

# DNR Capital Australian Equities High Conviction Fund

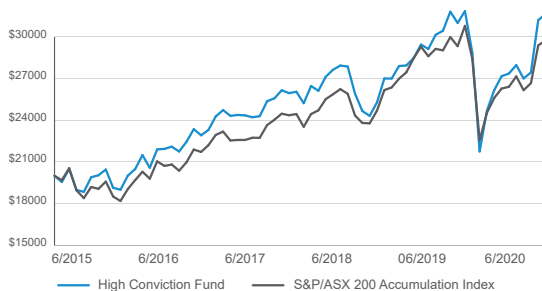
## Performance Report – December 2020

### Performance

The DNR Capital Australian Equities High Conviction Fund outperformed its benchmark for the month. Key stock contributors were CSL (CSL, no holding), Domino's Pizza Enterprises (DMP) and BHP Group (BHP). Key stock detractors were Fortescue Metals Group (FMG, no holding), Lendlease (LLC) and Afterpay (APT, no holding).

The S&P/ASX 200 Accumulation Index was up 1.21% during the period. Information Technology (+9.4%) was the best performing sector during the period. Large-caps Afterpay (APT, +24.4%) and Xero (XRO, +13.8%) drove the gains, following a strong lead from US technology peers. Materials (+8.8%) continued their strong run as iron ore prices remain elevated. BHP Group (BHP, +11.5%) and Fortescue Metals Group (FMG, +28.5%) remained the largest contributors to performance. Utilities (-6.8%) was the worst performing sector, as defensive sectors continue to underperform in the re-opening trade. AGL Energy (AGL, -11.5%) and APA Group (APA, -6.8%) led declines. Health Care (-4.9%) also underperformed as their defensive nature counted against them in a month that largely rewarded cyclical names. CSL (CSL, -4.8%) was the largest contributor to the sector's performance, however many of the large cap names were down strongly.

### Growth of \$20,000 since inception



Source: Mainstream Fund Services and DNR Capital

### Top 10 active holdings

Security details	Active weight %	Actual weight %
Tabcorp Holdings	4.40	4.87
Lendlease Group	3.93	4.42
National Australia Bank	3.84	7.89
Cash	3.68	3.68
Macquarie Group	3.54	6.10
BHP Billiton	3.09	9.90
Qube Holdings	3.07	3.37
ALS	2.97	3.23
SEEK	2.95	3.49
Computershare	2.91	3.31

Source: Mainstream Fund Services and DNR Capital

### Fund overview

APIR Code	PIM0028AU
Investment bias	Style neutral with a quality focus
Designed for	Investors seeking a medium-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	To invest in a high conviction portfolio of Australian equities that aims to outperform the Benchmark by 4% p.a. (before fees) over a rolling three-year period. The investment objective is not a forecast of the Fund's performance.
Benchmark	S&P/ASX 200 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 Minimum exposure of 80% of the Fund NAV to be invested in the S&P/ASX 200
Asset allocation	Australian Equities – 80-100% Cash – 0-20%
Risk level	High
Number of securities	Min 15 - max 30, typically 25
Minimum suggested investment timeframe	5 years
Buy/sell spread	+0.25% / -0.25%
Management fee	0.90% ( inclusive GST and RITC)
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 December 2020

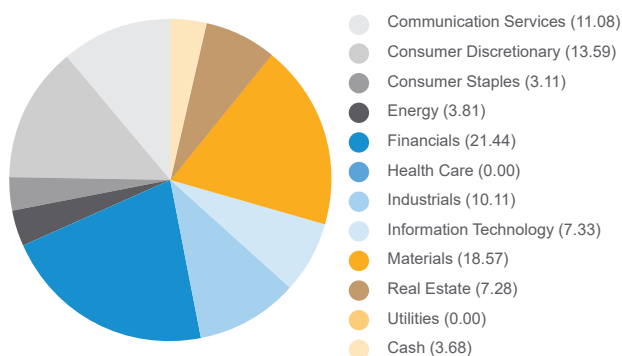
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	Incep.* %
High Conviction Fund	1.34	17.15	16.45	2.02	6.55	9.12	8.60
S&P/ASX 200 Accumulation Index	1.21	13.70	13.20	1.40	6.73	8.73	7.40
<b>Excess return</b>	<b>0.13</b>	<b>3.45</b>	<b>3.25</b>	<b>0.62</b>	<b>-0.18</b>	<b>0.39</b>	<b>1.20</b>

\* Inception Date—June 2015

Source: Mainstream Fund Services and DNR Capital

Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction 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.

## Sector weightings %



Source: Mainstream Fund Services and DNR Capital

## Attribution

The top stock contributors for the month were:

- CSL (CSL, no holding):** Underperformed in line with the broader health sector and after announcing its COVID-19 vaccine candidate, under development with The University of Queensland, would not be progressing to Phase 2/3 clinical trials.
- Domino's Pizza Enterprises (DMP):** Outperformed following an encouraging investor day outlining growth opportunities in Japan and Europe. We expect FY21 to deliver strong earnings growth as it leverages an expanded customer base and ongoing network expansion in Japan and Europe.
- BHP Group (BHP):** Outperformed as the strong iron ore price continues to hold up. Supply disruptions remain present following Vale's restrictions and demand is being driven by global fiscal stimulus, particularly from China. The strength should see bumper revenues at the half-year result.

The top stock detractors for the month were:

- Fortescue Metals Group (FMG, no holding):** Was up strongly during the period, as a consistently elevated iron ore price bodes well for revenues. Supply disruptions from Vale continue to inhibit global output and the fiscal stimulus spend (particularly in China) is resulting in strong demand dynamics.

- Lendlease (LLC):** Was weaker during the period on limited news flow. The departure of the CFO during the month was not entirely unexpected and of minimal impact to the investment thesis. The company also confirmed the limits of its exposure to the Melbourne Metro overruns, which have been guided to previously.
- Afterpay (APT, no holding):** Outperformed during December, following strong online sales events in North America. While we continue to monitor the story and recognise the potential of the platform, we find the stock unpalatable, given regulatory risks and a model relatively untested under bad debt scenarios.

## Market review

2020 is a year that will be analysed and dissected for decades to come. The economic and social chaos left in COVID-19's wake will no doubt fill more volumes of history and economic textbooks than any period in recent history. This month, as we soberly watch the most unpredictable and volatile markets in DNR Capital's history shrink in the rear view mirror, we find it more insightful to focus on the investment dynamics likely to define 2021, rather than rehash the gut wrenching volatility of the year that was. We also reflect on what stocks drove positive outcomes in 2020, and how we are positioned for the start of this recovery year.

As investors, we believe three key themes will drive 2021, all inextricably linked:

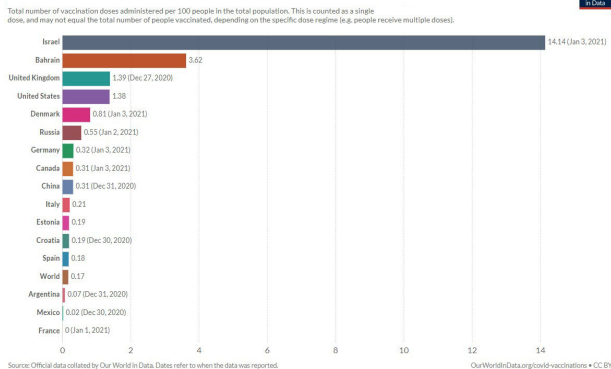
1. The rollout, uptake and efficacy of COVID-19 vaccines
2. The quantum and pace of global fiscal stimulus
3. Global inflation and central bank appetite for asset purchases, influencing the outlook for interest rates.

As key inputs to an ongoing and overarching debate around growth versus value, these will frame how best to position portfolios for a year (hopefully) defined by the recovery and reopening of the global economy.

### The vaccine rollout

Alongside infections, testing and mortality rates, tracking efforts now shift to include global vaccinations as a barometer of potential normalisation. The Pfizer-BioNTech and Moderna vaccine candidates are now approved in many countries, and early-stage inoculations have begun.

### COVID-19 Vaccination doses administered per 100 people, Jan 4, 2021



Source: Official data collected by Our World in Data. Dates refer to when the data was reported.

Undoubtedly, this provides a clearer road to defeating the virus, but the task of distributing and administering the doses is a logistical undertaking of epic proportions. Even in the developed world, coordinating hundreds of millions of recipients for multiple doses and transporting the vaccine and requisite equipment will be one of the biggest peace time logistical feats in history. Undertaking this in the developing world, lacking crucial supplies and infrastructure, is significantly more difficult.

Under the auspices of Operation Warp Speed (a US initiative), an ambitious target was set to produce and deliver 300 million doses of a safe and effective vaccine by January 2021. With the resources applied by President Trump, the pace of COVID-19 vaccine development was unprecedented. Attention now turns to the monumental task of manufacturing and distributing approved doses globally. Unique logistical hurdles are to be overcome, given the Pfizer-BioNTech candidate requires storage at -70°C and the Moderna at -20°C, with injection required soon after thawing. The requisite cold transportation infrastructure is not currently available, requiring investment and innovative solutions. In addition, millions of tonnes of medical supplies, including syringes, gloves and wipes must be available at each site. While efforts to manufacture have been underway for months, the ability to meet demand in the near future is unlikely, with a more realistic timeframe appearing to be towards the end of CY2021.

Focus is currently on the US, and to a lesser extent the UK and Eurozone, representing the key regions where unchecked infections could derail or delay a global recovery. Countries with lower apparent infection levels, including Australia, South Korea and New Zealand are reacting more slowly to push out vaccines as they monitor progress in global hotspots. Priorities will be determined by each country, but the Centre for Disease Control (CDC) recommends initial doses be concentrated on health workers, then high-risk essential service workers (police, teachers etc.), followed by aged care residents, the elderly and infirm.

In the US, initial vaccinations began on 14 December, with federal officials now forecasting 100 million Americans to be vaccinated by March. Despite tracking behind its initial targets, the goal of a rollout by the North

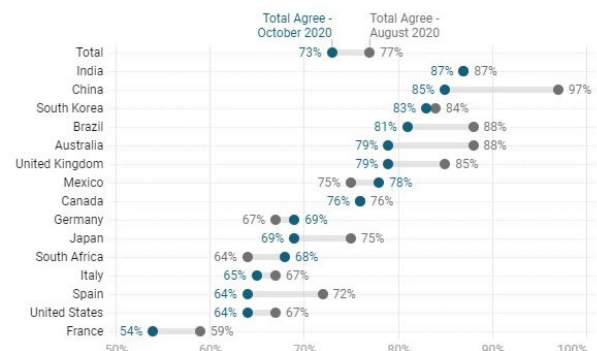
American summer is intact. Lead government advisor, Dr. Anthony Fauci, suggested that while benefits would be seen at a 50% uptake, blanket herd immunity would require 75–85% nationally but could be possible by the fourth quarter 2021<sup>1</sup>. Most Americans wanting the vaccine should be able to receive a dose by September.

The UK began vaccinating on 8 December with Pfizer-BioNTech, and Europe followed on 21 December. Europe’s rollout is likely to take longer given a planned reliance on the Oxford-AstraZeneca candidate which has produced lower efficiency and inconsistent results, requiring several more months of study.

The challenge of public scepticism is perhaps as large a hurdle as distribution. Despite the anti-vaccination movement being relatively small, a noisy and active social media cohort readily disseminates misinformation, notwithstanding the best effort of the platforms. An Ipsos survey of 15 countries found greater than two thirds would take the vaccine, but the percentage had fallen. Asian respondents were more likely to uptake than US and European countries. Unsurprisingly, the survey found propensity to take a vaccine was significantly higher one year after it is released than at the time it becomes available.<sup>2</sup>

### COVID-19 vaccine survey results

If a vaccine for COVID-19 were available, I would get it



Base: 18,526 online adults aged 16-74 across 15 countries  
Chart: Ipsos - Source: Global Advisor - Get the data - Created with Datawrapper

Source: Global Advisor

The high efficacy of the Moderna and Pfizer-BioNTech vaccines at >95% is positive in terms of encouraging uptake, and innovative solutions to the logistical challenges are being developed. Any significant delay in the distribution of the vaccine, or major health issues arising from it has the potential to slow the uptake from the population. This will have a material impact on the global recovery, and represents a key risk to our market outlook for 2021.

### Fiscal stimulus

Unprecedented levels of government support and fiscal stimulus have buffered economies around the world from the crippling impacts of economic lockdown and shelter-in-place orders. These measures have been of greater magnitude than that seen during the GFC.

<sup>1</sup> <https://www.npr.org/2020/12/15/946617217/fauci-it-would-be-terrible-if-people-choose-not-to-get-covid-19-vaccine>

<sup>2</sup> <https://www.ipsos.com/en/global-attitudes-covid-19-vaccine-october-2020>

**COVID-19 stimulus and spend**

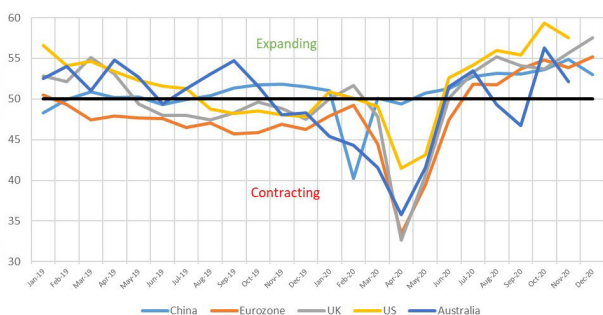
Country	Stimulus % GDP	GDP 2019 \$	Spend \$ (US Billion approx)
Japan	20	5,080	1,000
Canada	15	1,736	260
US	14	21,433	3,100
Australia	13	1,387	185
UK	10	2,830	290
Germany	9	3,862	340
China	7	14,731	1,065

Source: DNR Capital

Despite ballooning deficits, these measures have been successful in preventing a global depression. As second and third waves of the virus impact parts of the world, further extensions of welfare and business support are likely, on top of planned fiscal stimulus. The next phase of recovery needs to shift from stabilising financial systems and providing emergency support to households, to restarting economic growth and facilitating reopening and a return to normality.

The efficacy of these programs will be a key determinant of cyclical versus longer duration and growth stocks in 2021. Heavy focus will be placed on the purchasing manager indices (PMI) around the world, as a monthly indicator of economic activity. These surveys are a base measure of ordering activity at factories and serve as an early indicator of economic health. Following the rolling global shutdowns that started in February 2020, the indices rebounded strongly in the second half of the year but must be sustained in any global recovery.

**Global PMI**



Source: FactSet, DNR Capital

This indicator will continue to be volatile while varying levels of lockdown impact economic activity around the world, but it provides us cautious optimism as we assess the success of fiscal stimulus plans.

**The inflation outlook**

Central to the outlook for global equities is inflation, and more importantly, the markets' expectations for it. An unexpected inflationary surge would be negative for equities, as concomitant interest rate increases provide more attractive alternatives in the form of bonds and deposits. However, the relative impact on different sectors of the market may be stark as cheaper pro-cyclical industries like energy, resources and financials benefit from the increased economic activity coincident with inflation, while growth and defensive sectors like technology and consumer staples are likely to underperform.

Under consecutive waves of money printing in the form of quantitative easing (QE), the inflation narrative was widely expected to have taken hold following the GFC. This failed to materialise as subdued demand and excess capacity extinguished any inflationary spark. Following the extraordinary and coordinated fiscal and monetary intervention in response to COVID-19, the dormant spectre of inflation has again become a pivotal debate in the outlook for markets.

According to the IMF, developed world expectations for inflation in 2021 are modest at less than 2%, with emerging markets around 5%.

**IMF inflation expectations 2021 (%)**

Analytical group	Value
Middle East and Central Asia	9.3
Sub-Saharan Africa	7.9
Latin America and the Caribbean	6.7
Emerging and Developing Europe	5.2
Emerging market and developing economies	4.7
World	3.4
Emerging and Developing Asia	2.9
ASEAN-5	2.3
Major advanced economies (G7)	1.8
Advanced economies	1.6
European Union	1.2
Other advanced economies	1.1
Euro area	0.9

Source: IMF

The market-derived measure of consumer price expectations we favour is breakeven inflation, measuring the difference between inflation-linked and non-inflation-linked government bonds. This indicator is at two-year highs, although well within ranges tolerable to central banks.

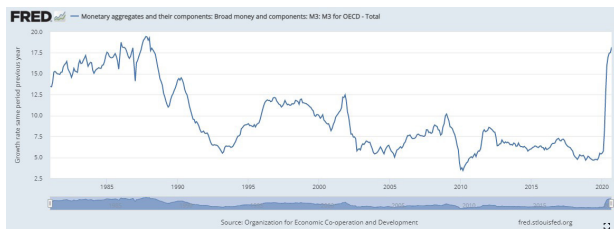
**Breakeven inflation**



Source: FactSet, DNR Capital

As noted, the global stimulus is without precedent in scale and timing. A key feature is the embracing of QE by central banks, which had previously excluded it from their options. Globally, the growth in the broad money supply (M3) is quite remarkable.

**Monetary aggregates and their components: Broad money and components: M3; M3 for OECD – total**



Source: FRED

While still driven primarily through major economies, countries including the UK, Australia and Canada have either restarted or initiated QE measures. Forcing an increase in the monetary base is theoretically inflationary but has been akin “to pushing on a length of string” to this point, flying in the face of monetarism. There also exists a significant output gap, which many argue will restrain any inflationary impulse for longer.

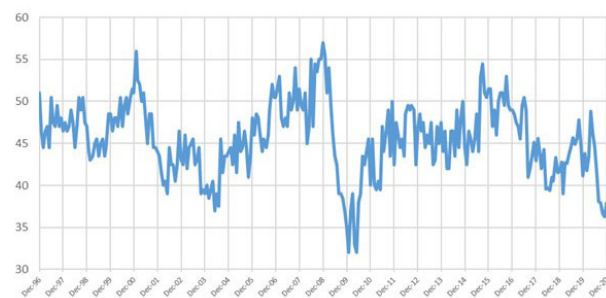
**US capacity utilization % of total capacity (SA, %), 1/1967 - 10/2020**



Source: Bloomberg, FRB, BofA US Equity & US Quant Strategy

Low levels of inventory in developed world countries need replenishment however, and supply chains are unable to facilitate demand owing to hamstrung manufacturing and global logistical capacity, potentially placing upward pressure on prices.

**ISM manufacturing, customer inventories - US**



Source: FactSet, DNR Capital

With unprecedented levels of stimulus and ongoing government support payments, it can be argued that a spike in consumer spending will see increased demand for a shrinking supply of resources, driving prices up. Receding globalisation and travel restrictions have

rendered migration for skilled labour difficult, and this has the potential to place further upward pressure on wages. Under this scenario, elevated inflation is plausible, in the near term at least.

**Positioning**

Reflecting on the largest contributors to 2020 performance, we observe a clear growth bias, which is consistent with the broader thematic over the year.

- **Domino’s Pizza Enterprises (DMP)** benefited from shelter-in-place orders in most of its markets. Limited dining options, an established delivery network and online offering made its offering uniquely positioned to serve customers in lockdown.
- **Xero (XRO)** benefited from a subscription model, accelerated move to the cloud for businesses unable to operate in offices, and reduced churn from moratoriums on bankruptcies.
- **James Hardie Industries (JHX)** on the back of the monetary response to the crisis, record low interest rates alongside demand for more spacious living is driving a housing construction boom in North America.
- **REA Group (REA)** despite a drop in listings during lockdown, REA has experienced a strong bounce back in listings with significant pent-up demand and historically low interest rates driving turnover. A flexible operating model supported margins with expenses held flat over the year.
- **Rio Tinto (RIO)** a rebound in global steel output supported by fiscal stimulus in China, combined with global supply constraints and delays in Vale’s production recovery, has sustained higher iron price prices.

Entering the first quarter of 2021, we do observe valuation risk in some areas of the market. While maintaining our core focus on quality, we have adjusted our positioning to gain further exposure to reopening beneficiaries, while reducing our higher growth and long-duration stocks exposures.

**Maintaining exposure to quality franchises**

Despite strong performance in 2020 we have maintained exposure to our strongest franchise names where we see earnings upside, but have adjusted exposure to reflect valuation support where appropriate.

- **Domino’s Pizza Enterprises (DMP)** can attribute much of its recent outperformance to a favourable position during lockdown, which increased demand for its food products and delivery services. We still see significant earnings upside for the group as traction in European and Japanese markets has been pulled forward. While many are looking to fade the group’s sales growth, we believe the opportunity for store rollouts and market penetration is immense, and the potential operating leverage underappreciated by the market.
- **Xero (XRO)** having materially outperformed during CY2020, still offers meaningful and sustainable growth as cloud accounting remains underpenetrated in most markets. With a recently strengthened balance sheet, strategic M&A opportunities also exist to unlock new verticals in regions.

- **James Hardie Industries (JHX)** maintains a market-leading position in the US and Australia and continues to harvest market share through a competitive advantage in product quality and competitive pricing. It continues to innovate fibre cement and seeks to compete in a greater proportion of the market and push into Europe, and we forecast earnings momentum to be sustained.

#### Increasing exposure to reopening beneficiaries

We have also taken new positions, or added to existing exposure, where we see material valuation upside and positive exposure to a reopening trend.

- **Aristocrat Leisure (ALL)** had its land-based gaming business heavily impacted by shelter-in-place orders across all its markets, especially North America. While this same theme boosted its digital division, casinos in the US have been slow to reopen and remain exposed to second and third-wave outbreaks. As the COVID-19 vaccinations programs progress, ALL is well positioned with a strong balance sheet and superior product to benefit from the reopening and win market share around the world.
- **Scentre (SCG)** maintains a portfolio of world-class shopping centres in prime locations. These destinations will be prime beneficiaries of reopening, with progress on domestic vaccinations to provide consumers with further comfort to resume shopping in physical stores. This will relieve much of the pressure faced by retailers throughout the pandemic, facilitating more productive lease negotiations and rent collection for landlords.

SKYCITY Entertainment Group (SKC) holds a number of casino licences across New Zealand (including Auckland, Queenstown, Hamilton) and Australia (Adelaide). The Auckland casino licence generates the majority of earnings and was significantly impacted by lockdown restrictions over CY2020, impacting both the FY20 and FY21 financial years. SKC provided a trading update in mid-November which highlighted a strong rebound on the back of pent-up demand and stimulus and more broadly, the resilience of revenues under a normal trading environment. For FY21 year to date, New Zealand revenues were ~88% of pre-COVID levels (excluding trading days lost to lockdowns). We expect the stock will continue to benefit from reopening the economy and improving consumer confidence.

#### Fund positioning

Over the past few months we have made a number of changes to the Fund and our current positioning is as follows:

1. Trimming quality franchise stocks that have benefited during COVID-19 – Xero (XRO).
2. Cutting stocks on deteriorating quality grounds – Treasury Wine Estates (TWE).
3. Adding stocks that will benefit from a COVID-19 reopening – South32 (S32).
4. Adding stocks we believe offer compelling upside not captured in the market – QBE Insurance Group (QBE).
5. Adding to existing stocks where we have become more bullish regarding the long-term growth opportunity – Domino's Pizza Enterprises (DMP).

#### Key risks

Key risks to the Fund include:

- **COVID-19 disruption.** The longer and deeper the disruption from the COVID-19 pandemic, the greater the negative impact on equity markets. Any disruption to the roll out of the vaccine would be negative.
- **Interest rates.** Low interest rates are the prime driver of markets at present. Any change to the inflation outlook would have a significant impact on valuations.
- **Inflation.** Given valuations have been supported by low interest rates, the emergence of inflation and higher bond yields could be a negative for markets.
- **Political environment.** Further geopolitical uncertainty, such as civic destabilisation in the US following the election, could create negative implications for stocks and portfolios.

#### Stock moves

##### Purchase of QBE Insurance Group (QBE)

QBE is a diversified, global property and casualty insurance group. Its main operations are in Australia, North America and Europe. QBE operates predominantly in the commercial lines / intermediated insurance markets. Individually significant operations include Lloyd's market operations, Australian lenders mortgage insurance (LMI) and US Crop insurance.

QBE meets DNR Capital's five-point quality web:

1. **Industry structure:** QBE is one of the top 20 insurers and reinsurers worldwide by Gross Written Premium (GWP).
2. **Earnings strength:** With global premium rate momentum continuing to be strong and potentially improving further, we see earnings growth of double-digits over the next three years.
3. **Balance Sheet:** QBE balance sheet is robust with CET1 ratio of ~1.2x.
4. **Management:** Richard Pryce has assumed the role of interim group Chief Executive Officer while the search process for a permanent replacement is underway. Having joined QBE in 2012, Richard became Chief Executive Officer, European Operations in 2013, and in 2019 he became Chief Executive Officer, International Operations.
5. **Environment, social and governance (ESG):** We rate QBE's ESG risk exposure as medium. Specifically, QBE faces increased risk from natural disasters due to climate change.

##### Key catalysts

**Margin improvement:** We see upside risk to margin expectations from pricing momentum, improving volume growth, delivery of cost initiatives, and higher yields.

**Interest rates:** QBE profitability and investment yields will benefit from higher interest rates / global bond yields.

##### Key risks

**Efficiency program execution:** Execution on efficiency programs may be more difficult in the current environment.

**COVID-19 headwinds:** Scope for recent rate increases to continue may reduce given COVID-19 economic headwinds.

**Catastrophes:** An above-average catastrophe season is expected in the Northern Hemisphere.

**Australian housing:** To the extent that the Australian housing market deteriorates significantly, QBE is a major player in the Lenders Mortgage Insurance sector.

#### Valuation

We value QBE at ~\$11 / share. Our valuation uses a WACC of ~11%, terminal growth rate of 3%, and beta of ~1.3x. QBE trades at ~12x FY21E and a dividend yield of >5%. We believe there is further upside from (1) improving underwriting discipline, (2) capital management, and (3) planned cost initiatives.

#### Conclusion

QBE is trading at an attractive valuation, has improving top-line growth momentum, improving underlying underwriting profits and a robust balance sheet. After years of repair the balance sheet and underwriting book looks much improved and the global market is enjoying an improved cycle. Margins should improve from here so the stock looks attractively priced on modest earnings expectations.

#### Purchase of Transurban (TCL)

TCL manages and develops urban toll road networks in Australia and the US.

TCL meets DNR Capital's five-point quality web:

- 1. Industry structure:** TCL has 25-100% ownership of 21 toll road concessions with a weighted average expiry of 2043.
- 2. Earnings strength:** TCL's road networks in Australia and the US are leveraged to inflation-linked toll increases, economic growth and employment, providing predictable and sustainable ongoing cash flows.
- 3. Balance sheet:** TCL's balance sheet is robust, with group net debt of ~\$22b and gearing of ~36% - its defensive earnings allow higher gearing levels.
- 4. Management:** Under the leadership of Scott Charlton, TCL management are successfully leveraging the existing asset base to expand and extend the network at attractive returns.
- 5. Environment, social and governance (ESG):** TCL has a low risk ESG exposure, as it works with partners to ensure the future of transport is efficient, safe and sustainable.

#### Key catalysts

**COVID-19 restrictions:** Faster / slower removal of COVID-19 restrictions will impact traffic volumes positively / negatively.

**New projects:** TCL has a material pipeline of opportunities emerging in core markets to drive growth over the medium term.

**Equity raising:** An equity raising is possible during 2021 as TCL investigates its potential involvement in Stage 2 of the WestConnex project.

#### Key risks

**Traffic:** The use of toll roads for passenger vehicles is linked to discretionary consumer spending, however risk is reduced given lack of alternatives and proximity to key residential catchment areas feeding into primary business districts in Australia's east coast capital cities.

**Capex projects:** Efficiencies / delays to construction projects, lower / higher capex than budgeted (including environmental costs with the Westgate tunnel).

**Interest rates:** TCL's high level of gearing exposes it to rising funding costs (a 1% move in interest rates would impact FCF/share by >10% of current DPS), however TCL is still benefitting from a cost of debt tailwind.

#### Valuation

We derive a Sum-of-the-Parts valuation of ~\$15 / share. This implies a FY22e EV/EBITDA multiple of ~20x and a ~5% dividend yield, in-line with long-term averages. We expect TCL's dividend to grow at ~10% pa over the next three years in-line with Free Cash Flow.

#### Conclusion

The recent pull-back in share price resulting from higher bond yields, provides an attractive entry point. We purchased TCL due to its combination of resilient earnings, underpinning a ~4% dividend yield, which is expected to grow at ~10% pa over the next three years and backed by free cash flow.

#### Sale of Cochlear (COH)

Having recovered strongly from March lows, we believe COH's valuation now represents recovered earnings on an elevated multiple. Despite offering high quality exposure to Health Care, given a stretched valuation and more attractively priced opportunities elsewhere in the market, we have exited the position.

#### Sale of Wesfarmers (WES)

WES outperformed during 2020 with increased DIY home and garden activity, combined with home office fit outs, benefitting both Bunnings and Officeworks. Cycling strong comparable sales and an elevated earnings multiple leaves valuation stretched, despite the high quality of its portfolio businesses. We have exited the stock to fund more attractively price opportunities, with a view to re-enter at a more palatable valuation.

#### Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when combined with a thorough valuation overlay. We seek to identify quality businesses that are mispriced by overlaying a quality filter, referred to as the 'quality web', with a strong valuation discipline. The portfolio is high conviction, and invests for the medium term.

## Investment strategy

The DNR Capital Australian Equities High Conviction Fund has an investment style best described as 'style neutral'. The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices. We define quality businesses as being those with the following five attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low environmental, social and governance (ESG) risk.

Where we are satisfied that a company possesses quality characteristics, then it is eligible for inclusion in the Fund. However, it must also represent value and sit comfortably within our portfolio construction requirements.

A range of valuation methodologies are used depending on the nature of the company being assessed to identify mispriced opportunities.

The portfolio construction process is influenced by a macroeconomic appraisal and also considers the risk characteristics of the portfolio, such as stock and sector correlations.

## Platform access

- Asgard & BT Wrap
- BT Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- My North & North
- Netwealth

## Disclaimer

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