Pendal Sustainable Balanced

Quarterly Investment Option Update

31 March 2022

Aim and Strategy

The option aims to provide a return (before fees, and expenses) that exceeds the option's benchmark over the medium to long term. The benchmark for the option is created from a weighted composite of market indices with reference to the option's neutral asset allocation. The option invests in Australian and international shares, Australian and international property securities, unlisted property (including infrastructure), Australian and international fixed interest, cash and alternative investments.

The option may also use derivatives. Sustainable and ethical investment practices are incorporated into the Australian and international shares, Australian and international fixed interest and part of the Alternative investment components of the option. Pendal actively seek exposure to securities and industries that demonstrate leading ESG and ethical practices and exclude companies not meeting the investable criteria.

Asset Allocation	Benchmark (%)	Actual (%)
Australian shares	26	26.3%
Global shares	34	27.8%
Australian property securities	2	1.9%
Global property securities	0	1.3%
Unlisted property and infrastructure	3	6.6%
Growth alternatives	15	10.7%
Australian fixed interest	8	6.2%
Global fixed interest	7	7.0%
Cash	5	12.3%

Investment Option Performance

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

Investment Option Overview

Investment Category	Multi-Sector
Suggested minimum investment timeframe	5 years
Relative risk rating	6 / High
Investment style	Active
Manager style	Single Manager

Investment Option Commentary

The fund outperformed the benchmark over the March quarter.

Active asset allocation positioning at the start of the quarter entailed a significant underweight to bonds, a slight overweight to equities and an overweight to growth related alternatives. Positioning changed over February to a more defensive stance responding to changing market dynamics and a number of near term event risks, which was mainly implemented via a move to underweight equities. Over a very volatile quarter, these positions added significant value given the key driver of the volatility was concerns around inflation and interest rates.

In equities, the fund began the quarter slightly net overweight equities reflecting the positive trend model based positions exceeding those of the negative valuation model based positions. In February the fund de-risked to an underweight position, as the trend equity models turned off due to mixed signals leading to the valuation model based negative positions to dominate. During February as the Russian/Ukrainian conflict escalated the fund increased the net equity underweight via underweights in the expensive Swiss SMI and Canadian TSE 60 market indices, partially offset with an overweight to the cheaper Japanese TOPIX market index. In March the fund continued to de-risk over the month via the removal of the overweight to the Mexican equity market. This position was established in June 2020, where lingering concerns around COVID-19 on the economy and emerging markets in general suppressed valuations and provided an attractive entry point for a medium term investment. As the economy started to recover and given its close links to the US, the equity market also recovered and rallied 42% over the holding period contributing materially to returns. Overall the manager is currently cautious on equity markets reflecting high valuations, mixed trend signals, an inflection in economic momentum, geopolitical risks and the necessity for the Fed to address significant inflation. The volatile equity markets over the quarter led to the equity positioning contributing a flat result, as positive contributing valuation based positions were offset by negative contributing trend following positions.

In fixed income, trend-following models started the quarter with a maximum underweight. In addition, the fund continued to hold valuation-driven underweights to a number of bond markets. The manager often finds that strong results from active asset allocation occur when both trend and valuation signals are aligned, as they are in this case. The underweight to fixed income was the main contributor to the strong active asset allocation returns for the quarter. Whilst yields have sold off significantly over the quarter and have become more attractive in nominal terms, inflation adjusting still suggests bonds are very unattractive. Further the flattening of the yield curve reduces their expected risk premia, suppressing their valuation score.

Within alternatives, an overweight to various commodity positions and short VIX were reduced over February, reducing the positive growth bias as market sentiment became more negative. The performance contribution from alternatives was flat over the quarter, as gains from a long copper position was offset from positions in gold and VIX futures. Active asset allocation positioning at the start of April remains underweight bonds and equities and overweight inflation linked commodities such as carbon emissions and copper. However bond markets have been particularly volatile, with the bond volatility trigger being activated for a number of bond markets, resulting in a halving of the underweight to bond markets.

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 FTSE 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 index than most other developed markets.

Outlook

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

Instead, there are three scenarios more likely than a continued strong equity market rebound.

1. The market consolidates and treads water for a few months as central banks try 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 there is a recession due to either policy error or difficulties in containing inflation. History indicates that when oil rises 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 also a beneficiary of rising commodities prices. This underpins the fund’s 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 the manager confidence in the potential for further outperformance. Pendal remain 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.

Availability

Product Name	APIR Code
SignatureSuper	AMP9559AU
SignatureSuper – Allocated Pension	AMP5144AU
SignatureSuper – Term Pension	AMP5144AU

Contact Details

Web: www.amp.com.au
Email: askamp@amp.com.au
Phone: 131 267

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