

Pendal Sustainable Balanced

Quarterly Investment Option Update

30 June 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	25.6%
Global shares	34	30.4%
Australian property securities	2	1.8%
Global property securities	0	1.2%
Unlisted property and infrastructure	3	7.5%
Growth alternatives	15	8.3%
Australian fixed interest	8	6.7%
Global fixed interest	7	7.4%
Cash	5	11.1%

Investment Option Commentary

The Fund outperformed the benchmark over the June quarter.

Pendal's active asset allocation positioning at the start of the quarter was underweight bonds and equities and overweight inflation linked commodities such as carbon emissions and copper. Equities and bonds sold off significantly over the quarter contributing significant returns. Whilst the contribution to returns from alternatives was marginally negative due to offsetting commodity and VIX positions. The strongly positive net return during a period of significant markets falls was particularly pleasing, providing valuable capital protection for investors.

In equities, the starting underweight position entirely reflected the manager's valuation and cycle models, whilst the trend models were net neutral. Pendal's valuation models were noting that markets were generally expensive, not just in absolute terms but increasingly so relative to bonds as yields had risen. The economic cycle models suggested that whilst fundamentals were good from a "level" perspective, the "momentum" of fundamentals had turned negative. Over May there were some changes to the equities positions, with an expansion of the underweight equity position due to the trend models moving from neutral to underweight, just in time for the significant falls in June. The nature of the trend models being able to move to an underweight stance in risk off environments adds an attractive defensive aspect to their return profile. In regards to Pendal's valuation and cycle models, the manager closed out an underweight Taiwanese equity market position for a modest holding-period gain as valuations had become less extreme and the fund sought to manage the overall equity market underweight. In addition the manager transitioned the valuation based ASX200 underweight to the Indian Nifty 50 index, as whilst both had similar valuation scores the economic cycle and defensive traits of the Australian market were more attractive. Despite the equity market falls the manager still views equity markets as expensive as the material increase in corporate bond yields reduces the relative attractiveness of equity markets. Further, equity market falls have been led by a fall in "pricing multiples" and earnings expectations from market analysts remains high. With the rapid rise in interest rates by central banks and the increasing talk of recession, it is the manager's view that earnings could be at risk. Within the broad equities underweight, the manager is underweight the US, Canada, France, Switzerland and India as these countries are all scored as expensive and generally their economic momentum has turned. The manager has overweights in better valued markets being the UK and Japan. Given the large equity market falls over the quarter, the equity positions added significant value.

In fixed income most of the manager's trend-following models "toggled-off" at the start of the quarter given the high volatility, which halved the starting net underweight. These then toggled back on by May such that the trend models were again at maximum underweight, only for some bond market to again toggle off during June to finish the quarter about half maximum underweight to bonds for the trend models. In addition, the manager continues to hold valuation-driven underweights to a number of bond markets. The manager's valuation models find Australian and Canadian bonds to be fair value, whilst US, Italian and UK bonds are viewed to be overvalued and thus the fund is underweight. Whilst yields have become more attractive in nominal terms, adjusting for increasing inflation expectations still suggests bonds generally are unattractive. Further the flat nature of yield curves reduces their expected risk premia, suppressing their valuation score. Given fixed income markets fell materially over the quarter, the net underweight to fixed income added material value.

Within alternatives a switch to short copper added value. This calendar year has undergone material macro outlook changes, from the start of the year inflation, to stagflation in Q2, and more recently recession which drove the falls in copper prices. The VIX strategy struggled with the high "vol of vol" environment over the quarter detracting material value. During April the manager initiated a long VIX position, as realised volatility started to materially exceed implied volatility and Pendal's Market Stress Indicator remained at concerning levels. Such a long position which has hedging properties was also consistent with the manager's qualitative views around numerous near-term event risks. The position proved timely as market volatility continued to remain high, leading to a material contribution to returns from the VIX position in April. However over May and June VIX positioning was challenged as markets incurred material intra month volatility, and the lack of VIX level consistency resulted in losses over the quarter.

Active asset allocation positioning at the start of July remains materially underweight bonds and equities. Within commodities the manager is overweight carbon emissions and underweight copper. Volatility positioning is short.

Market Commentary

There was a persistent undercurrent of concern over stubborn inflation and tightening interest rates throughout the period.

This boiled over in June as the Fed hiked rates 75bps and indicated that they could do the same again in July. They are now signalling that they could end the year at 3.4%, according to the "dot plot" of expected moves. Three months ago, this figure was 1.9%.

Other central banks have adopted a similarly hawkish tone. The Reserve Bank of Australia hiked 50bps in June.

All this triggered concerns that central banks would drive economies into recession, rather than the desired soft landing, in the quest to tame inflation.

Most of the damage to equity markets was done in June. It also saw rotation from value, which had outperformed in April and May, as investors start to factor in the risk of earnings downgrades.

The S&P/ASX 300 fell -12.7% over the quarter. It underperformed in June as financials and resources were hit hard. However Australia held up better than the S&P 500 (-16.4%) for the quarter and has outperformed over the calendar year to date.

Global equity markets continued their fall with 2 consecutive negative quarters to end the financial year on a negative note as concerns over slowing economic growth driven by tighter monetary policy to fight inflation, with the MSCI World ex Australia in AUD returning -8.42% whereas the local currency return was closer to -14.4%, as the falling Australian dollar helped offset some of those losses.

Outlook

The manager maintains a cautious near term outlook. It is increasingly hard to see how the US avoids a recession from here.

First the lagged effect of inflationary pressures means it is unlikely there will be much relief on this front given the fuel, food, and shelter components are still rising. This gives the Fed little room to back off hikes. Second, while overall economic activity remains reasonable, the lead indicators are deteriorating.

These include the “rule of ten” observation of mortgage rates and petrol prices - which has a good track record of predicting recessions – and falling house prices which can affect consumption. This is feeding through to a fall in the Atlanta Fed’s GDP tracker and other GDP forecasts rolling over.

This economic risk has implications for the market. The market is currently discounting a material drop in earnings, while the latter continue to hold up. Since 1987 this disconnection has been observed twice, in 2002 and 2011, where markets overstated risk.

However in 2000, 2008 and 2020 the earnings caught up with the market and therein lies the risk if the US and global economy go into a recession.

Valuations in the markets other than the US - including Australia - are lower and provide some protection. But the manager remains wary of how the market performs as downgrades come through.

While the risk is material, this bearish scenario is not a certainty. Factors which could see a better outcome include:

- Inflation momentum slows more quickly than now expected. There are some signs of hope with higher inventory at US retailers and evidence of discounting appearing. The fall in the oil price is a very important lead if sustained.
- Labour markets loosen up sooner. There have been announcements from the tech sector on layoffs, but collectively this is not sufficient. On the supply side perhaps inflation and the crypto bust help drive participation higher.
- Supply chains begin to ease up as China re-opens and demand softens.

Should these factors start to play out it is possible the Fed may swerve again and not be as aggressive on rates. It would still be unclear whether this is enough to avoid a recession; but in the market’s eyes it would at least signal the depth of the downturn could be lower.

One flag which is likely to mark the low in this cycle is the passing of time. This market looks closer in nature to 2000 and 2008 where the market had to consolidate near its lows for a number of months before sentiment improved – unlike the sharp policy-driven bounce of 2020.

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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