

DNR Capital Australian Equities High Conviction Fund

Performance Report – March 2021

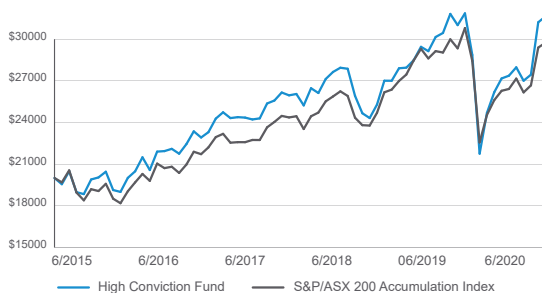
Performance

The S&P/ASX 200 Accumulation Index was up 2.44% during the period.

Consumer Discretionary (+6.9%) was the best performing sector. Improving consumer confidence, coupled with strong household savings and a surging housing market has encouraged the sector. Utilities (+6.8%) also outperformed, as the selloff in bonds moderated, allowing investors to revisit the outlook for bond proxies, including infrastructure and real estate. Materials (-5.0%) was the worst performing sector as iron ore prices slipped from their highs, prompting a selloff in the majors. Information Technology (-3.0%) also underperformed, with long-duration stocks continuing to be challenged by higher bond rates.

DNR Capital Australian Equities High Conviction Fund outperformed its benchmark for the period. Key stock contributors were Computershare (CPU), Aristocrat Leisure (ALL) and Fortescue Metals Group (FMG, no holding). Key stock detractors were BHP Group (BHP), Commonwealth Bank of Australia (CBA, no holding) and Lendlease (LLC).

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	4.82	5.37
Lendlease	4.19	4.65
National Australia Bank	4.06	8.56
Macquarie Group	3.85	6.57
Computershare	3.39	3.83
ALS	3.38	3.63
BHP Billiton	3.36	10.36
Aristocrat Leisure	3.33	4.47
Telstra Corporation	2.99	5.12
Qube Holdings	2.94	3.24

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 31 March 2021

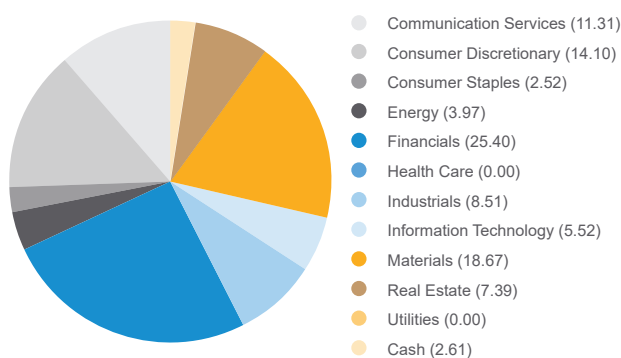
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	Incep.* %
High Conviction Fund	3.02	7.12	25.49	55.81	10.34	11.12	9.51
S&P/ASX 200 Accumulation Index	2.44	4.26	18.54	37.47	9.65	10.25	7.85
Excess return	0.58	2.86	6.95	18.34	0.69	0.90	1.66

* 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:

- Computershare (CPU):** Strong bounce back after underperforming in February. The steepening yield curve assisting the outlook for the mortgage business and an interesting acquisition, which increases its exposure to higher quality revenue streams, were key features during the month.
- Aristocrat Leisure (ALL):** Benefited from the steady reopening of casinos in the US and continued feedback that the ALL product is performing well. Recent online games are also performing well.
- Fortescue Metals (FMG, no holding):** Iron ore mining stocks declined over the month as softness in spot prices was compounded by concerns that Chinese efforts to curb steel production would limit medium-term demand. While Chinese steel production curbs are an ongoing feature of the iron ore market and historically have normalised, we prefer the higher-grade producers who are better positioned for medium-term trends in iron ore demand.

The top stock detractors for the month were:

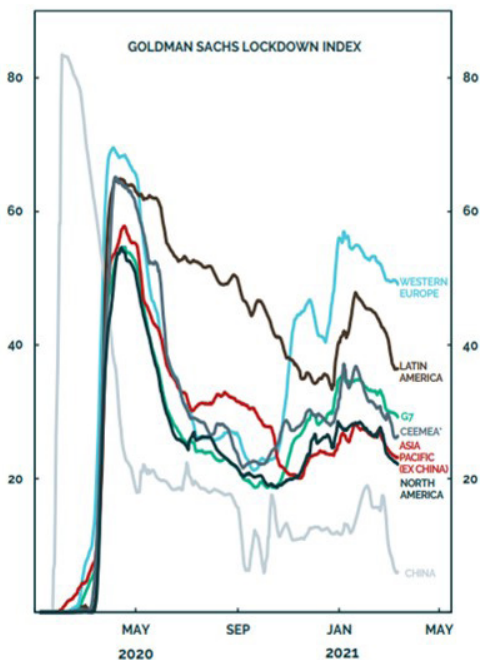
- BHP Group (BHP):** Iron ore mining stocks declined over the month as some softness in spot prices was compounded by concerns that Chinese efforts to curb steel production would limit medium-term demand. Chinese steel production curbs are an ongoing feature of the iron ore market and historically have normalised over the medium term. As a higher-grade producer, BHP is well positioned to work through near-term market volatility and maintain strong cash flow generation over the medium term.
- Commonwealth Bank of Australia (CBA, no holding):** Solid bounce back following selloff during February.
- Lendlease (LLC):** Fell over the month on incremental news flow. The company continues to make progress towards its \$8b development target and investor appetite for build-to-rent and commercial product are showing some signs of improvement.

Market review

Markets tracked sideways this month, fluctuating between enthusiasm for the reopening global economy and disappointment about the pace of the COVID-19 vaccine rollout in some regions like Europe. Furthermore, debate continues regarding the possibility of inflation lifting bonds and the potential boost provided to the economy from US President Biden's recent infrastructure plan. This month we discuss these developments.

Vaccine update

Dismantling of lockdown measures occurring at varying pace

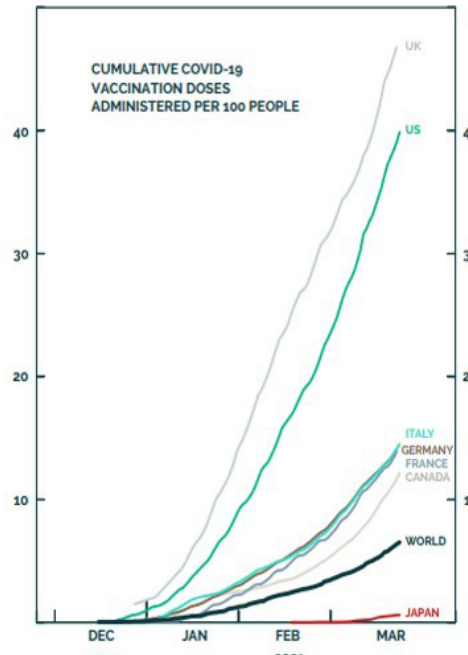


Source: Our World in Data, BCA Research

The pace of economies emerging from lockdown is varied across the globe. Those areas with more advanced vaccine rollout plans are generally emerging more quickly. Western Europe and Latin America are laggards with recent COVID-19 cases accelerating and vaccine rollout delayed. While this has caused some modest anxiety for markets, if the vaccine is effective it is simply a matter of timing in these regions.

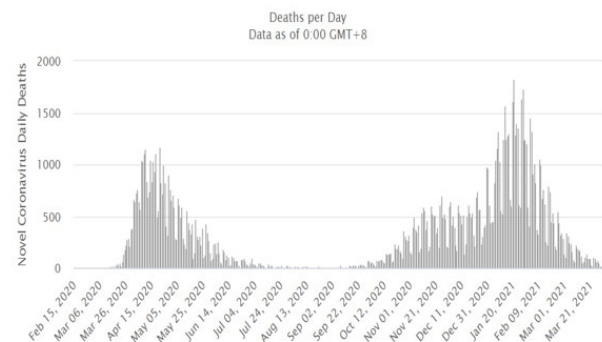
The UK and the US, two of the harder hit regions from COVID-19, have enjoyed the fastest vaccine rollout. It is worth noting how successfully this has reduced case numbers and deaths in the UK. This is encouraging and allowing the UK to announce further reopening initiatives.

US is among the vaccination leaders



Source: Our World in Data, BCA Research

Daily deaths



Source: Worldmeter.info

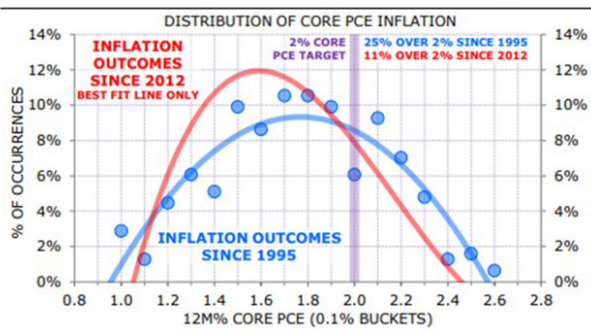
Politics have changed

For the past 40 years politics and economics have been dominated by the Friedman monetary economic policy agenda. Since the 1970s, major governments and central banks have been focused on monetary policies to fight inflation. We appear to be at the end of this approach.

Fiscal spending is on the increase. It is no longer political poison to increase debt. US President Biden has unveiled a large multi-trillion-dollar infrastructure plan called the "Build Back Better" infrastructure investment plan, focusing on transport infrastructure projects, manufacturing, renewable energy, high-speed broadband networks and affordable housing. The plan is subject to US Congress and Senate approval and if it is passed without change, we could see nearly US\$300b of incremental investment per annum (or c1.5% US GDP) over a period of 10 years, with potential upside from multiplier effects. US transport infrastructure investments amount to ~US\$150b per annum, while the total gross fixed asset investment by government amounts to ~US\$400b per annum. The plan also appears to favour "green development" of infrastructure assets, like building 30GW of offshore wind energy by 2030.

To fund this there will be some tax increases but ultimately the world will have more debt and central banks appear to be favouring allowing the economy to run hot. The Federal Reserve is changing its policy footings including no longer aiming to pre-emptively tighten policy to control inflation, which may unsettle markets. Another change is that central banks will care less about markets and will favour Main St over Wall St. From the early 1990s, central bank best practice included several features: a focus on an explicit inflation target; forward-looking policy adjustments; and a respect for markets. Central banks have tended to overreact in the past three decades, resulting in inflation being below trend most of the time. Poor forecasting means they are giving up on predicting inflation, preferring to wait to see the evidence, which means allowing the economy to overheat a little.

Central banks kept hooking left of the target



Note: The Fed adopted an explicit inflation target in January 2012.

Source: BLS; Minack Advisors

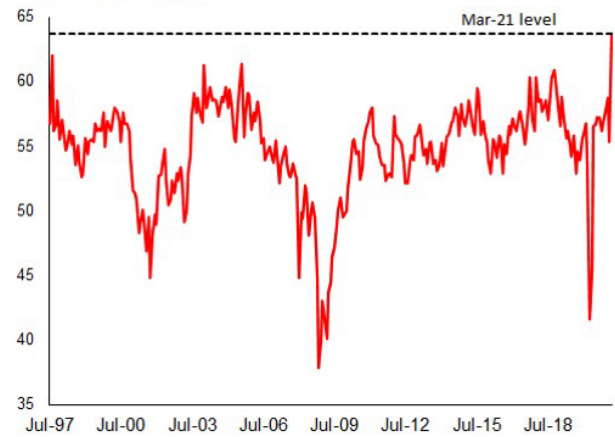
There is also a greater focus on the labour market with full employment plus low inflation increasingly seen as the goal. The Reserve Bank of Australia is hinting that it will ignore any rise in inflation as transitory unless it is due to sustained strong wage increases. Central banks will be more likely to dismiss increases in inflation (including increases in core inflation) as temporary if wage growth is not suitably robust.

Since the GFC, tighter fiscal policies saw governments resort to quantitative easing (QE) to lower interest rates. This approach was intended to lower long term interest rates, lower the currency to improve the competitive position, and to create a wealth affect where higher asset prices encouraged investment. However, QE wasn't particularly effective because as everyone was undergoing QE there was no currency benefit, there wasn't much credit creation and while asset prices went up, so did savings rather than investment. We now find ourselves in a different world where fiscal policy is now the prime tool of cycle management.

Economic recovery

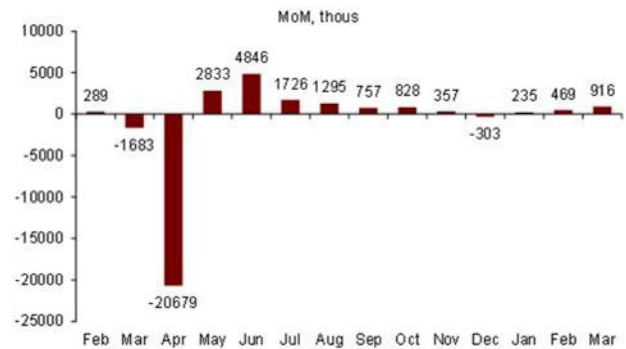
Stimulus and post COVID-19 recovery continue to take shape. Off a low base the US manufacturing survey has seen a startling recovery and job creation has surprised to the upside.

ISM Services PMI



Source: Macquarie Research

US jobs created

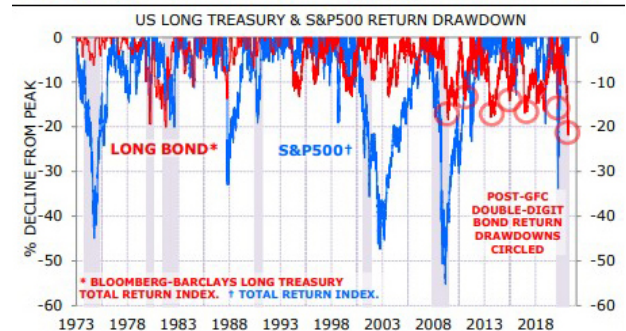


Source: Credit Suisse

Implications for bonds and inflation and equity multiples

Over the past decade bonds have been negatively correlated to equities. Investors in bonds have enjoyed strong returns plus a hedge against a negative equity market. However, volatility in bonds is increasing. The US long-term bond index has seen more double-digit drawdowns than the S&P 500 over the past decade.

No equity-like return, but equity-like volatility

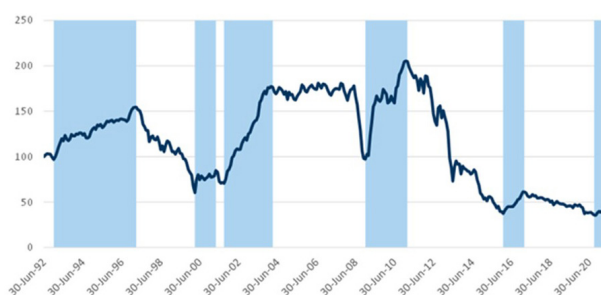


Source: Standard & Poor's, Bloomberg-Barclays, NBER, Minack Advisors

In a low-inflation environment, equities will be negatively correlated to bonds but this flips as inflation rises above 2.5%. When the correlation was negative, bonds would rise substantially in an equity-led bear market, but this is unlikely in an inflation-led bear market (note that bonds would still outperform a large equity drawdown, but perhaps not be up).

An economy being driven by fiscal stimulus with stronger inflation is likely to see change in market leadership. Those companies with stronger exposure to the economic cycle would tend to do better, while longer duration growth stocks would struggle. We have seen this play out over the past six months. The question is how far has this left to run. The following chart by Goldman Sachs suggests there could be substantially more to run. It shows some prior value rallies relative to growth when leadership changes. It would appear to be at the early stages of a value rally.

Value versus Growth Index



Start	Peak	Start to Peak (mths)	Benchmark	Returns (%)		
				Value (vs ASX 200)	Growth (vs ASX 200)	Value vs. Growth
31-Dec-92	27-Mar-97	52	109%	59%	-41%	100%
31-Mar-00	30-Apr-01	14	-5%	-4%	-30%	26%
28-Sep-01	31-Mar-04	31	40%	94%	-46%	141%
31-Dec-08	28-Feb-11	27	76%	97%	-46%	143%
29-Jan-16	28-Feb-17	14	24%	35%	-27%	62%
Average	28	49%	56%	56%	-38%	94%
30-Sep-20	30-Mar-21	7	17%	21%	-11%	32%

Source: Goldman Sachs

Bottom up

We are seeing a broader range of companies offering growth than we have seen in recent years. Digital disruption will continue to be a source of growth, but we note these other opportunities for growth:

1. Infrastructure spending and the move towards renewables.
2. The above driving demand for commodities boosting resources.
3. The war on waste creating growth opportunities for individual companies.
4. Cyclical recovery in earnings for financials.
5. Companies benefiting from the reopening of the economy and the strong increase in consumer savings, which will likely be spent.

Fund positioning

Our current positioning is:

1. Reopening beneficiaries: SKYCITY Entertainment Group (SKC).
2. Beneficiaries of infrastructure/green new deal spending: ALS (ALQ), QUB Holdings (QUB).
3. Improving quality: Computershare (CPU).
4. Strong franchise companies: James Hardie Industries (JHX), SEEK (SEK), Aristocrat Leisure (ALL).
5. Resilient/defensive: Tabcorp Holdings (TAH).

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 vaccines would be negative, as would the emergence of vaccine-resistant COVID-19 variants.
- **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.
- **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 Xero (XRO)

We have recently exited XRO. While we continue to think XRO is a strong company, it has re-rated substantially over the past year and trades on 18x sales. However, we saw opportunities to add to a range of companies which have seen weakness over the past few months including SEEK (SEK) and ALS (ALQ).

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

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