

DNR Capital Australian Equities High Conviction Fund

Performance Report – November 2021

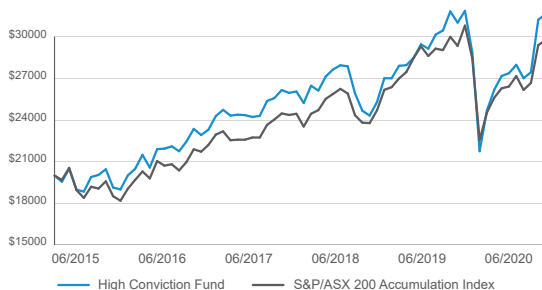
Performance

The S&P/ASX 200 Accumulation Index was down 0.54% during the period.

Materials (+6.2%) was the best performing sector, as tight Chinese economic policy appeared to ease slightly, boosting the outlook for iron ore exports. Communications (+5.2%) also outperformed as companies with defensive earnings were favoured, with Telstra Corporation (TLS +6.5%) in particular, benefitting. Energy (-8.4%) was the worst performing sector, as COVID-19 resurgences dampened the outlook for global growth and politicians called for action to lower cost of oil. Financials (-8.0%) also underperformed with bond rates reversing some of their previous gains and the cyclical outlook turning incrementally less positive.

DNR Capital Australian Equities High Conviction Fund outperformed the Index for the month. Key stock contributors were Commonwealth Bank of Australia (CBA, No Holding), Westpac Banking Corporation (WBC, No Holding) and SEEK (SEEK). Key stock detractors were Fortescue Metals Group (FMG, No Holding), Woodside Petroleum (WPL) and Goodman (GMG, No Holding).

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	4.08	4.63
Macquarie Group	4.05	7.44
National Australia Bank	3.62	8.02
Lendlease	3.56	3.92
Woodside Petroleum	3.00	4.01
SEEK	2.99	3.59
Scentre	2.98	3.76
Aristocrat Leisure	2.97	4.43
Computershare	2.94	3.48
QBE Insurance Group	2.94	3.78

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. 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	+0.20% / -0.20% (effective 3 December 2021)
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 2021

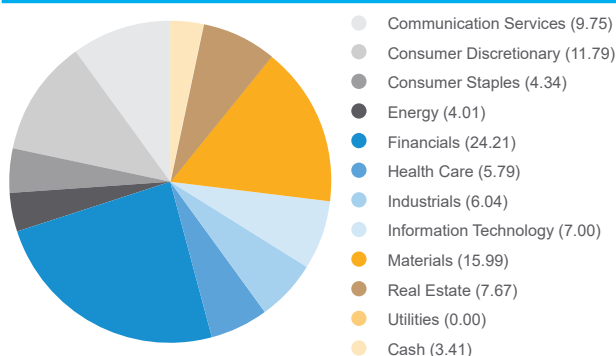
	1mth	3mth	6mth	1yr	3yr	5yr	Incep.*
	%	%	%	% p.a.	% p.a.	% p.a.	% p.a.
High Conviction Fund	0.19	0.46	6.42	23.21	15.97	11.38	10.64
S&P/ASX 200 Accumulation Index	-0.54	-2.48	3.35	15.48	12.56	10.11	8.51
Excess return	0.73	2.94	3.07	7.73	3.41	1.27	2.13

* 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:

- Commonwealth Bank of Australia (CBA, No Holding):** margins were down as competition began to bite in the mortgage market and as a larger proportion of the business is fixed.
- Westpac Banking Corporation (WBC, No Holding):** suffered from a poor result with very soft margins and elevated spending.
- SEEK (SEK):** outperformed the market following the release of a trading update and revised guidance at its annual general meeting. A rapid recovery in job listings and a re-architecting of its pricing structure positioning them well in the medium to long term.

The top stock detractors for the month were:

- Fortescue Metals Group (FMG, No Holding):** bounced over the month as spot iron ore prices stabilized following recent weakness. Concerns remain that Chinese steel production will remain soft, however there were early signs that Chinese policy makers are taking the first step towards trying to stimulate demand.
- Woodside Petroleum (WPL):** despite delivering a final investment decision on its Pluto project the stock fell as oil price retreated. Uncertainty over the BHP deal continues to overhang.
- Goodman (GMG, No Holding):** outperformed during the period, as a softening in bond rates benefitted the company's valuation. GMG benefits from lower interest rates due to its impact on both the valuations of its properties, as well as the built-in margins of its development business. The tightness of the industrial property market also contributed to outperformance as the pandemic boost to ecommerce continues to increase demand for assets.

Market review

The emergence of the Omicron variant during the month took markets by surprise, complicating both the trajectory of the global reopening and expectations for monetary policy adjustments. In reviewing key questions around the latest COVID-19 development, we explore the implications of Federal Reserve Chair Jerome Powell's comments on inflation and tapering. Several important developments in China provides us cautious optimism, which we discuss in context of a volatile property market. In addition, we explore some nascent growth trends providing opportunities to investors.

Omicron variant

Markets justifiably reacted negatively to the announcement of a new COVID-19 variant. In the context of a relentlessly strong year for equities, markets were probably seeking a catalyst for profit taking.



Source: FactSet

At the time of writing little is known about the Omicron variant. Key questions for investors and policy makers include:

- Will existing vaccines be effective and, if not, can timely replacements be developed? Decreased vaccine efficacy yields more symptomatic cases, but not necessarily hospitalisations. Some hope can be drawn from the experience to date. mRNA vaccinations against the original Alpha strain succeeded in protecting individuals from severe disease or hospitalisations from subsequent variants (Beta, Delta), despite significantly lower antibody neutralisation.
- With a heavily mutated spike protein, Omicron is expected to decrease vaccine efficacy against currently available vaccines. What impact will this have on transmissibility and severity?

3. Will policy responses lead to mobility restrictions, reducing aggregate demand and easing inflationary pressures, or will they trigger further supply side destruction, impact supply chains, and stoke further pricing pressure?

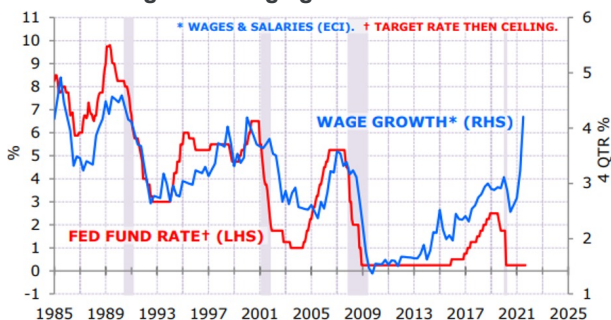
The outlook for markets in the short-term hinges on the answers to these questions, which should become clearer in the coming weeks. If the outcome sees inflationary pressure eased, stimulus can stay stronger for longer, with bond yields remaining subdued, and scarce growth remaining more valuable. Were the variant to prove less severe, the world economy may continue to normalise, enabling central banks to withdraw quantitative easing, potentially catalysing a rotation in the market. The elevated uncertainty, resting on the severity of the new variant, could see a rise in market volatility and present opportunities for investors.

Inflation

The US Federal Reserve (Fed) has described inflation as ‘transitory’ since the start of the year. Powell noted this month that the *“risk of higher inflation has increased”* and *“We now look at an economy that is very strong and inflationary pressures that are very high and that means it’s appropriate for us to discuss at our next meeting — which is in a couple weeks — whether it would be appropriate to wrap up our purchases a few months early.”*

We view this change of language as significant. Discussions with corporates highlight a significant and growing focus on inflationary pressures. We have consistently noted the difficulty companies are experiencing in securing labour, and the upward pressure this placed on wages, as noted below.

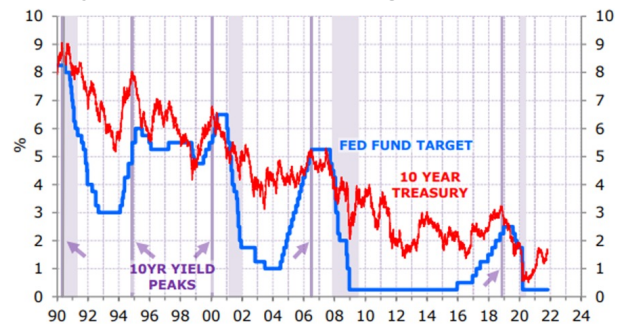
Fed fund target and wage growth



Source: BLS, Federal Reserve, NBER; Minack Advisors

The end of quantitative easing is likely to drive greater volatility in markets and the reaction of the bond market will be telling. Traders have been able to buy bonds knowing the Fed is on the other side, placing downward pressure on yields. As this unwinds, we expect yields to rise, with significant consequences for markets.

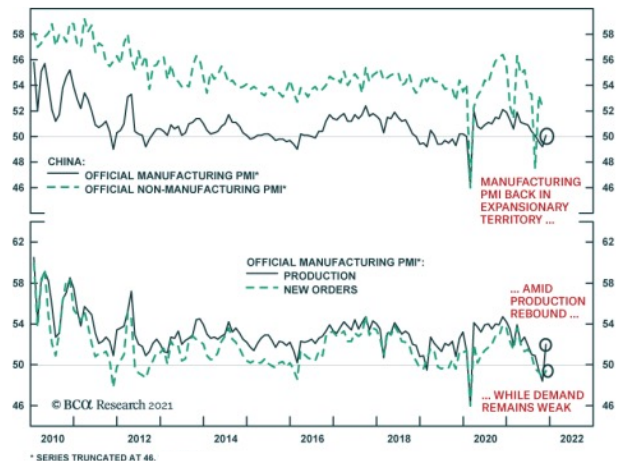
US 10 year bond and Fed funds target



Source: Bloomberg, NBER; Minack Advisors

China

Equity markets received some encouraging news with Chinese manufacturing indices improving during the month, as power shortages eased. Speculation of a renewed policy response to support the property market eased some investor anxiety following weeks of fallout from the giant developer Evergrande’s debt issues.

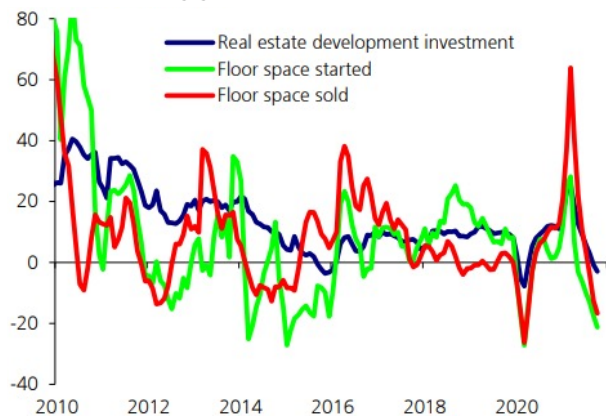


Source: NBS

Regulators have reportedly asked banks to ease restrictions on mortgage lending and to resume issuing loans to developers. In addition to the central bank increasing liquidity, local governments have been drafted in to help suspended property projects resume and prioritise their delivery.

The property market remains fragile. We would expect more support for the industry in the coming months, including easing of mortgage and developer financing, adjustment of land policies, and increased rental construction.

Growth rate (% y/y 3mma)



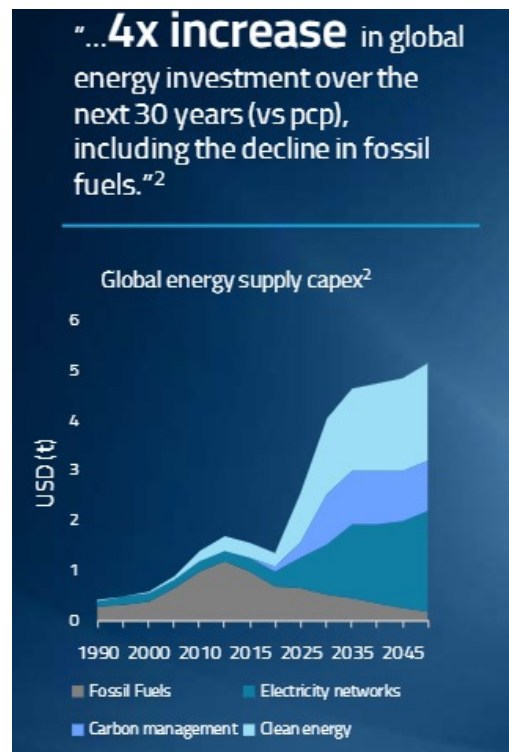
Source: CEIC, UBS estimates

Growth themes

In spite of the market's strong performance, we believe there are always mispriced growth opportunities. Our recent research has focused some underlying growth themes that we believe will drive investment opportunities in the coming years. In discussing some of these emerging trends, we highlight how our portfolios are positioned take advantage of them.

Decarbonisation

Following the COP26 UN Climate Change Conference (Glasgow), momentum continues to build for reducing carbon across the economy. Long-term opportunities exist for a range of companies exposed to this trend. Recent management discussions with contractor Worley (WOR), highlighted the scale of investment required to transition the world to net-zero carbon. This involves a substantial level of commodities, labour and capital to facilitate the goal. National Australia Bank (NAB) have highlighted initiatives to accelerate renewable project financing, in part offsetting their financing of fossil fuels. ALS (ALQ), a leader in testing, measuring and inspection, are well positioned to leverage this theme. Relevant activities include evaluating exploration samples necessary to support the copper expansion, soil testing for major renewable projects and assessing a corporate's carbon footprint.



Source: Worley

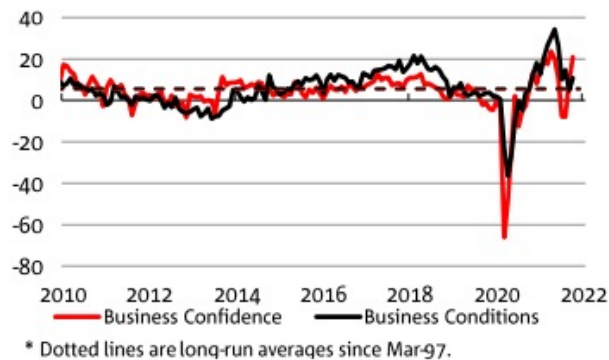
Digitisation

Digitisation is a well-established thematic that is still evolving. Alongside the explosion in new technology businesses, traditional companies are seeking to reduce costs by investing in digitisation and automating. Successfully deploying technology solutions to replace manual operations both supports margins and provides competitive advantages. This is well illustrated in home mortgage market where accelerated capex on systems has yielded lower loan approval times for Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Macquarie Group (MQG), over Westpac Banking Corporation (WBC) and ANZ Banking Group (ANZ). As labour markets have tightened and offshored administration teams struggle with mobility restrictions, processing of mortgage applications has become more challenging. Prescient investments in flexible and automated platforms have led to market share gains while saving on staffing costs.

Beyond retailers simply launching online stores to compliment bricks and mortar networks, many companies are succeeding in porting their products and services online. Aristocrat Leisure's (ALL) evolving digital strategy is a prime example of leveraging existing IP from traditional use cases to new online opportunities. Having acquired a portfolio of related gaming businesses, the group is pushing its best in class gaming products and development from land based into digital assets, broadening its customer base and global footprint.

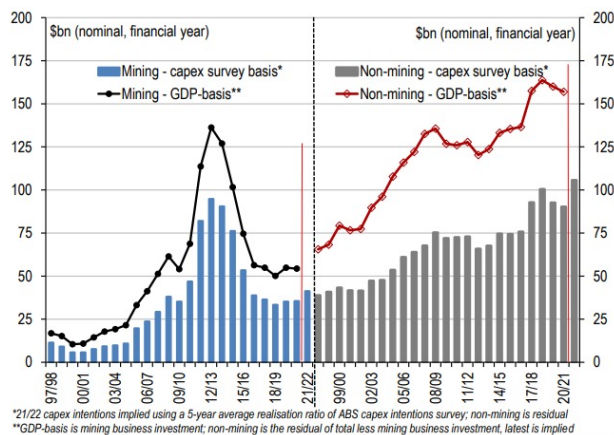
Business spending

Business confidence is elevated, and capex intentions are much higher than recent history.



Source: UBS

Despite strong demand for goods and services in the economy, businesses have been reluctant to invest in real world capacity over the past two years, as the effects of COVID-19 were uncertain. As demand has remained resilient, we now see strong evidence of businesses committed to allocating capital to increasing capacity.



Source: ABS, UBS, Macrobond

Supported by robust balance sheets, banks are showing willingness to support business in their endeavours, with data pointing to strong lending growth. Investing to upgrade plant and equipment, build new factories and warehouses and to implement new systems creates growth opportunities for both the providers of capital goods and their credit providers. Given its existing expertise, relationships and greater focus on business banking, we see NAB as well positioned to take advantage of growing business confidence and financing.

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 Insurance Group (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.

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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