

DNR Capital Australian Equities High Conviction Fund

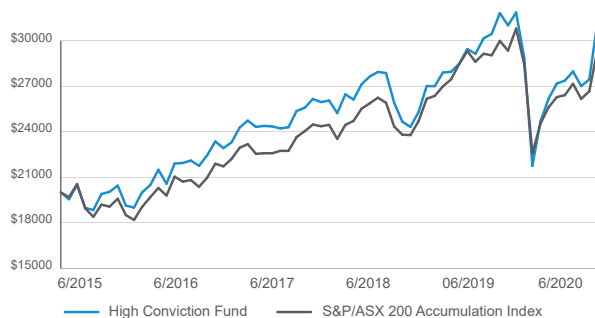
Performance Report – November 2020

Performance

The DNR Capital Australian Equities High Conviction Fund outperformed its benchmark for the month. Key stock contributors were CSL (CSL, no holding), National Australia Bank (NAB) and Scentre (SCG). Key stock detractors were Domino's Pizza Enterprises (DMP), ANZ Banking Group (ANZ, no holding) and Commonwealth Bank of Australia (CBA, no holding).

The S&P/ASX 200 Accumulation Index was up 10.21% during the period. Energy (+28.4%) was the best-performing sector during the period, as vaccine news caused a market-wide rotation into value and procyclical names. Oil and gas majors Woodside Petroleum (WPL, +29.1%) and Santos (STO, +29.4%) led the sector higher as oil prices staged a strong rebound. Financials (+15.2%) also benefited from the value rotation as banks (NAB, +23.1%) and insurers (SUN, +22.5%) are expected to benefit from a stronger global growth outlook. Consumer Staples (-0.7%) was the worst performer, with investors pulling out of the defensive, COVID-19 beneficiaries like Woolworths Group (WOW, -4.7%) and Coles Group (COL, -0.6%). Utilities (+1.2%) underperformed, with the defensive earnings of APA (APA, -1.4%) and Ausnet Services (AST, -7.3%) less favourable in a cyclical rotation.

Growth of \$20,000 since inception



Source: Mainstream Fund Services and DNR Capital

Top 10 active holdings

Security details	Active weight %	Actual weight %
Lendlease	4.57	5.10
Tabcorp Holdings	4.46	4.93
National Australia Bank	3.83	8.01
Cash	3.83	3.83
Macquarie Group	3.70	6.27
REA Group	3.11	3.51
SEEK	3.07	3.57
Qube Holdings	3.07	3.37
Computershare	2.93	3.33
James Hardie Industries	2.90	3.85

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 November 2020

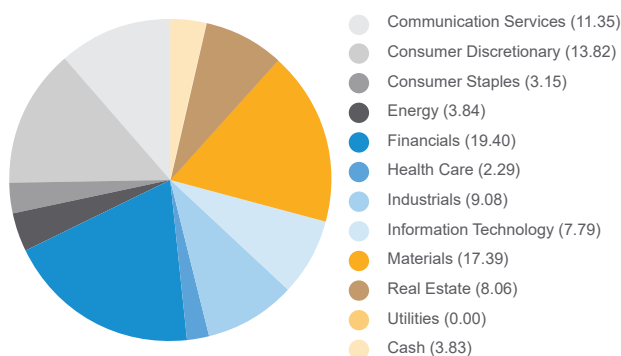
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	Incep.* %
High Conviction Fund	13.78	11.60	19.24	-1.89	6.87	9.27	8.47
S&P/ASX 200 Accumulation Index	10.21	8.22	14.76	-1.98	6.94	9.05	7.29
Excess return	3.57	3.38	4.48	0.09	-0.07	0.22	1.18

* 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):** While CSL outperformed over the month, it struggled to keep pace with the strong market surge in November. Plasma collection volumes remain below expectations.
- National Australia Bank (NAB):** Banks bounced as markets became more comfortable with the outlook for bad debts. NAB also produced a standout result during reporting season.
- Scentre (SCG):** Outperformed during the period as markets rotated into value names that had been negatively impacted by COVID-19. SCG has been trading at a significant discount to net tangible assets (NTA) following the perceived financial impact of national shutdowns and retailer rent assistance. The discovery of a vaccine has removed much of the worst-case scenario for the company, although much negativity remains in the market evidenced by a continued discount to NTA.

The top stock detractors for the month were:

- Domino's Pizza Enterprises (DMP):** Underperformed during the month in line with perceived COVID-19 lockdown beneficiaries and broader growth exposures. A November AGM trading update evidenced a moderation of comparable sales growth, as regions emerge from lockdown. A subsequent strategy day presentation, however, has strengthened confidence in the sustainability of growth in key markets.

- ANZ Banking Group (ANZ, no holding):** Banks bounced as markets became more comfortable with the outlook for bad debts, although the underlying profit results remained under pressure.
- Commonwealth Bank of Australia (CBA, no holding):** Banks bounced as markets became more comfortable with the outlook for bad debts, although the underlying profit results remained under pressure.

Market review

Everyone is well aware of what an extraordinary year we have been having. However, to place it into context, a global pandemic like the one that caused such a sharp fall in markets in March is a '1 in 100 year' event (last occurring in 1918), the fiscal stimulus response which supported markets was unlike any seen for 70 years (since World War 2) and, in the past month, the vaccines have contributed to a '1 in 30 year' event in terms of the rotation from growth to value stocks. We discuss this rotation, the current economic environment and its outlook post-vaccine, and some of the key risks from a market perspective.

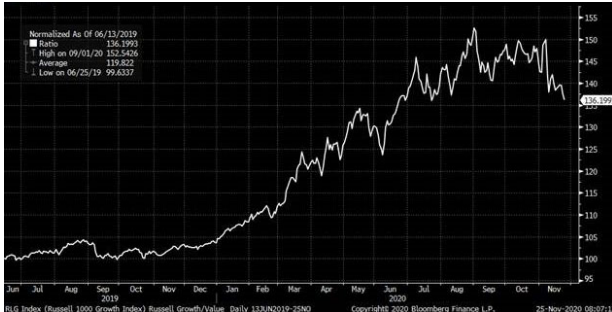
Growth to value

The rotation into value since early November 2020 has been quite marked. We see three main reasons for this:

- Vaccine efficacy data released from Moderna and AstraZeneca sets up CY21 for a rapid rollout and reversal of trends seen during lockdown. This positions the globe for a cyclical recovery.
- Biden's election with a Republican-controlled Senate positions the US to ideally support equities. Democrats are in favour of much higher spending than President Trump was, and retaining Senate control gives the Republicans the ability to block any tax cuts.
- We now have unprecedented stimulus in the global economy which is procyclical. This, along with the reopening of the global economy thanks to the vaccine, should drive growth and with it support the sectors that were left behind during the pandemic lockdown.

The following chart highlights the rotation back to value over the past month. It also highlights the strong run in growth stocks during the pandemic.

What value? Russell 1000 Growth/Russell 1000 Value RLG/RLV



Source: Bloomberg Finance L.P.

This is also noticeable when looking at the valuation difference between growth and value stocks. Growth stocks continue to retain a large valuation premium. As mentioned last month this is due to low interest rates, accelerated technology disruption and a lack of growth among alternative sectors.

Growth versus value dispersion

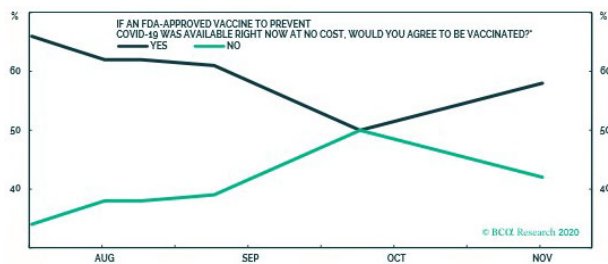


Source: UBS Quant & Strategy

A continued rotation is dependent on several factors:

1. Successful distribution and uptake of a COVID-19 vaccination ending the cycle of lockdowns, reduced activity and travel restrictions.
2. The implementation of the reopening and stimulus, especially in the US, which we believe is now likely.

The vaccine blues



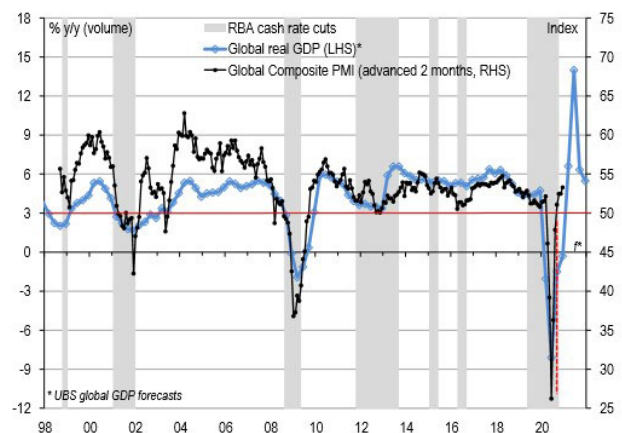
Source: BCA Research

If we return to an improved level of global growth, then finding growing companies will be less difficult. We would expect to see a continued flow into lower PE, cyclically leveraged sectors like resources, financials, discretionary retail and more traditional industrials at the expense of growth-biased health care, technology and defensive consumer stock sectors.

Current economic climate

At present COVID-19 disruption continues, especially in Europe and the US. The economic impact is however being dampened by the substantial stimulus being provided by governments. The manufacturing surveys and real GDP on the following chart shows a V-shaped recovery.

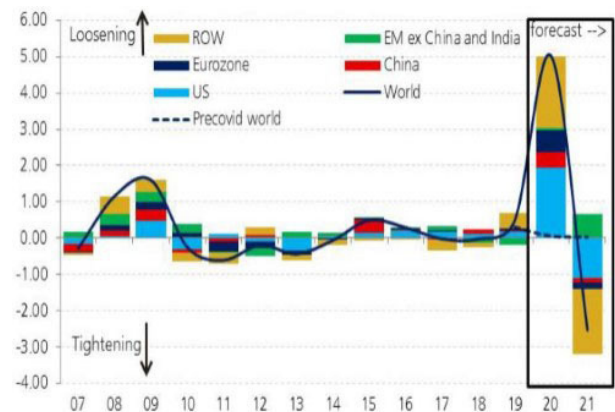
Economic recovery



Source: UBS

This is not something we were expecting some months ago and highlights the amount of money being thrown at the COVID-19 problem. The stimulus is highlighted on the next chart (5% of GDP has been contributed). A key concern for the market has been what happens when this stimulus unravels. Ideally we would like to see it coincide with the reopening of the economy, and in a perfect world, provide an offset. However, in reality populist politics is on the increase and we expect governments to lean towards over-stimulus and run fiscal deficits for some time into the future.

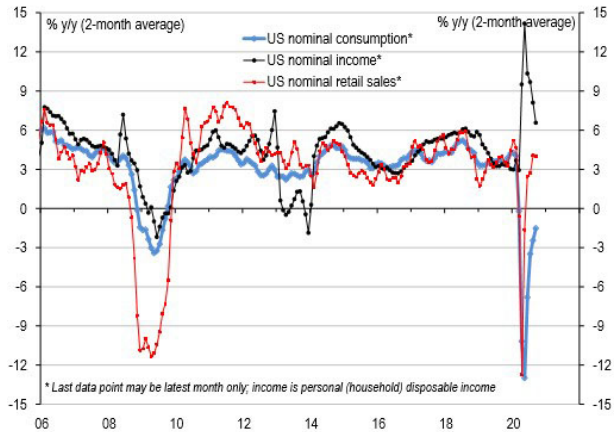
Change in cyclically adjusted primary fiscal balance as % global GDP



Source: UBS

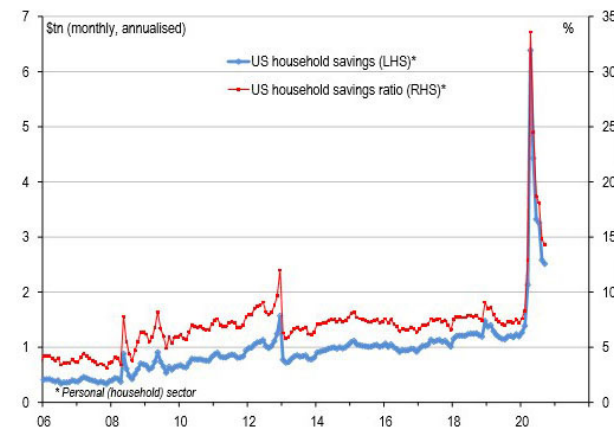
When looking at specific sectors, we note the strength of the consumer across the globe. Savings have accelerated, consumption choices are limited and as a result we are seeing the consumer support the economic recovery via consumption and demand for housing.

US consumer consumption



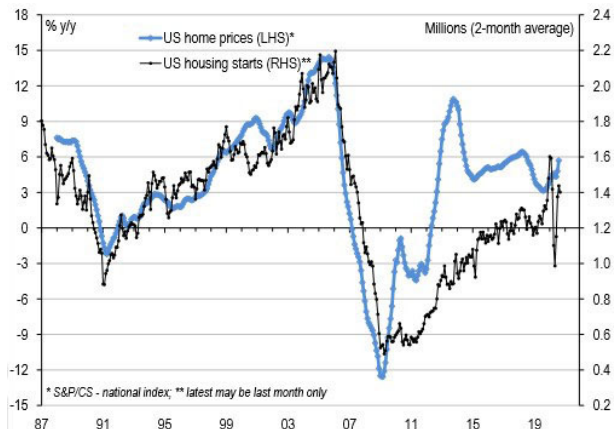
Source: UBS

US household savings



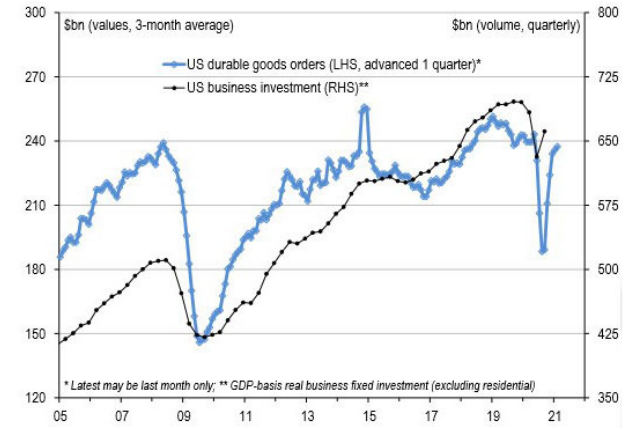
Source: UBS

US demand for housing



Source: UBS

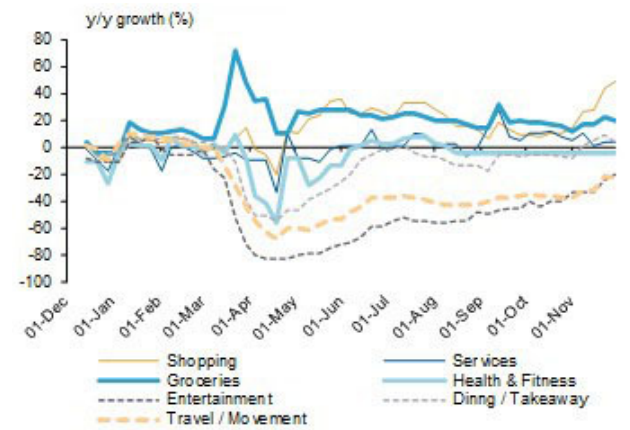
US business demand



Source: UBS

The following chart from Macquarie highlights that despite an improvement in spending on entertainment and travel, spending on shopping remains elevated due to the \$200b saved over the past six months and buoyant consumer confidence.

Consumer spending



Source: Macquarie

Risks

Ability to repay the borrowing

The strength of the economy despite COVID-19 raises the question as to how it will perform as the stimulus is removed. This will be dependent on three factors:

1. How quickly the global economy reopens and how quickly a vaccine will be distributed and taken up.
2. Whether geopolitical trade tensions worsen, dampening growth expectations.
3. Whether governments continue to provide fiscal support.

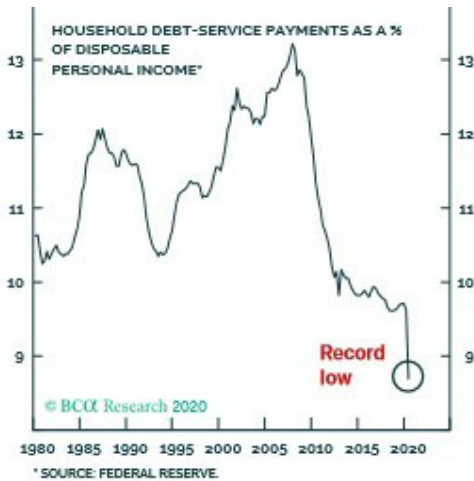
We tend to think governments will continue to provide a significant level of support because:

1. They have spent significant sums of money and will want to see the economy growing before removing support.
2. There is little ideological pushback against governments borrowing more money. This is at

odds with events during the GFC, where excess leverage had caused so many problems and as a result, governments and households were forced to deleverage.

Assisting the push towards higher government debt is very low interest rates. Household debt service payments in the US are at lows.

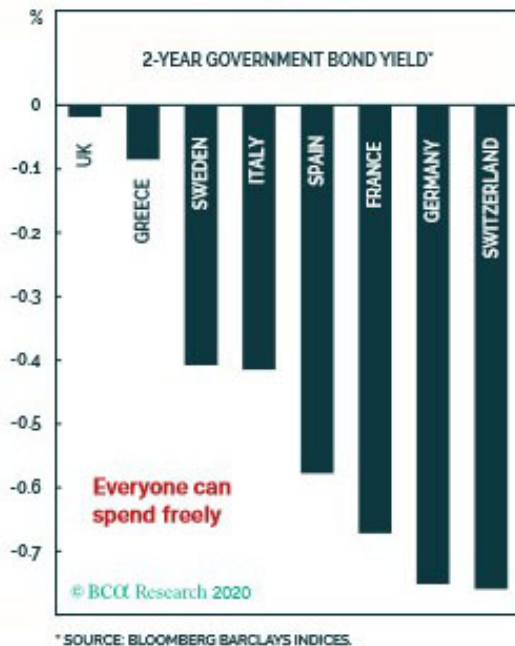
Household debt-service payments as a % of disposable personal income



Source: BCA Research, Federal Reserve

And with negative interest rates in many European countries, there is not much constraint on further borrowing.

Borrowing costs are not a constraint to spending

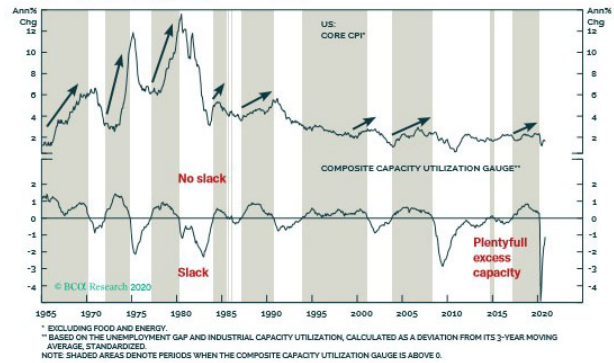


Source: BCA Research, Bloomberg Barclays Indices

Inflation

We do worry about what this will mean over the medium term. A build-up in debt can put the brakes on growth or, if we move further towards modern monetary theory and monetise debt, then it raises the prospect of inflation. Inflation would have major consequences for the types of investments that do well. However, we have just experienced a major deflationary shock and concerns of inflation seem pre-emptive.

Limited immediate inflationary pressures

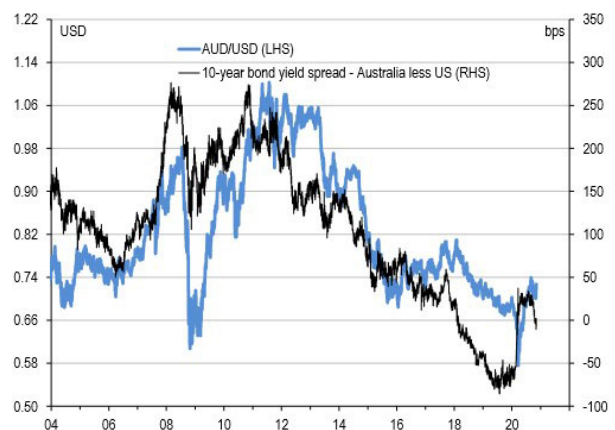


Source: BCA Research

Currency

The RBA is concerned that the Australian dollar will remain uncompetitive compared to other markets. Demand for commodities can potentially drive the currency, but in addition the interest rate differential between Australia and other markets is being monitored by the RBA. As a consequence, there remains some possibility that interest rates will be lowered further to try to avoid the strengthening of our currency.

Currency versus bond yield



Source: Macquarie

Commodity prices versus AUD



Source: Macquarie

China trade disputes – 2020

In May, the Chinese Government imposed 80% tariffs on Australian barley exports. In early November, Chinese importers were told by officials that Australian wine, lobsters, sugar, coal, copper ore, barley and timber exports, worth roughly US\$6b per annum, would be banned from the country. And in late November, the Chinese Government has imposed import taxes of up to 212.1% on Australian wine exports, affecting 39% of Australian wines.

The Chinese Government lists 14 grievances against Australian policy makers to explain its recent actions. According to Chinese Foreign Ministry spokesperson Zhao, the list includes: banning Huawei from the roll-out of 5G over “unfounded” national security concerns; foreign interference laws “viewed as targeting China and in the absence of any evidence”; calls for an inquiry into the origins of the coronavirus (COVID-19) effectively “siding with the US’ anti-China campaign”; speaking out on the South China Sea; speaking out on human rights allegations in Xinjiang; accusing the Government of “peddling lies”; “thinly veiled” allegations against China on cyber-attacks, which Beijing says lacks evidence; and new foreign relations laws which give the Federal Government power to veto state or local government agreements with foreign governments.

Australian exports make up 23.3% of gross domestic product (GDP). On the basis of FY20 data, exports to China make up 35.3% of Australia’s total exports. Excluding iron ore, China’s share declines to 13.3%. If China instantly bans all non-iron ore Australian exports, and Australia is not able to direct its exports elsewhere, nor reduce its imports from China, GDP would fall by 3.1%. We do think many commodities would find another home. The most vulnerable sectors would be tourism and education.

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 – Wesfarmers (WES).
2. Cutting stocks on deteriorating quality grounds – Treasury Wine Estates (TWE).
3. Adding stocks that will benefit from a COVID-19 reopening – BHP Group (BHP).
4. Adding to existing stocks where we have become more bullish regarding the long-term growth opportunity – ALS (ALQ).

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 could create negative implications for stocks and portfolios such as the Chinese asserting their political power.

Stock moves

Purchase of South32 (S32)

S32 operates as a diversified metals and mining company primarily in Australia, South Africa, North America, and South America. The company has a portfolio of assets producing alumina, aluminium, bauxite, energy and metallurgical coal, manganese ore and alloy, ferronickel, silver, lead and zinc.

S32 meets DNR Capital’s five-point quality web:

1. Industry structure: S32 operates across a diversified portfolio of commodities, with strongly positioned assets in the major value drivers of manganese, alumina and aluminium.
2. Earnings strength: The company is forecast to generate over 10% free cash flow yield over the next year, with upside exposure to further strength in underlying commodity prices.
3. Balance sheet: The balance sheet is very strong with a current net cash position. This provides flexibility to continue a buyback of stock as well as looking at developing further growth options in the medium term.

4. Management: We have high regard for the management. Since the demerger from BHP, the company has continued to divest lower returning assets while balancing the allocation of capital between returns to shareholders and future growth projects.
5. Environmental, social and governance (ESG): S32 is currently in the process of divesting the South Africa Energy Coal (SAEC) business which is involved in the mining of energy coal in South Africa. While this will reduce some risk, we acknowledge that mining more generally can have a high environmental impact and S32 has established policies and is well regarded for its strong corporate governance structures.

Key catalysts

Divestment of SAEC business: The divestment of the SAEC business is expected to complete before end of CY20. This will not only simplify the commodity exposure but should also free up capital that can be returned to shareholders or kept on the balance sheet to fund further opportunities.

COVID-19 rebound in commodity prices: S32's commodity mix should be positively exposed to a general rebound in economic activity as the global economy reopens post COVID-19.

Key risks

Commodity prices: Commodity markets can be volatile and S32 is highly leveraged to movements.

Valuation

The share price is trading at a discount to net present value (NPV) using a conservative commodity pricing outlook. The free cash flow yield of over 10% provides further valuation support with upside leverage to any improvement in commodity prices.

Conclusion

We see S32 as offering a diversified exposure to a number of commodities which, at current prices, generate strong cash flows with upside exposure to a rebound in global growth.

Sale of Treasury Wine Estates (TWE)

Following an interim ruling from The Ministry of Commerce of the People's Republic of China (MOFCOM) to apply tariffs of 107–212% to Australian wine imported to China, we have exited our position in TWE. The tariff for TWE is ~169% and at the high end of suggested ranges and our expectations. As a result, China has become a more difficult export market and the reallocation of the China volume is likely to have a detrimental impact to group margins. The industry structure has deteriorated and the outlook for earnings is unclear.

Sale of Ramsay Health Care (RHC)

The position in RHC was exited after a relatively short holding period. The stock was initially acquired during the period of heightened concerns around the impact of COVID-19 on hospital volumes and we participated in the successful capital raising. While we are still optimistic on the return of elective surgery volumes, the stock had rallied to a level where the risk/return trade off was more balanced and we decided to exit the position.

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.

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.

Platform access

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

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