

# DNR Capital Australian Equities High Conviction Fund

## Performance Report – September 2021

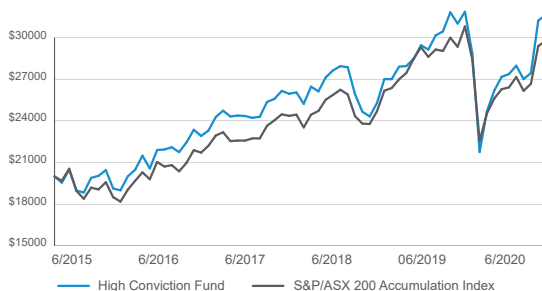
### Performance

The S&P/ASX 200 Accumulation Index was down 1.85% during the period.

Energy (+16.4%) was the best performing sector, following a surge in oil and gas prices due to recovering demand and limited supply. Utilities (+2.1%) also outperformed as a bidding war between APA (APA) and a private equity consortium erupted over Ausnet Services (AST +30.2%). Materials (-12.1%) was the worst performing sector, as commodities came under pressure again from slowing growth, particularly in China. Health Care (-5.5%) also underperformed as the sector leader CSL (CSL -5.9%), experienced continued issues in sourcing plasma.

DNR Capital Australian Equities High Conviction Fund outperformed the Index for the month. Key stock contributors were Woodside Petroleum (WPL), Macquarie Group (MQG) and South32 (S32). Key stock detractors were Iress (IRE), Commonwealth Bank of Australia (CBA), Underweight) and Lendlease (LLC).

### 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	4.24	4.77
Macquarie Group	4.10	7.13
National Australia Bank	3.80	8.22
Lendlease	3.63	3.99
Aristocrat Leisure	3.17	4.62
Woodside Petroleum	3.12	4.23
Computershare	3.08	3.59
SEEK	3.06	3.60
Qube Holdings	3.00	3.30
QBE Insurance Group	2.97	3.80

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 30 September 2021

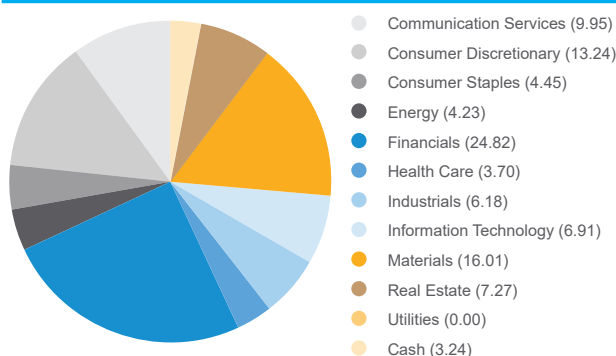
	1mth	3mth	6mth	1yr	3yr	5yr	Incep.*
High Conviction Fund	0.24	3.86	13.26	42.13	11.27	11.68	10.89
S&P/ASX 200 Accumulation Index	-1.85	1.71	10.14	30.56	9.65	10.42	8.86
<b>Excess return</b>	<b>2.09</b>	<b>2.15</b>	<b>3.12</b>	<b>11.57</b>	<b>1.62</b>	<b>1.26</b>	<b>2.03</b>

\* 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:

- **Woodside Petroleum (WPL):** bounced as global demand for energy increased as economies opened up and supplies remain limited.
- **Macquarie Group (MQG):** guided to a strong 1h profit result thanks to commodity volatility and active markets for asset sales.
- **South32 (S32):** performed strongly over the month with strong spot markets supporting upgrades to earnings. The business remains highly cash flow generative and management continues to focus on value accretive capital deployment.

The top stock detractors for the month were:

- **Iress (IRE):** fell following cessation of M&A discussions with private equity.
- **Commonwealth Bank of Australia (CBA, Underweight):** rallied into an off-market buyback where those tendering their shares have limited ability to sell.
- **Lendlease (LLC):** continued to underperform after reporting softer than expected guidance for FY22 at the August result. The softer outlook has been driven by rolling global lockdowns which have slowed the delivery of development projects. The company remains confident of development production reaching \$8bn by FY24.

## Market review

The market suffered its first down month in a year as concerns over China and higher energy prices weighed on market sentiment. We explore these issues and revisit market valuations and our positioning.

### China

Uncertainty regarding the solvency of large Chinese property developer, Evergrande raised a number of questions for investors during the month.

Firstly, markets have been concerned as to the possibility of a Lehman Brothers moment and cause systemic failure across the Chinese financial system. We view this risk as low. The failure is unlikely to have surprised authorities in China, as they appear to have 'allowed Evergrande to fail'. Evergrande has a substantial amount of debt as do other property players. Developers have long been restricted from raising funds in the domestic stock market, and access to bank and bond market funding has also tightened in recent years. This has increasingly forced Evergrande to rely on accounts payable to contractors and suppliers for short term funding. Evidence that Evergrande has been in trouble since early this year has made these creditors reluctant to extend financing to Evergrande, exacerbating the company's liquidity stress. Making matters worse, regulators have instructed banks to tighten mortgage lending standards, which significantly prolongs mortgage processing time reducing developers' turnover. Home sales have slowed, and new mortgage loan volume has contracted sharply, intensifying Evergrande's liquidity woes.

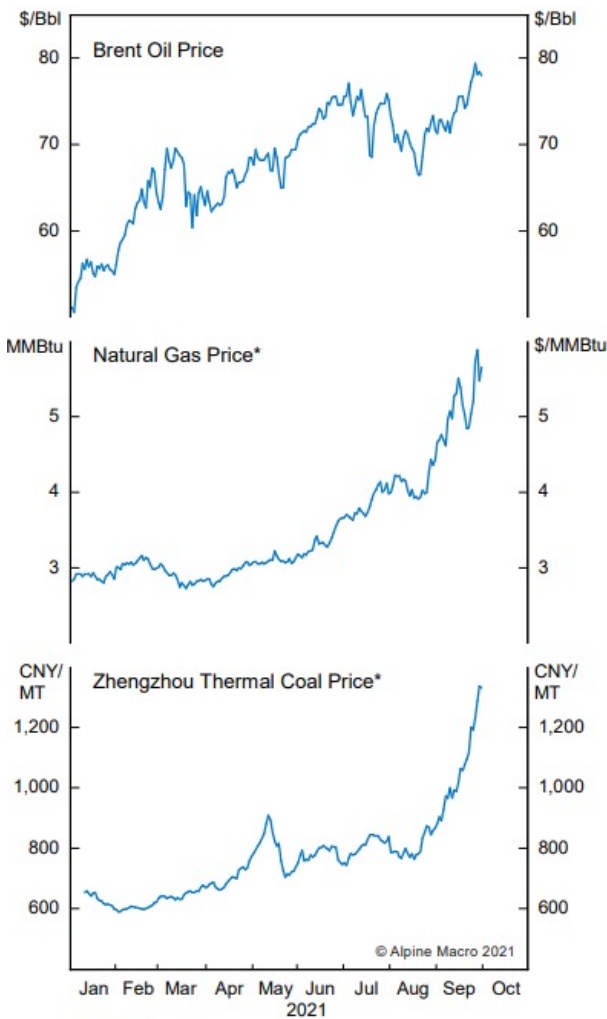
We are more concerned as to whether the Chinese have made a policy mistake. Having suffered from growing inequality, China is concerned about housing affordability, and the Communist Party is seeking to rebalance the economy. In the face of declining domestic expenditure, efforts have been focused on reducing reliance on exports to encourage domestic consumption. Furthermore, efforts to stomp on local internet billionaires, popular tik-tokers and movie stars, expose clear political motivations behind their current actions. An apparent willingness to sacrifice growth in order to regain control of the economy, is highlighted by recent edicts on the tech and education sectors. For some time, the Party has harboured a desire to reduce speculation in the property market and arguably, the failure of Evergrande will send that message. Ironically, meddling in the developer market may limit supply and actually increase house prices. We believe this intervention may undermine investor sentiment and confidence, catalysing further knock-on impacts to the economy.

Nonetheless, there is an old adage that investors stop panicking when the regulators start panicking. Historically, when problems have emerged within the Chinese economy, they have stimulated aggressively. Increasingly, authorities appear reluctant to do so, as it fuels speculation and drives up commodity prices. Instead, they have modestly loosened

credit restrictions over the past three months, but the market will be watching for further action. Property remains 20% of the Chinese economy, so the key question is whether China would really allow other property companies to fail. Gathering economic headwinds could force the Chinese authorities to further relax policies to support growth, setting the stage for the reflation trade to return. Until there is credible evidence of this shift in policy settings, the risks for Chinese growth remain elevated.

**Energy and supply chain disruption**

Panic buying of energy – from gas to coal to oil has accelerated as the Northern hemisphere fears being short of energy over winter.

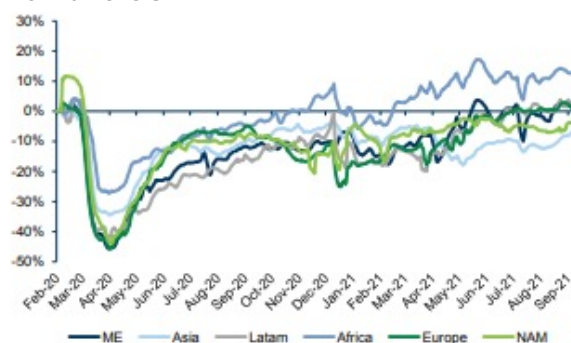


Source: Alpine

The drivers of this include:

1. Strong demand on reopening of the economies.

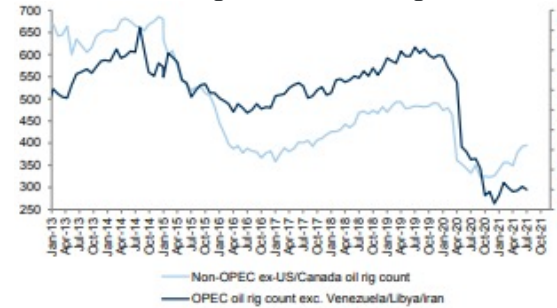
**Regional passenger fuel demand vs. seasonal normal levels**



Source: Google COVID-19 Community Mobility Reports, IEA, JODI, EIA, Apple, Goldman Sachs Global Investment Research

2. Supply constrained. A lack of investment in fossil fuels and related infrastructure as environmental, social and governance (ESG) concerns and concerns regarding investing in stranded assets limit investment.

**International oil rig counts excluding North America**



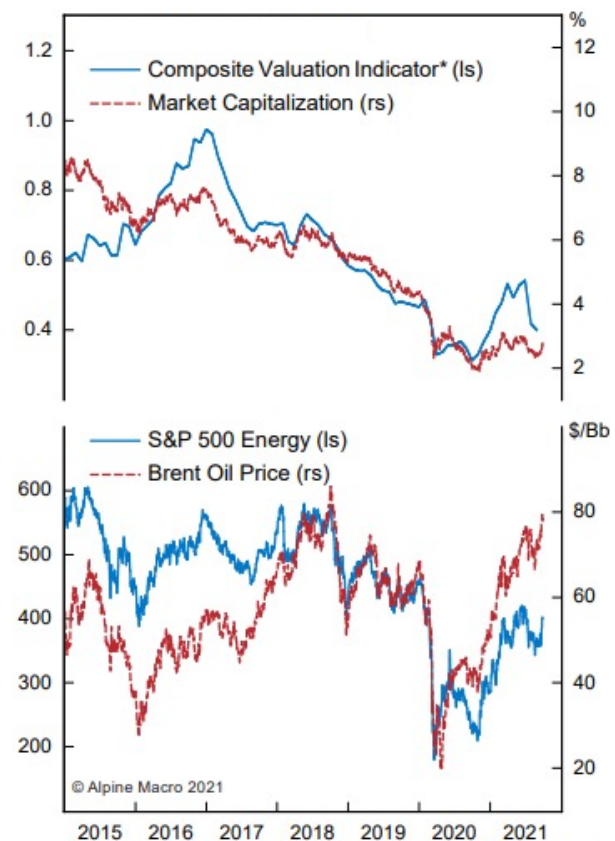
Source: Baker Hughes, Goldman Sachs Global Investment Research

3. Realisation that there are no quick fixes. Once renewables reach a certain threshold then there is a need to accompany it with LNG or nuclear to provide support at peak times when sun is not shining or wind blowing. Alternatives such as hydrogen appear to be some way off practical application and battery storage offers limited application at present.

The consequence is panic buying pushing oil price up to US\$75 a barrel and LNG in Asia at US\$30/BTU (compared to long term expectations of \$8). These moves have supported energy companies but they have still sharply underperformed over the past year which suggests they can continue to re-rate. We are favourably disposed to Woodside Petroleum (WPL) given we think the BHP Group (BHP) transaction substantially improves the quality of the WPL portfolio of assets and reduces the risks on project outcomes.

**Energy relative to S&P 500**

\*Equally-weighted average of relative P/B, P/S and P/C ratios



Source: Alpine

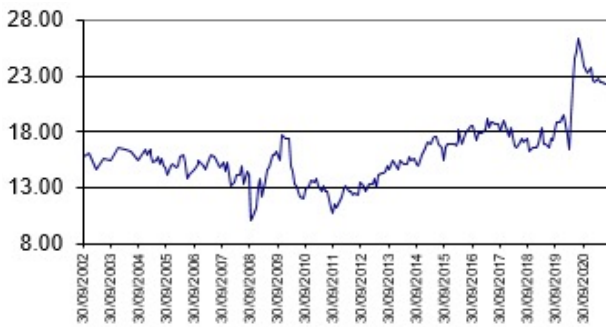
**Stagflation concerns**

Energy raises memories of a 1970's style energy crisis. The issue with tightness in energy markets is the problems are not quickly resolved. It is difficult to envisage a strong pick up in fossil fuel projects and nuclear remains politically difficult. We note however that the world is a different place from the 1970's. The US is less reliant on manufacturing and oil, labour productivity has been stronger and unions not as powerful. Nonetheless, the disruption increases risks regarding slower growth at the same time as inflation pressure builds. We would not forecast this as a base case but given the strong moves in markets to date we remain a little wary regarding this risk.

**Current market valuations**

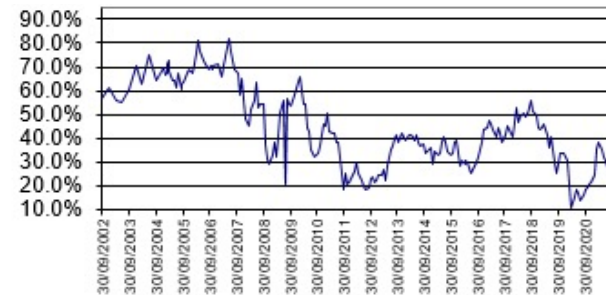
Market valuations remain elevated from a price earnings (PE) perspective but reasonable relative to low interest rates.

**Rolling forward per trend**



Source: DNR Capital

**Bond yield on earnings yield**

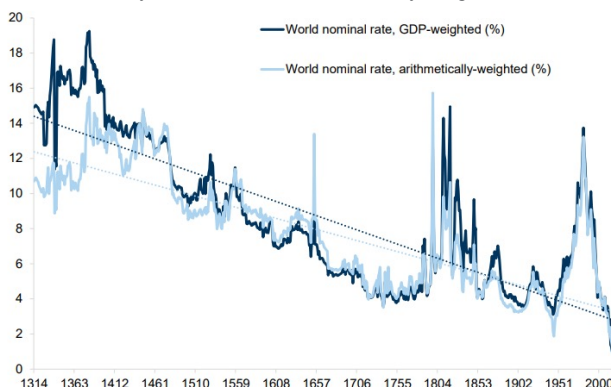


Source: DNR Capital

However interest rates are at 600 year lows and unlikely to become too much lower.

**Nominal interest rates are at record low levels**

Nominal bond yields, GDP- and arithmetically-weighted, 1314-2018

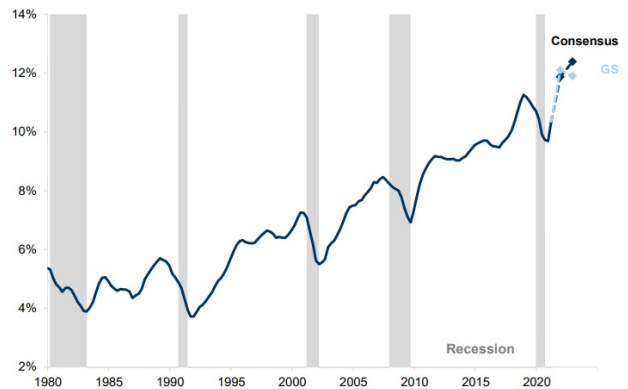


Source: Goldman Sachs, Bank of England

Profit margins are high which can be pressured by higher inflation.

**Margins are high**

S&P 500 net profit margin



Source: Goldman Sachs

And these low interest rates (as well as digital disruption driving earnings growth for tech stocks) has supported growth stocks.

**Growth has outperformed since the GFC**

MSCI Indices. Relative price performance in local currency\*



Source: Goldman Sachs

## Fund positioning

We have positioned the Fund as follows:

- **Inflation hedges.** Exposure to a number of stocks that benefit from rising inflation such as Computershare (CPU) and QBE (QBE).
- **Defensives with bottom up drivers.** We have increased our exposure to defensives given the Chinese / stagflation risks.
- **Quality market leaders.** Quality stocks with pricing power can protect earnings during an inflationary period. Stocks such as SEEK (SEK), James Hardie Industries (JHX) and Xero (XRO) retain strong pricing power.
- **Opening up laggards.** While the cyclical recovery might slow if the supply chain constraints accelerate, the economies will continue to open which will present opportunities for those stocks which have been impacted by lockdowns.

## 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 vaccines would be negative, as would the development of vaccine-resistant COVID-19 variants.
- **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.
- **Political environment.** Further geopolitical uncertainty including civic destabilisation in the US and regional tensions with China could create negative implications for stocks and portfolios.
- **Global growth.** Higher energy costs and supply chain disruptions could drag on global growth rates.

## Stock moves

### Purchase of Endeavour Group (EDV)

EDV has recently been added. Having recently spun out of Woolworths Group (WOW), the group primarily operates a network of retail liquor outlets and the largest portfolio of hotels in Australia.

#### EDV meets DNR Capital's five-point quality web:

1. **Industry structure:** Endeavour's largest segment, Endeavour Drinks, operates Dan Murphy's and BWS, in a well-structured duopoly, with dominant market share. The Hotels business maintains the largest market in a more fragmented industry. There are significant barriers to entry given regulatory requirements in both businesses.
2. **Earnings strength:** Excess growth has been observed in liquor retail, substituting sales in pubs and clubs during COVID-19 related lockdowns. This will likely reverse to some extent during a re-opening but likely to normalise in FY23. In general, liquor retail

exhibits highly defensive earnings growth. Food and alcohol sales in the hospitality segment are more cyclical but supported by resilient gaming revenues. Improved efficiency and capital allocation outside WOW's investment framework sees significant scope for margin expansion in the near term.

3. **Balance sheet:** The group has a strong balance sheet with net debt to earnings before interest, taxes, depreciation, and amortisation (EBITDA) ratio of 0.9x FY22. Despite ongoing investment, we believe this will come down further in the coming years.
4. **Management:** We view EDV's management as competent given their performance to date. CEO Steve Donohue has broad experience in food and liquor retail and has been clear with his strategy. As a newly listed entity, we continue to closely monitor their stewardship of capital and execution against the stated goals.
5. **Environmental, social and governance (ESG):** The group has strong governance and low environmental impact, but given the heavy exposure to alcohol and gaming, EDV has high ESG risk.

**Key risks:** Key risks include a change to regulation governing gaming machines, demographics shifts reducing alcohol consumption and further COVID-19 restrictions impacting the hospitality segment.

**Valuation:** We view the defensive characteristics of EDV as warranting a premium to ASX200 and our current DCF valuation of \$8.05 sees upside to its current FY23 price-to-earnings (PE) multiple of 24x, with a fully franked dividend of 3.0%.

#### Conclusion

We view liquor retailing as offering long duration, sustainable earnings growth, leveraging a dominant market share into expansion in to online and premiumisation trends. The Hotels business features more cyclical earnings exposure but offers significant upside from several years of underinvestment under Woolworths and an aging gaming machines fleet. We view the valuation as attractive with the market underappreciating the upside to returns and network expansion.

### Sale of Commonwealth Bank of Australia (CBA)

Following a strong run since we purchased CBA, we sold out to fund a range of other purchases.

CBA is performing well relative to the other banks with strong systems and a good franchise but following strong performance it trades at a 40% price-to-earnings (PE) premium to the majors and at a large premium compared to its history and to global peers.

## Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when it is 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

- Ausmaq
- Asgard
- BT Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- Mason Stevens
- My North
- Netwealth
- Powerwrap
- Praemium
- Wealth02

## Disclaimer

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