

Aberdeen Standard Focused Sustainable Australian Equity Fund



31 January 2022

Market Review

Australian equities fell at the start of the year, giving up their gains from the second half of 2021. The Australian dollar also suffered, falling back to an over one-year low against the US dollar by the end of the month; however, commodity prices increased.

While it appeared that investors had shaken off any concerns over the Omicron variant of Covid-19 at the end of 2021, it came back in force in January. The ANZ-Roy Morgan measure of consumer confidence fell to its lowest January level since 1992 last month. Credit and debit card data from ANZ backed this up, showing a sharp drop in spending over the first couple of weeks of 2022 as more than one million were in isolation, reducing both spending and the ability of businesses to operate. On top of this, Australian equities were not immune to the broader sell-off in global equities during the month, amid the sharp rotation away from growth stocks. This coincided with the release of the minutes from the US Federal Reserve's December 2021 Federal Open Market Committee meeting on 5 January - the minutes revealed some officials advocating an ultra-hawkish policy in 2022.

Elsewhere, the Reserve Bank of Australia (RBA) is now among the most dovish of all central banks. At its latest meeting, the RBA reiterated its stance that there is no need for a rate hike in the near term, despite the latest annual inflation figures for the fourth quarter of 2021 coming in higher than expectations at 3.5%. The RBA indicated that wage growth will be a key factor in rate hikes, especially as temporary visa holders remain at historically low levels.

Portfolio Review

The Fund fell by 10.98% (gross of fees) and 11.04% (net of fees) in January. This was behind its performance target, which fell by 6.35%.

In terms of individual stocks, Megaport underperformed following its latest operational update. While the company reported solid revenue growth, margin growth

- a key driver in the company's goal to improve cash flows

- was slower than expected, pushing breakeven expectations out to financial year 2023. Xero also underperformed, with the software company negatively affected by global inflationary concerns resulting in a sell-off in long-dated growth and tech-related companies.

However, we expect investors to refocus on the longer-term fundamentals of the company after it reports in February. Also driving the underperformance was the structural underweight to the resource sector, particularly mining, given the Fund undertakes a Sustainability and Responsible Investing framework. As a result, we do not own the likes of BHP Billiton and Rio Tinto, both large benchmark constituents that outperformed in January.

On the other hand, Insurance Australia Group performed well, despite limited fundamental news flow, as the sector is seen by investors to be largely insulated from a rising rate environment, given its ability to pass on costs to end-customers. A sector considered a beneficiary of a rising rate environment is banking, as increased interest rates tend to act as a positive for margin recovery. Consequently, our holding in ANZ outperformed. Elsewhere, Telstra performed strongly, despite minimal news flow. The company appeared to benefit from its position as a defensive stock and its positive outlook, with improving profitability across its mobile segment, productivity gains through its multi-year cost-out programme and the ability to monetise InfraCo.

In terms of trading activity, we initiated a position in Oz Minerals, given the copper-focused company's high-quality assets and solid production outlook, with an additional benefit being the exposure it offers to the broader decarbonisation and electric vehicle theme. This initiation was actioned following a deep analysis of their ESG credentials and meeting with the company's Head of Sustainability to better understand their risk framework. Conversely, we reduced our active position in medical device firm ResMed as we were concerned that supply

Investment strategy

The Fund utilises abrdn's Sustainable and Responsible Investment process to invest primarily in a concentrated portfolio of around 20-35 companies that are listed or proceeding to listing on the Australian Securities Exchange (ASX) and have the potential for capital growth and increased earning potential.

Investment objective

To outperform the benchmark, the S&P/ASX 200 Accumulation Index, after fees, over rolling three year periods.

chain constraints could lead to the company missing short-term market expectations in its latest quarterly results.

During the month, we engaged with the Chairman of Megaport ahead of the EGM to revote on an option package for directors. This was voted down previously because granting options to directors is not aligned with local market practice due to the potential impact on independent judgement. While the chairman assured us that there would be no further issuance of options, no changes were made to the current option package that is once again being voted on. We, therefore, advised the company that our position will remain unchanged.

Outlook

We expect the receding health crisis to provide a pathway for the long-awaited economic recovery to play out. The backdrop of a workforce approaching full employment, significant household savings, supportive monetary policy and a federal election due by May 2022 should provide the environment for positive economic growth.

With both transitory and permanent elements mixed in the fray, the debate on inflation remains, although what is clear is that near-term inflationary pressures are rapidly rising and central banks that have largely adopted 'behind the curve' monetary policy now find themselves in a position where they are forced to play catch up. Given that the theme of higher inflation is unlikely to get any clearer before the latter half of 2022, our portfolio positioning remains biased to businesses that offer strong pricing power and possess the ability to pass through cost increases to customers. Meanwhile, we remain cautious on rate-sensitive sectors and businesses that are earlier on in their journey towards profitability.

Despite the volatile start to the year, we retain our constructive view on equity markets for 2022. While some of our holdings in high-growth sectors of the market, such as information technology, have sold off, we remain steadfast in our investment approach through careful selection of high-quality businesses with strong operating moats. Having said that, we have taken advantage of the recent market volatility to further increase portfolio quality, trimming holdings that are more sensitive to higher interest rates in favour of those that have stronger pricing power. We have also recycled capital into high-conviction stocks that we feel have been

oversold.

We remain committed to our bottom-up investment style with a focus on quality companies. We favour businesses with clear growth prospects that are leveraged to long-term structural shifts. Our holdings' defensiveness, in terms of their robust balance sheets and prospects for through-cycle earnings and dividend growth, is an added advantage. Many are also leaders on governance and sustainability, positioning them well to adapt to future challenges and opportunities. This will ensure that the portfolio remains resilient amid present uncertainties.

Fund performance is available on the relevant factsheet.

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