

DNR Capital Australian Equities High Conviction Fund

APIR code: PIM0028AU

Performance Report September 2023

Performance

DNR Capital Australian Equities High Conviction Fund decreased -3.28% (net of fees) in September, underperforming the S&P/ASX 200 Total Return Index by -0.44%. Over the last 12 months, the Fund increased by 13.15%, underperforming the Index by -0.31% (net of fees). Over the last 3 years, the Fund increased by 16.00% p.a., outperforming the Index by 5.00% p.a. (net of fees).

Net active return as at 30 September 2023

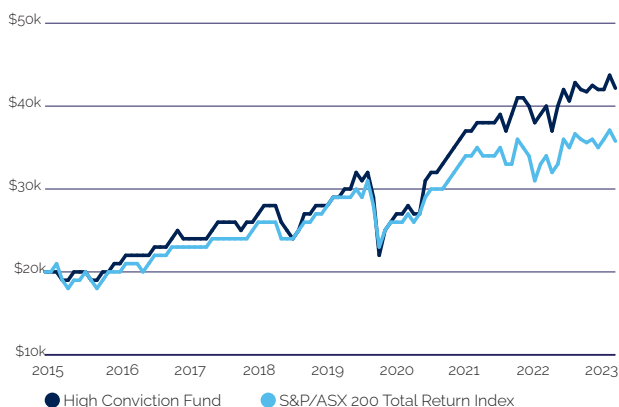
	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	Incep.* p.a. %
High Conviction Fund	-3.28	-0.01	1.01	13.15	16.00	8.63	9.66	9.39
S&P/ASX 200 Total Return Index	-2.84	-0.77	0.24	13.46	11.00	6.67	8.05	7.25
Excess return	-0.44	0.76	0.77	-0.31	5.00	1.96	1.61	2.14

* Inception Date—June 2015.

Source: DNR Capital and Apex Fund Services.

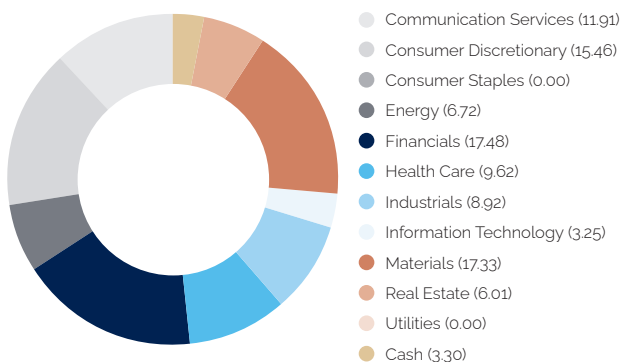
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been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

The Lottery Corporation (TLC)
 CSL (CSL)
 National Australia Bank (NAB)
 Aristocrat Leisure (ALL)
 SEEK (SEK)

Source: DNR Capital and Apex Fund Services

Monthly top contributors and detractors

Top 3 contributors

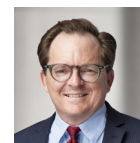
QBE Insurance Group (QBE)
 Computershare (CPU)
 National Australia Bank (NAB)

Top 3 detractors

James Hardie Industries (JHX)
 Scentre (SCG)
 CSL (CSL)

Source: DNR Capital and Apex Fund Services

Experienced portfolio managers



Jamie Nicol
Chief Investment Officer



Scott Bender
Portfolio Manager

Performance attribution

Contributors

- **QBE Insurance Group (QBE):** outperformed as rising bond yields supported expectations for return on shareholder funds, and broader insurance industry dynamics.
- **Computershare (CPU):** outperformed as rising bond yields supported margin income expectations on the group's rate sensitive cash balances.
- **National Australia Bank (NAB):** outperformed along with global banking exposures as steepening yield curves supported the outlook for financial stocks.

Detractors

- **James Hardie Industries (JHX):** underperformed as investors grow increasingly concerned regarding the impact of lower housing starts and increasing construction costs. Additionally, mortgage rates have increased to multi-decade highs, weighing on sector sentiment.
- **Scentre (SCG):** underperformed during the period, following a strong move higher in bond rates. As a result of REITs' high correlation with bonds due to their duration and pricing, the entire sector finished lower.
- **CSL (CSL):** underperformed during the month as the market continued to digest weaker than expected earnings guidance for growth in FY24. The stock has also been softer following the release of trial results for a competitor's treatment of Chronic Inflammatory Demyelinating Polyneuropathy (CDIP) which could impact demand for CSL's immunoglobulin (IG) portfolio.

Fund and market review

The S&P/ASX 200 Total Return Index was down 2.84% during the period. Energy (+1.3%) was the best performing sector, with higher energy prices in a tight market environment supporting equity names (Santos (STO +3.0%), Whitehaven Coal (WHC +16.8%)). Financials (-1.7%) also outperformed, as a shifting outlook towards higher rates could see benefits to margins in the near term (ANZ Group Holdings (ANZ +1.3%), QBE Insurance Group (QBE +4.9%)). The A-REIT sector (-8.7%) was the worst performing sector, with a strong move higher in bond yields leading to a broad-based sell off in duration assets (Goodman (GMG -8.2%), Scentre (SCG -10.6%)). Information Technology (-8.0%) also underperformed, similarly impacted by the moves in the bond market which impacts the present value of growing, future cash flows (Wisetech Global (WTC -6.3%), Xero (XRO -10.1%)).

Markets reacted negatively this month as expectations regarding higher for longer interest rates took hold. We discuss the consequences of the strong move up in interest rates, and the potential impact on markets and economies.

Bond rates moved up

We have seen a sharp move up in interest rates, especially for 10 year and 30 year government debt. When long term interest rates rise faster than short term interest rates it is known as a bear steepening rally. This can mean a few things:

- The market is losing confidence in the ability of the US Federal Reserve (the Fed) to rein in inflation. The recent strength of commodities, particularly energy has sparked renewed inflationary fears.
- The economy is holding up better than expected, meaning interest rates may need to remain higher, to slow economic activity and get inflation under control.
- The ability of the US Federal Government to continue issuing debt fund a range of spending programs is being questioned, because investors are demanding a higher return to buy the debt.

As shown below, the yield on the closely watched US 10-year government bond has again spiked.

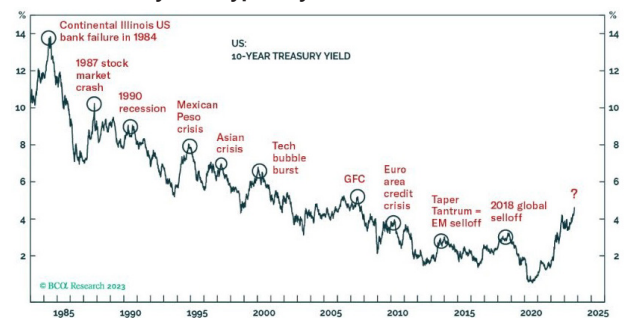
US Benchmark Bond – 10 Year (TRYUS1-Y -FDS)



Source: FactSet

The early part of the bull-steepening phase (which is when short term interest rates fall faster than long term interest rates), tends to coincide with an accelerated slowdown in corporate profit growth, which, in turn, tends to foreshadow an outright earnings contraction. Typically bear steepening events coincide with tightening financial conditions and higher real yields. This is difficult for investors because the risk of economic contraction makes forecasting earnings more difficult. Uncertainty regarding the appropriate risk free rate to use raises questions around valuations. A big sell off in yields typically does not end that well as a consequence.

A rise in bond yields typically ends with a financial accident



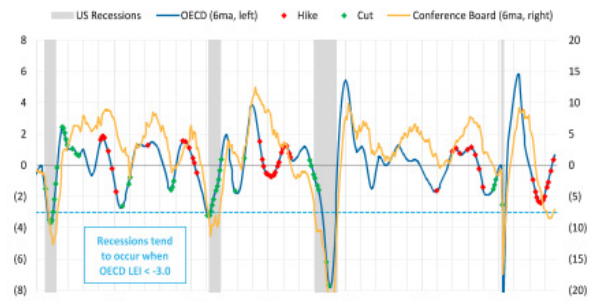
Source: BCA Research

Economy is holding up well

At present, however the economy is performing well, perhaps too well, forcing central banks to maintain higher interest rates which places pressure on over-extended borrowers.

The chart below highlights that, in a somewhat unusual situation, the OECD leading indicators are rising despite sustained interest rate rises.

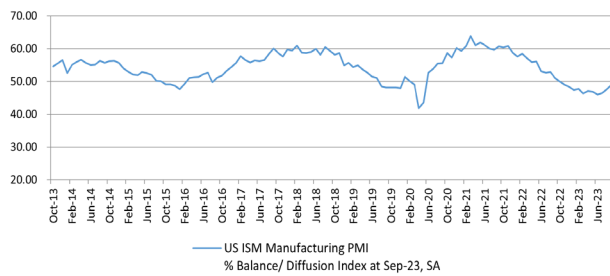
US Cycle – Leading indicators vs recessions



Source: Macquarie Bank

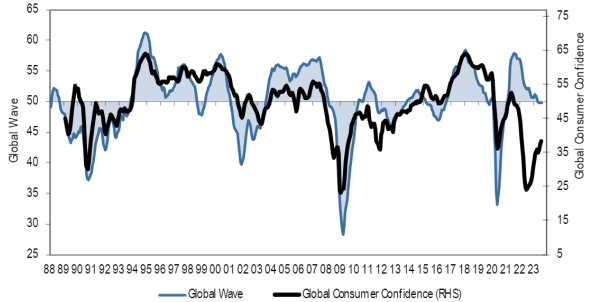
We have seen consumer confidence and business confidence rebound suggesting a stronger resilience to the economy despite the interest rate pressure.

US business confidence (PMI)



Source: FactSet, DNR Capital

Bank of America Global Wave index



Source: BofA Global Quantitative Strategy, MSCI, IBES, Haver, Bloomberg, OECD, IMF, ICE Bond Indices, National Statistics Database

Unemployment and wages growth also remain resilient, suggesting interest rates need to stay stronger for longer.

US unemployment rate

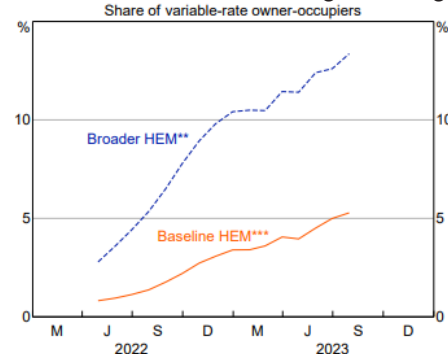


Source: FactSet, DNR Capital

In our view, stronger economic data is, however, a mixed blessing. For those Australian households with too much debt it means further pressure as higher interest rates continue to bite. Indeed the Reserve Bank of Australia (RBA) now estimates that 5-13% of variable owner-occupied borrowers now have mortgage repayments plus essential spending greater than their income – with no relief in sight.

The Household Expenditure Measure (HEM) relied on by the RBA for a couple in Sydney earning \$200,000 p.a. is just over \$4,000/month. For a family of 4 on \$300,000p.a., it is \$5,600/month. This clearly leaves little room for discretionary consumption.

Estimates of borrowers with cost-of-living exceeding income



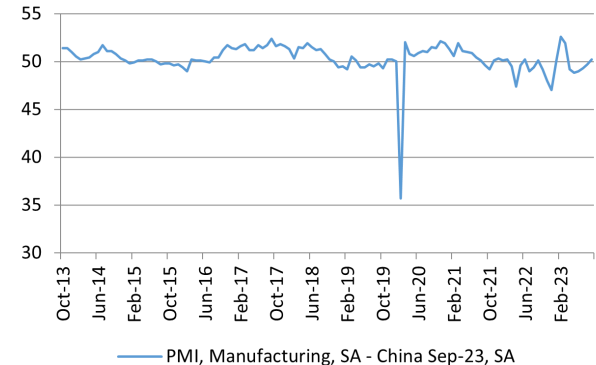
* Estimates of borrowers with mortgage payments and essential expenses (HEM) exceeding their income. Latest observation July 2023.
 ** Estimates based on the broader measure of essential expenses, which factors in some other expenses that are excluded from the baseline HEM (mainly private health insurance and school fees).
 *** Estimates based on the baseline HEM.

Source: ABS; Melbourne Institute; RBA; Securitisation System

China

Sentiment towards the outlook for the Chinese economy remains understandably poor. The market has been hoping for a larger stimulus package to boost demand. Rather than a large stimulus package China has been undertaking a number of smaller packages. These include reducing minimum mortgage downpayments and allowing cuts to existing mortgage interest rates. It also increased personal income tax allowances for children's education and caring for infants and the elderly. On the stock market, policymakers sliced trading fees and took other measures. The result has been a modest boost to business confidence but not enough, at this point, to improve market sentiment towards the economic outlook.

China business confidence (PMI)

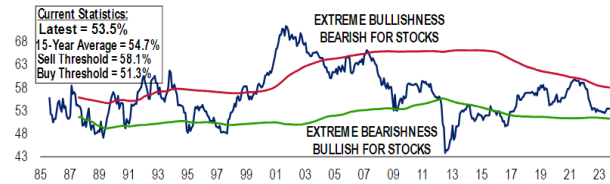


Source: FactSet, DNR Capital

Sentiment and valuations

Whilst the current economic and political set up is difficult for markets, sentiment is already reasonably cautious.

Bank of America Bull & Bear Index over time



Source: BofA US Equity & Quant Strategy

While at first glance this is not that apparent from a valuation perspective, once you back out the top ten stocks then the US looks a little more attractive.

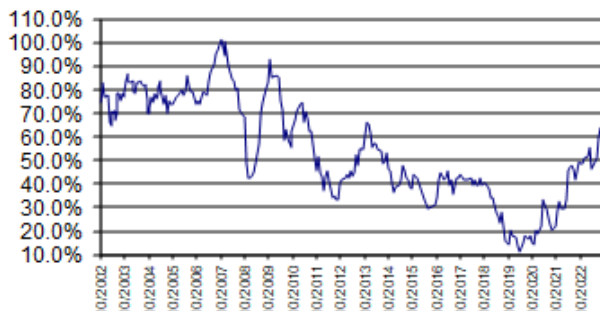
Price Earnings (P/E) ratio of the top 10 and remaining stocks in the S&P 500



Source: JP Morgan Asset Management

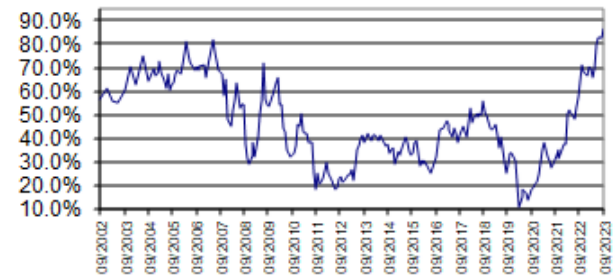
As can be seen below, the US market looks particularly expensive versus current bond yields (partially influenced by the top ten stocks). The market has also not yet priced the 5% risk free rate into growth stocks, ultimately where interest rates settle will be crucial from a valuation perspective.

Australian bond yield on earnings yield



Source: FactSet

US bond yield on earnings yield



Source: FactSet

Outlook

At present the outlook for equities is difficult.

- Given rising interest rates, investors now have alternatives in cash or bonds not seen for years.
- The appropriate valuation multiple to pay is unclear as it is difficult to assess where bond yields will settle.
- And the appropriate earnings ratio is also a little unclear given the potential for higher rates to squeeze the economy.

However, amongst the uncertainty and negative sentiment, opportunities arise.

- With the capitulation of markets around the idea of higher for longer we can begin to think about the other side of the trade. Some companies have moved quicker than others to price in higher bond yields.
- Some defensive companies, where we are confident about earnings, have derated and therefore we can buy with greater confidence.
- Some quality early cyclicals are already forecasting or pricing in a cycle and these companies likely will do better when interest rates peak. Obviously, timing can be difficult here but for investors willing to take a longer-term view, opportunities arise.
- Resources and energy will potentially be less correlated to yields and more to the outlook for China.

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.

Target Market: The DNR Capital Australian Equities High Conviction Fund is an actively managed fund that offers investors exposure to a concentrated portfolio of high quality, large cap Australian listed equities. This product is likely to be appropriate for a consumer seeking capital growth to be used within an investment portfolio where the consumer has a medium or long investment timeframe, high or very high risk/return profile and needs daily access to capital.

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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