

DNR Capital Australian Equities High Conviction Fund

APIR code: PIM0028AU

Performance Report May 2023

Performance

DNR Capital Australian Equities High Conviction Fund decreased 1.45% (net of fees) in May, outperforming the S&P/ASX 200 Total Return Index by 1.08%. Over the last 12 months, the Fund increased by 4.27%, outperforming the Index by 1.37% (net of fees).

Net active return as at 31 May 2023

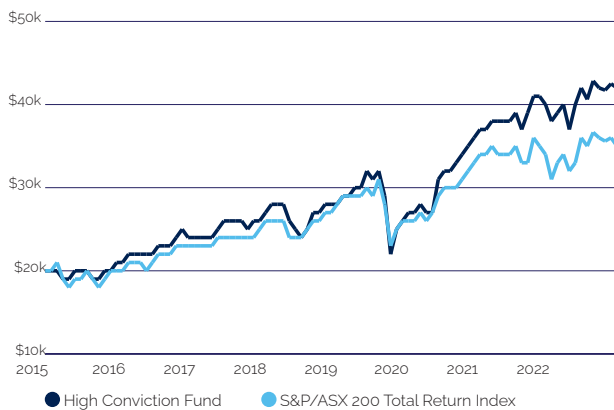
	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	5yr p.a. %	Incep.* p.a. %
High Conviction Fund	-1.45	-0.64	0.78	4.27	16.94	9.89	9.71
S&P/ASX 200 Total Return Index	-2.53	-0.89	-0.58	2.90	11.43	7.47	7.44
Excess return	1.08	0.25	1.36	1.37	5.51	2.42	2.27

* Inception Date—June 2015.

Source: DNR Capital and Apex Fund Services.

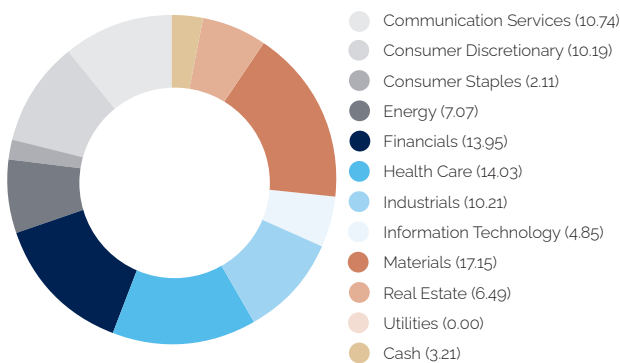
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been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

Computershare (CPU)

Carsales.com (CAR)

Source: DNR Capital and Apex Fund Services

Monthly top contributors and detractors

Top 3 contributors

Xero (XRO)

James Hardie Industries (JHX)

Lendlease Group (LLC)

Top 3 detractors

Ramsay Health Care (RHC)

ALS (ALQ)

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 period following its annual earnings result, which highlighted a strong recovery in its UK operations, alongside continued progress with cost-out and restructuring, driving free cash flow growth.
- **James Hardie Industries (JHX):** reported a result which was better than feared and highlighted their ability to extract good margins in a difficult market.
- **Lendlease Group (LLC):** outperformed on no stock specific news. Management continues to make incremental progress towards their stated 2024 target return targets with a sharpened focus on executing the existing development backlog of over \$100bn.

Detractors

- **Ramsay Health Care (RHC):** underperformed during the month following a negative trading update for the March quarter. While volumes were strong, the business struggled with staffing, which dragged on margins.
- **ALS (ALQ):** reported a result which was better than expected but also highlighted some declines in sample volumes, and the stock sold off.
- **National Australia Bank (NAB):** soft results for the banks across the board, but NAB suffered most given it was well held going into reporting season.

Fund and market review

The S&P/ASX 200 Total Return Index was down 2.53% during the period. Information Technology (+11.6%) was the best performing sector, following the lead of US peers who rallied significantly due to hype surrounding Artificial Intelligence (AI) advances (WiseTech Global (WTC) +9.2%, Xero (XRO) +17.8%). Utilities (+1.1%) also outperformed, with AGL Energy (AGL) (+13.1%) benefitting from increasing electricity prices and implicit earnings upgrades. Consumer Discretionary (-6.2%) was the worst performing sector as cracks in spending finally started to appear following a tightening of financial conditions. Financials (-4.8%) also underperformed, with mounting economic pressures weighing on the banks (Commonwealth Bank of Australia (CBA) -2.6%, Westpac Banking Corporation (WBC) -4.9%), who are vulnerable to earnings shocks after operating with record-low bad debts.

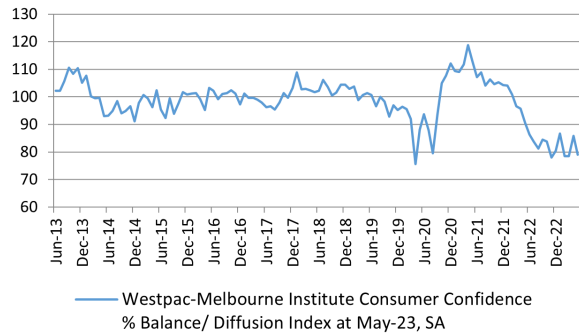
This month saw a range of contradictions impacting the market. Economic data has been deteriorating, but employment and inflation remains sticky, driving interest rate expectations up. Artificial Intelligence (AI) excitement boosted tech stocks, despite higher inflation placing upward pressure on interest rates. We discuss these contradictions and our current positioning.

Economic update

The market has spent the past year waiting impatiently for a recession to arrive. The consumer has held up well thanks to high levels of savings, strong employment and fixed mortgages. However, we have begun to see some tightening in the consumer.

Consumer confidence is weak...

Australian consumer confidence



Source: DNR Capital, FactSet

Our discussions with a range of corporates suggest the younger consumer who is renting is feeling the pinch. At the same time, the older cohort enjoying higher interest earnings on term deposits remains reasonably robust. Of course, most attention is focused on the mortgage cliff as fixed rate mortgages roll to variable. The impact will be felt over the second half of this year and is expected to squeeze the consumer steadily. The chart below highlights the reduction in compensation after interest costs and taxes are taken into account (but excludes interest revenue). In addition, energy costs, interest costs, insurance costs and food costs have been rising, and while wages are also rising, eventually, the consumer must tighten.

Compensation of employees, after interest, tax and inflation



Source: ABS, Macrobond, ANZ Research

The impact of the pressure has resulted in consumers reducing their savings rate, albeit the level of deposits sitting in banks remains elevated. This elevated savings offers some relief to the consumer albeit it is likely concentrated in the wealthier demographics.

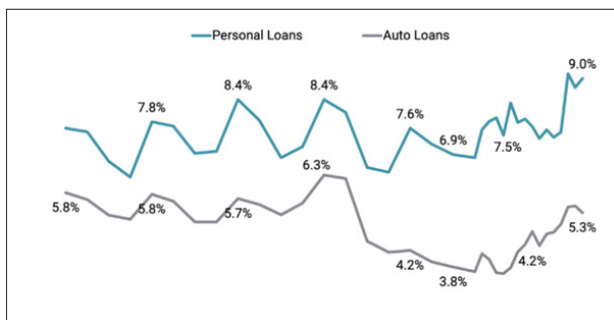
Household saving rate



Source: ABS, Macrobond, ANZ Research

We have been monitoring New Zealand's bad debts as a lead indicator to Australia. New Zealand has tightened interest rates earlier and harder than Australia. We note New Zealand has begun to see loan arrears rise, albeit it is not overly concerning at this stage.

Consumer loan arrears



Source: Jarden

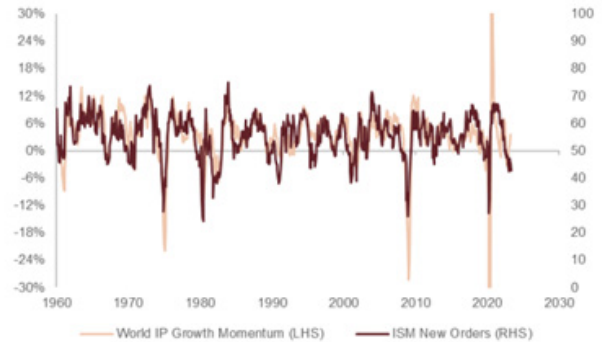
Reflecting the softening consumer, we have seen a number of downgrades in consumer related companies, including:

1. Best & Less Group Holdings (BST)
2. Adairs (ADH)
3. Dusk Group (DSK)
4. Universal Stores Holdings (UNII)
5. Michael Hill International (MHJ)
6. City Chic Collective (CCX)
7. Domino's Pizza Enterprises (DMP)
8. Nick Scali (NCK)
9. Baby Bunting Group (BBN)

US business confidence

Headlines from the Institute of Supply Management (ISM) manufacturing survey for May looked poor, with new orders hitting a new cyclical low and prices paid falling sharply, suggesting the US economy is beginning to feel the effect of higher interest rates.

ISM new orders



Source: Bloomberg, Barrenjoey Research

Despite this softening economic activity, employment remains very strong, with May payrolls holding up much better than expected, and recent earnings have been reasonably resilient. Note payrolls tend to be a lagging indicator, but nonetheless, higher unemployment is needed to release capacity within the economy and take the pressure off inflation.

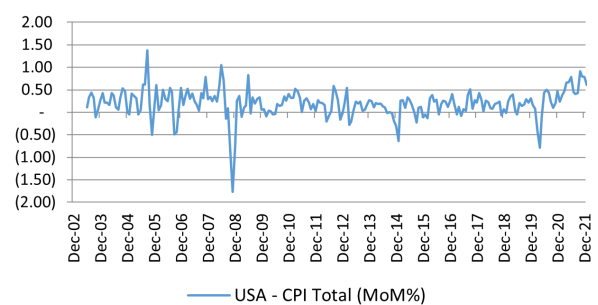
US unemployment rate



Source: DNR Capital, FactSet

Given this has not happened, inflation remains higher than the Federal Reserve would like. Our discussions with corporates suggest they are budgeting for 4-5% wage increases and expecting suppliers to be passing on higher prices, all of which adds to inflation pressure.

US - CPI (MoM%)



Source: DNR Capital, FactSet

As a consequence, interest rate expectations have risen. This trend of a deteriorating economy, and a tight labour market driving higher interest rate expectations is also apparent in Australia.

United States 2Y - yield



Source: FactSet

Valuation and contradictions

Key contradictions:

1. Overall the market has remained relatively resilient in the face of concerns regarding the economic outlook, which means valuations are not particularly compelling.

Rolling forward per trend



Source: DNR Capital, FactSet

2. Consequently, many are hiding in defensive stocks, but we are not convinced there are significant excess returns to be made in the longer term in this segment.
3. The economy is deteriorating, yet inflation remains sticky, suggesting interest rates will remain higher for longer.
4. Higher rates suggest valuation multiples should be lower in growth stocks, but excitement regarding AI is keeping interest elevated in technology stocks.

Australia growth PE premium vs. US 10yr Treasury yield



Source: FactSet, Goldman Sachs Global Investment Research

Positioning

In light of these contradictions above, we have sought strong quality franchises that we are happy to own through the cycle. A downturn often allows stronger companies to become stronger as they acquire the weak or invest through the cycle.

Some examples that we have been adding to include SEEK (SEK) and Macquarie Group (MQG). While these investments have an element of cyclicity, earnings expectations and valuations reflect this cyclicity and present the opportunity.

We are finding some opportunities in oversold businesses with reasonably resilient characteristics, such as DMP and look forward to further volatility to present opportunities in other quality businesses.

We continue to avoid banks which is a leveraged play on the consumer, and mortgages which we see as a risk.

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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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

dnrcapital.com.au