outcome or pathway in terms of the key macroeconomic uncertainties currently at play.

Within this framework, Pendal is finding stocks which have a company-specific aspect which can support valuation and/or drive outperformance. A key element of this at the moment is an emphasis on pricing power and of cash flow that has resilience even if market does see economic momentum start to slow.

Availability

Product name	APIR
SignatureSuper*	AMP1469AU
SignatureSuper Allocated Pension*	AMP1340AU
SignatureSuper Term Pension*	AMP1340AU
Flexible Lifetime Investment (Series 1)**	AMP0835AU
Flexible Lifetime Investment (Series 2)**	AMP1405AU

* Closed to new investors
** Closed to all investors

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