

DNR Capital Australian Equities High Conviction Fund

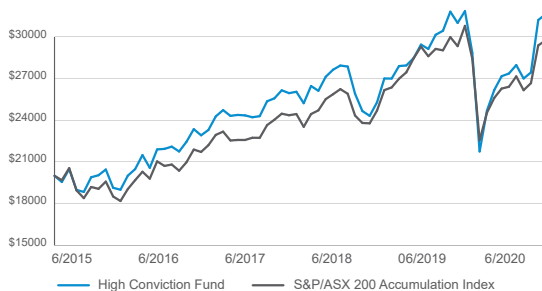
Performance Report – January 2021

Performance

The S&P/ASX 200 Accumulation Index was up 0.31% during January. Consumer Discretionary (+4.7%) was the best performing sector. Promising economic data regarding housing and consumer spending saw strong support for exposed retailers, including the Wesfarmers stable (WES, +8.4%), Harvey Norman Holdings (HVN, +13.9%) and Breville Group (BRG, +13.5%). Also outperforming was the Communications sector, similarly benefiting from the housing and consumer theme. Telstra Corporation (TLS, +4.7%) and TPG Telecom (TPG, +2.5%) finished higher, as did online property listings duopoly member Domain Holdings Australia (DHG, +11.1%). A-REITs (-4.1%) were the worst performers, as fears of rising bond yields saw the likes of Goodman (GMG, -6.5%) and Dexus Property (DXS, -4.2%) lower. Industrials also underperformed with travel-related Sydney Airport Holdings (SYD, -10.8%) and Qantas Airways (QAN, -7.2%) sold off as the timeline for international border reopenings was pushed out.

DNR Capital Australian Equities High Conviction Fund underperformed its benchmark for the period. Key stock contributors were CSL (CSL, no holding), Woodside Petroleum (WPL) and Fortescue Metals Group (FMG, no holding). Key stock detractors were Lendlease (LLC), Westpac Banking Corporation (WBC, 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	4.51	4.99
National Australia Bank	4.10	8.32
Lendlease	3.86	4.31
BHP Billiton	3.59	10.58
Macquarie Group	3.53	5.96
Cash	3.29	3.29
Aristocrat Leisure	3.28	4.34
ALS	3.23	3.49
Qube Holdings	3.02	3.31
Woodside Petroleum	2.95	4.25

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. (before fees) 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	+0.25% / -0.25%
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 2021

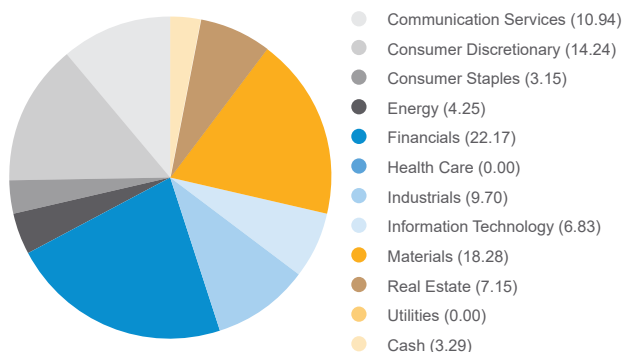
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	Incep.* %
High Conviction Fund	-0.16	15.12	15.42	-0.85	6.77	10.55	8.43
S&P/ASX 200 Accumulation Index	0.31	11.89	12.99	-3.11	7.00	10.03	7.35
Excess return	-0.47	3.23	2.43	2.26	-0.23	0.50	1.08

* 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:

- CSL (CSL, no holding):** Underperformed as the impact of COVID-19 on plasma collections weighed on the growth outlook. The near-term earnings outlook remains positive driven by prior period collection volumes and the drawdown of safety stock but this is already priced into the stock.
- Woodside Petroleum (WPL):** Outperformed over the month thanks to prospects of a recovery in the travel industry. Improving outlook saw the price of oil bounce.
- Fortescue Metals Group (FMG, no holding):** Iron ore prices softened over January following a very strong December quarter. While still trading at attractive levels compared to spot pricing, the market started to capture the potential for prices to fall into the seasonally weaker period of Chinese steel production.

The top stock detractors for the month were:

- Lendlease (LLC):** Was weaker during the period on limited news flow. The first half result is expected to be soft given the soft trading conditions due to COVID-19, however this will likely be largely understood by the market.
- Westpac Banking Corporation (WBC, no holding):** Outperformed as interest in the banks continued to build as the outlook for bad debts improve and credit growth accelerates.
- Wesfarmers (WES, no holding):** Was stronger in January, as a slew of strong retail and housing data indicated a continuation of the household spending behaviours that have dominated since the COVID-19 lockdowns. WES is highly exposed to this thematic, reflected in its record-high valuation.

Market review

Over the past year we have experienced a one in 100-year event (the pandemic), a one in 70-year event (the huge rise in government spending in response to the pandemic at a level not seen since WWII), and a one in 30-year event (being the rotation from growth stocks to value stocks upon the announcement of effective COVID-19 vaccines). Our hopes for a relaxing and benign 2021 were dashed by the craziness of Robinhood¹ private traders, supported by an army of TikTok chartists, taking on hedge funds in a number of heavily shorted stocks US small-cap stocks. We discuss this and the key areas of focus for DNR Capital this year.

Robinhood

Lashings of schadenfreude greeted the decline of hedge funds as the army of small investors rode to the rescue of a number of small, low-quality companies. From our perspective, we think it is a reminder that hedge funds need to be careful of crowded trades (in some instances stocks were more than 100% short). There is an adage to 'be cautious when the bellhop is giving you stock tips' - TikTok investors speculating on companies and instruments they barely understand is not likely to end well. In the last three months, the 50 Russell 3000 stocks with market caps above \$1b and the largest short interest (as a % of float) have rallied by 98%. This has driven outperformance of stocks with heavy short interest. We see this event as largely a distraction from the main game of finding quality companies at attractive valuations.

Short interest



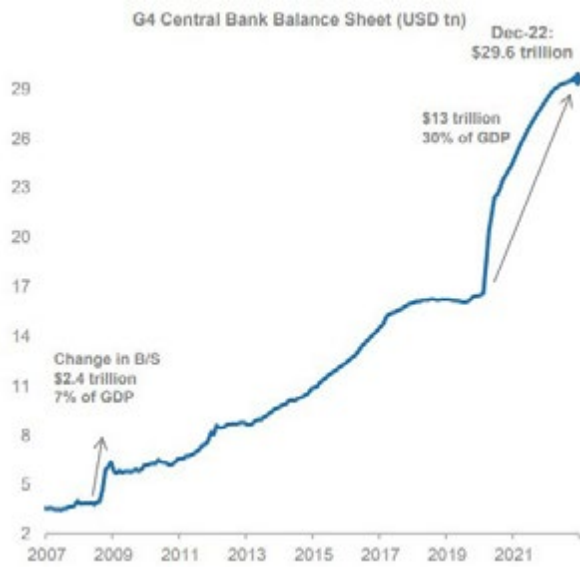
Source: Goldman Sachs

Economic outlook

Underpinning equity markets has been the stronger-than-expected economic recovery. This has been fuelled by exceptionally loose monetary and fiscal policy.

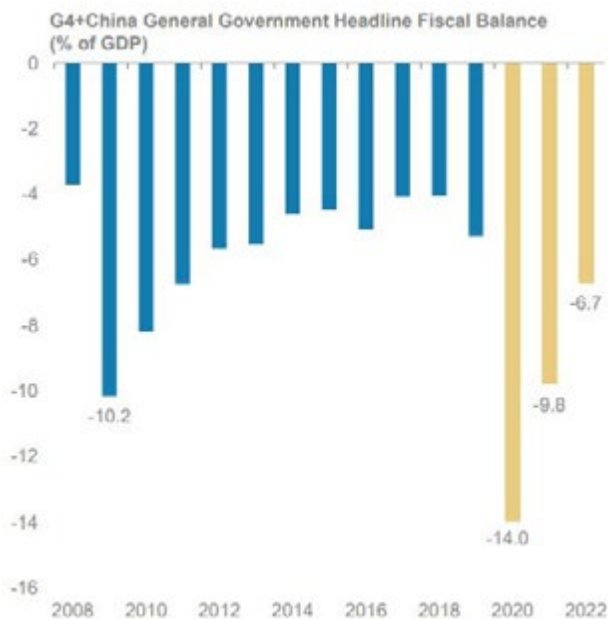
1 <https://robinhood.com/us/en/> - no commission trading platform

G4 central banks to expand balance sheets by 30% of GDP by the end of 2022



Source: Haver Analytics, CEIC, IMF, national sources, Morgan Stanley Research forecasts. RHS: G4+China aggregate is a PPP-based GDP-weighted average.

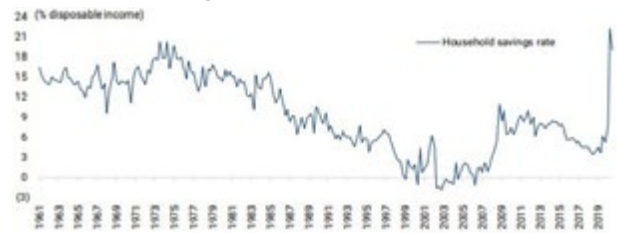
Fiscal deficit in G4 and China to widen to levels not seen since the GFC



Source: Haver Analytics, CEIC, IMF, national sources, Morgan Stanley Research forecasts. RHS: G4+China aggregate is a PPP-based GDP-weighted average.

We have seen it manifest itself in strong household savings and demand for credit, which is feeding into strong consumer sales and demand for housing.

Household savings rate



Source: Reserve Bank of Australia

Demand for credit



Source: Australian Bureau of Statistics

It is not only Australia that has been impacted in this way. The US and many other countries have seen a similar impact, which is improving sentiment across the globe. Consequently, we have seen a large improvement in the earnings per share (EPS) expectations that are typically correlated to the market. With further fiscal and monetary stimulus being promised and potential recovery from the pandemic, the outlook for improvement in the economy remains buoyant.

EPS expectations

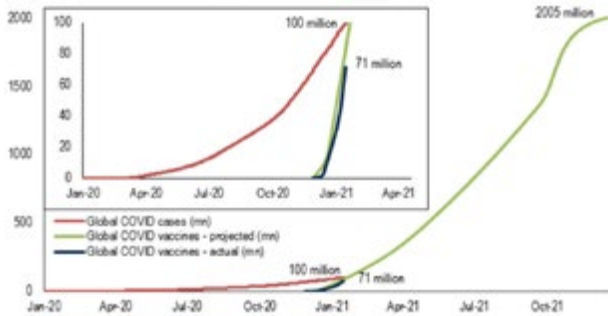


Source: J.P. Morgan estimates, Bloomberg Finance L.P.

Progress of the COVID-19 vaccine

While this backdrop is supportive, all eyes remain on the roll out of the vaccine which is gathering pace. There have been some hiccups in delivery, which is a little behind schedule, but we think ultimately time will resolve these issues. The greater question is once inoculated, how quickly can we return to normality?

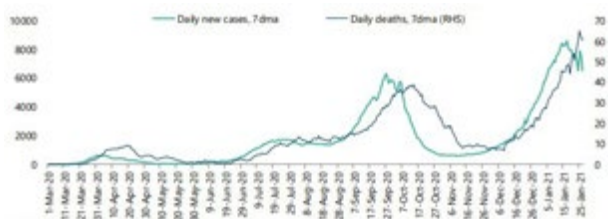
Vaccine progress falling behind projections



Source: BofA Global Investment Strategy, Bloomberg

Early progress in Israel has been encouraging. Further Oxford-AstraZeneca studies show that one shot of the vaccine is reducing the transmission of the virus by nearly two thirds. There is a way to go for the world to normalise but a steady progression has begun.

Progress of Israel



Source: Johns Hopkins University

Risks of inflation

With such a huge expansion in the supply of money and record levels of fiscal spending, concern naturally centres on the potential rise of inflation.

M2 growth is at record level and loan growth has held up, this is in sharp contrast during GFC



Source: FactSet and DNR Capital

Many will remember a similar debate a decade ago. We think there are some key differences in the current situation.

Post-GFC	Today
April 2011- The European Central Bank (ECB) raised rates, central banks focus on austerity	Dovish central banks across the world
Eurozone crisis	Mutualisation of Eurozone debt, German fiscal easing
Fiscal tightening of c3% GDP in the US in 2011/12	Massive fiscal expansion globally
Outsourcing of manufacturing and servicing rapidly expanding	Concerns around supply chain, modern slavery slow the pace of globalisation
Banks forced to aggressively de-lever	Capital requirements have been eased to release c\$200b capital in Europe
HY markets largely closed	Environmental standards increasing the cost of goods

Populist politicians are encouraging tariffs and minimum wages and globalisation has peaked with security of the supply chain a concern. Environmental concerns are raising the cost of energy and there is a lack of capex into new low-cost projects. While technology disruption remains, we are not sure it will be at the same pace as what we experienced in the past decade.

Furthermore, governments have too much debt. What can they do? Raising taxes or cutting costs does not seem politically feasible. Defaulting on debt would collapse currencies and so this leaves inflating out of the current situation. With the rise in most soft and hard commodities, we are potentially seeing the beginnings of the shift in inflation expectations. We see it as the end game but have been unsure of the timing. No doubt, excess capacity still exists but with asset prices being supported by the low-inflation environment we think it is the most crucial aspect to get right as it impacts portfolio positioning significantly.

Growth versus value

The past decade has been a golden age for growth investors. This has been fuelled by a number of factors:

1. Falling inflation and interest rates
2. Low-growth environment, meaning those with growth attracted a scarcity premium
3. Technology disruption of old industries, meaning some companies are in decline and others are rising.

We see the disruption continuing given the potential for companies to utilise software to improve productivity, movement to the cloud and adopt renewable technology. However, inflation might start to turn and cyclical growth is accelerating, which is increasing the alternative investment opportunities.

The gap between growth and value remains stretched. We believe there are opportunities to find some quality businesses that have faced headwinds in the past, but under a stronger economic backdrop, will begin to attract interest.

High PE firms trade at a 80% premium to the market, which is 35% above the 20-yr average



Source: FactSet, Goldman Sachs Global Investment Research

Low PE firms trade at a 55% discount to the market, which is 9% below the 20-yr average



Source: FactSet, Goldman Sachs Global Investment Research

Fund positioning

Over the past few months we have made a number of changes to the Fund and our current positioning is:

1. Trimming quality franchise stocks that benefited during COVID-19 - Xero (XRO).
2. Adding stocks that will benefit from a COVID-19 reopening - South32 (S32).
3. Adding stocks we believe offer compelling upside not captured in the market - QBE Insurance Group (QBE).
4. Adding to existing stocks where we have become more bullish regarding the long-term growth opportunity - Domino's Pizza Enterprises (DMP), Aristocrat Leisure (ALL).

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 vaccine would be negative.
- **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.
- **Inflation.** Given valuations have been supported by low interest rates, the emergence of inflation and higher bond yields could be a negative for markets.
- **Political environment.** Further geopolitical uncertainty, like civic destabilisation in the US following the election, could create negative implications for stocks and portfolios.

Portfolio moves

There are no major portfolio moves to report this 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 Wrap
- BT Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- My North & North
- Netwealth

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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