Pendal Australian Equity

Quarterly Investment Option Update

31 March 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, risk factors (both financial and non-financial), 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	97.43
Cash	0	2.57

Sector Allocation	%
Cash & Short Term	2.57
Consumer Discretionary	5.81
Consumer Staple	4.32
Energy	7.85
Financials x Prop Trusts	23.90
Health Care	8.13
Industrials	5.11
Information Technology	5.72
Materials	25.27
Real Estate Investment Trusts	2.51
Communication Services	8.76
Utilities	0.00
Futures	0.06

Top Holdings	%
BHP Billiton Limited	13.35
CSL Limited	7.62
Commonwealth Bank of Australia Limited	5.96
Telstra Corporation Limited	5.63
Westpac Banking Corporation	5.22
Santos Limited	4.86
National Australia Bank Limited	3.82
Xero Limited	3.75
Qantas Airways Limited	3.74
South32 Limited	3.29

Investment Option Commentary

The Fund underperformed the index over the March quarter.

Key contributors

Overweight BHP (BHP, +30.5%)

BHP benefited from a 29% rebound in the iron ore price as signs emerged that Beijing is looking to ease its policy stance and depleted inventories are rebuilt. Prices strengthened across most of its commodity portfolio. It also saw a material up-weight in the index as a result of the collapse of its dual-listed structure.

Overweight Santos (STO, +13.2%)

STO benefited from the surge in energy prices on the back of recovering demand, constrained supply and the risk posed by sanctions on Russia in response to the Ukraine invasion.

Key detractors

Overweight Xero (XRO, -27.4%)

The prospects of higher interest rates continued to weigh on long duration growth names such as Xero (XRO). IN this environment, Pendal believes it is important to be very selective in this part of the market. Pendal maintains conviction in XRO's fundamental growth profile and earnings visibility, which they believe can support the outlook despite the macro backdrop.

Overweight James Hardie (JHX, -26.6%)

Higher US mortgage rates have weighed on sentiment around housing-related companies such as JHX. Thus far, the company is not seeing any impact on demand. It is benefiting from the structural under-build in US housing that took place post-GFC which support favourable supply/demand dynamics. Its quarterly result was broadly in line with expectations.

Market Commentary

The S&P/ASX 300 gained 2.1% for the quarter and calendar year to date. Looking to the rest of the world, the MSCI World index was down -8.2% (in AUD terms) over the same period. Germany's DAX and the US' Dow Jones suffered the most, returning -9.3% and -9.1% respectively. Asia fared slightly better with the Topix (-2.3%), Nikkei (-3.4%) and Hang Seng (-6.0%) seeing moderate negative returns. The UK was able to stay ahead, with the FT 100 returning 1.8%.

The quarter was dominated by the collision between the invasion of the Ukraine, the ongoing challenges of Covid – particularly in China, persistent inflation, and the Fed's hawkish bent and first rate hike in response to it.

The interplay between these issues is creating policy dilemmas and a number of second and third order effects. However the key outcome at this point is greater inflationary pressure, both through higher commodity prices in the short term and via greater spending on re-directed supply chains and defence over the medium term.

The US Fed hiked rates 25bps in March and continues to ply the line that it is looking to return to a neutral rate of 2.5% as quickly as possible. How far beyond that it will need to go remains to be seen. The interplay between inflation and government's hawkish sentiment saw bond yields rise sharply in the quarter. Most notably, the Australian 10-year yield rose 115 bps to 2.83% and the US 10-year yield rose 81 bps to 2.32%.

The US economy remains strong. Australian reporting season emphasised that the domestic economy also remains strong, underpinned by a rebound in pent-up demand.

Australia is proving more resilient than overseas equity markets. This is due to a combination of a softer inflationary pulse and less need to tighten rates as well as self-sufficiency in many commodities and a higher proportionate weighting of resource companies and financials in the market than most other developed markets.

The Brent crude oil price rose 39% for the quarter in USD on the combination of recovering demand and constrained supply, exacerbated by the Ukraine conflict. Thermal coal was up 53% and natural gas 50%. Energy (28.4%) was the strongest sector as a result with names like Whitehaven Coal Limited (WHC, +63.0%) and Woodside Petroleum (WPL, +54.0%) driving sector performance.

Broader commodity price strength also fed through to outperformance in Materials (+15.2%). Precious metals saw consistent gains peaking in early March before reconsolidating at the end of the quarter. Gold ended up 6%, silver 3% and iron ore by 34%. The collapse of its dual-listing also saw a large up-weight in BHP (BHP, +30.5%), which is now over 11% of the S&P/ASX 300 and the largest stock in it.

Banks (+7.9%) outperformed as the prospect of higher bond yields is seen as supportive of margins and trading updates were generally well received. Bendigo Bank (BEN, +16.4%) led, followed by Westpac (WBC, +13.5%) and National Australia Bank (NAB, +12.2%). That said, there is still a question about the degree to which this tailwind is competed away.

Long-duration growth stocks generally underperformed as market expectations around the pace of US interest rate hikes grew more aggressive. This saw Information technology (-13.7%) underperform despite a rebound towards the quarter's end. PC-based software company Altium Limited (ALU, -24.0%) is a prime example of this, seeing the share price rise quickly by 7% in the last weeks of March.

Consumer discretionary (-10.4%) also underperformed. Index heavyweight Wesfarmers (WES, -13.6%) fell as higher Covid-related costs and disruptions weighed on earnings for K-Mart and Officeworks. Aristocrat Leisure (ALL, -15.8%) also struggled as its bid for online gambling giant Playtech lapsed in February.

Outlook

Pendal remains cautious on the market in the near term. The Fed needs financial conditions to tighten – and rising equities works against this objective.

Instead, Pendal sees three more likely possible scenarios than a continued strong equity market rebound.

1. The market consolidates and treads water for a few months as they gauge central bank ability to contain inflation. This would be consistent with the history of US bull markets, which shows that the third year is often lacklustre, particularly if the first two are very strong.
2. The market falls back to set new lows, reflecting falling liquidity, concerns over slower growth dragging on earnings and a lack of certainty. Slower economic growth eases inflationary pressure, allowing interest rates to peak at levels the market or Fed are currently expecting, without triggering a recession. This then enables a market recovery. In this vein, Fed Chair Powell noted that there had been similar "soft landings" in US monetary history in 1967, 1984, 1994 and 1998. Each involved the yield curve going flat, with the Fed funds rate subsequently getting cut.
3. The same as scenario 2, except the economy end up in recession due to policy error or as the only way inflation can be contained. History indicates that when you see oil rise more than 100% year-on-year it triggers a recession. So too does persistent inflation at current levels.

Australia is better placed than many other countries. There is less need to raise rates, allowing them to remain lower for longer. The economy is benefiting from pent-up demand as restrictions roll back. The country is larger self-sufficient in key commodities and is a beneficiary of rising prices here.

This underpins our relatively positive view of the domestic equity market. This is reinforced by the degree to which the Australian market has underperformed the S&P 500 since the GFC. While recent outperformance has been material, it is a blip on a longer-term view, which gives us confidence in the potential for further outperformance.

Pendal remains of the view that the macroeconomic and geopolitical environment remains highly uncertain and that the shift in US monetary policy means that the market is likely to be less thematically – driven than in recent years. This places greater importance on a portfolio which is focused on managing macro risk and owns companies with visibility on earnings and the ability to deliver cash flows. This plays to the strengths of our approach.

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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