

## Pendal Monthly Commentary

### Pendal Sustainable Future Australian Shares 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

Sustainable Future Australian Shares Portfolio	
<b>Investment strategy</b>	Pendal’s investment process for Australian shares is based on its core investment style and aims to add value through active stock selection and fundamental company research. Pendal’s core investment style is to select stocks based on its assessment of their long term worth and ability to outperform the market, without being restricted by a growth or value bias. Pendal’s fundamental company research focuses on valuation, franchise, management quality and risk factors (both financial and non-financial risk)
<b>Investment objectives</b>	To deliver outperformance relative to the benchmark before fees over a rolling five year period by investing in companies which Pendal has identified as having leading financial, ethical and sustainability characteristics.
<b>Benchmark</b>	S&P/ASX 300 (TR) Index
<b>Number of stocks</b>	15 - 40 (30 as at 31 October 2023)
<b>Sector limits</b>	Australian Shares, 65 - 98%, Australian Property 0 - 30%, Cash 2 - 5%
<b>Dividend Yield</b>	3.86% <sup>#</sup>

#### Top 10 holdings

Code	Name	Weight
CSL	CSL Limited	9.34%
CBA	Commonwealth Bank of Australia	7.09%
TLS	Telstra Group Limited	6.59%
RIO	Rio Tinto Limited	5.89%
NAB	National Australia Bank Limited	5.65%
QBE	QBE Insurance Group Limited	5.49%
GMG	Goodman Group	4.06%
WBC	Westpac Banking Corporation	3.98%
MQG	Macquarie Group, Ltd.	3.75%
QAN	Qantas Airways Limited	3.74%

Source: Pendal as at 31 October 2023

#### Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
TLS	Telstra Group Limited	4.46%
QBE	QBE Insurance Group Limited	4.37%
CSL	CSL Limited	3.92%
RIO	Rio Tinto Limited	3.78%
QAN	Qantas Airways Limited	3.33%

#### Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
BHP	BHP Group Ltd (not held)	-10.90%
WDS	Woodside Energy Group Ltd (not held)	-3.14%
WES	Wesfarmers Limited (not held)	-2.77%
WOW	Woolworths Group Ltd (not held)	-2.07%
TCL	Transurban Group Ltd. (not held)	-1.76%

Source: Pendal as at 31 October 2023

<sup>#</sup>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 Sustainable Future Australian Shares Portfolio	-3.80%	-8.57%	-6.61%	1.17%	7.32%	8.21%	6.89%
S&P/ASX 300 (TR) Index	-3.80%	-7.29%	-5.41%	2.51%	8.68%	7.15%	6.02%
<b>Active return</b>	<b>0.00%</b>	<b>-1.28%</b>	<b>-1.19%</b>	<b>-1.34%</b>	<b>-1.36%</b>	<b>1.06%</b>	<b>0.87%</b>

Source: Pendal as at 31 October 2023

\*Since Inception - 16 June 2018

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	0.26%
RIO	Rio Tinto Limited	0.26%
QBE	QBE Insurance Group Limited	0.13%
TLS	Telstra Group Limited	0.12%
<i>LTR</i>	<i>Liontown Resources Limited (not held)</i>	<i>0.11%</i>

### Top 5 detractors - monthly

Code	Name	Value Added
<i>BHP</i>	<i>BHP Group Ltd (not held)</i>	<i>-0.46%</i>
AKE	Allkem Limited	-0.21%
ORA	Orora Ltd.	-0.20%
PLS	Pilbara Minerals Limited	-0.19%
CSL	CSL Limited	-0.16%

### Top 5 contributors - 1 year

Code	Name	Value Added
QBE	QBE Insurance Group Limited	1.07%
FMG	Fortescue Metals Group Ltd	0.86%
XRO	Xero Limited	0.62%
NST	Northern Star Resources Ltd	0.51%
NXT	Nextdc Limited	0.47%

### Top 5 detractors - 1 year

Code	Name	Value Added
<i>BHP</i>	<i>BHP Group Ltd (not held)</i>	<i>-2.12%</i>
CSL	CSL Limited	-0.78%
QAN	Qantas Airways Limited	-0.71%
AKE	Allkem Limited	-0.65%
ORA	Orora Ltd.	-0.54%

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 Rio Tinto (RIO, +3.55%)

Resilience in the iron ore price and a view that Beijing will do more to underpin economic growth saw Rio Tinto hold up relatively well. Rio's quarterly production report was largely in-line with expectations, having already release iron ore production figures. Both its copper and aluminium divisions came in slightly ahead of consensus expectations.

#### Overweight QBE Insurance (QBE, -0.70%)

There was little stock-specific news for QBE during the month, although as a beneficiary of higher interest rates, the insurance sector held up better than the broader market. We continue to like the combination of a supportive industry trend of insurance premiums rising faster than inflation costs, coupled with the improvements in QBE's structure and quality of earnings as it withdraws from its more challenged products and services in the US.

## Three largest detractors

### Underweight BHP (BHP, +0.56%)

Resilience in the iron ore price and a view that Beijing will do more to underpin economic growth saw BHP hold up relatively well. The company's quarterly production was in line with expectations for iron ore and copper, however metallurgical coal was weaker than expected due to a number of issues including maintenance. The company confirmed the sale of its Blackwater and Daunia coal assets to Whitehaven Coal. BHP is excluded from the portfolio's investable universe due to its coal exposure.

### Overweight Allkem (AKE, -18.88%)

The exposure to lithium miner Allkem detracted as the broader sector remains under pricing pressure given an excess of material in the battery metals supply chain. That said, this drag was more than offset by the underweight exposure to other lithium miners such as Liontown (LTR), IGO (IGO) and Pilbara Minerals (PLS). We maintain a positive medium term view on the sector and regard AKE as among the highest-quality exposures, however the supply/demand imbalance may see further near-term softness.

### Overweight Orora (ORA, -10.55%)

Investors expressed concern over the earnings outlook for the recently acquired Saverglass business, exacerbated by downgrades from global spirit companies and glassmakers. We believe that Saverglass is a high quality acquisition with strategic merit. Near term earnings risk is more than reflected in ORA's current stock price, in our view. We also expect ORA to grow volumes at a faster rates than the industry, helped by a larger exposure to luxury-end glass, which is benefiting from premiumisation.

## Performance and outlook

The portfolio finished in-line with the index for the month, before fees. Several of the more defensive exposures helped, while the modest underweight in iron ore miners 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.

### Carbon performance

The estimated weighted average carbon intensity (WACI) of the portfolio, using greenhouse gas emissions (scope 1 and 2<sup>1</sup>) data supplied by ISS and weighted by the size of our holding in each company, is shown in the table below. In other words, this provides an indication of a portfolio’s exposure to carbon intensive companies. We also compare this to the weighted average emissions for the companies in the aggregated ASX300 index.

We caution that there are limitations of using carbon metrics as an indicator of a portfolio’s overall exposure to climate-related risks. For example, not all companies report their emissions data and hence some of the below analysis includes estimates. Also, it does not include scope 3 emissions. Further, portfolio carbon analysis does not capture exposure to physical climate-related risks, or the unique transition risks some companies within the portfolio face. Nevertheless, the WACI metric is recommended by the Task Force on Climate-related Financial Disclosures (TCFD)<sup>2</sup>, noting it supports greater comparability of investor reporting.

### Weighted Average Carbon Intensity (tonnes CO<sub>2</sub>e / \$M revenue)

Pendal Sustainable Future Australian Share Portfolio	ASX 300	Relative to ASX300
128.84	170.77	-41.93

Source: ISS, Pendal holdings as at 31 October 2023. Report run on 08/11/2023 using latest ISS data. Currency AUD

<sup>1</sup> Scope 1 emissions result from sources directly owned or controlled by the company. Scope 2 accounts for emissions from the generation of purchased electricity consumed by the company. Scope 3 emissions result from activities not directly owned or controlled by the company but are associated with its operation such as business travel, waste management, commuting, and the use of sold products and services. <https://ghgprotocol.org/sites/default/files/standards/ghg-protocol-revised.pdf>

<sup>2</sup> Recommendations of the Task Force on Climate-Related Financial Disclosures, June 2017 <https://www.fsb-tcfd.org/recommendations/>

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key account manager or visit [pendalgroup.com](https://pendalgroup.com)

**PENDAL**

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