DNR Capital Australian Equities High Conviction Fund

APIR code: PIM0028AU

Performance Report March 2023

Performance

DNR Capital Australian Equities High Conviction Fund decreased 0.97% (net of fees) in March underperforming the S&P/ASX 200 Total Return Index by 0.81%. Over the last 12 months, the Fund increased by 0.74% outperforming the Index by 0.64% (net of fees).

Net active return as at 31 March 2023

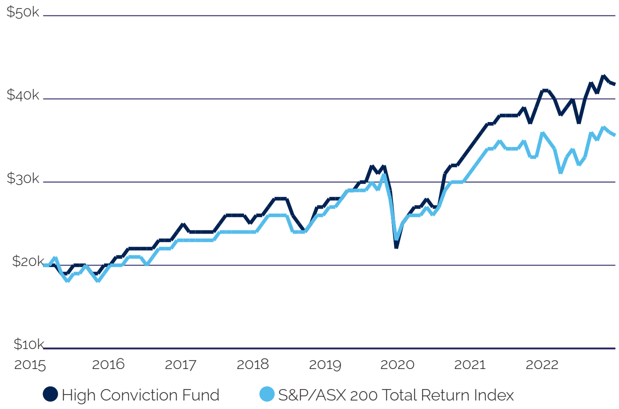
	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	5yr p.a. %	Incep.* p.a. %
High Conviction Fund	-0.97	2.75	12.02	0.74	24.27	10.59	9.88
S&P/ASX 200 Total Return Index	-0.16	3.46	13.19	0.10	16.52	8.69	7.70
Excess return	**-0.81**	**-0.71**	**-1.17**	**0.64**	**7.75**	**1.90**	**2.18**

* Inception Date—June 2015.

Source: DNR Capital and Apex Fund Services.

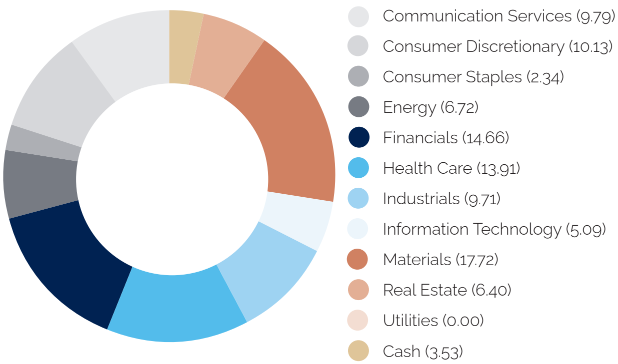
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been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

Growth of $20,000 since inception



Source: DNR Capital and Apex Fund Services

Sector weightings %



Source: DNR Capital and Apex Fund Services

Top 5 active holdings

Security details
Woodside Energy Group (WDS)
CSL (CSL)
The Lottery Corporation (TLC)
Ramsay Healthcare (RHC)
National Australia Bank (NAB)

Source: DNR Capital and Apex Fund Services

Monthly top contributors and detractors

Top 3 contributors
Xero (XRO)
ANZ Group Holdings (ANZ, no holding)
Commonwealth Bank of Australia (CBA, no holding)

Top 3 detractors
Computershare (CPU)
Scentre (SCG)
National Australia Bank (NAB)

Source: DNR Capital and Apex Fund Services

Experienced portfolio managers

Jamie Nicol
Chief Investment Officer

Scott Bender
Portfolio Manager

Performance attribution

Contributors

- **Xero (XRO):** outperformed during the month following a restructuring announcement from new CEO Sukhinder Singh Cassidy. Following a review of group operations, redundancies across the firm are being undertaken to improve operational efficiency and drive greater focus on profitability.
- **ANZ Group Holdings (ANZ, no holding):** banks sold off following the run on US banks and failure of Silicon Valley Bank.
- **Commonwealth Bank of Australia (CBA, no holding):** banks sold off following the run on US banks and failure of Silicon Valley Bank.

Detractors

- **Computershare (CPU):** following the failure of Silicon Valley Bank expectations around interest rates declined.
- **Scentre (SCG):** underperformed during the period due to concerns regarding broader commercial property funding. Following the regional banking stress observed in the United States, spreads on commercial debt have expanded and equities have responded by selling down the REITs, with an emphasis on those with leverage or upcoming liquidity events.
- **National Australia Bank:** banks sold off following the run on US banks and failure of Silicon Valley Bank.

Fund and market review

The S&P/ASX 200 Total Return Index was down 0.16% during the period. Materials (+4.1%) was the best performing sector, with challenges in the US financial system seeing a rotation into the China reopening scenario. The majors (BHP Group, BHP +7.5%, Rio Tinto, RIO +5.7%) were the main beneficiaries, with gold names also outperforming (Newcrest Mining, NCM +19.1%, Northern Star Resources, NST +19.8%). Communication Services (+1.6%) also outperformed. A flight to defensives saw Telstra Group (TLS +3.5%) trade higher, while REA Group (REA +13.0%) saw some support as domestic house pricing appeared to stabilise. A-REIT's (-6.9%) were the worst performers as commercial real estate funding concerns surfaced following regional bank stress in the US (Goodman, GMG -5.4%, Dexus, DXS -10.9%). Financials (-5.1%) also underperformed, with banks sold off globally. Increasing bad debts, falling asset prices and a more expensive, less sticky deposit base paint a poor outlook for the sector (Commonwealth Bank of Australia, CBA -2.4%, National Australia Bank, NAB -7.6%).

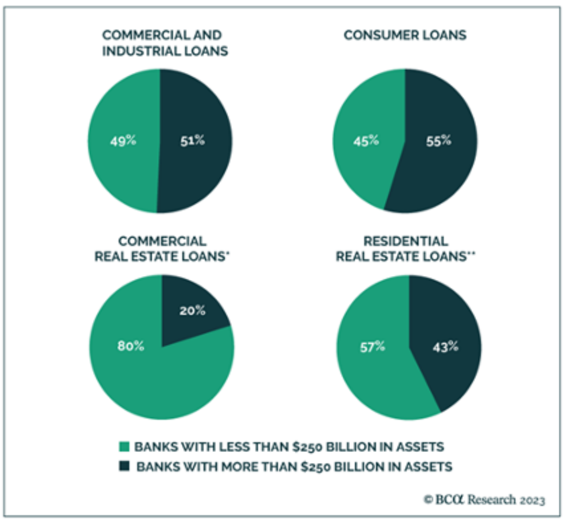
From the evolving US banking crisis to signs of slowing economic activity and interest rate expectations falling, the fast-paced events of the past month require a more complex discussion of the dynamics driving markets. In assessing the implications of a still fluid environment for financial institutions, we reflect on parallels drawn against the Global Financial Crisis (GFC) of 2008 and the emerging areas of risk. The portfolio has taken advantage of several opportunities from consequent volatility which we further discuss.

Bank crisis in the US

The failure of Silicon Valley Bank (SVB), reverberations around regional US banks and the ultimate collapse of Credit Suisse punctuated the most impactful month for financial institutions since the GFC. Simply put, things begin to break when interest rates are lifted sharply. In this instance, banks had invested in portfolios of bonds, which were deeply underwater as interest rates rose. SVB compounded this issue with deposits tied to the tech businesses, which were drawing down cash balances to fund operating losses. The subsequent balance sheet crunch catalysed a broader bank run on smaller and less capitalised lenders. Capital fled to the safety of larger institutions, requiring the government to step in and guarantee all SVB bank deposits to stabilise the banking system. We consider some of the consequences of this collapse.

1. Does this signal systemic problems in the banking sector akin to the GFC? We tend not to think so. The GFC was a major credit crisis stemming from undercapitalised financial institutions and a tsunami of problem loans. This time around, it is a liquidity issue. The banks have been paying too little for deposits and now need to pay more for funding to protect liquidity. This impacts net interest margins and profitability but does not create systemic issues. We do retain a watching brief on the asset side of bank balance sheets, specifically on commercial property loans. Regional banks in the US grew these loans aggressively over the past decade and now command an estimated 80% market share. With bond yields higher and occupancy lower, there will be further losses in this segment of the market. The magnitude of losses is unclear but note lending standards have generally been tighter than pre-GFC. Unfortunately, many assets have been priced off lower interest rates, and banks have likely lent against inflated values.

Large vs. small US bank share of loans by category



* INCLUDES COMMERCIAL, MULTI-FAMILY RESIDENTIAL, CONSTRUCTION & LAND DEVELOPMENT, AND FARMLAND REAL ESTATE LOANS.
** INCLUDES SINGLE-FAMILY REAL ESTATE LOANS.
NOTE: DATA AS OF Q4 2022. INCLUDES ALL FDIC-INSURED INSTITUTIONS (COMMERCIAL BANKS AND SAVINGS INSTITUTIONS).

Source: BCA Research

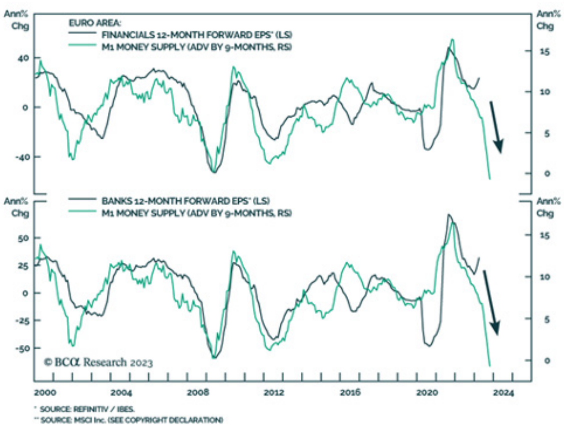
2. Banks are tightening lending standards in response to the crisis, further restricting economic growth and potentially aiding a slowdown in inflation.

Commercial lending and lending standards

Source: Federal Reserve, NBER; Minack Advisors

We have already seen money supply fall in recent months, further tightening the economy.

Money supply

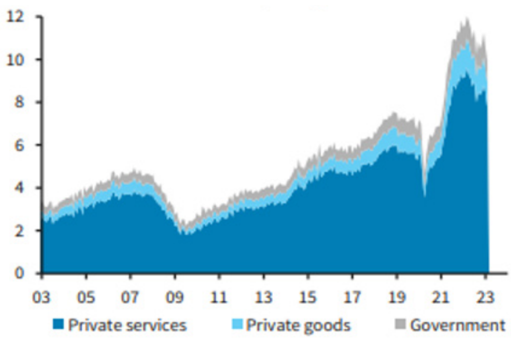


Source: BCA Research

US economy

This month we also saw tangible signs of the US economy slowing, with job openings coming off their peak. This is important, as rising unemployment is crucial in freeing up capacity in the economy and enabling the Federal Reserve (Fed) to cease lifting interest rates.

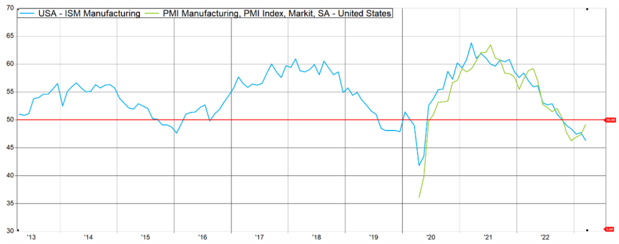
US job openings



Source: Bureau of Labor Statistics, Haver Analytics

Additionally, the US Manufacturing PMI survey currently sits below 50, consistent with a contraction in economic activity and often accompanied by a recession.

US ISM

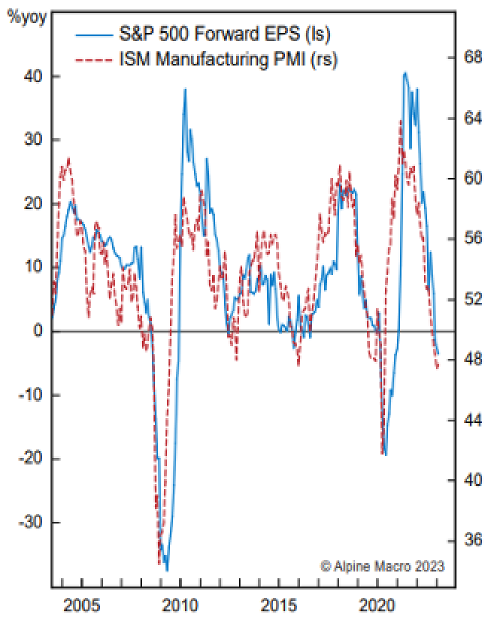


Source: FactSet, DNR Capital

Earnings

Credit tightening and slowing lead indicators suggest company profits are set to moderate, however markets have been worried about this for several months. Companies with obvious economic sensitivity have therefore already experienced substantial earnings adjustments. As illustrated below, the US market has already lowered earnings estimates, albeit more modestly than before the GFC or COVID-19 downs. We are cautious in expecting further downgrades as the economic cycle plays out but selectively seizing opportunities where valuations already discounted a downturn.

S&P 500 EPS vs ISM manufacturing PMI

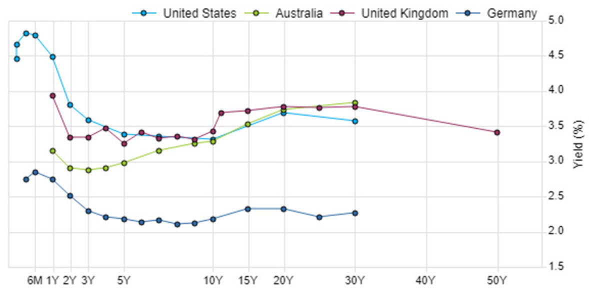


Source: Alpine Macro

Interest rates

Interest rates reacted to the news through the month. The market started to price in expectations that interest rates will peak and subsequently fall over the next few years. Longer term interest rate markets are consistent with inflation easing. The yield curve in the US, Germany and the UK suggests interest rates are close to peaking and will subsequently fall consistent with a recession. In Australia, we may well withstand another recession thanks to a resilient China and higher population growth.

Comparable treasuries

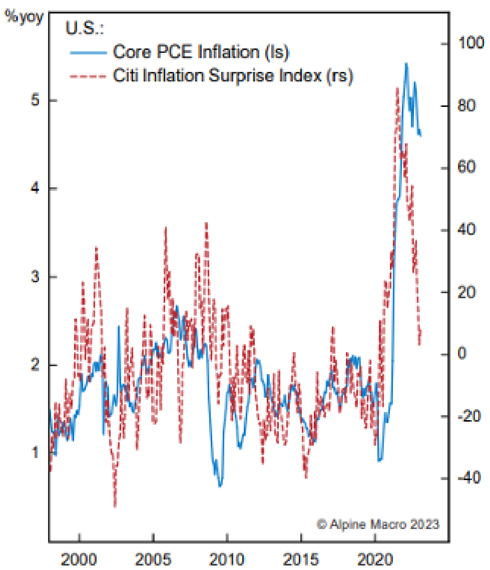


Source: FactSet, DNR Capital

Inflation

Inflation remains a crucial piece of the investment puzzle. Capacity within the economy remains tight albeit we expect pressure to ease as the economy slows. The Citi inflation surprise index is consistent with inflation easing.

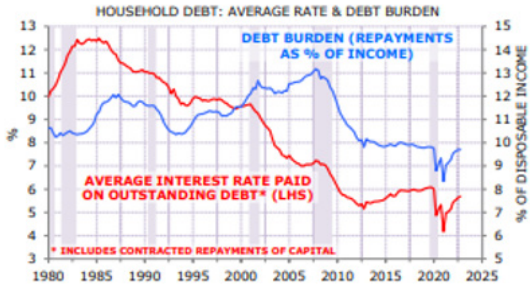
US Core PCE Inflation vs. Inflation Surprise Index



Source: Alpine Macro

We note that in the US, most consumers are on long-term fixed mortgages, so they are yet to be impacted by higher rates.

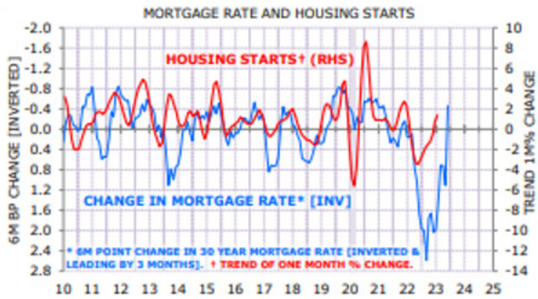
Higher rates are yet to bite consumers



Source: BEA, Federal Reserve, NBER; Minack Advisors

But housing related stocks are reacting to lower long-term interest rates, creating an interesting dynamic, and potentially meaning short-term rates will need to stay stronger for longer.

Housing responds fast to lower rates



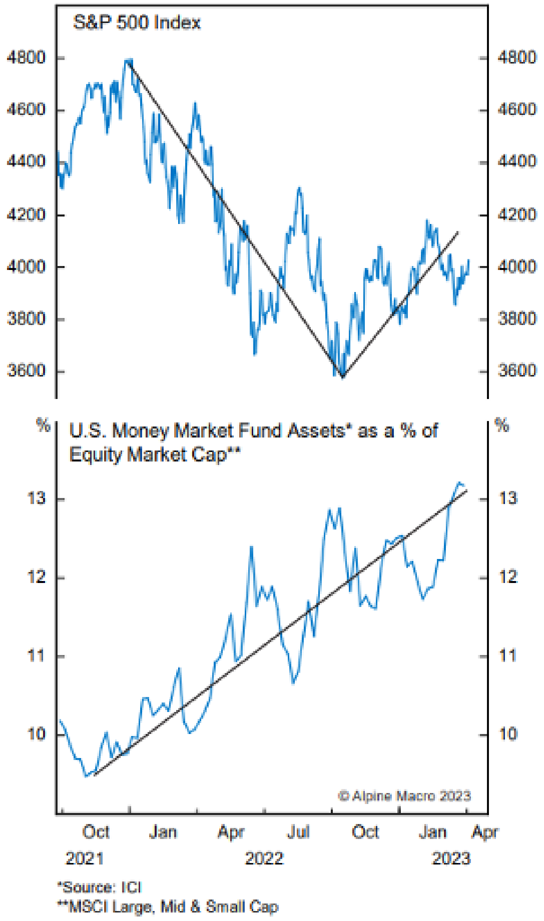
Source: Census Bureau, Freddie Mac, NBER; Minack Advisors

Several factors that have driven inflation, such as underinvestment in energy and deglobalisation, remain in place. Central banks will likely be wary of stoking the next round of inflation, so we remain wary regarding the speed of interest rate declines.

Portfolio positioning

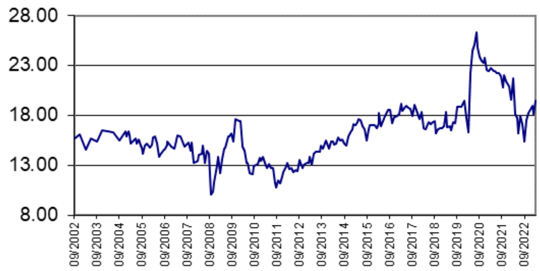
We consider a range of factors that can influence portfolio positioning at present:

- There is likely to be more failure and further cracks appearing in credit markets as the impact of higher rates plays out.
- Earnings to slow – be careful on earnings downgrade risk.
- Inflation should begin to slow, which should provide some interest rate relief.
- Expectations are already low, with this recession widely predicted. Cash weightings have increased, and the market has pulled back.
- Market valuations are not cheap. Valuation relativities will depend on the extent inflation can ease.



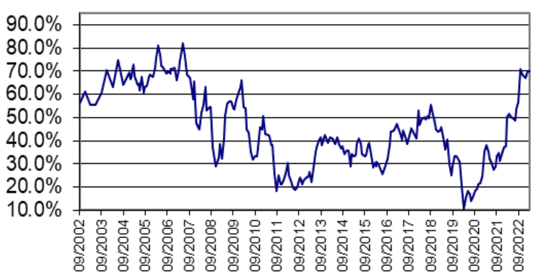
Source: FactSet, DNR Capital

US market rolling forward per trend



Source: FactSet, DNR Capital

US market bond yield on earnings yield



Source: FactSet, DNR Capital

Given the broader uncertainty, we have continued buying quality businesses that we want to own on a through-the-cycle basis. The volatility in the market has presented opportunities to add to selected existing positions.

Ramsay Health Care (RHC) thesis

RHC is the number 1 private hospital operator in Australia with just under 40% share. The portfolio of hospitals is well positioned from a demographic perspective and the majority of the portfolio is freehold. Private health insurance participation rates have returned to growth, and this looks set to continue, given the growing pressure on the public hospital system. The business also has scale operations in the UK, France, and the Nordics.

COVID-19 lockdowns materially impacted private hospital volumes; however more recent trends have been positive, with a backlog of activity supporting a return to more normal operating margins. Cost pressures, particularly around staffing are largely managed through more constructive negotiations with private health funds. The gradual return of overseas nursing staff is also helping to ease shortages in key nursing specialties.

Recent results have highlighted that the underlying healthcare service demand remains intact, with a growing and ageing population driving strong demand. The last five years have seen minimal additional capacity added to the private hospital system, further supporting the demand of RHC's hospitals.

RHC trades at less than 20 times normalised earnings, with a low teens growth outlook and has significant asset backing via the freehold hospitals.

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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