DNR Capital Australian Emerging Companies Fund
Performance Report – January 2022

Performance

The DNR Capital Australian Emerging Companies Fund decreased 7.61% (net of fees) in January, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 1.39%. Over the last 12 months the Fund increased by 24.44%, outperforming the Index by 17.79% (net of fees).

Market review

The new calendar year started with a sharp correction in equity markets, with investors reacting to the prospect of higher interest rates to address inflationary pressures across the global economy. Some of the major central banks are now indicating that unprecedented levels of monetary stimulus will need to be wound back sooner than expected, with an interest rate hiking cycle about to commence. This represents a shift from the previous narrative around inflation being only a transitory issue.

In recent months we had become increasingly concerned about the risk of higher inflation, and the implications for the wider market and Fund positioning. Greater inflationary pressure has been evident during just about all our recent discussions with company management. Whether this be due to supply chain challenges, higher commodity prices, increased energy costs associated with the transition towards renewables, higher property costs and ongoing labour constraints. Clearly COVID-19 is having a disruptive impact, and some normalisation can be expected as the impact of the pandemic recedes, however many of these issues also appear more structural in nature and may not be resolved quickly.

With bond yields increasing sharply this year in response to expectations of tighter monetary policy, longer duration growth stocks and the more expensive sectors of the market were worst hit during January, like many of the technology and online related companies. Many of these are generating very limited profitability in the short-term, and usually require highly optimistic assumptions about the future to justify the expensive valuations. The key outperformers during January come from a narrower section of the market, in particular the more value and cyclical related sectors like resources and energy. These are also some of the key beneficiaries of higher inflation and are benefiting from low starting valuations.

We had been highlighting this dispersion in performance as a key risk in recent months, with the valuation gap between high and low-priced stocks in the Australian market having reached a multi-decade high. Consistent with our style neutral investment process and focus on staying disciplined on valuations, we have been progressively reducing the Fund's exposure to the more expensive areas of the market in recent months. This has been in favour of the cheaper sectors of the market, including resources, energy and attractively priced defensives. In fact, we finished 2021 with the forward price earnings (PE) multiple at one of the lowest levels since the inception of the strategy four years ago (18x forward PE currently, versus closer to 30x one year ago). The cash weighting had also increased towards 15%, reflecting recent divestments, and our expectation of

Fund overview

APIR Code	PIM4357AU
Investment bias	Style neutral with a quality focus
Designed for	The Fund is designed for investors seeking a medium-longer term investment focused on achieving growth, with less focus on generating excess income. The investor is prepared to accept higher volatility in pursuit of higher growth.
Investment objective	The Fund's investment objective is to invest in a portfolio of Australian emerging companies that aims to outperform the Benchmark over a rolling five-year period. The investment objective is not a forecast of the Fund's performance.
Benchmark	ASX/S&P Small Ordinaries Accumulation Index
Investable universe	Australian equities and cash
Investment constraints	The Fund will not invest in derivatives
Investment guidelines	Maximum exposure to an individual security is 15% of Fund NAV
Asset allocation	Australian Equities - 80-100% Cash - 0-20%
Risk level	High
Number of securities	Min 20 - max 45
Minimum suggested investment timeframe	5 years
Buy/sell spread	+0.25% /- 0.25%
Management fee	1.15% p.a. of the NAV of the Fund (inclusive GST and RITC)
Performance fee	20% of outperformance of the Fund relative to the Fund's Benchmark (after the management fee)
Minimum initial application amount	$20,000
Minimum further application amount	$5,000
Minimum withdrawal amount	$5,000
Valuation and unit pricing frequency	Each business day
Distribution frequency	Semi-annual
Responsible entity	The Trust Company (RE Services) Limited as part of the Perpetual Limited group of companies
Entry/exit fees	Nil

Net active return as at 31 January 2022

	1mth %	3mth %	6mth %	1yr % p.a.	2yr % p.a.	3yr % p.a.	Incep.* % p.a.
Emerging Companies Fund	-7.61	-3.87	-1.97	24.44	20.63	22.60	15.67
S&P/ASX Small Ordinaries Accumulation Index	-9.00	-7.99	-4.61	6.65	6.01	10.13	5.80
Excess return	**1.39**	**4.12**	**2.64**	**17.79**	**14.62**	**12.47**	**9.87**

** Inception Date—August 2018*

Source: Mainstream Fund Services and DNR Capital

Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Emerging Companies Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry fees or taxation.

greater market volatility going forward, which will provide opportunities to deploy this capital.

Although the short-term outlook could remain volatile, we believe the shift in market leadership could have further to run. Many of the main beneficiaries from the long period of low inflation and low interest rates, could find it difficult to repeat this period of outperformance. Many growth stocks were simply priced for perfection, with extremely high valuation multiples, combined with optimistic earnings expectations to justify these high valuations. This compares to many of the more value and cyclical related sectors, where earnings expectations appear more on the conservative side and offer a margin of safety in the valuation. High valuations and high expectations versus low valuations and low earnings expectations, is a potent combination for a significant dispersion in performance as we are currently witnessing. It should also provide an attractive environment for active management and bottom-up stock picking.

To highlight some examples at the pointy end of the market, one of the worst performing small caps during January was the well-liked medical diagnostic imaging company Pro Medicus (PME) (no holding). The shares have fallen nearly 30% so far this year, yet it still trades on a forward PE multiple > 100x. The market also forecasts earnings growth of >30% per annum over the coming years, which is a high bar with limited margin of safety in the valuation. This compares to some of the top performing shares this calendar year like the commodity producer Champion Iron Ore (CIA). This company trades on a PE of <6x with a net cash balance sheet, with the market cautiously forecasting declining commodity prices and earnings. A key debate for investors this year is, where is the risk-reward more attractive? We believe the pain trade could be in holding too much of the former, and not enough of the latter. January certainly played out this way, which highlights the importance of having a style neutral and flexible investment process.

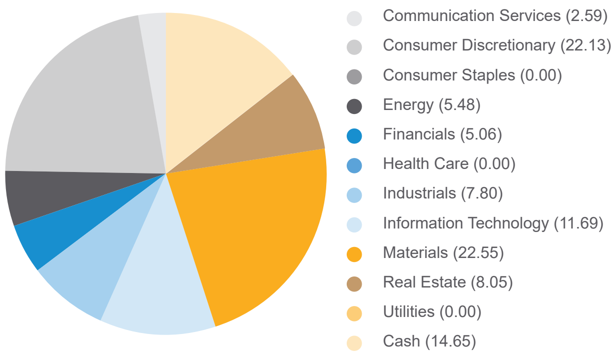
As we look ahead to the 2022 calendar year, our outlook for the market, and the positioning in our Australian Emerging Companies Fund, remains unchanged. We continue to look for strong bottom-up investment opportunities, in quality companies trading on attractive valuations. We expect that market leadership going forward could come from a narrower selection of companies, which will require a more concentrated and benchmark agnostic approach to managing the Fund. To take advantage of these opportunities, the Fund is currently positioned across 23 high conviction holdings, with limited overlap versus the benchmark. Although this means that returns could differ more materially from the benchmark in the short-term, we believe this approach will better position the Fund to take advantage of the opportunities we are currently identifying.

Top 3 active holdings (alphabetical order)

IPH
Iress
PEXA Group

Source: Mainstream Fund Services and DNR Capital

Sector weightings %



Source: DNR Capital

Attribution

The key stocks contributing to the Fund's monthly relative performance include:

Contributors

- **Whitehaven Coal (WHC)** benefited from robust coal prices given strong underlying demand and persistent supply-side disruptions. December quarterly production was lower given disruptions from COVID-19 and adverse weather, however cash generation was a feature with WHC to be in a net cash position by March and considering capital management options.
- **Credit Corp Group (CCP)** shares remained resilient during the market sell-off. Expectations of tighter financial conditions should lead to increased credit card charge-offs and delinquencies. CCP is well positioned to participate in this increased supply, both domestically and offshore, with a strong balance sheet to deploy.
- **Champion Iron Ore (CIA)** shares rallied 19% for the month as the iron ore price stabilised. The doubling of capacity at its Bloom Lake project in Canada is set to deliver 15mtpa of high-grade iron ore by the end of the calendar year. Given the project is fully funded the Board announced its inaugural dividend.

Detractors

- **hipages Group (HPG)** released its 2Q FY22 results which showed solid progress but near term uncertainty from COVID-19 weighed on revenues and subscription tradie growth. The business is in a strong position, with $15m cash on the balance sheet and positive operating cash flows, leaving them well positioned to expand its ecosystem.
- **Brainchip Holdings (BRN) (no holding)** the 147% share price rise in BRN detracted from the Fund's relative performance. The developer of Artificial Intelligence chips has a $3b market capitalisation and minimal revenue, presenting a risky investment proposition.
- **IDP Education (IEL)** shares fell as Omicron delays the recovery of international students along with a broader sell-off in long duration stocks. IEL has a leading market position that has accelerated during the pandemic,

Monthly - top contributors and detractors

Top 3 contributors
Whitehaven Coal
Credit Corp Group
Champion Iron Ore
Top 3 detractors
hipages Group
Brainchip Holdings (no holding)
IDP Education

** Alpha is the fund return less benchmark return. These tables represent the stocks contribution of alpha to overall fund alpha and is determined by the stocks active weight relative to the benchmark and share price return relative to the benchmark.*

Investment strategy

DNR Capital's security selection process has a strong bottom-up discipline and focuses on buying quality emerging businesses at reasonable prices. The process involves comprehensive company and industry research, company visits and meetings, and detailed valuation analysis and modelling. This information is used to assess the quality of a business, and the expected return.

The portfolio construction process considers stock weightings based on the risk versus the expected return. It is also influenced by a top-down economic appraisal, sector exposures and liquidity considerations.

The investment strategy of the Fund is intended to result in a concentrated portfolio that is high conviction and invests for the medium to long-term.

Investment philosophy

DNR Capital believes a focus on quality will enhance returns when combined with a thorough valuation overlay. DNR Capital seeks to identify good quality emerging businesses that are mispriced by overlaying DNR Capital's quality filter, referred to as the 'quality web', with a strong valuation discipline.

Platform access

- AMP MyNorth
- BT Panorama
- CFS FirstWrap
- HUB24
- Macquarie Wrap
- Mason Stevens
- Netwealth
- Praemium

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