

# DNR Capital Australian Equities High Conviction Fund

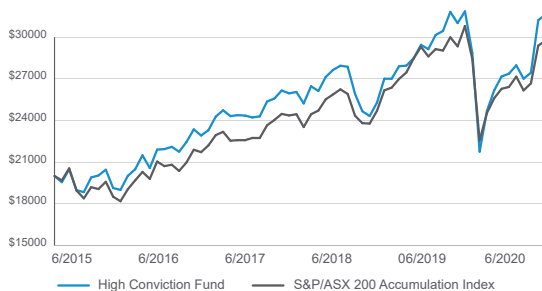
## Performance Report – February 2021

### Performance

The S&P/ASX 200 Accumulation Index was up 1.45% during the period. Materials (+7.2%) was the best performing sector. The economic recovery, supported by large fiscal and monetary stimulus, has led to a much stronger outlook for inflation and bond yields, which is historically beneficial to this sector. Financials (+4.5%) similarly outperformed, as the rising yields gave further life to the value rotation that started last year. Information Technology (-9.1%) was the worst performer, as growth stocks were heavily impacted by a steepening in the yield curve. Utilities (-8.8%) also underperformed as the assets with fixed-interest-like qualities followed bonds lower.

DNR Capital Australian Equities High Conviction Fund outperformed its benchmark for the period. Key stock contributors were Virgin Money UK (VUK), Tabcorp Holdings (TAH) and Lendlease (LLC). Key stock detractors were Westpac Banking Corporation (WBC, no holding), Coles Group (COL) and Computershare (CPU).

### 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	4.81	5.35
Lendlease	4.64	5.13
National Australia Bank	4.00	8.35
Macquarie Group	3.81	6.40
BHP Billiton	3.80	11.57
ALS	3.25	3.50
Cash	3.21	3.21
Qube Holdings	3.10	3.42
Aristocrat Leisure	3.01	4.06
Computershare	2.95	3.31

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 28 February 2021

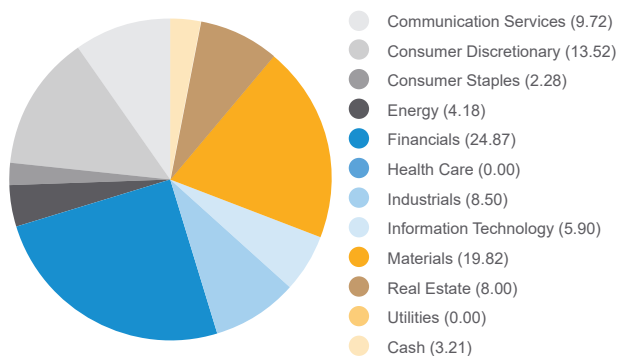
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	Incep.* %
High Conviction Fund	4.15	5.38	17.61	13.97	8.09	11.61	9.09
S&P/ASX 200 Accumulation Index	1.45	3.00	11.47	6.48	7.39	10.74	7.52
<b>Excess return</b>	<b>2.70</b>	<b>2.38</b>	<b>6.14</b>	<b>7.49</b>	<b>0.70</b>	<b>0.90</b>	<b>1.57</b>

\* 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:

- **Virgin Money UK (VUK):** A strong bounce for VUK as the vaccine rollout in the UK accelerates and rotation to value stocks continues.
- **Tabcorp Holdings (TAH):** Outperformed after confirming that it has received several indicative bids for the wagering and media business. The external interest has helped focus the market on the underlying value of not just wagering and media, but also the larger lotteries division, which continues to perform very well.
- **Lendlease (LLC):** Rallied after highlighting an increasing level of confidence in a rebound in development activity with an \$8b annual run rate now expected by 2023. This pointed to an accelerated realisation of profits from the current backlog of >\$100b in large-scale projects.

The top stock detractors for the month were:

- **Westpac Banking Corporation (WBC, no holding):** Banks enjoyed strong quarterly results which aided laggard, WBC.
- **Coles Group (COL):** Released a strong first half result but underperformed after providing a more cautious full-year outlook. In lapping elevated comparative sales period from 3Q20, earnings growth will be challenging. The stock was also negatively impacted by sharp increases in the bond market driving a selloff in defensive sectors.
- **Computershare (CPU):** Underperformed despite a good result and guidance upgrade. Softness in its US mortgage business perhaps weighed on the stock.

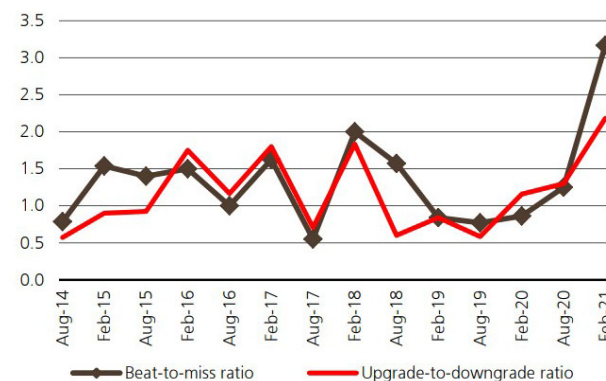
### Market review

The focus this month was on the reporting season, which was one of the best we have seen in terms of positive surprises to earnings. However the market did not always react accordingly, especially for those companies that have benefited during COVID-19. Market attention is moving to the recovery. Mid way through the month bond yields rose as discussions around inflation accelerated. This caused a rotation from growth to value stocks, supporting some of our recent decisions. We discuss the reporting season and key insights, as well as the move in bonds.

#### Reporting season

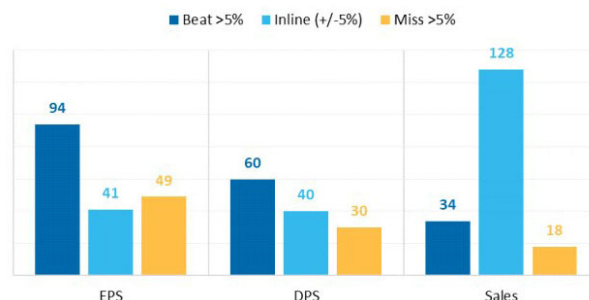
- Beat-to-miss ratio the strongest in years.

#### Beats versus misses



Source: UBS

#### Half year beat or miss versus MRE - number of companies

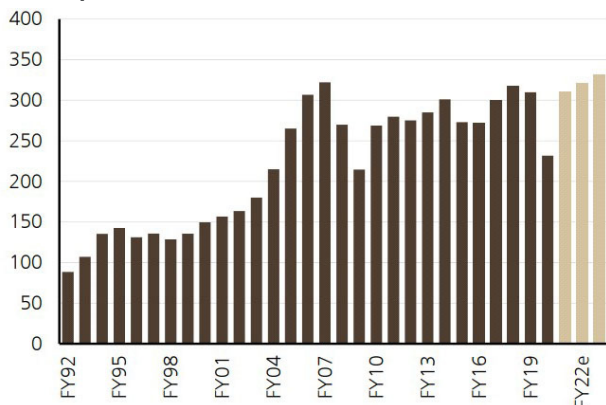


Source: Macquarie Research, February 2021

- Beats were enjoyed by consumer stocks (benefiting from stimulus), banks (lower bad debts) and resources (higher commodity prices). Earnings per share (EPS) rose by 7% over the reporting season.

- Consensus now expects EPS to fully recover FY19 levels in FY21.

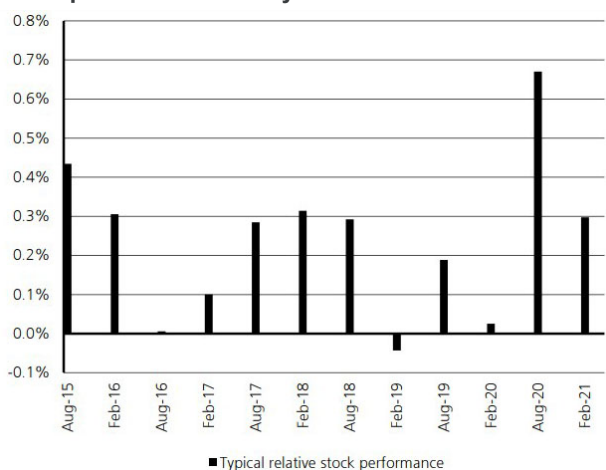
**EPS expectations**



Source: FactSet, RBA, UBS

- Despite the strong profit results the share price reactions often underwhelmed, suggesting the market had already priced in the profit improvement.

**Stock performance on day of result**



Source: FactSet, UBS, Median relative performance on day of result

- COVID-19 winners delivered good results but the market is starting to look through to a post-vaccine period. Early COVID-19 winners started calling out that they will be cycling a strong period of growth, which will mean growth will be more challenging.
- Large cap defensives – Coles Group (COL), Woolworths Group (WOW) and Wesfarmers (WES) have all outperformed expectations but underperformed on the cyclical rotation.
- In recent years a narrow range of companies offered growth (technology, healthcare). The broader range of companies beginning to enjoy revenue growth surprised us. In many cases it comes after years of restructuring has resulted in opportunities for growth and examples can be seen in banking, insurance, resources and cyclicals.
- Financials generally were a highlight. There were good sets of results across the board. The steepening yield curve helped, activity levels improved, and costs have been removed.
- Renewables remain a big focus for the market. Companies are keen to push environmental, social

and governance (ESG) credentials and get ahead of the potential regulatory changes afoot. We see opportunities for a range of businesses from commodities to environmental testing.

- Domestic-leveraged companies (old school industrials) are beginning to see cyclical benefits as goods move across Australia and stimulus supports growth.
- Supply side strains are emerging in some areas. This has been partially driven by strong demand and by COVID-19 disruption. Examples include difficulty accessing student labour and higher lumber prices in the US as housing bounces.
- Digital opportunities are emerging for many businesses. Consumer companies are communicating directly with their customers, traditional businesses are seeking efficiency benefits (banks, general insurance) and infrastructure and construction companies are seeking to leverage digital capabilities to drive productivity.

**Bond sell off**

Confidence regarding the strengthening economy has resulted in a steepening of the yield curve as the market begins to anticipate stronger economic activity. This has also stoked fears of potential inflation.

**10-year bonds**



Source: Iress, DNR Capital

We discussed inflation expectations last month, detailing the differences between the current climate and the post-GFC climate.

To reiterate, we think there are some key differences in the current situation.

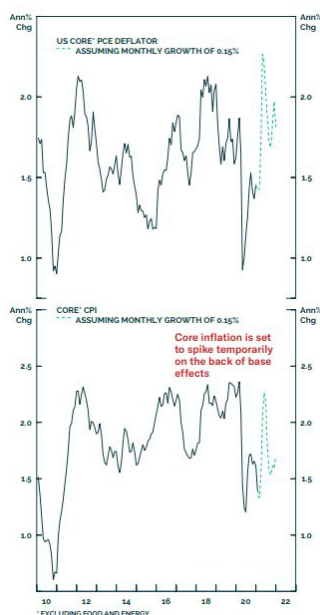
Post-GFC	Today
April 2011– The European Central Bank (ECB) raised rates, central banks focus on austerity	Dovish central banks across the world
Eurozone crisis	Mutualisation of Eurozone debt, German fiscal easing
Fiscal tightening of c3% GDP in the US in 2011/12	Massive fiscal expansion globally
Outsourcing 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.

In coming months inflation will push higher by virtue of a very low base. The market might misinterpret a large inflation print.

**Base effects will push inflation higher**



Source: BCA Research 2021

**Inflation expectations have recovered but are still below levels that would cause concern for The Fed**



Source: BCA Research 2021

The market fears centre around the inflation problems of the 1970s, which were negative for equity markets (and economies). Oil shocks exacerbated the inflation problem in the 1970s, but it was an overheated economy that permitted inflation to rise in the first place. Inflation took off in 1966, seven years before the first oil shock. By 1969, core CPI inflation was running at close to 6%.

Like today, fiscal policy was exceptionally accommodative in the mid-1960s. The escalation of the Vietnam War produced a surge in military expenditures. Social spending rose dramatically with the introduction of Lyndon Johnson’s “Great Society” programs. Medicare and Medicaid took effect in July 1966. As fiscal policy was loosened, the economy began to overheat. The unemployment rate fell to 3.8% in 1966, two percentage points below what economists later concluded had been its full-employment level.

The preceding three recessions were provoked by growing economic imbalances, which were ultimately laid bare by a Federal Reserve (Fed) hiking cycle. One can debate the degree to which the US economy is suffering from non-pandemic-related imbalances today, but one thing is certain: The Fed is not keen on raising rates anytime soon. Thus, whatever imbalances exist today may not be exposed before the economy has had the chance to overheat.

**Fund Commentary**

**Interesting results from reporting season**

**Macquarie Group (MQG)**

MQG delivered positive earnings surprises during the month.

- 1) Stronger activity levels have surprised as markets bounce back and corporate activity has been stronger.
- 2) In addition, strong 3Q21 sales and trading results in fixed income (notably commodities) and equity derivatives.
- 3) Strong 3Q21 infrastructure equity raisings (leading also to a higher balance of funds to deploy).
- 4) Higher banking balances in 3Q21 (excluding Australian vehicles).
- 5) Strong energy trading.

It highlighted the resilience of the MQG business and suggests the bottom of the earnings cycle has been reached for MQG.

**QBE Insurance Group (QBE)**

While QBE’s FY20 headline net profit after tax (NPAT) loss was pre-announced, result disclosures highlight a more favourable story around underlying profit improvement. Twin tailwinds in the form of stronger premium growth and improved underlying claims ratios saw underlying underwriting (UW) profits double in FY20 as global premium rate increases accelerated. Looking forward, we see underlying UW profits rising substantially as insurance price increases feed through and cost cutting takes effect.

### Qube Holdings (QUB)

QUB reported an underlying NPAT of \$74.3m (forecast \$52.4m), up 9.3% on the prior corresponding period (pcp), the beat in the NPAT is driven by stronger-than-expected performance in the operating division and Patrick Terminals, highlighting the delivery of operating leverage in the business from the strong volume environment. All parts of the business saw growth in volumes (containers, mining commodities, forestry, energy) with some offset from restrictions in Melbourne, and also the challenges in WA from the availability of fly in, fly out workers. Management reached a non-binding agreement with LOGOS Property for the sale of 100% of its interest in the warehousing and property components of Moorebank Logistics Park, at a price of \$1.65b (pre-tax). This was broadly in line with expectations, although it was highly anticipated and the stock did not react as strongly as we would have expected. Nonetheless, it is a great outcome and the underlying business is performing very well. With strong profit upgrades and a strong balance sheet the company looks very well placed.

### SEEK (SEK)

SEK delivered a strong result in its core Asia Pacific & Americas (AP&A) business and guided to a much stronger result for the full year. It is benefiting from strong job advertising numbers, as well as a new pricing structure. In addition, SEK announced it is planning on splitting out the investment division which is investing in early-stage businesses and contributing to \$55m in annual losses (yet the businesses are hard to value given a lack of disclosure). Finally, it also announced a partial sale of a stake in the Chinese business at a lower-than-expected valuation and the market reacted to this. However, the core business continues to perform well.

## 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

### Sale of Transurban (TCL)

We sold TCL after a short hold period. Our original thesis was that TCL would perform well as inflation rose (due to inflation hedges in its contracts) with central banks containing interest rates. However, considering market moves in bond yields we became concerned the market would anticipate TCL's debt burden in a higher interest rate environment. Furthermore, we have seen significant opportunities emerge during reporting season and were interested in freeing up capital to deploy into companies that delivered good results, like Computershare (CPU) and QBE Insurance Group (QBE)

## 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

## Disclaimer

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