

# DNR Capital Australian Equities High Conviction Fund

APIR code: PIM0028AU

Performance Report September 2022

## Performance

DNR Capital Australian Equities High Conviction Fund decreased 6.41% (net of fees) in September, underperforming the S&P/ASX 200 Accumulation Index by 0.24%. Over the last 12 months, the Fund decreased by 2.95%, outperforming the Index by 4.74% (net of fees).

## Net active return as at 30 September 2022

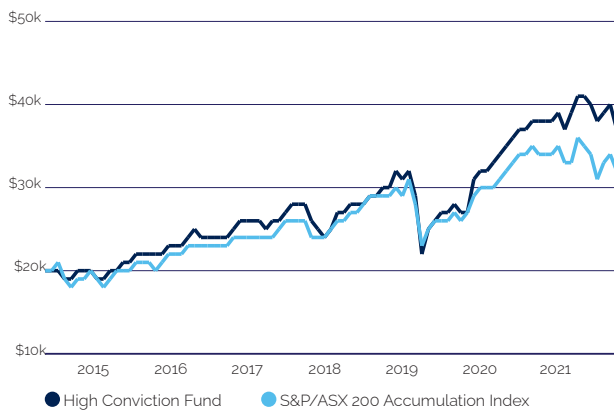
	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	5yr p.a. %	Incep.* p.a. %
High Conviction Fund	-6.41	-2.51	-10.07	-2.95	7.29	8.92	8.89
S&P/ASX 200 Accumulation Index	-6.17	0.39	-11.56	-7.69	2.67	6.76	6.43
<b>Excess return</b>	<b>-0.24</b>	<b>-2.90</b>	<b>1.49</b>	<b>4.74</b>	<b>4.62</b>	<b>2.16</b>	<b>2.46</b>

\* Inception Date—June 2015.

Source: DNR Capital and Mainstream Fund Services.

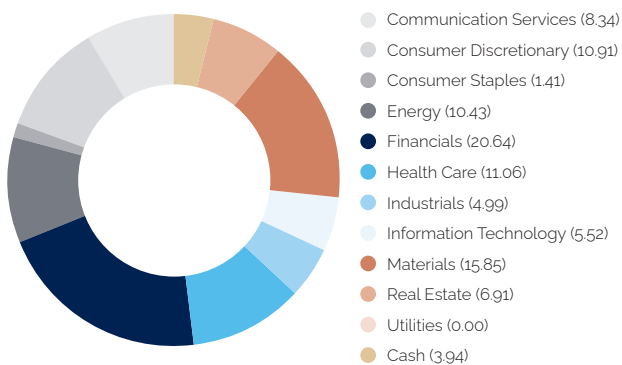
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry/exit fees or taxation.

## Growth of \$20,000 since inception



Source: DNR Capital and Mainstream Fund Services

## Sector weightings %



Source: DNR Capital and Mainstream Fund Services

## Top 5 active holdings

### Security details

CSL (CSL)

The Lottery Corporation (TLC)

National Australia Bank (NAB)

Woodside Energy Group (WDS)

QBE Insurance Group (QBE)

Source: DNR Capital and Mainstream Fund Services

## Monthly top contributors and detractors

### Top 3 contributors

Goodman (GMG, no holding)

Computershare (CPU)

CSL (CSL)

### Top 3 detractors

Domino's Pizza Enterprises (DMP)

ALS (ALQ)

Iress (IRE)

Source: DNR Capital and Mainstream Fund Services

## Experienced portfolio managers



**Jamie Nicol**  
Chief Investment Officer



**Scott Bender**  
Portfolio Manager

## Performance attribution

### Contributors

- **Goodman (GMG, no holding):** underperformed during the period, following a sell-off in the bond market. GMG remains one of the most sensitive companies in the Australian market to the movement in bond rates, given its asset base and earnings streams. As a fund manager, developer and owner of commercial property, its earnings, margins and balance sheet remain closely tied to the valuations of those property assets.
- **Computershare (CPU):** expectations regarding inflation and interest rates saw interest re-emerge.
- **CSL (CSL):** outperformed the market during the month as investors sought defensive earnings. Plasma collection volumes continue to improve and are now tracking above pre COVID-19 levels.

### Detractors

- **Domino's Pizza Enterprises (DMP):** underperformed as concerns over its European earnings grow as inflation and the general economic conditions deteriorate in key markets. We view the group as well positioned to navigate inflation, but DMP remains exposed to energy costs, labour availability and adverse currency movements. Current valuation is compelling despite these challenges, and we remain attracted to the long-term store rollout opportunity.
- **ALS (ALQ):** gold companies selling off likely contributed to softening sentiment towards the company despite reiterating a strong outlook at the recent strategy day.
- **Iress (IRE):** a downgrade and change in CEO have weighed on the stock. Higher US\$ costs and slowing sales in Australia contributed.

## Fund and market review

The S&P/ASX 200 Accumulation Index was down 6.17% during the period. Healthcare (-5.1%) was the best performing sector, with the defensive nature of key companies such as CSL (CSL -2.9%) attracting investors in the face of recession fears. Consumer staples (-5.8%) also outperformed, similarly benefitting from its relatively defensive earnings characteristics, with grocers Woolworths Group (WOW -5.9%) and Coles Group (COL -6.4%) the largest constituents. Utilities (-14.9%) was the worst performing sector, as bond rates moved higher and Origin Energy (ORG -18.1%) announced the early closure of the Eraring power plant. REITs (-13.8%) also underperformed, similarly impacted by surging bond rates which are direct comparators to REIT cap rates.

This month saw a sharp drop in equities with concerns regarding continued inflation and higher rates weighing on valuations, and large currency and bond market moves created uncertainty for markets. We consider a range of factors impacting markets at present.

### Inflation and fiscal policy

Over the past year, fiscal policy has been at odds with monetary policy globally. With stubbornly high inflation, central banks have attempted to moderate demand by lifting interest rates. Fearing a cost of living backlash, politicians have unfortunately been trying to ease the inflation burden by handing cash to voters. Student debt relief, petrol/energy rebates, excise tax relief, infrastructure spending and tax demand, blunting the impact of rate hikes. This month, in the UK at least, the market decided it had had enough, and long dormant "bond vigilantes" returned to punish irresponsible financial policies. The Chancellor of Exchequer's disastrous "mini-budget" resulted in a collapse of the Sterling and UK bonds (Gilts). Simply put, the Truss government was set to deliver a fiscal stimulus of as much as 7.5% of GDP next year when inflation is running at 10%. As such, both the Gilt and Sterling markets seized up, triggering a global bond rout forcing the Bank of England to intervene to shore up the financial system. Ultimately, the UK Government was forced to back down on the plan.

The question raised is whether other governments will face similar scrutiny. Will markets force greater fiscal discipline so that interest rates do not need to do all the work? If so, this will have implications for growth rates across the globe. Indeed, there appear to be similarities between the 1980s in the current period. The UK faced a similar situation in the 1970s and early 1980s as it does today. Back then, the UK suffered high inflation (above 20%) and low economic growth. Margaret Thatcher enacted significant supply-side reforms to rejuvenate the UK economy. While cutting income taxes aggressively, she also introduced the Value Added Tax (VAT) and Poll Tax to maintain revenue neutrality. Throughout the 1980s, the UK ran a small fiscal deficit of around 2-3% of GDP. The UK managed to contain inflation and set the economy up for sustained growth, but not before a painful recession and social unrest.

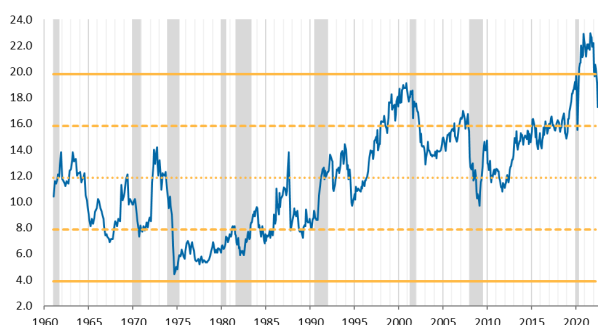
Oversized moves in currency and bond yields are likely to cause headaches for a range of businesses and pension funds. We will likely see the results come through in earnings volatility and potentially further valuation adjustments.

### Valuation impact

In valuing equities, higher bond yields raise the cost of capital, negatively affecting valuations. Post the GFC (when bond yields fell), it took several years for the lower rates to be reflected in valuations, and the inverse may be true today. Whilst some sectors, such as property trusts, act like bond proxies and already factor in higher yields, unlisted infrastructure and high growth technology companies have only partially factored in the increase.

If inflation is brought under control, then higher valuations can be supported. A sanity check is to compare valuations to previous market falls. The market remains elevated compared to these periods at 16.5x (albeit the size of the de-rating, especially in the US, has been sharp). We note it can be dangerous to compare eras given the changing shape of the index. Back in the 1970's, there was substantially greater cyclicality. Nonetheless, we see risk weighted to the downside.

### ASX Industrials forward PER (x) vs US recessions



Source: Macquarie Bank

To date, the sell-off in markets has reflected a valuation de-rating, driven by rising real yields, not EPS downgrades. Typically, central bank interest rate hiking cycles end in recessions; therefore, we expect an earnings adjustment to occur in the future.

We are looking for signs of a slowing economy to herald slowing wage growth and inflation moderating to target. Our recent trip to the US highlighted robust activity levels and a very tight employment market. Slowing wage growth will almost certainly require a higher unemployment rate, potentially leading to a recession.

### Capitulation and opportunities

The market seems awash with risks at present. Russian threats of nuclear strikes, and the potential for a harsh winter to cause Europe to run out of gas, does little to attract investors. These types of tail risks are difficult to price but impactful on valuations.

We believe investors are acutely cognisant of these risks and that the market is at least partially pricing these concerns. Whilst we constantly address the question of "what could go wrong?", equally, it is worth asking, "what could go right?" Perhaps the Ukraine/Russian war tensions will ease (hopefully, but not likely). Perhaps demand will slow, causing inflation to ease (a higher probability now that central banks are taking inflation more seriously and fiscal policies are easing). Perhaps China will offer more stimulus, opening up quickly from onerous lockdowns (more likely).

We have been waiting for signs of capitulation in the market and for further valuation support to emerge before turning more bullish. Markets are transitioning towards this point, and opportunities are emerging to buy good companies at attractive prices. However, we remain patient, stepping into stocks progressively, given the likelihood of an economic slowdown.

### Fund positioning

We believe Domino's Pizza Enterprises (DMP) offers a compelling long-term earnings growth opportunity. Consensus earnings downgrades already reflect challenges from European inflation, and its earnings multiple has significantly de-rated. Looking through a difficult period over the next six months, we observe several underappreciated factors:

1. DMP's value offering is well positioned to benefit from trading down as inflation pressures build;
2. The market appears to be capitalising depressed European margins which can at least be partially addressed through pricing architecture and passed through;
3. Recent acquisitions in Asia present a significant growth opportunity, with Malaysia in particular offering very attractive store economics.

These opportunities support strong long-term revenue growth, and an attractive discount cash flow (DCF) valuation relative to the current share price. Our confidence in the structural growth story is reflected in a strong active position within the fund.

### Fund facts

**Inception date:** June 2015

**Minimum initial investment:** \$20,000

**Risk level:** High

**Management fee:** 0.90% ( inclusive GST and RITC)

**Performance fee:** Nil

**Entry/exit fees:** Nil

**Buy/sell spread:** +0.20%/-0.20%

**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.

### About DNR Capital and the Fund

**Concentrated:** Investing in 15-30 highest conviction, quality large cap Australian listed equities.

**Style neutral and quality focussed:** A disciplined approach to quality and valuation. Concentrated portfolios of quality companies maximise the opportunity for outperformance.

**Experienced and aligned team:** The portfolio managers have more than 50 years of combined investment experience and are invested alongside our clients.

**Proven process:** DNR Capital was established in 2001 and a consistent firm-wide investment process has delivered more than 19 years of investment outperformance.

### Disclaimer

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