Pendal Sustainable Balanced

Quarterly Investment Option Update

30 September 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	25.6%
Global shares	34	31.3%
Australian property securities	2	1.8%
Global property securities	0	1.2%
Unlisted property and infrastructure	3	8.0%
Growth alternatives	15	8.9%
Australian fixed interest	8	7.3%
Global fixed interest	7	8.7%
Cash	5	7.2%

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 underperformed its benchmark over the quarter. Active asset allocation added material value whilst security selection detracted.

In regards to the security selection, underperformance was driven by the International Shares asset class. The Sustainable Concentrated Global Share Fund and Global Select Fund were the key drivers. Offsetting somewhat was strong outperformance by the emerging markets equity exposure which screens out “repressive” regimes.

The fund’s active asset allocation positioning at the start of July remained materially underweight bonds and equities. Within commodities the portfolio is overweight carbon emissions and underweight copper. Volatility positioning was short. Equities and bonds fell significantly over the quarter, as such these positions added material value over the quarter. It was pleasing that the active asset allocation added to returns when market returns were poor, providing capital protection to the portfolio.

Changes to the equity positions over July were the closures of an overweight and underweight position to the FTSE100 and the India Nifty50 respectively at the start of the month, as well as during the month a switch from an underweight position in the Canadian TSX60 to a new underweight DAX position. Despite these changes there were was no net change to the underweight to equities over the month. The closure of the FTSE100, India Nifty50 and Canadian TSX60 positions reflected these markets moving closer to Pendal’s measure of fair value, and as such were closed out profitably over their respective holding periods. During September there was only one change to the equity positions, with the removal of the trend based underweight to US equities due to The fund’s volatility “toggle” suggesting that the underperformance might have become stretched; the portfolio remain underweight US equities based on valuation grounds. This marginally reduced The fund’s net equity underweight by quarter end. The net underweight of equities and the large falls in equity markets over the quarter led to the equity positions adding material value. We remain of the view that whilst market pricing multiples have reduced back to more normal levels, valuations are still expensive compared to corporate bond yields. Further we view that sticky wage inflation could force central banks to keep rates higher for longer, thus inducing recession risk and potentially lower corporate earnings. As such we remain comfortable with The fund’s underweight to equities and in particular the US and Europe, whilst we favour Japan based on valuation.

In fixed income underweights to German, UK and Canadian bonds toggled back on at the start of July as volatility had subsided. In regards to the German position, this was in lieu of a previous underweight to Italian bonds that was held given a view around the heightened risks of the Italian economy and the potential for spread widening. This underweight of Italian bonds paid off over the year holding period as Italian bond spreads increased by circa 80bps. Chatter around the ECB potentially entering the bond markets to provide support to Italian bonds provided a catalyst to close the exposure at a material profit. Whilst in August, and post the prior month’s bond rally, we had increased the fund’s net underweight as valuations had further deteriorated. Over the course of the month the significant rise in yields and more concerns around a potential recession led to a reduction in the valuation-based underweight. Offsetting this somewhat was some of the fund’s trend model based underweights “toggling” back on as volatility subsided. As such whilst the fund’s net underweight was only reduced marginally, there was a composition change from valuation to trend-based positions. The manager’s trend models still strongly dislike bonds, however given the step-change in bond yields Pendal’s valuation models are abating from extreme levels. Coupled with concerns around a potential recession it’s likely that valuation-based positions could start to move back towards neutral levels over the near term. Given the material fall in bond markets over the quarter, the bond positions added material value.

Within alternatives, the fund’s commodity positions added slightly over the quarter. VIX positioning added value over the quarter and in particular in July during the more stable macro environment allowing for an attractive harvesting of volatility risk premia. Overall alternatives made a positive contribution to returns.

The fund’s active asset allocation positioning at the start of October remains materially underweight bonds and equities. Within commodities the portfolio is underweight via an underweight in gold, and volatility positioning is long. The view remains that equities are still generally on the expensive side, especially compared to corporate bond yields, and earnings has more downside risk than upside risk. The manager’s believes bonds remain expensive once adjusting for inflation and the lack of a fair term premia, but the valuation metric is turning.

Market Commentary

Equity and bond markets started Q3 strongly as investors latched on to signs that inflation may be peaking, and that growth was slowing, interpreting this may be enough to open the door to the Fed scaling back the speed and scale of interest rate hikes. The rally lasted July and early August before the market sharply turned with the Fed putting a stop to the loosening financial conditions by tightening their rhetoric at the Jackson Hole symposium and onward, reflecting their commitment to fighting inflation and keeping policy tighter for longer.

This in combination with persistent strength in the US dollar – which rose to twenty-year highs on a trade-weighted basis – and high US bond yields, which hit twelve year-highs, made a tough environment for equities. The MSCI World index fell -6.2% in USD terms, while emerging markets underperformed, falling -11.6% in USD terms. The S&P500 finished down -5.0%. In regard to style factors, value outperformed growth and small caps marginally outperformed large caps.

Similarly, the ASX300 essentially gave up it gains from early in the quarter but continues to outperform the US equity market finishing up 0.45% for the quarter. Macro factors overshadowed a benign reporting season for corporate Australia. FY22 results were broadly in line with historical averages in terms of revisions. FY22 delivered 23% EPS growth, driven by 38% EPS growth in resources. Importantly, the feared plunge in earnings expectations did not occur. Energy (+5.8%) was the strongest sector over the quarter. Health care (+3.2%) also outperformed while traditional defensive asset-based sectors like utilities (-12.5%) and real estate (-6.4%) underperformed.

The Bloomberg Global Aggregate (AUD Hedged) declined -3.8% as US 10-Year Treasury yields rose 82 basis points. Reflecting rising recessionary risk, the US curve became more inverted as US 2-Year Treasury yields rose 132 basis points in the quarter.

The Bloomberg Commodity index fell -4.8% in USD terms over the quarter. While energy was broadly flat, most other commodities were negative. Iron ore (-18.0%) and brent crude oil (-23.0%) both fell, along with copper (-7.4%), a commodity often seen as a leading indicator for economic health. The VIX index more than doubled over the quarter, from 15.8 to 31.6, highlighting the material lift in market uncertainty.

Outlook

The key issue is that while there are clear signs of inflation slowing, it is still more persistent than the Fed wants.

Consumption remains strong in the US, particularly in the service sector, and while household savings have run down, they remain at elevated levels, supporting further spending. Wages also continue to grow, and the labour market remains tight. All this is inconsistent with an economy slowing sufficiently to meet the Fed's stated inflation goals indicating it is unlikely we will see a near term pivot in monetary policy.

However, a critical risk is that attempts to slow the economy translate into some sort of destabilising financial system shock. Actions by the Bank of England and comments from the Fed in response to the sharp moves in the UK bond market and risk to pension fund balance sheets – can be understood in this context. This is the tightrope that central banks are walking.

We are particularly mindful that any sustained or extended rally in equities would loosen total financial conditions, acting contrary to the Fed's objectives. Even though equity markets have fallen, and price multiples have declined, we are yet to see a breadth of earnings downgrades. Ultimately, it will be declining company earnings that tightens financial conditions, allowing central banks to ease their hawkish rhetoric.

Overall, the manager remains cautious on the near-term outlook, with cautious positioning across the funds. This view reflects the signals from Pendal's investment process and also near-term event risks such as potential demand destruction due to lower real disposable incomes, central bank policy overreach and/or a financial system shock. The manager's investment process adjusts bond yields for inflation and in real terms they previously were not offering a commensurate risk premium. Rising real yields increases the attractiveness of bonds. When added to the diversification benefits bonds traditionally offer, the asset class is beginning to look more attractive.

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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