

DNR Capital Australian Equities High Conviction Fund

Performance Report – July 2022

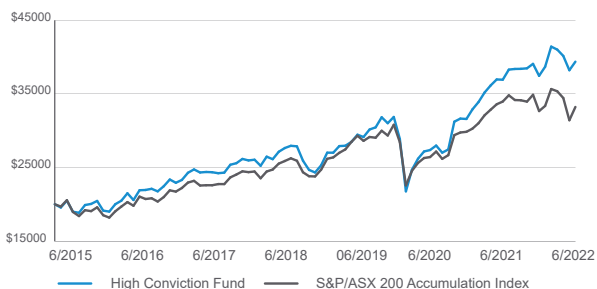
Performance

The S&P/ASX 200 Accumulation Index was up 5.75% during the period.

Information Technology (+15.2%) was the best performing sector, with key constituents Xero (XRO +20.8%) and WiseTech Global (WTC +32.4%) benefitting from the impact of falling bond rates during the month. REITs (11.9%) also outperformed, similarly benefitting from falling bond rates and the positive implications for property valuations. Materials (-0.7%) was the worst performing sector, with a perceptibly weaker Chinese economy adding to concerns of a global recession (BHP Group (BHP) -6.2%, Rio Tinto (RIO) -4.7%). Energy (+2.1%) also underperformed, as oil prices retreated in the face of the same growth concerns, despite a historically tight physical market (Woodside Energy Group (WDS) +0.44%, Santos (STO) -1.6%).

DNR Capital Australian Equities High Conviction Fund underperformed the Index for the month. Key stock contributors were Lendlease (LLC), National Australia Bank (NAB) and Scentre (SCG). Key stock detractors were Commonwealth Bank of Australia (CBA, No Holding), QBE Insurance Group (QBE) and Woodside Energy Group (WDS).

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	4.45	7.40
National Australia Bank	3.88	8.68
The Lottery Corporation	3.64	4.13
Lendlease	3.45	3.79
CSL	3.18	10.04
SEEK	3.00	3.40
Scentre	2.89	3.62
QBE Insurance Group	2.88	3.73
ALS	2.79	3.06
Aristocrat Leisure	2.61	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%
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 July 2022

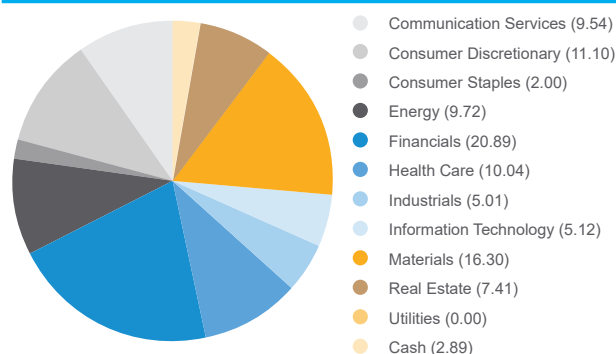
	1mth	3mth	6mth	1yr	3yr	5yr	Incep.*
	%	%	%	%	% p.a.	% p.a.	% p.a.
High Conviction Fund	3.04	-4.00	5.14	6.63	10.16	10.09	9.95
S&P/ASX 200 Accumulation Index	5.75	-6.04	1.71	-2.17	4.27	8.03	7.36
Excess return	-2.71	2.04	3.43	8.80	5.89	2.06	2.59

* 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:

- Lendlease (LLC):** rallied during the month after a period of underperformance. Management continues to make incremental progress towards its stated 2024 return targets with a sharpened focus on executing the existing development backlog of over \$100bn.
- National Australia Bank (NAB):** banks bounced following a weak June where they sold off on recession concerns.
- Scentre (SCG):** outperformed during the period, with lower bond rates and favourable retail conditions benefitting the stock. Capitalisation rates that are used to value properties are highly sensitive to longer-duration bond yields, which fell during the month on the back of lower inflation expectations.

The top stock detractors for the month were:

- Commonwealth Bank of Australia (CBA, No Holding):** banks bounced following a weak June where they sold off on recession concerns.
- QBE Insurance Group (QBE):** bond yields pulling back likely caused sentiment towards QBE to soften but there was no specific news impacting the company.
- Woodside Energy Group (WDS):** underperformed during the period as oil prices declined. Concerns over a global slowdown and demand destruction saw oil prices finish lower, despite physical markets remaining tight. Gas prices, which WDS is more directly exposed to, increased during the period, increasing the disconnect between the two energy commodities.

Market review

Market wrap

The market bounced strongly in July following a sharp drop in June. The reason for the bounce was a change in rhetoric from the Federal Reserve (the Fed), which announced its determination to fight inflation and lifted interest rates by a further 0.75%. This signalled to the market that we are potentially closer to the end of the interest rate rising cycle. Rotation from crowded defensive positions also provided the market room for a bounce. We remain cautious on how far the market can run, given a slowing economy and stubbornly high inflation. This is the first monetary policy tightening cycle in 40 years and coincides with the Fed battling high inflation. This is also the first monetary policy tightening cycle where avoiding recession is not the Fed's primary concern. Markets tolerate economic downturns better when the Fed is easing monetary policy, rather than tightening into a slowdown.

Inflation

Inflation remains high as noted in the chart below. Some of the drivers will prove to be temporary (shipping costs, microprocessors), whilst others appear structural (supply chain de-globalisation, energy costs). The benefits of globalisation realised from Eastern European, Chinese and Indian producers entering the world's supply chain, has been a key feature in driving additional global capacity. We now observe states and corporations moving to secure supply of strategically important goods (oil, gas, batteries, microchips, mineral sands) by producing onshore or near shore and being willing to sacrifice cost efficiency to achieve it. In addition, the drive towards zero carbon emissions implies a substantial spend on capex, driving commodity demand and placing further pressure on inflation.

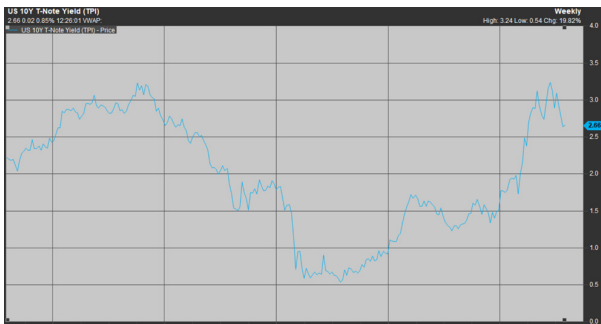
US Consumer Price Index (CPI)



Source: U.S. Bureau of Labor Statistics

The Fed is aware of these challenges however, and is seeking to weaken demand to enable supply chains to catch up. Strong rhetoric by the Fed has led the market to begin anticipating the end of the rate raising cycle, as evidenced by peaking US Treasury bond yields. Our discussions with companies still point to a challenging supply environment, and we view the markets sentiment as potentially premature. We continue to see tight labour and commodity markets (despite Chinese economic difficulties), suggesting the US will need to continue lifting rates to further slow the economy. Whilst the US may technically be in recession, nominal GDP growth is still ~7%.

US 10Y T-Note Yield (TPI)

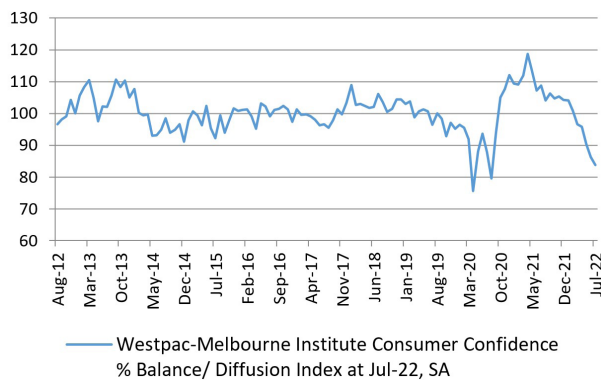


Source: Iress

Economy slowing slowly

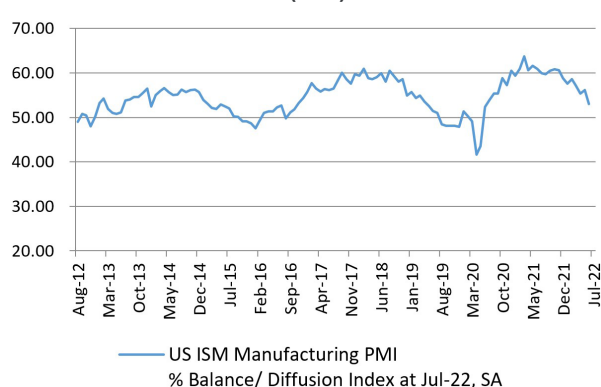
In response to the higher interest rates, the US economy has moved into technical recession, following two quarters of negative real growth (after deducting inflation). Whilst nominal growth of ~7% remains high, consumer and business confidence has declined, and we expect this to feed through to lower corporate earnings over the next few months.

Australian consumer confidence



Source: Factset

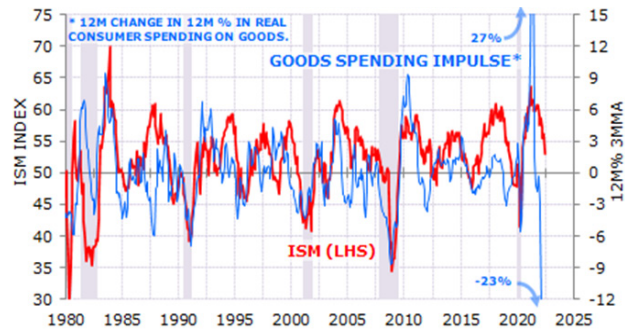
US business confidence (PMI)



Source: Factset

A key highlight of the pandemic era was an elevated consumer savings rate, as government handouts and lack of mobility saw household savings improve. This resulted in higher levels of spending on discretionary goods, which now appears to be reverting.

Manufacturing ISM & goods spending impulse



Source: Minack Advisers

This decline in consumer spending coincides with elevated retail inventories which were increased to address supply chain issues, thus compounding the economic risks as demand slows.

ISM inventory index & inventory GDP contribution



Source: Minack Advisers

Valuations

With corporate earnings expected to slow, market valuations have adjusted, and appear more reasonable at 14.4x earnings. We believe earnings may fall circa 10% and adjusting for this, the market is trading at around 15.5x earnings. Whilst this also seems reasonable, it potentially masks an elevated range of possible returns within the market.

High PE firms trade at an average forward PE of 35.4x, which is 42% above the 20 year average



Source: Goldman Sachs

Low PE firms trade at an average forward PE of 8.1x, which is 13% below the 20 year average



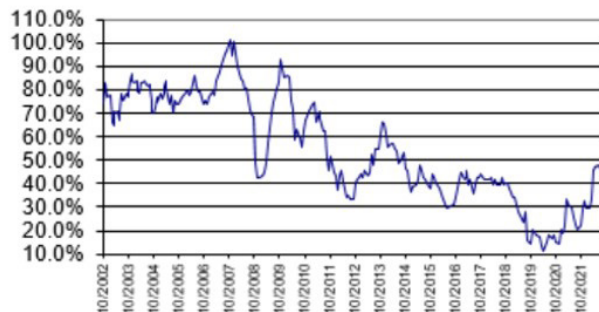
Source: Goldman Sachs

Rolling one year forward PE ratio



Source: Factset

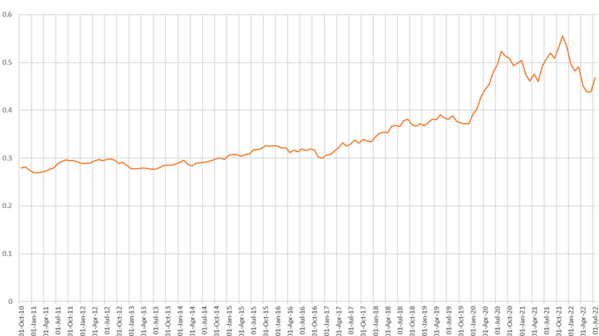
Bond yield on earnings yield



Source: Factset

Growth and duration stocks have bounced over the past month, with expectations of a slowing economy lowering bond yields and supporting valuations. We appreciate the justification for the market gravitating to higher quality growth companies, but we have also observed lower quality, speculative stocks rallying sharply. Our experience suggests the bear market ends when capital exits these lower quality businesses.

Russell 1000 Growth ETF/Russell 1000 Value ETF



Source: Iress

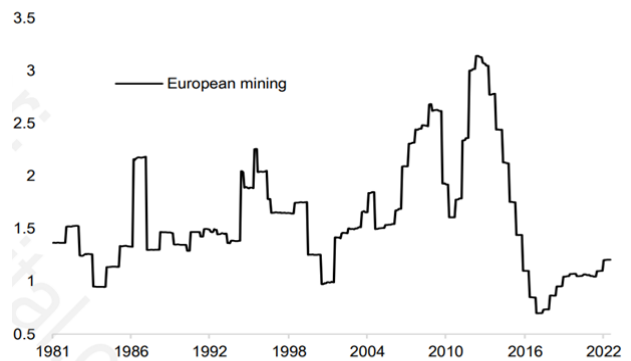
This recent rally suggests the market is optimistic that a swift taming of inflation will return us to pre-pandemic economic settings, favouring technology and growth exposures. We are not convinced of this scenario, and believe the new demands of real economy present different opportunities than before the pandemic.

Opportunities in the real economy

The past ten years saw Western capex underinvestment in new mining and energy projects. Meeting the net zero demands of the next decade necessitates a shift in priorities. Countries are seeking to secure their supply chains, and are investing heavily to transition the economy to a zero carbon future. Capital investments in renewables, energy transmission, microchips, manufacturing, gas, and potentially nuclear power, require a range of currently undersupplied commodities, such as lithium, cobalt and nickel.

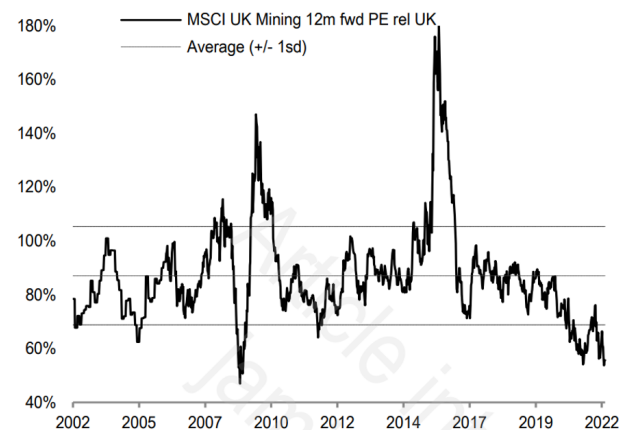
As noted in the chart below, capex for miners has been running unsustainably below depreciation for some time.

Capex to depreciation



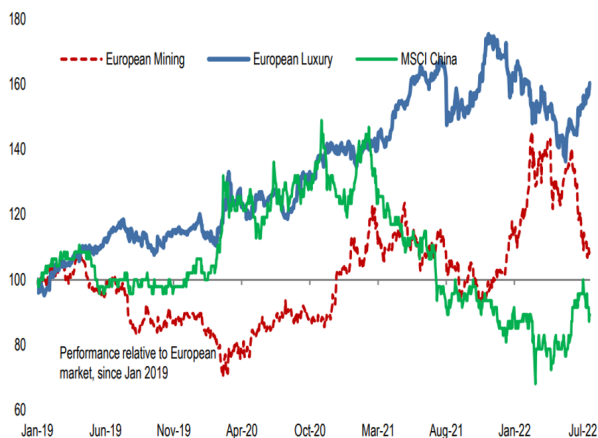
Source: Refinitiv, Credit Suisse research

Despite this, the supply imbalance provides a long-term opportunity. Mining stocks are trading at significant discounts to the market. This is largely due to short-term economic risks, but presents an opportunity to buy quality miners, offering attractive free cash flow yields and which are uniquely positioned to benefit from these long-term structural trends.



Source: Refinitiv, Credit Suisse research

The key risk for miners remains China's trajectory, with a restrictive COVID-19 policy further disrupting the Chinese economy. Despite creating a range of imbalances, China has lower inflation than many developed nations, retaining a degree of economic flexibility. Beijing is increasingly signalling support for industry, with a range of stimulus packages. We have already seen luxury goods bounce in expectation of a recovery but resources are lagging – suggesting that an opportunity is emerging.



Source: Refinitiv, Credit Suisse research

Conclusion

Uncertainty remains high and we have positioned the portfolio in a range of quality resilient businesses as well as an exposure to the increasing spend on the real economy (which presents a longer term opportunity). Volatility is likely to continue in the short term while the economy adjusts to higher rates and this will in turn present further opportunities for our clients.

Fund positioning

We remain 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 that have de-rated.
- Focusing on ensuring the **resilience of the earnings of the portfolio** in light of the 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 overconsumption 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 SKYCITY Entertainment Group (SKC)

SKC was sold to fund increases in other positions in the portfolio. The business continues to show operational progress in recovering from COVID-19 lockdowns, however, is likely to face increasing regulatory scrutiny over the next 6–12 months. This combined with recent market volatility drove the decision to exit SKC and redeploy the proceeds into other opportunities.

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