

DNR Capital Australian Emerging Companies Fund

APIR code: PIM4357AU

Performance Report January 2023

Performance

The DNR Capital Australian Emerging Companies Fund increased 4.66% (net of fees) in January, underperforming the S&P/ASX Small Ordinaries Total Return Index by 1.90%. Over the last 12 months, the Fund increased by 5.65%, outperforming the Index by 10.09% (net of fees).

Net active return as at 31 January 2023

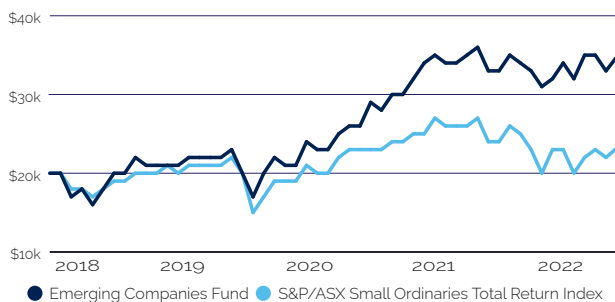
	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	4yr p.a. %	Incep.* p.a. %
Emerging Companies Fund	4.66	0.63	7.47	5.65	15.41	18.13	13.32
S&P/ASX Small Ordinaries Total Return Index	6.56	7.64	2.35	-4.44	2.41	6.29	3.39
Excess return	-1.90	-7.01	5.12	10.09	13.00	11.84	9.93

* Inception Date—August 2018

Source: DNR Capital and Apex Fund Services

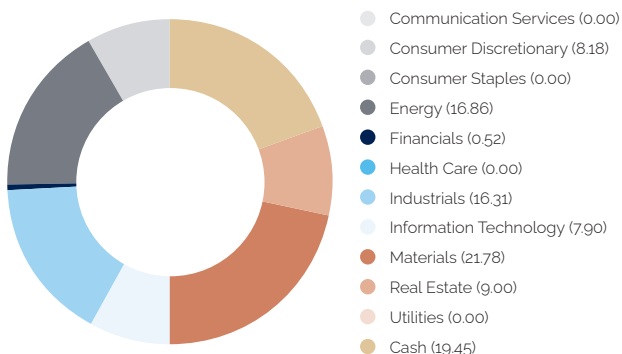
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Emerging Companies Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made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

Growth of \$20,000 since inception



Source: DNR Capital and Apex Fund Services

Sector weightings %



Source: DNR Capital and Apex Fund Services

Top 3 active holdings (alphabetical order)

Security details

Beach Energy (BPT)

IPH (IPH)

Pexa Group (PXA)

Source: DNR Capital and Apex Fund Services

Monthly top contributors and detractors

Top 3 contributors

Lynas Rare Earths (LYC)

IDP Education (IEL)

Allkem (AKE)

Top 3 detractors

Whitehaven Coal (WHC)

Beach Energy (BPT)

IPH (IPH)

Source: DNR Capital and Apex Fund Services

A team with global experience



Sam Twidale
Portfolio Manager
CFA



Mark Sedawie
Portfolio Manager
CFA

Fund and market review

The new calendar year has started strongly for equity markets, with investors taking a more constructive view on the growth outlook. For now, Europe has avoided the worst-case scenario from the energy crisis brought on by the Russia-Ukraine conflict. Helping the situation was an unusually mild winter, which reduced energy demand and limited the impact of constrained supply. China's re-opening has boosted sentiment towards the global economy, with the potential for pent-up demand to be unleashed following the removal of COVID-19 restrictions. The continued easing in the rate of inflation has also been supportive, providing central banks with flexibility to pause the aggressive interest rate hiking cycle. This is leading investors to speculate that the "Goldilocks scenario" could be unfolding (moderate growth and low inflation), favouring a more risk-on approach towards equities.

Through January, this positive sentiment saw a reversal of many of the trends observed in 2022. This included a sharp rotation back into the more growth and speculative companies, which were some of the worst performers last year. Heavily shorted names also increased strongly. This was at the expense of the more defensive and value sectors, which significantly lagged the market during the month. Given the Fund's current value bias and more defensive positioning, this contributed to the relative underperformance versus the Index during the month. The main detractors were in the Energy sector including Whitehaven Coal (WHC) and Beach Energy (BPT), which gave back recent gains on falling energy prices. IPH (IPH) also underperformed the market rally given its more defensive characteristics. Key positive contributors were the Fund's holdings in the Materials sector like Lynas Rare Earths (LYC) and Allkem (AKE), with commodities benefiting from optimism surrounding China's re-opening, and the impact this will have on demand.

Following the recent market rally, we are once again seeing a significant valuation gap opening up between the cheap and expensive sectors of the market. This is similar to what we observed in late 2021, before central banks commenced their interest rate hiking cycle. High price-to-earnings multiple sectors are on extremely high valuations, with a range of small-cap growth companies trading on price-to-earnings multiples of 50-100x or more. These valuations are now close to the highs observed when interest rates were close to zero, despite interest rates having increased substantially.

The consumer discretionary sector in particular has seen valuations re-rated sharply higher, with valuations now looking stretched given that earnings expectations are also on the optimistic side – the "priced for perfection" scenario all over again? We remain concerned that earnings risks are still to the downside, with the lagged impact of tighter monetary policy still

to flow through to earnings. Although earnings for some consumer companies are coming in stronger than expected, this could be backward looking. Savings are being depleted, and higher interest rates have yet to fully impact spending given the high proportion of fixed rate mortgages still to reset to higher rates.

With a fear of missing out driving the market rally, investors appear to be suffering from a dose of recency bias, comparing current valuations to the preceding period when interest rates were at record low levels. This implies that valuations are already pricing in an interest rate easing cycle, with limited margin of safety if this proves to be premature. With labour markets remaining tight, and wage growth still strong, central banks still have some work ahead to stamp out the stickier components of inflation.

Through the month, we were active in reducing the Fund's exposure to growth holdings where valuation upside has reduced, redeploying the capital into shares of highly cash generative companies which have lagged the market. Overall the Fund remains positioned in the more value sectors of the market, with the forward price to-earnings multiple for the Fund below 10x, which compares to the Index on 15x. It is also one of the lowest valuations since the inception of the Fund, and at significant discount to the market. The Fund remains concentrated in our best ideas, with key overweights across the materials, energy, and industrials sectors. The cash weighting remains elevated, which provides flexibility to deploy into the ongoing volatility we expect going forward.

Performance attribution

Contributors

- **Lynas Rare Earths (LYC):** shares rose on an expected recovery in demand for rare earths following the re-opening of China. Production in the December quarter rebounded from the water supply issues experienced in the prior quarter.
- **IDP Education (IEL):** set to benefit from a policy change in China favouring in-person education over online learning, reversing previous rules set in place during the pandemic. Better relations between China and Australia should lead to a strong influx of Chinese students into Australian universities.
- **Allkem (AKE):** lithium prices stabilised as Electric Vehicle demand remains robust. The re-opening of China is positive for lithium chemicals and spodumene concentrate as battery manufacturers look to re-stock.

Detractors

- **Whitehaven Coal (WHC):** shares fell given uncertainty around the NSW Government's proposed domestic coal reservation scheme. Offsetting this was China resuming imports of Australian coal, ending an unofficial ban imposed in 2020 in response to political disagreement between the countries.

- **Beach Energy (BPT):** delivered a mixed quarterly production result. Key projects in Otway and Waitsia will provide a step change in production and free cash flows. While risks remain in the timing and capital cost of these projects, the depressed share price reflects some of these risks. A net cash balance sheet should also provide some downside protection.
- **IPH (IPH):** lagged the strong market due to its defensive characteristics. A weakening US dollar also provides a headwind to translated earnings.

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.

Disclaimer

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