Group Chief Executive Officer’s Report

The 2018 financial outcome is the sixth consecutive year of earnings per share growth.

Pendal Group marked a number of milestones this financial year. We reported our sixth year of uninterrupted growth in profitability and FUM, which took us to a notable achievement of exceeding $100 billion in funds under management. In December 2017, we celebrated our ten-year anniversary since listing on the ASX, and in May we launched our independent brand identity, Pendal Group.

While achieving three positive milestones in one year is pleasing, we are not complacent, recognising the continual change in our industry and the markets in which we operate. Over the years, market conditions have fluctuated, but our growth and development has continued. This I attribute to the consistent execution of our strategy and our commitment to the fundamentals of our business: investment independence, the attraction and retention of investment talent, and diversification across markets, clients and geographies.

Cash NPAT, our key measure of profitability, was 17 per cent higher at $201.6 million, while Cash earnings per share (Cash EPS) increased 15 per cent. This result was underpinned by continued strong growth in base management fee revenue, up 12 per cent on pcp to $501.1 million. This was led by a 10 per cent increase in average funds under management (FUM) and a higher base management fee margin of 51 basis points (bps), up 1 bp on pcp.

The increase in average FUM over the period was assisted by higher markets, with the average level of the MSCI All Countries World Index in local currency terms up 13 per cent, and the average level of the S&P/ASX 300 Index 6 per cent higher compared to pcp.

Despite some strategies coming in and out of favour and the flow mix across channels varying, our overall base management fee revenue has continued to grow. This demonstrates our core strategy at work: strength through diversification, giving us steady and sustained revenue growth over the long term.

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There were net outflows of $3.7 billion, which were driven by redemptions associated with the BT Financial Group MySuper portfolio reconfiguration, as well as a mandate loss from a UK Equities strategy following the retirement of a key fund manager in late 2017. It was a much more difficult period for the Asia and Japan strategies, which significantly underperformed their benchmarks.

Importantly, we've garnered strong client support for strategies that have demonstrated longevity and strong performance over the long term. In particular, we raised $2.8 billion across Australian Equities (excluding Westpac), while European Concentrated Values and UK Dynamic strategies together raised $1.5 billion, and the Global Emerging Markets Opportunities Fund raised $0.5 billion during the period. The consistency, stability and longevity of these teams provides confidence to clients, which is reflected in positive flows.

Also, US pooled funds continued the momentum from prior periods, with the JOHCM International Select Fund attracting $1.5 billion (US$1.1 billion) and positively contributing to our fee margin growth.

While we have enjoyed another successful year and markets have continued to rise, it is a challenging time for the financial services sector. Disciplined cost management is a focus to offset rising regulatory costs and industry-wide fee pressure.

In Australia, The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has created a level of mistrust amongst customers and stakeholders in the financial services industry. We await the outcome of the final Royal Commission Report in 2019, but the Interim Report suggests it will usher in an era of increased prudential supervision. During the year, three out of the top four banks have divested, or indicated that they will divest, their wealth management businesses. As an independent, active manager, we see opportunities from these types of structural changes in the wealth management sector as it opens up the market for more competition.

The global trend towards increased regulation continues to drive compliance costs higher as more resources are required to meet the needs of increased regulation. The positive side of the growing regulatory scrutiny is that it increases the barriers to entry and makes it very onerous and expensive for teams to 'go out on their own'. This makes Pendal's business proposition even more appealing for investment talent who value what we have to offer.

The ongoing trend in the growth of passive investment strategies continues to apply fee pressure across the industry. This puts the onus of responsibility on active managers, like ourselves, to better articulate our value proposition. We strongly believe in the opportunity to identify mispriced securities in the marketplace. The continued strength in flows towards passive strategies increases this mispricing as more and more capital is allocated based on a company's size instead of its fundamentals. The market can and does get it wrong, and for this reason alone there will always be a place for active managers. With the right skill and processes we can create wealth for our clients, but it takes discipline and patience, and we will continue to remind investors of our value proposition and demonstrate our proven results.

A summary of the macroeconomic conditions affecting our various markets can be found of pages 18 and 19 of this year's Annual Report, and a more detailed view of our Investment Strategies across the Group can be found on our Pendal Annual Report website. In the more expansive online report, our investment managers summarise the year in review, explain our portfolio positioning and provide market perspectives.

Managing capacity is important for delivering sustainable long-term investment performance as well as protecting revenue margins. We recognise that our clients are focused on value, and our ability to earn our fees is directly proportional to our investment performance and the success of our wealth generation strategies. Protecting investment performance is key, hence our strong discipline in the management of our capacity to ensure we can sustain our success.

As at 30 September 2018, we have five soft-closed strategies. The need to progressively soft-close funds reflects our success, and the courage to limit the capacity of investment strategies is necessary to position us for continued success. Further to this, we are a firm that prides itself on investment independence, and allowing our portfolio managers to regulate their capacity helps us to attract and retain the best investment talent.

Our business spans multiple markets and jurisdictions and we are now represented in 90 per cent of the world's markets where assets are being managed. The largest market is the US and we have had good success in raising FUM. This remains a focus for the business with continued investment in sales and ongoing support in marketing and compliance. In October 2017 we moved to a permanent New York office with the addition of the Multi-Asset Investment team. We are focused on continuing to broaden our investment offering, which means seeking out individuals who can provide strategies that complement our current offering, as well as providing extension strategies to build on our current capabilities.

As a talent management business, it is incumbent on us to continuously seek investment talent that creates long-term value for clients and shareholders. To that end, we maintain a program of expanding our investment capacity, either through development of internal talent and new extension strategies emanating from existing investment teams, or by attracting new investment talent to the business.

Notably, we launched three new investment strategies during the period. The JOHCM Global Income Builder Fund was launched in the US in November 2017 and represents our first multi-asset proposition outside Australia. This taps into the tremendous demand for income-generating strategies catering to the swelling ranks of income-focused retirees across the developed world. We also created the Pendal Dynamic Income Fund and initiated the Pendal Multi-Asset Target Return Fund in the Australian market.

In last year's report, I touched on the investment of seed capital to support new teams as part of our strategy to diversify and expand our investment offering. Seed capital can be used to fund a new strategy, or to scale up a fund to make it marketable for clients. During the period, we committed a further $100 million to the following strategies: the JOHCM Global Income Builder Fund, JOHCM Emerging Markets Small Mid Cap Equity Fund, and the Pendal Multi-Asset Target Return Fund. Importantly, the ability to utilise our balance sheet and support our growth through seed investment gives confidence to clients willing to co-invest in the funds. Indeed, a review of our seed portfolio shows that since October 2011 we have raised $4.8 billion in flows for funds that we have seeded over that period, with much of that success coming three years after initial seeding.

Investment in new teams requires patience and long-term vision. Pleasingly, we have a number of funds that have recently achieved strong three-year track records, allowing them to be rated and marketed. These are the JOHCM Emerging Markets Small Mid Cap Equity Fund, which has delivered a return of 7.3 per cent per annum in excess of its benchmark over a three-year period; the JOHCM Global Smaller Companies Fund, which outperformed its relevant benchmark by +3.4 per cent per annum, and the JOHCM European Concentrated Value Fund, which achieved outperformance of +3.2 per cent per annum, both over the same timeframe.

This year, we successfully launched Pendal as our new brand name and identity. The change applies to the listed parent company, Pendal Group, and the Australian business. Over the past decade we have achieved standalone success and carved out an independent reputation as a global asset manager. This independence is now reflected in a new name and identity which supports our culture, serves our reputation, and builds our brand into a valuable asset. The name Pendal was chosen for its connection to the origins of the firm, derived from the name given to BT's nominee company, established to hold assets on behalf of its first prospective client: Dal(gety) Pen(sions). The J O Hambro name continues to trade in markets outside of Australia.

Looking to the future, we see exciting opportunities.

We may be at a critical turning point in the financial cycle. We are seeing a steady transition away from the ultra-loose monetary policy environment that defined the post-Global Financial Crisis decade and helped fuel prices of equities, bonds and real estate. The US Federal Reserve is in the vanguard of this policy shift, steadily normalising US interest rates to keep inflation in check with the US economy running at full pace, helped by President Trump's pro-growth agenda. Rising interest rates and bond yields globally may well have significant implications for equity markets. Certainly, higher US interest rates and a stronger dollar have weighed heavily on emerging market economies and stock markets in 2018, leading to marked investment outflows and currency weakness.

These conditions present an opportunity to earn our corn as an active manager. After an unusually long bull market, the immediate years ahead may prove tougher for investors to navigate successfully. As interest rates rise and the global cost of capital resets, we believe the role of active managers as discriminating stewards of capital will become more, not less, important.

Our challenge is deciding where best to allocate our resources and what opportunities not to pursue. I have already pointed out the importance of the US market and our ongoing investment in a business that has already achieved good early success. We continue to look for new investment talent that can add to our existing capabilities and we have further plans to expand our distribution channels to drive sales.

We will look to expand in Europe, particularly in light of the developments around the UK's impending exit from the European Union, which will affect the cross-border marketing and provision of financial services by UK-based companies across Europe. While a range of Brexit outcomes exists, our planning has been predicated on a 'hard Brexit', where there is no ongoing relationship between the UK and the EU other than World Trade Organisation rules. We are in a strong position to manage the transition in that we already manage an Irish-domiciled UCITS fund in which continental European clients currently invest. We are in the process of restructuring our funds in Dublin so we can continue to market to and service our European clients. Once we have more clarity on post-Brexit trade arrangements, we will consider our options on opening an office in Europe.

Another area of opportunity is in the growing ESG/Responsible Investing space. We already have specific ESG-themed funds where we manage $2.1 billion under ESG criteria. We have a strong heritage in this area through our 50 per cent ownership of Regnan, a governance research and engagement business that addresses environmental, social and corporate governance practices. This sets a strong platform to think more broadly about our capability and products in this fast-growing segment of the market, as we seek to globalise our ESG investment offering.

We are also seeking to expand our fixed income offerings, given the anticipated rise in demand for income solutions expected to come from an ageing population worldwide. With advances in healthcare technology leading to increases in life expectancy and individuals generally enjoying longer, healthier, and more active retirement phases of their lives, we see a long-term trend towards increasing demand for income-generating, low volatility investment strategies. Governments around the world are increasingly legislating for individuals to be responsible for their own self-funded retirement, rather than relying on social welfare pensions.

Both the ESG and fixed income areas represent future growth opportunities and we already have established capability within the Group to build on while we assess other complementary opportunities.

Another area of focus for the Group is the use of technology in our processes and how can we better leverage technology to improve efficiencies. This comes at a particularly pertinent time for us, as the Australian business is tasked with replacing existing service arrangements, held with Westpac, with new providers. This represents an opportunity to redesign our processes and improve efficiency, recognising the important role technology can play as a business enabler.

We look to the future with promise but we are cognizant of the many challenges that lie ahead. We have a strong balance sheet, excellent investment capability, a clear strategy for growth and dedicated staff. We remain confident that our high conviction, investment-performance-led approach will continue to resonate with our clients in the years ahead. I would like to thank our teams across Australia, the UK, Europe, Asia and the US for another year of hard work and dedication. It is their passion and commitment to the business and clients that has helped deliver the results we have been able to achieve.

Emilio Gonzalez, CFA
Group Chief Executive Officer

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