DNR Capital Australian Emerging Companies Fund

Performance Report – October 2021

Performance

The DNR Capital Australian Emerging Companies Fund increased 0.70% (net of fees) in October, underperforming the S&P/ASX Small Ordinaries Accumulation Index by 0.22%.

Market review

Although the ASX Small Ordinaries Index only posted a modest increase for the month, under the surface there was a wide dispersion in performance across various sectors. Companies set to benefit from the re-opening of the economy led the market higher. Vaccination rates have increased rapidly in Australia, providing greater visibility on the path towards a normalisation of the economy post COVID-19. This benefited the Fund's holdings in Lovisa Holdings (LOV) and IDP Education (IEL), which were the largest positive contributors during the month.

In contrast, recent developments in China resulted in many commodity related shares lagging the market. The Chinese Government is attempting to restrict activity in its real estate sector, as it struggles with excessive investment and high prices. It has also been dealing with spiking energy prices and supply shortages. This saw iron ore and thermal coal prices falling sharply during October, negatively affecting a number of holdings in the Materials sector. In contrast, a number of mining companies exposed to renewables outperformed during the month, including the producers of lithium and the rare earths.

Across the market, we are seeing increasing signs of speculative activity driving share prices higher, with no shortage of smaller companies looking to provide exposure to topical themes. Reviewing the top performing shares on a daily basis has made for interesting reading of late.

The list includes a collection of companies promoting themselves as developing either a transformational improvement in battery technology, cancer treatment, artificial intelligence, or a mining exploration asset that is many years and capital away from generating any cash flow. Given the speculative nature of these companies, it is unsurprising they have limited revenue and are generating significant losses (hence the need to attract investors). What is surprising however is that many have entered the ASX Small Ordinaries Index in recent months, with market capitalisations frequently exceeding $1bn.

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 (net of fees) 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	+0.30% / -0.30%
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 October 2021

	1mth %	3mth %	6mth %	1yr % p.a.	2yr % p.a.	3yr % p.a.	Incep.* % p.a.
Emerging Companies Fund	0.70	1.97	14.71	51.46	25.66	25.59	18.49
S&P/ASX Small Ordinaries Accumulation Index	0.92	3.68	7.88	31.01	13.08	13.52	9.11
Excess return	**-0.22**	**-1.71**	**6.83**	**20.45**	**12.58**	**12.07**	**9.38**

** 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

This trend highlights one of our concerns around certain parts of the market at present, which is the lack of valuation discipline from many investors. Rising valuations appear to be receiving little attention, with significant future growth already reflected in many share prices. This is evident in the increasing dispersion in valuations across the market. Companies trading on high price to earnings multiples are trading at the highest premium to the market seen over the last 20 years, with low priced companies trading at one of the largest discounts to the market. In other words, investors are paying up for growth. Warren Buffet's quote "The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own" is ringing loud in our ears. It is no surprise that there has been a surge in new IPOs in recent months, with the bankers looking to take advantage.

Increasing inflation is another topic receiving more attention, with considerable debate in the market around whether the recent increase is transitory or structural. Most of the companies we speak with are highlighting a range of inflationary pressures, including increasing raw material costs, higher energy prices and transportation costs. Labour shortages are also frequently being mentioned, with upside pressure on wages as employers compete for workers. Companies are increasingly suggesting that these issues will not be resolved quickly, with higher inflation likely to persist. As a result, the market is starting to anticipate the withdrawal of the extremely accommodative monetary policy, with interest rates set to rise from the record low levels. This highlights the importance of remaining disciplined on valuations at this point in the cycle, with higher interest rates likely to impact the more speculative and overvalued sectors of the market.

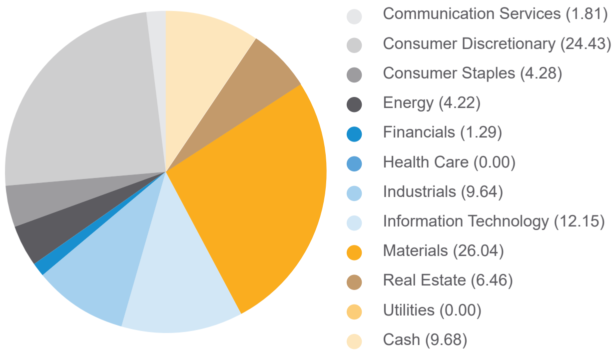
Recent activity in the Fund has focussed on reducing its exposure to holdings where valuation upside has reduced or been eliminated, whilst adding to holdings where we still see attractive upside.

Top 3 active holdings (alphabetical order)

Champion Iron Ore
IPH
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

- **Lovisa Holdings (LOV):** announced the departure of CEO Shane Fallscheer after 12 years with the company. Shane has been a solid operator growing LOV from humble beginnings to over 550 stores across 20 countries. Whilst it is disappointing to see Shane depart we are impressed with the successor, Victor Herrero. Victor brings a strong pedigree of retail experience having worked at Inditex (owner of fast fashion label Zara) for over 13 years operating and rolling out stores in China and India. Victor's skillset and long term incentive targets position LOV well for further geographic expansion.
- **IDP Education (IEL):** is seeing the benefits of economies re-opening with a strong start to the financial year. Student volumes to the Northern Hemisphere are up 120% and English language testing volumes also rebounded up 84%. Australia remains a drag with student volumes down 24% but expected to improve as Australia opens its borders to international students at some point in CY22.
- **Lynas Rare Earths (LYC):** benefited from strong rare earths prices as demand for electric vehicles accelerates. The quarter was overshadowed by COVID-19 disruptions impacting utilisation rates out of Malaysia. LYC stated 'demand for rare earth materials continues to be very strong in the magnet market and our customers report that they expect this demand to further accelerate in 2022'.

Detractors

- **Whitehaven Coal (WHC):** shares retreated as China intervenes to ease its energy crisis by increasing coal production and setting price caps. China has been impacted by energy shortages hampering its energy intensive manufacturing activities. WHC is generating significant cash flows with expectations of being in a net cash position in the March 2022 quarter.
- **Champion Iron Ore (CIA):** continues to execute with production reaching nameplate capacity and Phase 2 ramping up ahead of expectations. This will see CIA produce 15mtpa of high quality iron ore in CY22. However, shares remain under pressure from ongoing declines in iron ore prices due to negative rhetoric out of China. Production cuts in China will likely persist through the end of the Beijing Winter Olympics in February 2022 and property taxes are being implemented to cool the property market.
- **IPH (IPH):** shares drifted lower on limited newsflow. IPH is an attractive investment with defensible earnings, organic growth, strong cash generation and balance sheet capacity to fund acquisitions. We believe these quality characteristics are not reflected in the valuation which currently trades inline with the market multiple.

Monthly - top contributors and detractors

Top 3 contributors
Lovisa Holdings
IDP Education
Lynas Rare Earths

Top 3 detractors
Whitehaven Coal
Champion Iron Ore
IPH

** 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*

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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