Pendal Sustainable Balanced

Quarterly Investment Option Update

31 December 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.

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

Asset Allocation	Benchmark (%)	Actual (%)
Australian shares	26	28.3%
Global shares	34	32.9%
Australian property securities	2	2.0%
Global property securities	0	0.0%
Unlisted property and infrastructure	3	2.8%
Growth alternatives	15	14.5%
Australian fixed interest	8	7.6%
Global fixed interest	7	8.8%
Cash	5	3.1%

Investment Option Commentary

The portfolio marginally outperformed its benchmark over the quarter. Security selection added value whilst active asset allocation detracted.

In regard to security selection outperformance was driven by the International Shares strategies (in particular the “value style” strategy), whilst Australian shares and the Sustainable Listed Investment Companies within Alternatives detracted.

The investment manager’s active asset allocation positioning at the start of October was materially underweight bonds and equities. Within commodities Pendal were underweight gold, whilst volatility positioning was long. Equities rallied over the quarter on dovish pivot speculation and a satiating Q3 earnings season that calmed nerves, leading to the equity positions detracting value. Whilst the bond and volatility positioning added value over the quarter, this was offset by the commodity positions.

There were a number of changes to the equity positions near the end of the month of October, resulting in a reduction of the net underweight equity position. A review of the valuation based positions and a slight model recalibration led to conclude that Pendal now view equities as generally fair value, based on absolute market multiples levels and also relative to corporate bond yields. Equity markets had fallen circa 25% to their worst point during the quarter, which likely factored in a mild recession which is more the investment manager’s base case. These insights led Pendal to close its profitable value based net equity underweight via reducing the size of the US underweight and closing out the Swiss market underweight position. At the same time, Pendal opened a new underweight position on Spain, and overweights to the UK and Australia. These new value positions combined with the remaining value positions provided an equal but offsetting exposure towards markets Pendal view as cheap and with better fundamentals vs markets that Pendal view as more expensive and less attractive fundamentals. The investment manager’s trend based positions were still contributing to a mild net underweight to equities. The rally in equities over the quarter led to these positions detracting value, but pleasingly the changes made materially reduced the potential detraction. Whilst Pendal still view equities are generally close to fair value, Pendal’s global economic cycle model has turned materially negative and coupled with concerns around the lagging effects of substantial cumulative global interest rate hikes which could induce a recession, leads Pendal to view that corporate earnings and thus equities have more downside risk than upside. Pendal view the recent equity market rally is more likely than not a “bear market rally”.

In fixed income, as Pendal noted last quarter, Pendal’s trend models still strongly dislike bonds, however given the step-change in bond yields their valuation models are abating from extreme levels. Coupled with concerns around a potential recession it’s likely that Pendal’s valuation based positions could start to move back towards neutral levels over the near term. This turned out to be the case, as such Pendal closed their profitable value based underweights to the US and UK near the end of October. This left the only valuation based bond position being underweight Canada, and Pendal’s net underweight position being mainly driven by their trend following process. At the start of November Pendal reduced the size of this underweight by half as Pendal viewed there was a material risk that dovish and recession sentiment could further boost bond prices, which turned out to be the case. Bond markets generally increased over the quarter, but despite Pendal’s net short exposure, their active management of the positioning lead to a slight positive contribution. Looking forward, with headline inflation having peaked and potential recession concerns, bonds may start to gain market support.

Within alternatives, Pendal’s commodity positions of short gold and copper detracted as these metals rallied on the significant drop of the USD and positive sentiment on China relaxing its zero-Covid policy. Pendal’s net short commodities position reflects unattractive “backwardation” traits (that is, longer dated futures prices are relatively higher than shorter dated futures prices than typical), and mixed trend signals. Pleasingly a material portion of the commodity losses were offset by gains on the volatility positioning, which was generally short over the quarter and benefited from the “risk on” environment. VIX positioning remains short as Pendal’s Risk Sentiment Index remains at low levels, and implied volatility has tended to exceed realised volatility.
The investment manager’s active asset allocation positioning at the start of January has moved back to a modest underweighting of equities, whilst maintaining modest underweight positions in bonds, commodities and volatility.

Market Commentary

Despite giving back some gains in December, equity markets delivered a solid rebound in the final quarter, as inflation prints began to peak, the US dollar softened, and longer-term bond yields showed some suggestion of stabilisation. Signs that US inflation is trending downwards, opening the door to a more moderate pace of rate hikes, generally buoyed markets in October and November. However, the US labour market remains strong and continues to concern the Federal Reserve. As a result, Chair Powell's hawkish comments following the interest rate hike in December emphasised the need to continue hiking.

Both developed & emerging equity markets delivered positive returns as the MSCI World (7.6%) outperformed the MSCI Emerging Markets (6.7%) in local currency terms. The S&P500 gained 7.4% whilst the Eurozone outperformed gaining 10.0%. In AUD terms, the MSCI World ex Australia returned a positive 4.0% as a strong AUD eroded returns from an Australian investor's perspective. In regard to style factors, value outperformed growth.

Continuing its strong relative performance throughout 2022, the S&P/ASX 300 climbed 9.1% over the quarter. Every sector rose in Q4 2022. Utilities (+28.0%) did best, followed by Materials (+14.7%). Consumer Staples (+1.7%) and Information Technology (+1.9%) underperformed the market.

Central banks continued with monetary policy tightening over the 4th quarter. Of the major central banks, the Fed, ECB and BoE all tightened policy rates by 1.25% in the 4th quarter. Even the BoJ was involved when they broadened the tolerance for its yield curve control target band on the 10yr JGB yield in December from 25bps to 50bps. The bond rally early in the quarter, curbed by hawkish central bank comments in December, resulted in muted performance for Q4. The JP Morgan GBI Global (Traded) (AUD Hedged) came in broadly flat (-0.2%). The Bloomberg commodity index was positive in Q4, rising 2.5%. Gold (9.5%) and copper (10.6%) both rallied on the significant drop of the USD and positive sentiment on China relaxing its zero-Covid policy. The "risk on" environment in Q4 saw the VIX retrace -31.5%, highlighting a calming of recent heightened uncertainty.

Outlook

The key issue is whether Pendal are seeing the US economy slowing enough to relieve inflationary pressure via labour markets and commodity prices. This would allow the market to conclude the forward pricing of rate increases has peaked, regardless of Fed rhetoric.

Initial signs in 2023 are positive, with the first data points of the year suggesting inflation is lower or in-line with slowing consensus expectations.

There are several possible scenarios:

1. A softer economy leads to falling bond yields and commodity prices. Earnings weakness is limited, allowing equities to continue their rally.
2. A softer economy comes through followed by a significant earnings downturn, which after a near-term rally sees the market reverse to prior lows.
3. Inflation remains stubbornly high meaning the central bank rate path needs to stay higher for longer despite the softening economy, seeing the market fall to new lows.

All scenarios are plausible at this stage.

On balance Pendal's view is that whilst inflation has likely peaked, in the US for example it could become sticky around the 4-5% range, with further drops dependent on a softening of wages inflation via increased unemployment.

Whilst Pendal still view equities are generally close to fair value, Pendal's global economic cycle model has turned materially negative and coupled with concerns around the lagging effects of substantial cumulative global interest rate hikes which could induce a recession, leads the investment manager to view that corporate earnings and thus equities have more downside risk than upside. For bonds, with headline inflation having peaked and potential recession concerns, bonds may start to gain market support. Overall, Pendal remain cautious on the near-term outlook, with modest positioning across the funds.

Availability

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

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