

# DNR Capital Australian Equities High Conviction Fund

## Performance Report – June 2022

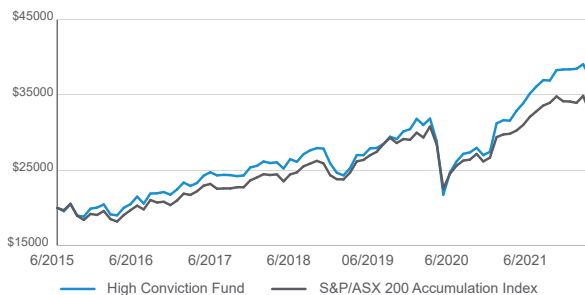
### Performance

The S&P/ASX 200 Accumulation Index was down 8.77% during the period.

Consumer Staples (+0.2%) was the best performing sector, with retailers Woolworths Group (WOW +2.7%), Coles Group (COL +1.6%) and Endeavour Group (EDV +4.3%) favoured for defensive characteristics in a potential recessionary scenario. Energy (-0.3%) also outperformed, with the successful merger of Woodside Petroleum (WPL) and BHP Petroleum creating immediate value in the new Woodside Energy Group (WDS +7.0%). Materials (-12.4%) was the worst performing sector, with fears of a recession taking a toll on commodity names, including the big iron ore miners (BHP -7.5%, RIO -10.3%, FMG -12.8%). Financials (-11.9%) also underperformed, with sensitivity to lower economic growth causing stocks in the sector to trade down.

The DNR Capital Australian Equities High Conviction Fund outperformed the Index for the month. Key stock contributors were Woodside Energy Group (WDS), Computershare (CPU) and Commonwealth Bank of Australia (CBA, No Holding). Key stock detractors were South32 (S32), Lendlease (LLC) and Woolworths Group (WOW, 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 %
Woodside Energy Group	4.26	7.37
The Lottery Corporation	3.60	4.11
National Australia Bank	3.43	7.99
Computershare	3.17	3.89
Lendlease	3.13	3.46
CSL	3.13	9.77
Aristocrat Leisure	3.08	4.27
QBE Insurance Group	3.01	3.94
Seek	2.69	3.07
Scentre Group	2.62	3.32

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 30 June 2022

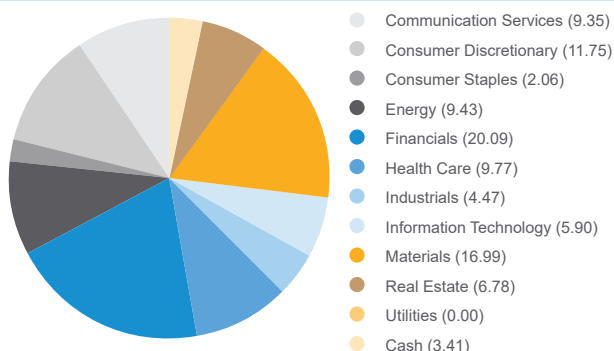
	1mth	3mth	6mth	1yr	3yr	5yr	Incep.*
	%	%	%	%	% p.a.	% p.a.	% p.a.
High Conviction Fund	-4.83	-7.75	-2.22	3.37	10.29	9.40	9.61
S&P/ASX 200 Accumulation Index	-8.77	-11.90	-9.93	-6.47	3.34	6.83	6.61
<b>Excess return</b>	<b>3.94</b>	<b>4.15</b>	<b>7.71</b>	<b>9.84</b>	<b>6.95</b>	<b>2.57</b>	<b>3.00</b>

\* 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 Energy Group (WDS):** outperformed during the month, following continued turmoil in global energy markets. Underinvestment in the supply of fossil fuels combined with the severe disruptions caused by Russian sanctions has seen significant appreciation in energy prices. Despite the higher prices, fossil fuels capital expenditure intentions among energy companies remains low, underpinning an elongated period of undersupply going forward.
- Computershare (CPU):** outperformed during the month as a 1% increase in interest rates boost profits by 50%. The market has begun to accept higher rates for longer.
- Commonwealth Bank of Australia (CBA, No Holding):** pullback as the market begins to fear a slowdown in housing.

The top stock detractors for the month were:

- South32 (S32):** underperformed over the month. Spot prices for S32's commodity mix were weaker over the month on concerns that tightening monetary policy will lead to a material economic slowdown.
- Lendlease (LLC):** underperformed during the month as the outlook for higher rates weighed on the property sector generally. Management continues to make incremental progress towards their stated 2024 return targets with a sharpened focus on executing the existing development backlog of over \$100b.
- Woolworths Group (WOW, No Holding):** outperformed in-line with broader food retail stocks during the period, with food inflation trends underpinning sales growth. Metcash's full year earnings highlighted ongoing strong sales and price increases underpinning margins. WOW valuation remains unresponsive however, with earnings risk from rising costs potentially underappreciated.

### Market review

#### Market wrap

The market has suffered this year on the back of higher inflation, interest rates and the war in Ukraine. We provide an update on our thinking which continues to evolve during this period.

#### Inflation

In the midst of high inflation, Jerome Powell, Chair of the US Federal Reserve (Fed) has recommitted to fighting inflation, lifting rates by 0.75% and commenting that "we are strongly committed to bringing inflation back down, and we're moving expeditiously to do so".

Inflation has been sharply higher this year with supply chain disruptions, higher commodity prices and a tight labour market all contributing. Our discussions with US operating companies, including portfolio holding Computershare, highlight that wage increases of 6-8% have been necessary to retain labour and the impact of how interest rate rises will be working through the economy over the course of the year. We have also noted in recent reports the requirement to prioritise security of supply over efficiency. This means we are observing the beginning of a structural trend to invest closer to home at higher cost. In addition, the cost of energy continues to rise and environmental concerns are being prioritised over the lower cost of energy supply.

#### US: trimmed mean PCE inflation\*

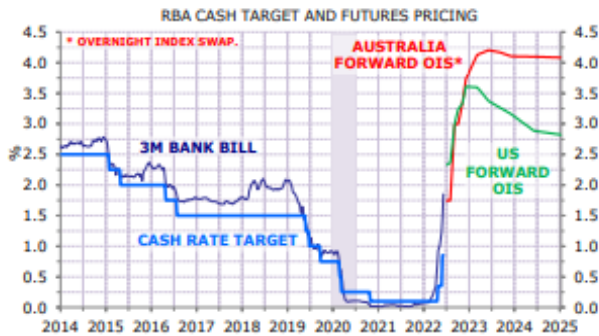


\*6-month annualised rate. Source: Federal Reserve Bank of Dallas

### Interest rate expectations

In response to the more aggressive actions by central banks, markets are anticipating sharply higher interest rates. Somewhat surprisingly, the Australian market has priced in more aggressive rate rises than the US. We find this very unlikely given higher level of consumer debt in Australia relative to the US.

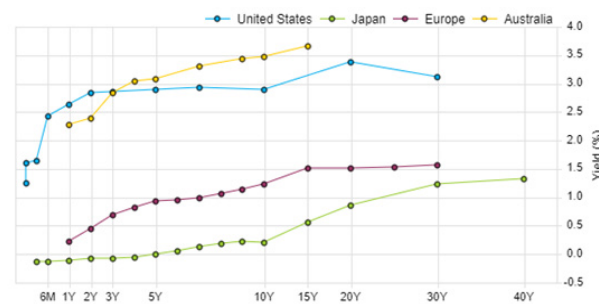
#### Markets expect RBA to out-hawk the Fed



Source: RBA, Bloomberg; Minack Advisors

Longer term we have seen bond market yields begin to flatten a little as markets become concerned regarding the ability of the economy to handle higher rates. The Fed is seeking to dampen demand to slow the economy. We wonder whether the Fed will remain committed to this goal in the face of likely political pressure as job losses mount. However the Fed will also be well aware of the policy mistakes made in the 1970's when the Fed cut rates as the economy faulted, thereby embedding inflation. There is no doubt they will be keen to avoid this mistake again. It will be a very narrow path to walk for central banks with ample room for policy mistakes but at this point Chair Powell appears committed to addressing inflation.

### Bond yields

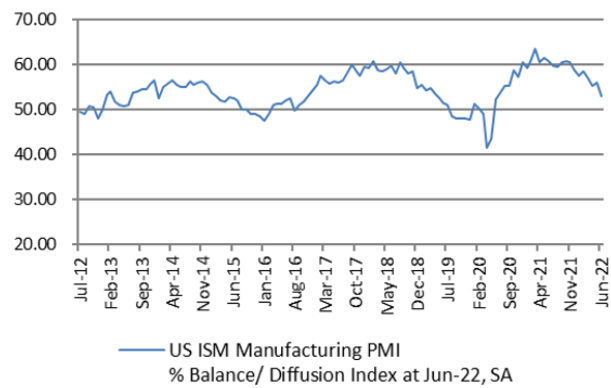


Source: Factset

### Economic outlook

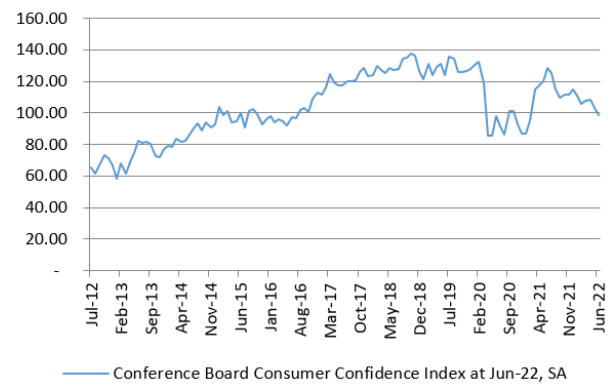
The economy has been holding up reasonably well at this point, however we anticipate the economy will begin to respond to higher interest rates and inflation. Consumer confidence has taken a decent hit and yet consumer spending remains reasonably strong given elevated levels of savings. Business confidence remains solid but is beginning to slow and the unemployment rate remains low but perhaps this too is at a bottom.

#### US business confidence (PMI)



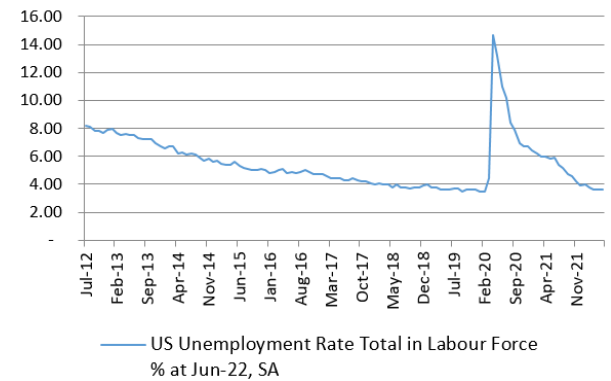
Source: DNR Capital, Factset

#### US consumer confidence



Source: DNR Capital, Factset

#### US unemployment rate

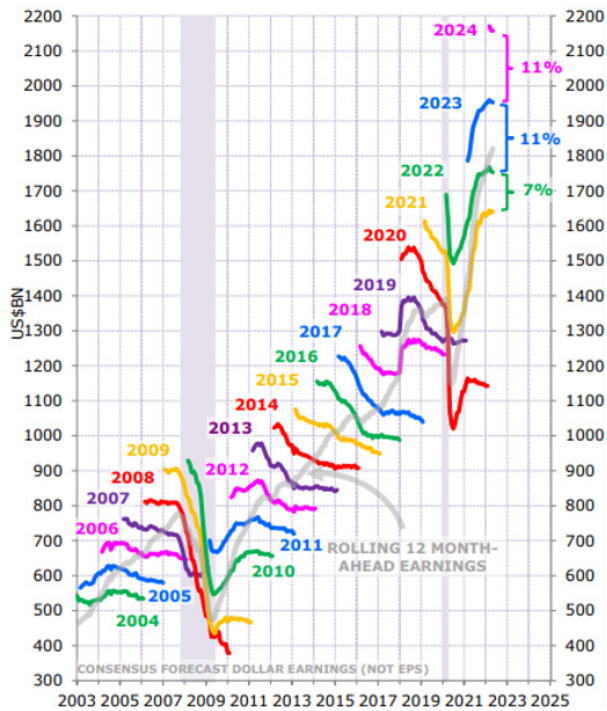


Source: DNR Capital, Factset

### Earnings expectations remain elevated

In light of the above we expect earnings expectations will need to be revised lower in the coming months. Expectations into FY23 and FY24 in the US appear over inflated with double digit growth.

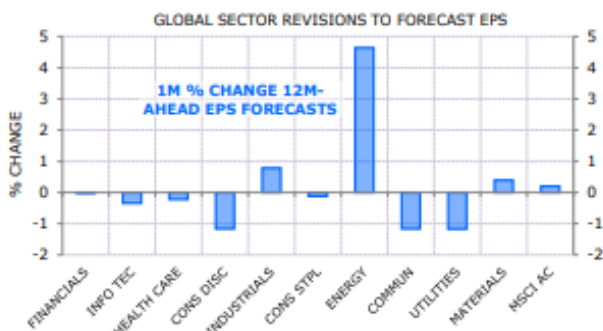
### S&P500 ex-energy consensus earning forecast



Source: Minack Advisers

Over the past month we have seen upgrades to the Energy sector and downgrades to other sectors, especially the consumer exposed industries. We expect adjustments to continue over time.

### A mixed picture for EPS revisions

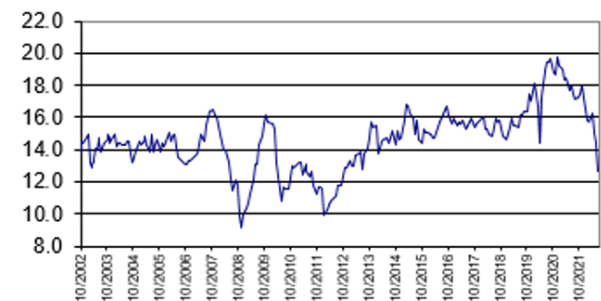


Source: MSCI, IBES/Datastream; Minack Advisors

### Valuations

The de-rating of the market looks largely complete with valuations moving back to below average. This is probably a little misleading given we do expect downgrades to work through the market.

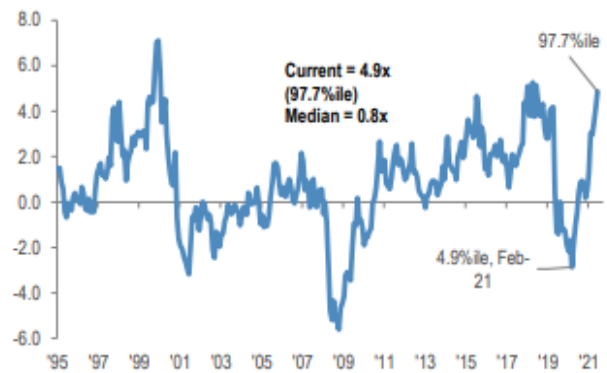
### Rolling forward per trend



Source: DNR Capital

It is perhaps best expressed when looking at the valuation spread between defensives and cyclicals that cyclicals look very cheap, but also have the most risk of earnings decline. A key debate will be the sharpness of the earnings fall and whether to be tempted to buy into these cyclicals. Ordinarily we would expect cyclicals to struggle until we have begun to move through the downgrade cycle. The challenge at present is that markets have moved well ahead of the downgrades but the downgrade cycle could be quite protracted with the Fed reluctant to step in on fear of rekindling inflation.

### Defensives vs cyclicals FWD P/E spread

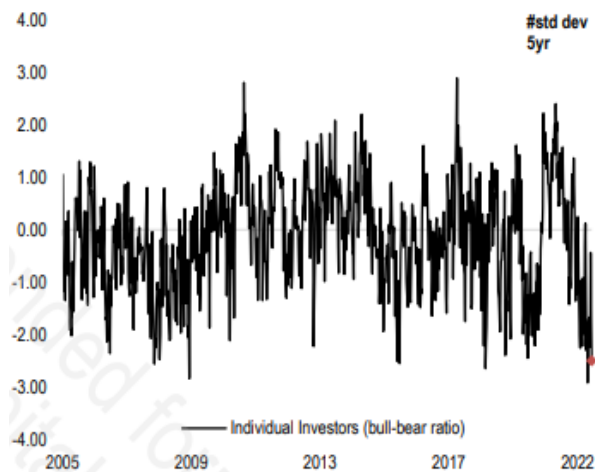


Source: J.P. Morgan Equity Macro Research

### Sentiment

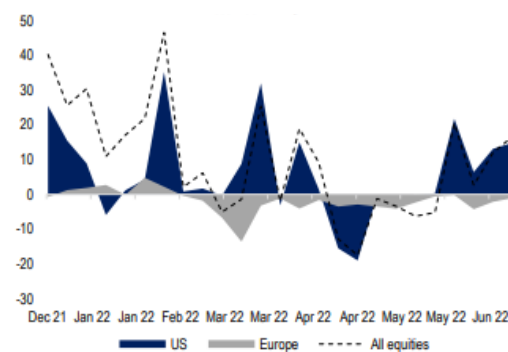
Market sentiment is reasonably cautious, as you would expect given the pull back in markets, but we are still seeing money flow into equities which suggests we have not seen a capitulation.

#### Individual investor bull/bear ratio



Source: Bank of America Merrill Lynch

#### Weekly net flows



Source: Bank of America Merrill Lynch

Conclusion: While markets have pulled back and valuations look attractive, earnings need to be adjusted before the market finds a bottom. We are using discounted valuations to buy into quality companies that have already de-rated with additions to companies such as Domino's Pizza Enterprises (DMP) and CSL (CSL) over the past month and reduced our cyclical exposure across the portfolio.

### Fund positioning

Focused on identifying strong bottom-up investment opportunities in an environment of higher inflation, but a potentially slowing economy.

- Reduced our position in **diversified quality mining** companies but favour those exposed to a recovering China.
- Positive on **high quality industry leaders** with strong pricing power to offset inflation. We have been adding to quality names which have de-rated.
- Focusing on ensuring the **resilience of the earnings of the portfolio** in light of slowing economy.
- **Overweight financials with leverage to higher rates** but underweight banks (given they have recession risk).
- **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 Portfolio 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 evolution 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

No stock moves to report for June.

## 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

## Disclaimer

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