DNR Capital Australian Equities High Conviction Fund

Performance Report – January 2022

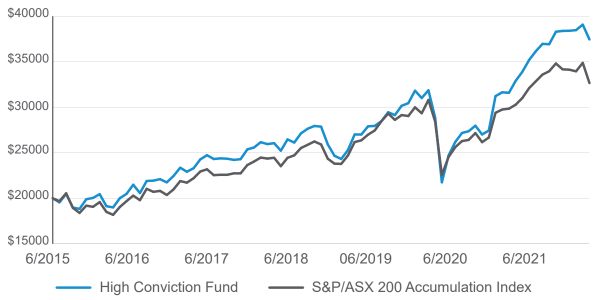
Performance

The S&P/ASX 200 Accumulation Index was down 6.35% during the period.

Energy (+7.9%) was the best performing sector, as oil and gas prices continued to climb and quarterly production reports from Woodside Petroleum (WPL +14.3%) and Santos (STO +13.1%) beat expectations. Utilities (+2.6%) also outperformed as Origin Energy (ORG +7.2%) similarly benefitted from record gas prices. Information Technology (-18.4%) was the worst performing sector, continuing the bond-yield-induced rout of high valuation names across global markets. Healthcare (-12.1%) also underperformed, with the more speculative healthcare stocks facing the worst of the sell off.

DNR Capital Australian Equities High Conviction Fund outperformed the Index for the month. Key stock contributors were Woodside Petroleum (WPL), BHP Group (BHP) and Virgin Money UK (VUK). Key stock detractors were James Hardie Industries (JHX), Santos (STO, No Holding), and Macquarie Group (MQG).

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	4.79
Macquarie Group	3.95	7.09
National Australia Bank	3.84	8.15
Woodside Petroleum	3.63	4.79
Lendlease	3.39	3.72
Aristocrat Leisure	3.30	4.58
Computershare	3.10	3.63
QBE Insurance Group	3.01	3.79
Suncorp Group	2.93	3.61
Scentre	2.91	3.63

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%
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 January 2022

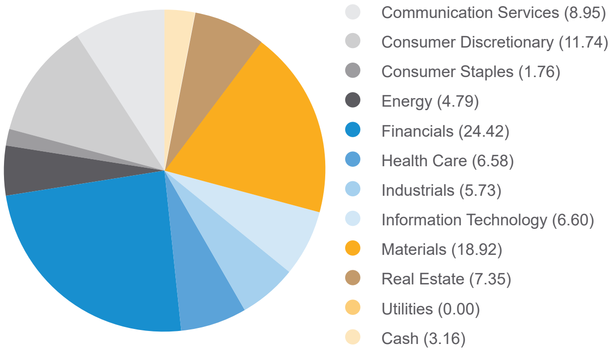
	1mth %	3mth %	6mth %	1yr % p.a.	3yr % p.a.	5yr % p.a.	Incep.* % p.a.
High Conviction Fund	-4.16	-2.48	1.42	18.54	13.97	10.32	9.90
S&P/ASX 200 Accumulation Index	-6.35	-4.30	-3.81	9.44	9.77	8.50	7.66
Excess return	**2.19**	**1.82**	**5.23**	**9.10**	**4.20**	**1.82**	**2.24**

** 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):** outperformed during the period, following a strong rally in the oil price and a solid quarterly update. Energy prices continue to rise as pandemic-impacted supply has failed to recover due to geopolitical impacts and environmental pressures. WPL reported sales above expectations in the quarter, largely due to their spot price exposure to LNG, which reached record highs in the month.
- **BHP Group (BHP):** rallied over the month as iron ore prices rebounded strongly after significant falls in the second half of calendar 2021. Quarterly supply updates have highlighted the difficulties in ramping up production given supply chain and COVID-19 related issues.
- **Virgin Money UK (VUK):** expectations regarding interest rate rises in the UK resulted in increased interest in value financials.

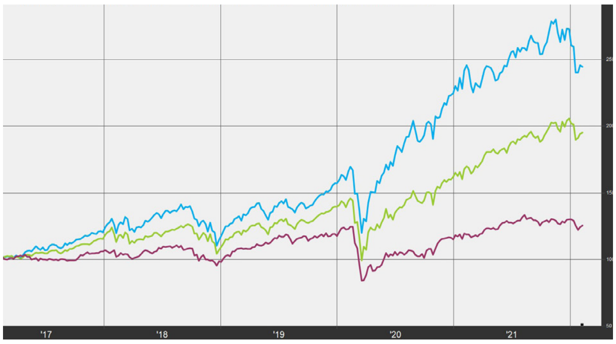
The top stock detractors for the month were:

- **James Hardie Industries (JHX):** a change in leadership and an increase in interest rates raising fears of a slowdown in housing caused JHX to fall.
- **Santos (STO, No Holding):** outperformed during the period, following a strong rally in the oil price and a solid quarterly update. Energy prices continue to rise as pandemic-impacted supply has failed to recover due to geopolitical impacts and environmental pressures. STO reported sales above expectations in the quarter, largely due to their spot price exposure to LNG, which reached record highs in the month.
- **Macquarie Group (MQG):** a pullback in markets caused the higher beta MQG to pullback despite strong fundamentals.

Market review

The market has experienced a decent pullback to start the year with the Nasdaq experiencing the sharpest falls. We discuss the reasons for this and whether investors should be thinking about 'buying the dip'.

Major indices



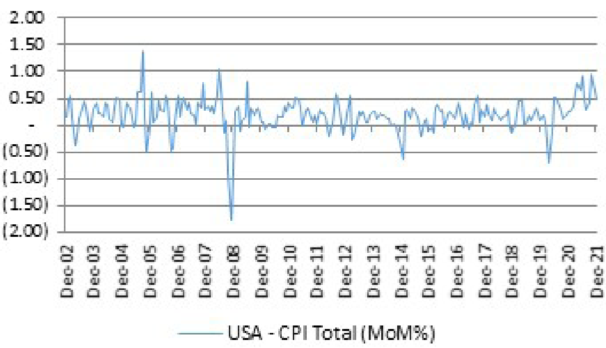
Source: Factset

A number of factors are driving the market at present such as geopolitical tensions with Ukraine and the Omicron variant. However the primary reason for the fall has been the rise in inflation expectations and a change in language from the US Federal Reserve (Fed).

As can be seen in the chart below inflation has risen strongly due to supply constraints and strong fiscal stimulus. The debate around transitory inflation has been put to bed. The Fed is clearly indicating they will seek to raise interest rates.

"with inflation well above 2% and a strong labor market, the Committee expects it will soon be appropriate to raise the target range for the federal funds rate."

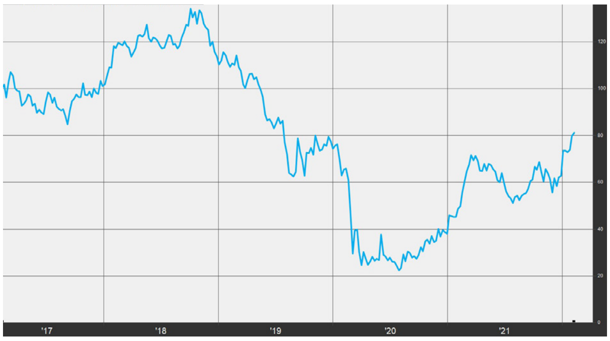
US – CPI (MoM%)



Source: Factset

This change in stance has been reflected in a change in bond yields.

US 10 year bonds



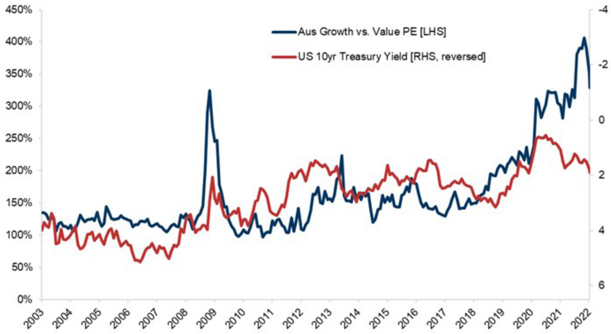
Source: Factset

There are a number of consequences due to this change in stance.

Growth versus value

There has been a strong correlation between the strong performance of growth stocks relative to value stocks and low interest rates. As can be seen in the chart below the change in yields has not been accompanied by a change in the relative winners in the market (until the past month).

Australia growth/value fwd 12mth PE premium vs US 10yr Treasury yield



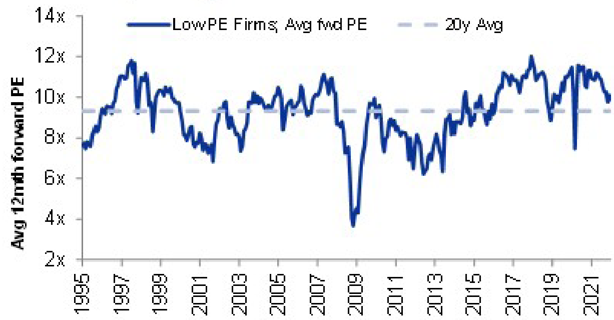
Source: Goldman Sachs, Factset

An alternative way of looking at this is to compare the valuation of growth stocks compared to value stocks. As we have previously discussed interest rates and inflation expectations have been one of the drivers of the outperformance. There has also been a range of structural drivers.

High PE firms trade at an average forward PE of 43.2x, which is 75% above the 20yr average

Source: Goldman Sachs, Factset

Low PE firms trade at an average forward PE of 9.9x, which is 6% above the 20yr average.



Source: Goldman Sachs, Factset

The question is whether this change of stance has pricked the bubble in high growth stocks?

Certainly there has been excessive speculative heat in markets as evidenced by the following:

- Gamestop. The rally in this low quality company in a declining industry was driven by social media speculation causing a massive rally of 120x.
- Dogecoin. This cryptocurrency rallied $90b due to Elon Musk jokes.
- Hertz rallied 3x because they were going to buy some electric vehicles.

The last six months have seen a sell off in unprofitable companies and more than one-third of all Nasdaq stocks are now all down more than 50% from their highs.

The sell off in these lower quality, speculative companies is now starting to bleed into other segments and historically when the price earnings (PE) premium begins to unravel it can continue to fall until it reaches a compelling level. Patience will be rewarded as the Fed is no longer a backstop. That is the Fed will not be looking to save markets by lowering interest rates or lifting quantitative easing. Furthermore, it is doubtful governments will be lifting fiscal stimulus in the face of political pressure on inflation. Nonetheless, opportunities will be provided to buy good businesses that become caught up in the sell off albeit being selective and avoiding those companies that have been overearning.

Impact on growth

Higher interest rates kill cycles and the market has begun worrying that future higher interest rates will hurt the economy. Sentiment regarding interest rates has deteriorated just as the economy becomes incrementally softer following a very strong period. Weakness associated with a disrupted supply chain and Omicron driven instability has fed into this sentiment.

US business confidence (PMI)

Source: Factset

We think it is unusual to start worrying about the Fed making a policy mistake and ending the cycle before they have even undertaken the first rate rise. Once more certainty exists regarding the Fed policies, and assuming the current Omicron/Ukraine situations do not deteriorate, we anticipate cyclical sectors will enjoy a bounce. We are observing several buying opportunities emerging in select companies.

Conclusion

The pullback in the market looks like a typical correction. Excess valuations are unravelling and this leads to cautiousness among some of the higher growth / speculative parts of the market. Softness associated with a slowdown in the economy is potentially overdone. We have been talking to the risks posed by higher inflation for some time and have positioned in a range of companies which do well in a higher inflation environment. This is offering some relative protection. Volatility often presents stock picking opportunities, and we will continue to seek quality companies when we identify mispriced opportunities

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, regional tensions with China and instability in Eastern Europe 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 report for the month.

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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Office address
Level 23
307 Queen Street
Brisbane QLD 4000

Postal address
GPO Box 3263
Brisbane QLD 4001

Telephone
07 3229 5531

Email
info@dnrcapital.com.au

Website
www.dnrcapital.com.au