

Pendal Monthly Commentary

Pendal Australian Specialised Retirement Income Portfolio

October 2023

Market commentary

Higher long-term bond yields in both the US and Australia weighed on equity markets in October.

Inflation continued to trend in the right direction in the US. However resilience in the economy, underpinned by several stronger-than-expected economic data points, saw the market shift to a “higher for longer” narrative in its outlook for interest rates.

Instability in the Middle East added to the mix, and saw sharp rallies in both gold and oil, although Brent crude finished off -8.3% for the month.

In Australia, the RBA held rates steady at 4.10%. However the headline monthly consumer price index (CPI) rose 5.6% for September, which was stronger than August’s 5.2% gain and is still well ahead of the RBA’s target. This underpinned the view that the RBA has to shift rates higher to bring inflation under control.

The S&P 500 fell -2.2% while the S&P/ASX 300 shed -3.8%.

Weakness was broad-based across the Australian market with every sector except Utilities (+1.68%) going backwards. The gains in this sector came as a result of the ACCC granting conditional authorisation for the Brookfield consortium’s proposed takeover of Origin Energy (ORG, +3.99%), although the deal still remains in doubt.

Materials (-1.19%) held up relatively well on the back of the large cap miners with BHP (BHP) up 0.56%, Rio Tinto (RIO) +3.55% and Fortescue Metals (FMG) +6.6%. The iron ore price rose a further 2.1%, defying ongoing weakness in the Chinese property sector. There is continued hope and speculation that Beijing will stimulate further to put a floor under economic growth.

It was the long-duration growth stocks and sectors which bore the brunt of higher bond yields.

Information technology (-7.36%) fell furthest as higher yields weighed on valuations. Xero (XRO, -5.11%), Wisetech (WTC, -10.59%), NextDC (NXT, -5.17%) and Altium (ALU, -8.63%) all finished the month down.

Higher yields also dragged on the growth names in Health care (-7.11%). This sector has seen additional volatility in recent months as the market grapples with the potential impact of anti-obesity GLP-1 drugs on the addressable market for various companies. Of the three largest stocks in the index, CSL (CSL) was off -7.36%, Cochlear (COH) -5.67% and Sonic Health Care (SHL) -3.52%.

Portfolio overview

| Australian Specialised Retirement Income Portfolio | |
|--|---|
| Investment strategy | Pendal employs a bottom up, fundamental approach to build a diversified portfolio of Australian shares where the majority of active risk and outperformance is driven by stock selection. The portfolio focuses on both capital growth and delivering a higher than market yield and franking credits but no considerations for Capital Gains Tax (CGT) allowing for higher turnover to drive returns. |
| Investment objective | To deliver outperformance relative to the benchmark after fees over a rolling three year period while delivering a higher gross yield than the market. |
| Benchmark | S&P/ASX 300 (TR) Index |
| Number of stocks | 15 - 35 (30 as at 31 October 2023) |
| Sector limits | Australian Shares 60 - 98%, Australian Property 0 - 30%, Cash 2 - 10% |
| Dividend Yield | 4.33% [#] |

Top 10 holdings

| Code | Name | Weight |
|------|---------------------------------|--------|
| BHP | BHP Group Ltd | 12.94% |
| CSL | CSL Limited | 7.75% |
| TLS | Telstra Group Limited | 6.48% |
| CBA | Commonwealth Bank of Australia | 6.26% |
| NAB | National Australia Bank Limited | 5.94% |
| STO | Santos Limited | 5.74% |
| WBC | Westpac Banking Corporation | 4.97% |
| QBE | QBE Insurance Group Limited | 4.20% |
| QAN | Qantas Airways Limited | 3.33% |
| MTS | Metcash Limited | 3.24% |

Source: Pendal as at 31 October 2023

Top 5 overweight versus S&P/ASX 300

| Code | Name | Weight |
|------|-----------------------------|--------|
| STO | Santos Limited | 4.54% |
| TLS | Telstra Group Limited | 4.35% |
| QBE | QBE Insurance Group Limited | 3.07% |
| MTS | Metcash Limited | 3.06% |
| QAN | Qantas Airways Limited | 2.92% |

Top 5 underweights versus S&P/ASX 300

| Code | Name | Weight |
|------|----------------------------------|--------|
| WES | Wesfarmers Limited (not held) | -2.77% |
| RIO | Rio Tinto Limited (not held) | -2.11% |
| WOW | Woolworths Group Ltd (not held) | -2.07% |
| TCL | Transurban Group Ltd. (not held) | -1.76% |
| ANZ | ANZ Group Holdings Limited | -1.76% |

Source: Pendal as at 31 October 2023

[#]The Portfolio’s dividend yield represents the weighted average 12-month forward-looking dividend yield of the portfolio holdings (excluding cash), as at the date of the Factsheet. Each individual security’s dividend yield is calculated using market consensus Dividend Per Share (DPS) before tax and franking credits, collated by Pendal and divided by the closing market price of the security as at the date of the Factsheet. The portfolio dividend yield therefore is only an estimate, and does not reflect the actual returns of the Fund, which will be affected by market movements in the price of individual securities, the returns on other assets such as cash holdings and variances of individual security’s actual dividends from the forecasted DPS.

Performance

| | 1 month | 3 month | 6 month | 1 year | 3 year (p.a.) | 5 year (p.a.) | Since inception (p.a.)* |
|---|--------------|--------------|--------------|---------------|---------------|---------------|-------------------------|
| Pendal Australian Specialised Retirement Income Portfolio | -3.14% | -6.43% | -4.32% | 2.48% | 10.02% | 8.04% | 7.77% |
| S&P/ASX 300 (TR) Index | -3.80% | -7.29% | -5.41% | 2.51% | 8.68% | 7.15% | 7.19% |
| Active return | 0.66% | 0.86% | 1.09% | -0.04% | 1.34% | 0.89% | 0.58% |

Source: Pendal as at 31 October 2023

*Since Inception - 20 August 2015

Performance returns are pre-fee. Investors should contact their platform provider for applicable fee rates.

Past performance is not a reliable indicator of future performance.

Top 5 contributors - monthly

| Code | Name | Value Added |
|------------|--|--------------|
| NST | Northern Star Resources Ltd | 0.15% |
| TLS | Telstra Group Limited | 0.12% |
| <i>LTR</i> | <i>Liontown Resources Limited (not held)</i> | <i>0.11%</i> |
| BHP | BHP Group Ltd | 0.09% |
| QBE | QBE Insurance Group Limited | 0.09% |

Top 5 detractors - monthly

| Code | Name | Value Added |
|------------|---|---------------|
| NEC | Nine Entertainment Co. Holdings Limited | -0.17% |
| <i>RIO</i> | <i>Rio Tinto Limited (not held)</i> | <i>-0.14%</i> |
| CSL | CSL Limited | -0.10% |
| <i>NEM</i> | <i>Newmont Corporation (not held)</i> | <i>-0.09%</i> |
| ORA | Orora Ltd. | -0.09% |

Top 5 contributors - 1 year

| Code | Name | Value Added |
|------|-----------------------------|-------------|
| QBE | QBE Insurance Group Limited | 0.71% |
| BHP | BHP Group Ltd | 0.41% |
| NXT | Nextdc Limited | 0.37% |
| NST | Northern Star Resources Ltd | 0.29% |
| XRO | Xero Limited | 0.29% |

Top 5 detractors - 1 year

| Code | Name | Value Added |
|------------|---------------------------------------|---------------|
| QAN | Qantas Airways Limited | -0.61% |
| <i>RIO</i> | <i>Rio Tinto Limited (not held)</i> | <i>-0.58%</i> |
| CSL | CSL Limited | -0.48% |
| <i>NEM</i> | <i>Newmont Corporation (not held)</i> | <i>-0.38%</i> |
| MIN | Mineral Resources Limited | -0.35% |

Source: Pendal as at 31 October 2023

Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Northern Star (NST, +11.76%)

The gold price rose 7.3% in October, helped by geopolitical instability, which saw the gold miners such as the portfolio's position in Northern Star (NST) outperform. NST's quarterly production report was among the best in the sector although it missed consensus expected production by 4%, with costs 4% higher. Management retained full year guidance, expecting better production in the second half of the year.

Overweight Telstra (TLS, -1.04%)

Some minor disappointment around its fixed-line business in its FY23 result, as well as broader weakness in some higher-yield names, has weighed on Telstra in recent months. However it held up better than the market in October, with management reaffirming FY24 guidance at its AGM update. We continue to see TLS as a preferred defensive exposure, with its dividend yield underpinned by a return to profitability in its mobile phone division.

Underweight Liontown Resources (LTR, -45.24%)

The challenging headwind of softer lithium prices was exacerbated in Liontown's case by the news that US miner Albermarle was withdrawing its indicative takeover offer. The company raised equity capital and negotiated a debt package to fund the Kathleen Valley lithium project in Western Australia, which is due to start production in mid-2024. The portfolio does not hold Liontown.

Three largest detractors

Overweight Nine Entertainment (NEC, -10.00%)

Nine fell along with other cyclical exposures as September's CPI number came in stronger than August and emphasised the view that the RBA may have to raise rates further to bring inflation under control. Management are seeing a slowdown in advertising spending, however it is offsetting this to a degree via increased market share. The more diversified nature of Nine's business, with a diverse range of revenue drivers, provides an additional cushion against near term cyclical headwinds.

Underweight Rio Tinto (RIO, +3.55%)

Rio Tinto outperformed as the iron ore price remains elevated and resilient despite weakness in the Chinese property sector. The market has been holding out hope for further stimulus from Beijing to support economic growth. The portfolio holds BHP in the iron ore space, which has less headwind from the need to replace production and more exposure to copper. This offset much of the drag from the underweight in Rio Tinto.

Overweight CSL (CSL, -7.36%)

Concern over the potential impact of GLP-1 drugs used to treat diabetes and obesity on the addressable market for CSL weighed in October. CSL fell on news of a potentially successful trial to use GLP-1 drugs to slow a patients' progress to kidney dialysis. CSL has exposure to dialysis via its recently-acquired Vifor division. Management estimate that, at worst, this could see 1-2% of group revenue at risk. However there are plausible scenarios where CSL may be a net beneficiary. It is very early days with regard to understanding the impact of GLP-1 drugs on the health care sector. We continue to see CSL at very attractive valuation given its quality and tailwinds.

Performance and outlook

The portfolio finished slightly ahead of the index for the month, before fees. Several of the more defensive exposures helped, while some of the more cyclical positions detracted.

At this point, our base case remains that both the US and Australian economies continue to "muddle through" with low growth.

The Australian economy is being supported by population growth, a weaker currency, resilient commodity prices and government spending. At this point, consumers have been able to withstand the "mortgage cliff" of variable home loans re-sets better than many feared, although there are strains in some parts of the household sector. Further, domestic real interest rates (ie nominal rates minus inflation) are lower than other developed markets.

In the US, the chance of achieving the "soft landing" of bringing inflation under control without a deep recession has increased.

However the risk of mild recession in early 2024 remains, given the potential combination of the lagged effects of tighter monetary policy, waning fiscal spending and the run-down of excess savings. Potential headwinds from higher oil prices and/or a government shutdown also remain wildcards.

The risk to Australia is more that of persistent inflation leading to the RBA ratcheting rates higher than expected in the next six months, which could lead to a market de-rating.

Other considerations are:

1. Geopolitical risk. Further instability in the Middle East could disrupt oil markets. We are also wary that Russia may seek to restrict oil supply and cause further instability in a US election year.
2. China. The economy is weak, but this is well known. At this point it appears policy will be sufficient to underpin growth, but not lead to an acceleration.

The S&P/ASX 200 is trading at around 15x next twelve month P/E. We see this as consistent with the level of interest rates. The market multiple could fall on a material shift in expectations around higher rates. Conversely, if perceived risk around the economic outlook diminished, this could support a gradual re-rating.

Consensus earnings growth for the market for the next twelve months is around zero. Industrials are expected to grow earnings in mid-to-high single digits, but this is offset by expectations of falling earnings in the resource sector.

Importantly, at this point we are not seeing any signs of economic weakness affecting revisions.

Given the context of continued uncertainty in the potential economic environment, we continue to focus portfolio risk primarily on stock and industry-specifics, rather than style or other macro thematic factors. As always, our aim is to mainly drive performance via insight at the company level.

In this vein, we note that sector-level dispersion has fallen and stock-level dispersion has risen over the course of 2023, suggesting we are possibly moving into an environment which is better for stock picking.

New stocks added and/or stocks sold to zero during the month

Buy a new position in Medibank Private Ltd (MPL)

Medibank Private (MPL) is the largest private health insurer in Australia. It provides hospital and extras cover, for residents and international students/workers, via the Medibank and ahm brands. It differentiates itself from peers by having the largest investment in new care settings. Its ancillary division, Amplar Health, offers at home care, preventative health and telehealth services.

We see an attractive opportunity in MPL, with valuation upside driven in a large part by a more positive view on claims costs than current valuations suggests.

We draw comfort from MPL's \$250m of remaining provisions, which provide a buffer against a bounce back in costs. We also note that cost of living pressures are seeing fewer optometrist and dental visits, which may help offset higher-than-expected hospital claims.

More important, on our view, is the structural benefits of a shift to treatment via short stay procedures rather than hospital care. This is an area of ongoing focus as Australia catches up to global trends. For example, MPL estimates 40% of patients treated in expensive overnight hospitals could be treated in other settings or at home. These structural changes are prompting some push back from hospitals, especially those with an excess of rehabilitation over surgical beds. However we believe this reflects sub-optimal investment decisions from hospitals, which will need to change over time.

Finally, at an industry level, we think the market is negative overall on the issue of claims returning to normal following three years of subdued activity post-COVID. The market appears worried about potential earnings ramifications, with MPL having de-rated from a PE of 19.5x to 17.5x. However, insurers never benefited directly from COVID. Instead they passed benefits straight through to policyholders via give backs and lower price rises. As claims return to normal, give backs will stop, but premium increases are likely to remain below wage inflation. This should support ongoing participation, as will lengthy public hospital waitlists. As a result, we think the market is overestimating the headwind from this trend.

In terms of sustainability, we see MPL's role in shifting the emphasis in health-care to shorter-term stays as a positive for the structure of the overall system. Beyond this, the company is focused on health improvement and preventative health care via programmes such as the Live Better Rewards initiative and other programmes focused on improving mental health and community health issues such as loneliness.

We view the current price an attractive entry into a high quality, defensive franchise and see particular appeal in the investments MPL is making to improve the sustainability of the system.

For more information contact your
key account manager or visit pendalgroup.com

PENDAL

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