DNR Capital Australian Emerging Companies Fund

APIR code: PIM4357AU

Performance Report October 2022

Performance

The DNR Capital Australian Emerging Companies Fund increased 6.93% (net of fees) in October, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.47%. Over the last 12 months, the Fund increased by 0.94%, outperforming the Index by 19.25% (net of fees).

Net active return as at 31 October 2022

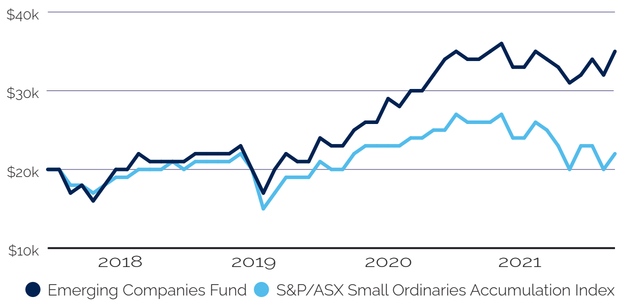
	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	4yr p.a. %	Incep.* p.a. %
Emerging Companies Fund	6.93	6.80	0.34	0.94	16.81	18.92	14.01
S&P/ASX Small Ordinaries Accumulation Index	6.46	-4.91	-14.36	-18.31	1.46	4.56	1.79
Excess return	**0.47**	**11.71**	**14.70**	**19.25**	**15.35**	**14.36**	**12.22**

* 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 (0.43)
- Consumer Discretionary (11.81)
- Consumer Staples (0.00)
- Energy (10.79)
- Financials (2.33)
- Health Care (0.00)
- Industrials (16.45)
- Information Technology (8.02)
- Materials (22.94)
- Real Estate (7.76)
- Utilities (0.00)
- Cash (19.47)

Source: DNR Capital and Mainstream Fund Services

Top 3 active holdings (alphabetical order)

Security details
Beach Energy (BPT)
IPH (IPH)
PEXA Group (PXA)

Source: DNR Capital and Mainstream Fund Services

Monthly top contributors and detractors

Top 3 contributors
PEXA Group (PXA)
Iress (IRE)
Stanmore Resources (SMR)

Top 3 detractors
Deterra Royalties (DRR)
Liontown Resources (LTR, no holding)
Telix Pharmaceuticals (TLX, no holding)

Source: DNR Capital and Mainstream Fund Services

A team with global experience

Sam Twidale
Portfolio Manager
CFA

Mark Sedawie
Portfolio Manager
CFA

Fund and market review

The Index recouped more than half the prior month's loss by closing up 6.46% during October. The Fund outperformed the strong market despite its overall more defensive positioning. Key outperformers came from a range of companies like PEXA Group (PXA), Iress (IRE) and Stanmore Resources (SMR). We continue to view high levels of speculation in the market, with a number of loss making stocks seeing their share price bouncing between 25%-50% during the month. This dragged on the Fund's relative performance versus the Index.

The rise in interest rates this year has seen a compression in equity market multiples, with long-duration growth stocks the hardest hit. However, on a historical basis and relative to the current interest rate settings, valuations still appear elevated for certain sectors of the market. The denominator in the multiple equation is earnings, which also appears at risk as leading economic indicators point to slower growth. Some companies may optically appear cheap on a price-to-earnings multiple, yet the earnings outlook could be deteriorating, setting up potential value traps for investors. During the month we saw earnings downgrades from companies (the Fund has no position in these names) like Baby Bunting Group (BBN -26% share price during October), Codan (CDA -30%) and Appen (APN -18%), highlighting the need to focus on companies with resilient or recovering earnings streams at this point in the cycle.

The outlook for inflation and interest rates remains one of the key challenges for investors going forward, with the market experiencing significant volatility as investors adjust to the potential for a new regime characterised by higher inflation and higher interest rates. Following a long period of low inflation and falling interest rates, we believe this regime shift has significant implications for portfolio positioning, with new sources of market leadership set to emerge. The significant dispersion in returns across the market this year highlights the painful nature of this adjustment, as well as the opportunities for investors alert to the new sources of leadership going forward.

In an environment of low inflation and low interest rates, it was clearly the more growth-orientated sectors that thrived at the expense of value. This was evident across the small-cap sector, with excitement around companies promoting large addressable markets and long runways for growth. This saw the valuations of companies exposed to trends like cloud based computing, online retailing, payment processing, buy-now pay-later and artificial intelligence, bid up to extremely excessive levels. In an environment of higher interest rates, we may never see these valuations repeated. Many of these companies struggled to generate positive cash flows, instead relying on external funding to sustain loss making business models. Access to this funding has now largely disappeared, with the sustainability of companies dependent on cheap money under scrutiny.

Whilst there are likely to be opportunities emerging from the rubble of the growth bubble bursting, we are conscious that the next decade could look very different from the last, with new sources of market leadership. This means that buying the dip in the previous winners may not be the most profitable strategy. Following a decade that saw significant capital directed at the intangible side of the economy, we believe the more attractive investment opportunities could now be in the tangible side of the economy that has seen significant underinvestment. Arguably, the long period of low interest rates contributed to this misallocation of resources, with the more capital intensive industries like resources and energy now struggling with capacity shortages.

Industries set to drive earnings growth over the next decade could include trends like higher energy capital expenditure, the transition towards electric vehicles, renewable energy investment and growth in liquefied natural gas (LNG) demand as Europe reduces its reliance on Russia. There are also trends from the last decade that are likely to continue to present opportunities for investors. For example, a tight labour market and high wage growth will continue to drive automation and the need to reduce manual processes. Demand for university education from foreign students also remains a key structural trend. The Fund has positions across a range of opportunities that we believe can take advantage of these trends.

The Fund is exposed to several industry leaders, which benefit from strong pricing power to pass through greater inflationary pressures like PEXA Group (PXA). We are also positive on business models with recurring revenue streams, which can withstand an uncertain economic environment, like IPH (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 appear well positioned.

Performance attribution

Contributors

- **Pexa Group (PXA):** shares rose on limited news flow during the month. PXA continues to make progress in the UK with its first remortgage transaction successfully completed in September with the Hinckley & Rugby Building Society.
- **Iress (IRE):** shares recouped the prior months loss following a downgrade to earnings expectations. New CEO Marcus Price commenced during the month.

- **Stanmore Resources (SMR):** completed acquisition of the remaining 20% interest in BHP Mitsui Coal from Mitsui. The previous acquisition of BHP's stake was transformational for SMR and full ownership will streamline operations.

Detractors

- **Deterra Royalties (DRR):** shares were soft as the iron ore price slid on concerns around economic growth and the impact of COVID-19 lockdowns in China on steel demand.
- **Liontown Resources (LTR, no holding):** detracted from relative performance as shares rallied on strong lithium prices. We have a preference for lithium producers over development/exploration assets such as LTR which carries greater risk.
- **Telix Pharmaceuticals (TLX, no holding):** detracted from relative performance as shares rallied on strong sales for its prostate imaging drug, Illuccix. The company is valued at over $2billion and burned $5m in cash in the September quarter.

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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