DNR Capital Australian Emerging Companies Fund

APIR code: PIM4357AU

Performance Report September 2022

Performance

The DNR Capital Australian Emerging Companies Fund decreased 6.21% (net of fees) in September, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 4.99%. Over the last 12 months, the Fund decreased by 4.94%, outperforming the Index by 17.62% (net of fees).

Net active return as at 30 September 2022

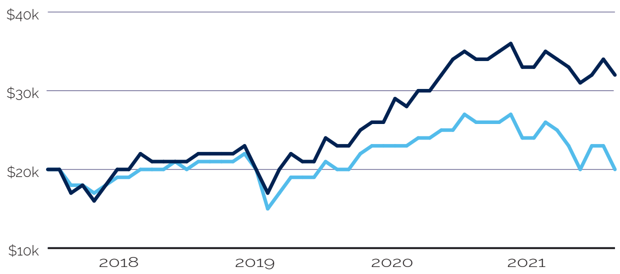
	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	4yr p.a. %	Incep.* p.a. %
Emerging Companies Fund	-6.21%	5.76%	-8.25%	-4.94%	14.45%	12.69%	12.46%
S&P/ASX Small Ordinaries Accumulation Index	-11.20%	-0.47%	-20.76%	-22.56%	-0.80%	0.37%	0.27%
Excess return	**4.99%**	**6.23%**	**12.51%**	**17.62%**	**15.25%**	**12.32%**	**12.19%**

* Inception Date—August 2018

Source: DNR Capital and Mainstream Fund Services

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/exit fees or taxation.

Growth of $20,000 since inception



Source: DNR Capital and Mainstream Fund Services

Sector weightings %

- Communication Services (0.58)
- Consumer Discretionary (8.91)
- Consumer Staples (0.00)
- Energy (16.82)
- Financials (2.32)
- Health Care (0.00)
- Industrials (16.45)
- Information Technology (5.91)
- Materials (25.00)
- Real Estate (6.96)
- Utilities (0.00)
- Cash (17.05)

Source: DNR Capital and Mainstream Fund Services

Top 3 active holdings (alphabetical order)

Security details
IPH (IPH)
Pexa Group (PXA)
Whitehaven Coal (WHC)

Source: DNR Capital and Mainstream Fund Services

Monthly top contributors and detractors

Top 3 contributors
Whitehaven Coal (WHC)
IPH (IPH)
Mondelphous Group (MND)

Top 3 detractors
Iress (IRE)
New Hope Corporation (NHC, no holding)
Beach Energy (BPT)

Source: DNR Capital and Mainstream Fund Services

A team with global experience

Sam Twidale
Portfolio Manager
CFA

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Performance attribution

Contributors

- **Whitehaven Coal (WHC):** is proposing a resolution at its AGM to increase its share buy-back to 25% of shares outstanding. WHC has completed 9% of its 10% targeted share buy-back that it commenced in March 2022.
- **IPH (IPH):** outperformed as its earnings are less sensitive to the economic cycle and the strengthening US dollar provides a tailwind for earnings.
- **Monadelphous Group (MND):** secured new contracts and extensions totaling approximately $160million. MND won its first offshore decommissioning contract with Petrofax for its Northern Endeavor FPSO which is situated 550km north of Darwin in the Timor Sea.

Detractors

- **Iress (IRE):** downgraded FY22 segment profit to $166m-$170m, down 5% at the mid-point. Earnings have been rebased ahead of Marcus Price commencing as CEO in October 2022. The downgrade overshadowed a super admin win with CSC to adopt IRESS software for the administration of its 500k members.
- **New Hope Corporation (NHC, no holding):** shares advanced on stronger coal prices. No holding detracted from the Fund's relative performance.
- **Beach Energy (BPT):** retreated as oil prices pulled back. Beach is in a strong net cash position to deliver growth projects and consider capital management initiatives.

Fund and market review

The small ordinaries index was hit hard during the month closing down 11.20% on the back of global central bank tightening. The Fund fared better, falling 6.21% given the more defensive holdings, overweight energy and higher levels of cash. IPH (IPH) benefited from its resilient earnings and tailwinds from an appreciating US dollar. Whitehaven Coal (WHC) continues to generate strong cash flows and is seeking shareholder approval to buy back a further 25% of its shares outstanding. The key detractor came from Iress (IRE) falling 20% during the month after downgrading earnings. Timing delays in the conversion of the sales pipeline and higher supplier technology costs were the key drivers. IRE is trading at the lower bound of its historical valuation ranges, generating high levels of recurring revenue and a 5% dividend yield should provide a favourable risk/reward setup.

Global markets reacted negatively to central bank developments. The US Federal Reserve (Fed) increased rates by 75bp in response to a stronger than expected inflation print. In the press conference Fed Chairman Jerome Powell dashed any hope of a Fed 'pivot' (cutting rates) by pledging to get inflation back to its 2% target even if it requires economic hardship. The Bank of England reversed course on its quantitative tightening plans by purchasing back bonds in response to market turmoil. UK bonds fell, sending yields rising, fuelled by forced selling from pension funds. Many UK pension funds employ leverage to match liabilities, and the sudden spike in yields required them to post more assets as collateral. Domestically, the RBA increased the cash rate by 50 basis points to 2.35%.

We continue to view large dispersions in valuation and quality in the small cap benchmark. Despite the recent valuation adjustment (small caps index down 24% calendar year to date), growth stocks are still expensive relative to the broader market and history. Over the past decade the phrase TINA (there is no alternative) has emerged, where zero rates and quantitative easing forced investors up the risk curve. This is now changing with risk-free 1 year term deposits in Australia and US 1 year t-bills offering ~4%. While high levels of inflation mean the real yield is negative, it does highlight that higher yields are now competing for investor's capital. This could further compress equity market multiples, with long-duration growth stocks most at risk.

We have also been concerned around elevated earnings expectations which are now beginning to unravel. US bellwethers such as Fedex, Apple and Nike have started downgrading earnings and this presents an ominous sign for the broader market. In the past, the Fed has 'pivoted' at the first signs of economic weakness. However, with inflation still elevated the Fed wants to see a reduction in demand to bring back inflation to its 2% target. Conditions would need to get a lot worse for the Fed to provide a backstop for the markets.

We believe we could be in the early stages of a regime change in the market of both higher interest rates and inflation. This backdrop will have important implications for market leadership going forward. The QE fuelled rally in long duration growth stocks and profitless tech could be a long and painful unwind. We expect market leadership to come from the more value areas of the market which lends itself to energy and materials.

The Fund is exposed to several industry leaders, which benefit from strong pricing power to pass through greater inflationary pressures such as PEXA Group (PXA). We are also positive on business models with recurring revenue streams, which can withstand an uncertain economic environment, such is IRE and IPH. We remain positive on several of the higher quality commodity producers, in particular, those generating strong cash flows, and where we expect significant capital to be returned back to shareholders. In addition, companies exposed to a recovery in mining and energy capital expenditure such as Monadelphous Group (MND) and Imdex (IMD) are well positioned.

We are focused on a narrow opportunity set resulting in the Fund being concentrated in around 20 names and an agnostic approach to the benchmark. While we see downside risks for many segments of the market, we are constructive on the Fund noting that it trades on a PE of 9.3x, a 25% discount to the market and the aggregate holdings in a net-cash balance sheet position. The Fund's cash weighting of 17% provides flexibility to take advantage of greater market volatility.

Fund facts

Inception date: August 2018

Minimum initial investment: $20,000

Risk level: High

Management fee: 1.15% p.a. of the NAV of the Fund

Performance fee: 20% of outperformance of the Fund relative to the Fund's Benchmark (after the management fee)

Entry/exit fees: Nil

Buy/sell spread: +0.25%/-0.25%

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.

About DNR Capital and the Fund

Concentrated: Investing in 20-45 highest conviction, quality small cap Australian listed equities.

Style neutral and quality focussed: A disciplined approach to quality and valuation. Concentrated portfolios of quality companies maximise the opportunity for outperformance.

Global & domestic investment experience: Portfolio managers with global and domestic research experience, helps to identify globally competitive emerging companies.

Aligned team: Portfolio managers are invested in the Fund.

Proven process: DNR Capital was established in 2001 and a consistent firm-wide investment process has delivered more than 19 years of investment outperformance.

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