DNR Capital Australian Equities High Conviction Fund

Performance Report – October 2021

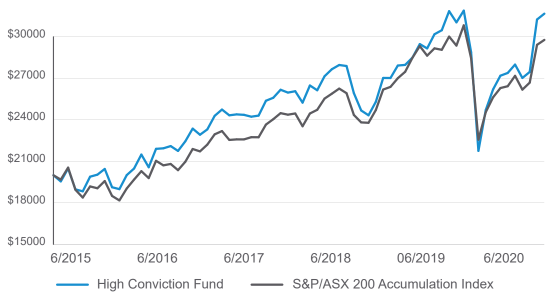
Performance

The S&P/ASX 200 Accumulation Index was down 0.10% during the period.

Information Technology (+2.1%) was the best performing sector, following global peers higher after underperforming last month. Health Care (1.0%) also outperformed with companies exhibiting pricing power outperforming in an inflationary environment. Industrials (-3.3%) was the worst performing sector, as infrastructure-style assets were sold down with higher interest rates. Consumer Staples (-2.3%) also underperformed with sector heavyweight Woolworths Group (WOW -3.2%) disappointing shareholders at its quarterly update.

The DNR Capital Australian Equities High Conviction Fund outperformed the Index for the month. Key stock contributors were Macquarie Group (MQG), SEEK (SEK) and National Australia Bank (NAB). Key stock detractors were Domino's Pizza Enterprises (DMP), Suncorp Group (SUN) and Virgin Money UK (VUK).

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	4.27	4.80
Macquarie Group	4.09	7.38
National Australia Bank	3.95	8.56
Lendlease	3.49	3.84
Woodside Petroleum	3.26	4.35
Computershare	3.18	3.71
SEEK	3.11	3.67
QBE Insurance Group	3.00	3.85
Scentre	2.91	3.67
Aristocrat Leisure	2.85	4.37

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 October 2021

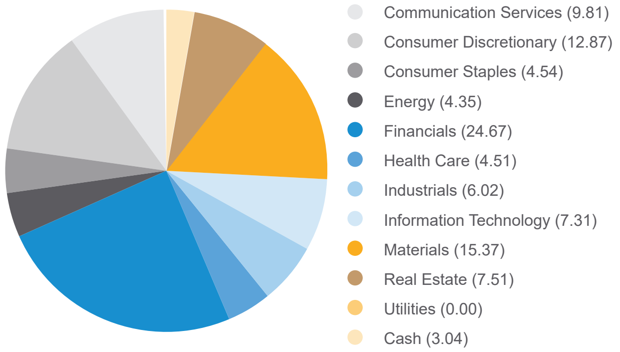
	1mth %	3mth %	6mth %	1yr % p.a.	3yr % p.a.	5yr % p.a.	Incep.* % p.a.
High Conviction Fund	0.04	4.00	9.14	39.95	14.01	12.04	10.74
S&P/ASX 200 Accumulation Index	-0.10	0.51	6.34	27.96	11.92	10.88	8.72
Excess return	**0.14**	**3.49**	**2.80**	**11.99**	**2.09**	**1.16**	**2.02**

** 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:

- **Macquarie Group (MQG):** performed strongly delivering a strong 1H22 profit result which was substantially above expectations with energy volatility, strong M&A activity, and the Green Investment Group (GIG) contributing.
- **SEEK (SEK):** outperformed during the month as the stock benefits from continued improvement in jobs listing data and tight employment conditions support the group's new pricing structure.
- **National Australia Bank (NAB):** rallied ahead of its result in November. Australia and New Zealand Banking Group (ANZ) and Westpac Banking Corporation (WBC) have been struggling operationally which has meant NAB has been a preferred bank ahead of its dividend.

The top stock detractors for the month were:

- **Domino's Pizza Enterprises (DMP):** underperformed during the month following a near 30% rally in the previous quarter. The group's European strategy day highlighted the large opportunity and remains positioned for long term sustainable growth.
- **Suncorp Group (SUN):** a large amount of catastrophe activity including a range of hail storms means the 1H will be soft. SUN has strong reinsurance cover which will support the full year.
- **Virgin Money UK (VUK):** announced a major restructuring program aimed at taking costs out, which they plan to partially reinvest to drive growth. The market focused on the higher near term costs rather than the potential longer term revenue growth.

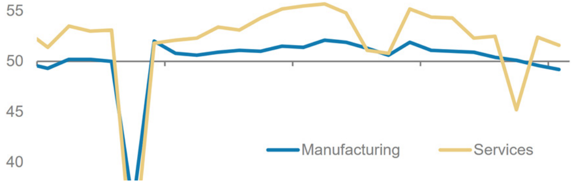
Market review

This month we review the major issues impacting our view of markets. These include the outlook for growth in China, inflation / supply chain issues, bond market activity, and the transition to net zero carbon.

China

China remains in transition seeking to reduce its reliance on the property market, increase domestic consumption, deliver common prosperity and reduce inequality. President Xi is powerful, a populist and lacks challengers which increases the dangers of a policy mistake. China has been reluctant to support the economy despite it slowing. Is this a sign of overconfidence? Does cracking down on prominent businessmen and movie stars reduce risk appetite in the broader economy? If the economy continues to stagnate, income levels for most people will not grow. Increasing social discontent will be the needed trigger for the government to back off from monetary austerity.

China PMI



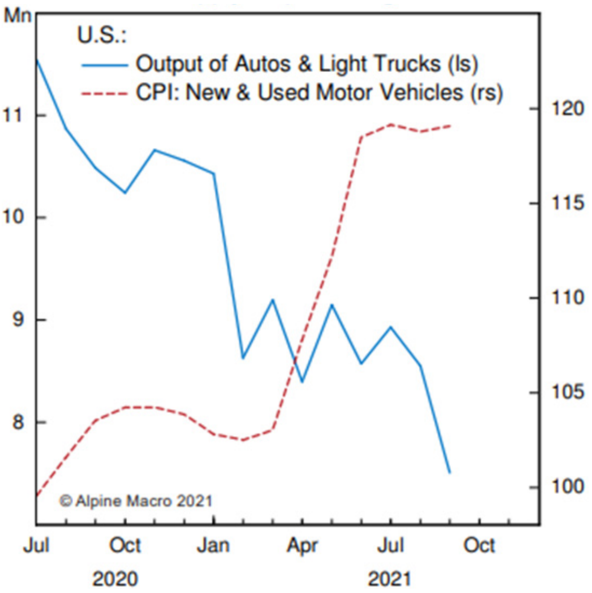
Source: Morgan Stanley

China's goal of common prosperity aims to increase labour's share of national income relative to capital's share by increasing the marginal productivity of labour and having laws and regulations that ensure that workers get paid in accordance with their higher productivities. In certain sectors, they would rather eliminate certain business models they deem detrimental to social equality rather than nationalize them despite their profitability (e.g. how much productivity does TikTok add to society?). Authorities want to encourage more investment in higher-risk projects that, if successful, can increase labour productivity and enhance technological self-reliance. However this is a difficult task to undertake without reducing risk appetites.

Supply disruption and inflation

A synchronised economic recovery post-pandemic and strong fiscal stimulus have boosted demand across the globe. Supply chains are groaning at present across many markets – oil, gas, wheat and other goods. Access to labour is also causing constraints. A lack of mobility is causing tightness in labour markets which appears to be further exacerbating the supply response. We give an example of the motor vehicle market in the US which has seen strong price pressure but a lack of a supply response due to a lack of goods such as computer chips and labour constraints.

U.S. Auto sector: supply-inspired stagflation



Source: Alpine Macro 2021

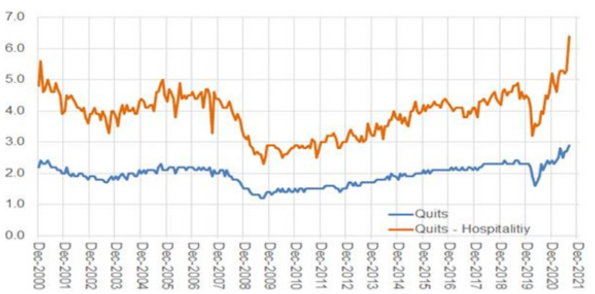
Ultimately we would expect to see these supply constraints resolved but wage pressure is building which might prove less transitory. We note the wage pressure beginning to build in the chart below.

Atlanta Fed wage tracker: 20 year + highs

Source: Atlanta Federal Reserve

In addition the quit ratio is high and job openings remain at a record high which again suggests inflation pressure is building.

Quit ratio at record highs

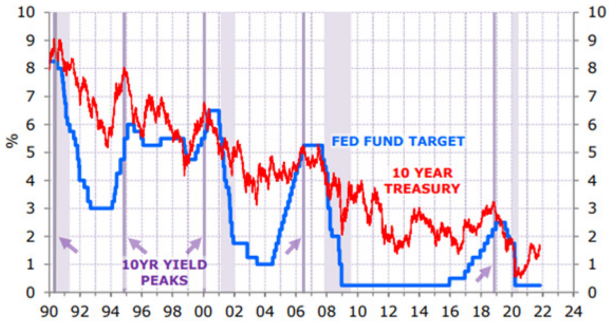


Source: Atlanta Federal Reserve

Bond market response

The sharp rise in labour costs in the US does bring closer the likely start date for US Federal Reserve (Fed) tightening. The surprising market development has been that 10 year bond yields have not pushed up very aggressively. Rate markets are now pricing several rate increases next year. That may prove to be too aggressive, but that is typical: short-rate futures often price policy tightening that ends up not occurring.

US 10 year bond and Fed funds target

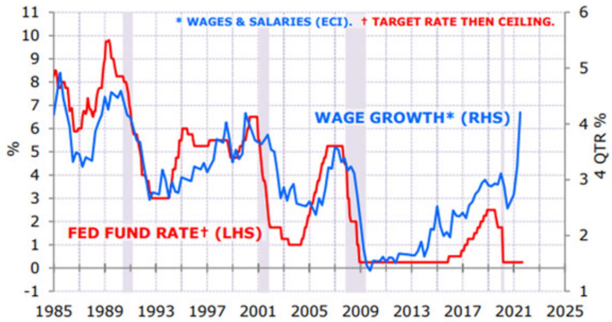


Source: Bloomberg, NBER; Minack Advisors

It's notable that the 10 year bond rates fell as short rates rose. This is consistent with what seems to be a deeply held view that the neutral rate of interest remains exceptionally low (and that the Fed will make a policy mistake by lifting interest rates too aggressively). Rate markets continue to expect that the Fed fund rate will be negative in real terms over the medium term.

In short, markets don't see that the pandemic has changed the structural framework for rates. However there have been two big framework changes. Firstly, governments now embrace fiscal policy across the globe. Secondly, central banks are no longer setting policy on a pre-emptive basis, rather waiting until they see inflation especially wage inflation. This increases the risk of inflation taking hold, in our view.

Fed fund target and wage growth



Source: BLS, Federal Reserve, NBER; Minack Advisors

Transition to net zero carbon

As the Conference of the Parties takes place in Glasgow (COP26), it is appropriate to revisit the state of global energy markets and the transition to a zero, net zero or low carbon world. So far, COP26 has elicited 'Net Zero' pledges from large carbon emitters India and Russia, to be achieved in 2070 and 2060 respectively. These commitments join those of the US (2050), the European Union (2050), Japan (2050) and China (2060) among others, to cover the majority of global emissions.

The transition plans of the various nations differ based on geographic, demographic and political differences; however, there are some common themes. Renewables are expected to become the primary source of energy on the planet by 2050. Solar and wind power is an intermittent energy source (the sun and wind are not 24-hour producers) therefore the renewable solution is paired with storage, the most prominent of which is battery technology (and potentially hydrogen).

We see substantial investment opportunity within the renewables supply chain, namely the financing and development of renewable assets through Macquarie Group's (MQG) MIRA and Green Investment Group (GIG) divisions. MQG is the largest financier of renewables in the world and has announced that the GIG will be incorporated under the Asset Management division and that they will seek external capital to support growth in the division. It has been estimated that $1 trillion a year needs to be spent each year until 2050 to hit net zero carbon targets. If MQG can support a small proportion of this it should support very strong growth for this division.

Another area that we expect to benefit from the energy transition is through the demand for commodities needed to build the renewable assets and infrastructure. As well as direct exposure to commodity producers for iron ore, copper, aluminium, manganese, silver, lead and zinc through holdings in BHP Group (BHP) and South32 (S32), we also expect to benefit from ALS (ALQ) and its commodity testing business.

A challenge for markets is that there is a misunderstanding of the realities of energy supply and demand in the transition period, as we attempt to shift from a fossil fuel energy model to a renewable energy model. In an effort to curb emissions quickly, significant pressure from investors, governments and the broader public has been applied to fossil fuels companies to restrict expansion activities and therefore reduce the supply of fossil fuels to the market.

As mentioned above, the key flaw of renewables is their intermittency. Solar panels produce significant amounts of energy during the peak of the day, but rely heavily on fossil fuels to supplement energy needs in the morning, afternoon and night. Battery technology is touted as the solution to the intermittency problem, however current solutions are far from capable of meeting this need. Battery technologies will improve over time; however there remains a long transition period where fossil fuels will be necessary to meet this demand.

This mismatch in the supply and demand of fossil fuels has been highlighted in recent weeks as the world emerges from the COVID-19 pandemic unable to meet its energy needs. Prices of coal, oil and gas have increased substantially in the Northern hemisphere, leading to rolling blackouts, soaring energy prices, production shutdowns and social unrest. China, as a case study, has forced factories to close, made coal hoarding illegal and reopened thousands of coalmines across the country to alleviate the supply shock.

Complicating the issue is the lack of energy reserves across Europe and Asia as they head in to winter. By some estimates, reserves are less than 10% of where they should be going in to the winter months, meaning that a particularly cold winter (as was witnessed last year) would result in significant consequences.

We maintain exposure in Woodside Petroleum (WPL) as we believe that the demand outlook for fossil fuels remains robust in the transition period (especially for LNG which can assist countries relying on coal reduce their carbon footprint). We also believe that the current political and social pressure to restrict fossil fuel expansion will likely remain, leading to restricted supply and creating a favourable pricing environment for its commodities (but also, ultimately improving the economic case for alternatives).

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 and 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

No changes to portfolio.

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

- Asgard
- BT Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- My North & North
- Netwealth
- Wealth O2

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