

DNR Capital Australian Equities High Conviction Fund

Performance Report – March 2022

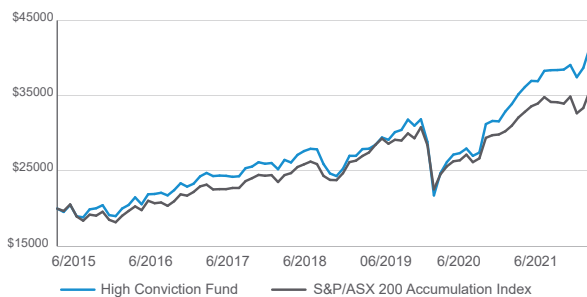
Performance

The S&P/ASX 200 Accumulation Index was up 6.89% during the period.

Information Technology (+13.2%) was the best performing sector, with key constituents Wisetech (WTC +17.2%), Computershare (CPU +14.0%) and Xero (XRO +9.6%) all stronger. Energy (+9.6%) also outperformed as global energy shortages remain, exacerbated by the war in Ukraine and its ramifications for Russian oil and gas exports. A-REITs (+1.2%) were the worst performing sector, as bonds sold off sharply during the month, increasing funding costs and discount rates. Health Care (+1.9%) also underperformed, with COVID-19 beneficiaries Fisher & Paykel Healthcare (FPH -12.5%) and Resmed (RMD -2.9%) pulling the sector down.

DNR Capital Australian Equities High Conviction Fund outperformed the Index for the month. Key stock contributors were Woodside Petroleum (WPL), National Australia Bank (NAB) and Computershare (CPU). Key stock detractors were Commonwealth Bank of Australia (CBA, No Holding), Aristocrat Leisure (ALL), and Scentre (SCG).

Growth of \$20,000 since inception



Source: Mainstream Fund Services and DNR Capital

Top 10 active holdings

Security details	Active weight %	Actual weight %
National Australia Bank	4.58	9.31
Tabcorp Holdings	4.16	4.69
Lendlease	3.67	4.02
Woodside Petroleum	3.66	5.08
Macquarie Group	3.17	6.50
Computershare	3.05	3.69
QBE Insurance Group	2.98	3.75
Aristocrat Leisure	2.93	4.05
Scentre	2.79	3.51
SEEK	2.77	3.25

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%p.a. (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 March 2022

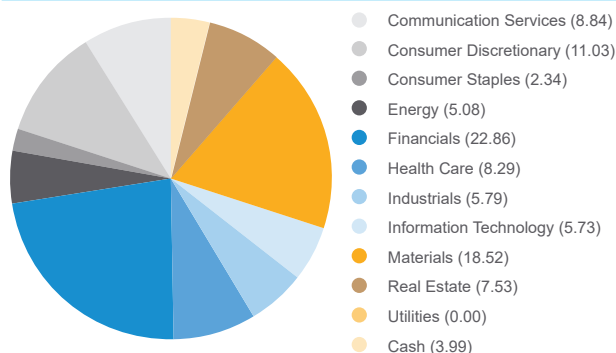
	1mth	3mth	6mth	1yr	3yr	5yr	Incep.*
	%	%	%	% p.a.	% p.a.	% p.a.	% p.a.
High Conviction Fund	7.08	6.00	7.91	22.21	15.32	11.28	11.30
S&P/ASX 200 Accumulation Index	6.89	2.24	4.38	14.97	10.59	9.22	8.87
Excess return	0.19	3.76	3.53	7.24	4.73	2.06	2.43

* 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 on the back of higher oil and gas prices. An emerging global energy shortage has been exacerbated by the invasion of Ukraine, with implicit and explicit sanctions on Russia restricting supply into an already tight market. Many LNG shipments previously destined for Asia are being re-routed towards Europe at higher prices to plug the Russian gap.
- National Australia Bank (NAB):** bounced with expectations that the yield curve is helpful for earnings. NAB continues to win share versus other majors.
- Computershare (CPU):** expectations of higher interest rates are fuelling interest in the company given a 100bp move in rates enhanced profits by 50%.

The top stock detractors for the month were:

- Commonwealth Bank of Australia (CBA, No Holding):** bounced with expectations that the yield curve is helpful for earnings. We also saw foreign investors deploying into Australia with CBA likely being a beneficiary of this flow of money.
- Aristocrat Leisure (ALL):** declined with a slowdown in digital games revenues possibly impacted by the fact it has had a range of developers in the Ukraine unable to support the games.
- Scentre (SCG):** was a detractor in March as property generally underperformed. A sharp increase in bond yields weighed heavily on bond-proxies (including REITs) as it impacts both the cost of funding and future capitalisation rate expectations. SCG was weaker than peers following a strong full-year result in February.

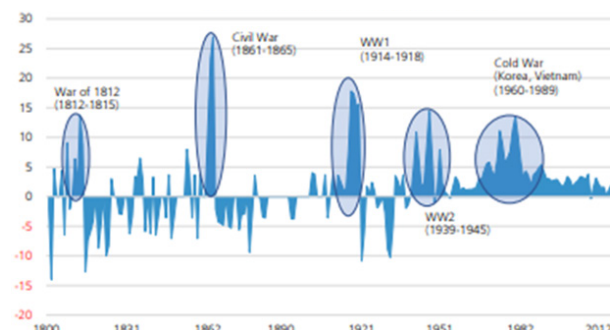
Market review

This month we continue to discuss the implications of the conflict in Ukraine given our increasing concerns regarding its impact on the global economy particularly with respect to globalisation and inflation.

Ukraine conflict

As the horrific toll of the war in Ukraine continues to be revealed, opposition to the Russian regime hardens and this continues to drive a range of long term consequences. War is historically inflationary as capacity is taken out of the global economy. In this case we have seen commodity prices rise as Russian commodities struggle to find a new home. At the same time, re-armament fuels further demand as does the drive to improve security of supply.

US CPI annual percentage change (rate of inflation)

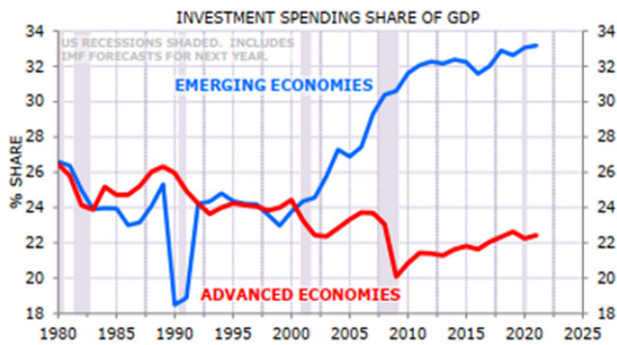


Source: UBS, www.minneapolisfed.org

Globalisation

One of the more significant implications of the war is the impact on globalisation. Globalisation over the past few decades has been one of the key benefits of the end of the cold war and the opening up of China. It has been a key contributor to reducing inflation with manufacturing shifting to developing economies such as China. This improved living standards and ensured consumers in Western economies had access to cheaper goods resulting in lower inflation. Investment spending has remained elevated in emerging economies relative to developed economies as a result. Greater economic integration reduces global inequality between nations and was seen as a result to reduce potential conflict.

Globalisation transferred investment from DM



Source: IMF, MBER, Minack Advisors

However, as nations increasingly seek to leverage their economic power this perceived advantage is deteriorating. For example, Russia’s strong position with respect to gas has no doubt emboldened its ambitions. This is leading to a rapid reappraisal of the importance of security regarding the supply of strategically important goods. This is a concern that was already at the forefront of minds following the disruption to supply chains caused by COVID-19.

Furthermore, the rise of inequality in the West as lower income jobs were transferred to emerging nations has been causing greater political tensions for some time. So a step away from globalisation can potentially improve security of supply, with the political benefits of greater jobs (and wages) for low income workers. There is a cost however, and it is large, being rising inflation and the potential increased risk of global conflict.

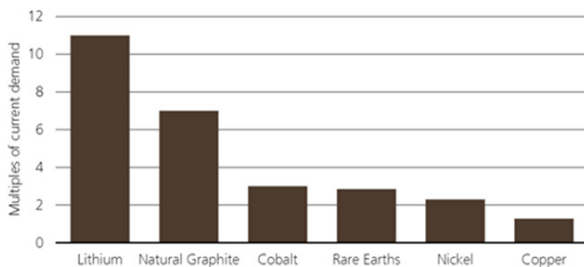
Sustained commodity prices

Commodity prices have enjoyed a very strong run which look more sustainable than usual. We see higher demand meeting disrupted supply and underinvestment meaning a period of higher prices are needed to stimulate activity.

Demand drivers include:

- 1. Energy transition.** Electric vehicles are expected to be 50% of sales by 2030, utilities are transitioning to renewables and corporates are focused on transitioning to net zero carbon. The result is substantial demand for commodities.

Estimated demand through to 2030



Source: UBS estimates

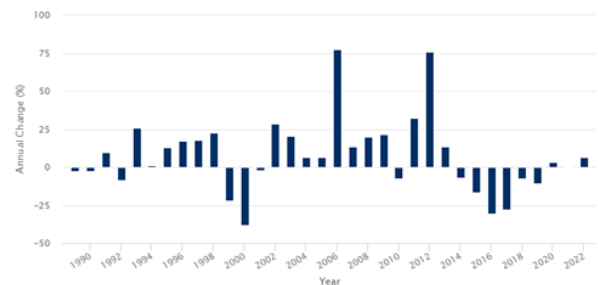
- 2. Re-armament.** A move towards re-armament and the preparedness of governments to run deficits to support it promises to drive further demand.
- 3. Infrastructure build.** Post COVID-19 infrastructure continues to be built out.

- 4. Europe needs to replace Russian supply of many commodities but especially gas.** Despite the move towards renewables, storage remains a problem and secure base load energy is essential for industry and communities. Europe is building LNG terminals and other infrastructure to offset the Russian capacity taken out.
- 5. China stimulus.** The Chinese economy has remained subdued, impacted by the harsher lockdowns during COVID-19 and by government actions to subdue the property market. Recent activity suggests they are seeking to provide greater stimulus to support the economy.

Supply remains constrained with a number of drivers influencing this including:

1. A decade of under investment.

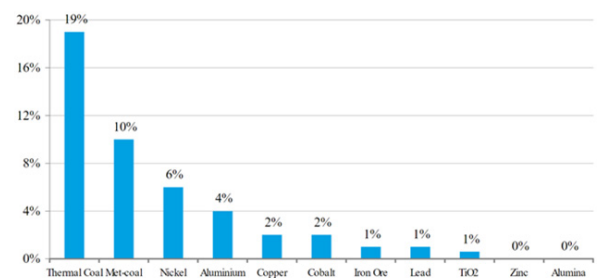
Actual Capital Expenditure on Mining (Annual Change)



Source: IBES estimates

2. Russian exports struggling to find markets. Over time we expect some of the Russian commodities will find homes in China and other markets but new supply chains need to be built. Furthermore, future supply in Russia will struggle to be built with sanctions limiting the supply of key equipment, and intellectual knowhow provided by Western consultants.

Russia’s exports as a share of global demand ex-Russia



Source: Morgan Stanley

3. Environmental, Social and Governance (ESG) pressures and regulation provide further constraints on the emergence of new supply. The flow of capital into oil and gas has been constrained which means the required cost of capital necessary to stimulate new activity is higher.

Parallels with the 1970's

It is hard not see the parallels with the 1970's. In that decade oil price shocks were caused by Middle Eastern countries embargoing oil exports to the West as punishment for supporting Israel in Yom Kippur war. Energy prices fed into consumer prices, higher wage demands and spiralling inflation. There is much less reliance on oil now, but greater reliance on natural gas. There is less unionised labour, a greater ability to leverage technology and higher consumer debt so we would be reluctant to assume the decade plays out precisely as the 1970's did but nonetheless it is instructive.

Sector performance in the 1970's was led, not surprisingly, by energy and materials with the consumer being squeezed out as a greater proportion of money was spent on necessary items such as oil and utilities.

Sector performances in 1970s

Sector	Performance (%)
Energy	142%
Industrials	28%
Materials	22%
Financials	-9%
IT	-11%
Telecoms	-11%
Healthcare	-16%
Staples	-24%
Utilities	-29%
Discretionary	-42%
Market	-2%

Source: Bloomberg Finance L.P., Datastream, J.P. Morgan, Greyed portion in tables above is for MSCI Europe

Australia is the lucky country

Australia is well positioned relative to other developed world economies given that the demand for resources benefits Australia through the Terms of Trade (TOT). Rising TOT enable Australia to purchase more imports for a given quantity of exports, thereby increasing domestic real income. This supports employment, government revenues and increased shareholder profits.



Source: Jarden

Outlook

The outlook for equities is more challenging than it has been for some time. The end of quantitative easing, higher interest rates and rising inflation increases the risks for investors. Australia, however, looks relatively well placed given its ability to supply commodities from a politically secure environment.

Fund positioning

Focused on identifying strong bottom-up investment opportunities in an environment of higher inflation, higher bond yields and an ongoing recovery from COVID-19:

- Positive on **diversified quality mining** companies generating strong cash flows.
- Positive on **high quality industry leaders** with strong pricing power to offset inflation.
- Adding to **domestic defensive exposures** given relative outlook for domestic economy.
- **Overweight financials with leverage to higher rates** but underweight banks (given they have recession risk).
- **Disciplined on valuations**, especially longer duration stocks where valuations are highly sensitive to interest rates changes.
- **Cautious on low quality/negative cash flow** companies where higher interest rates will expose excessive risk taking.
- **Cautious on** companies that have experienced significant over consumption during COVID-19.
- **Positive on** companies that have been under-earning due to COVID-19 restrictions.

Key risks

Key risks to the Fund include:

- **Political environment.** The crisis in Ukraine and sanctions against Russia are severely impacting commodities markets, with the potential to destabilise the region and cause global inflationary shocks. Regional tensions with China also continue to pose risks to trade.
- **COVID-19 disruption.** The development of vaccine-resistant COVID-19 variants or sustained supply chain impacts still poses risks, especially with government support mostly withdrawn.
- **Interest rates.** Low interest rates have been a primary driver of markets over the past few years. With markets now pricing monetary tightening, changes to this trajectory or further inflationary shocks would have a significant impact on valuations.
- **Global growth.** Sanctions against Russia are driving up energy prices and creating global energy security concerns. Historically, sustained price shocks in oil have impacted global growth and catalysed recessions.

Stock moves

Sale of Virgin Money UK (VUK)

We have exited our position in VUK due to the increased risk of a recession in Europe resulting from the impact of the Russia invasion of Ukraine and specifically higher energy prices. The UK economy is likely to be negatively impacted by a slowdown in Europe resulting in higher bad debts. We have deployed the proceeds across other existing positions in the portfolio that have better resiliency characteristics and where risk / return metrics are more favourable.

Sale of Xero (XRO)

We have exited our remaining position in XRO after assessing the prospect for slowing subscription growth in key markets, and in context of a stretched valuation. Whilst XRO remains a high quality business with a large addressable market, customer acquisition costs are likely to grow, while churn is set to normalise upwards. With several opportunities available within the portfolio, we have deployed the proceeds across favourably valued holdings.

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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