

DNR Capital Australian Equities High Conviction Fund

Performance Report – June 2021

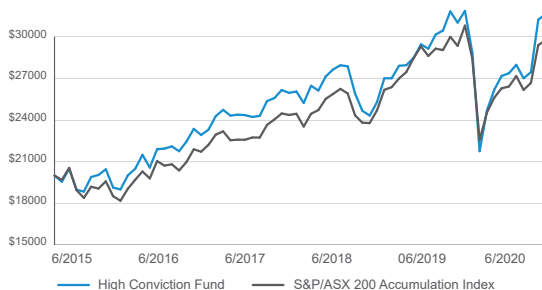
Performance

The S&P/ASX 200 Accumulation Index was up 2.26% during the period.

Information Technology (+13.4%) was the best performing sector. The observed market rotation away from value in part reflects a flattening of the yield curve, pointing to transitory inflation and a slowing in recently strong economic growth. Implied lower-for-longer interest rates benefit longer duration and growth stocks. Communication Services (+5.6%) also outperformed, with the telcos lifting the sector on favourable industry dynamics. Financials (-0.2%) was the worst performing sector, in a direct reversal of the procyclical trade last month. Materials (+0.3%) similarly suffered from the shift towards lower inflation, lower growth sentiment.

DNR Capital Australian Equities High Conviction Fund performed largely in-line with its benchmark for the period. Key stock contributors were Iress (IRE), Westpac Banking Corporation (WBC, no holding) and CSL (CSL, underweight). Key stock detractors were Lendlease (LLC), Afterpay (APT, no holding) and National Australia Bank (NAB).

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	4.68	5.24
Macquarie Group	3.73	6.32
Lendlease	3.65	4.04
National Australia Bank	3.61	7.82
Cash	3.60	3.60
Aristocrat Leisure	3.57	4.91
Computershare	3.47	3.94
ALS	3.13	3.44
BHP Billiton	3.08	10.03
Telstra Corporation	3.05	5.18

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 30 June 2021

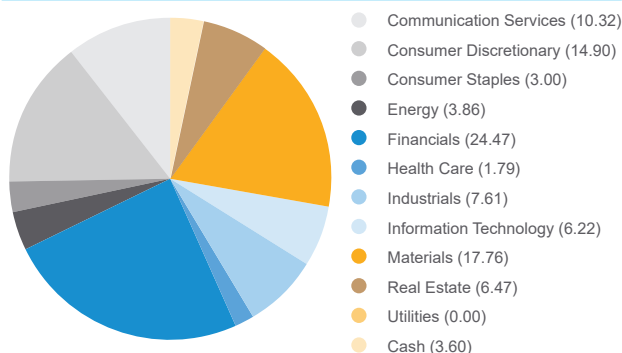
	1mth	3mth	6mth	1yr	3yr	5yr	Incep.*
High Conviction Fund	2.25	9.05	16.81	36.03	10.85	12.43	10.67
S&P/ASX 200 Accumulation Index	2.26	8.29	12.90	27.80	9.59	11.16	8.94
Excess return	-0.01	0.76	3.91	8.23	1.26	1.27	1.73

* 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:

- Iress (IRE):** A surprise raid by a broker highlighted potential corporate interest in the company. As part of a defence the company reported an intention to sell its digital mortgage software business and to buy back shares.
- Westpac Banking Corporation (WBC, no holding):** The banks were soft after going ex-dividend and with the broader rotation to growth.
- CSL (CSL, underweight):** Underperformed over the month on concerns of a slower-than-expected ramp up in collection volumes with new restrictions on Mexican donors. While FY22 will still be a tough year given the lower volumes collected during COVID-19, a continuation of stronger collection trends will underwrite a strong rebound in FY23.

The top stock detractors for the month were:

- Lendlease (LLC):** Fell over the month on concerns that project delays might result in softer-than-expected earnings in 2H21, with the earnings contribution possibly pushed into the December half. The new CEO continues to review the operating structure with the potential for future write-downs also weighing on sentiment. LLC continues to make progress towards its \$8b development target and investors' appetite for build-to-rent and commercial products are showing some early signs of improvement.
- Afterpay (APT, no holding):** Outperformed in line with other growth stocks and following initiatives to broaden access to online brands in North America. While we continue to monitor the story and recognise the potential of the platform, we find the valuation unpalatable, given regulatory risks and a model relatively untested under bad-debt scenarios.
- National Australia Bank (NAB):** The banks were soft after going ex-dividend and with the broader rotation to growth.

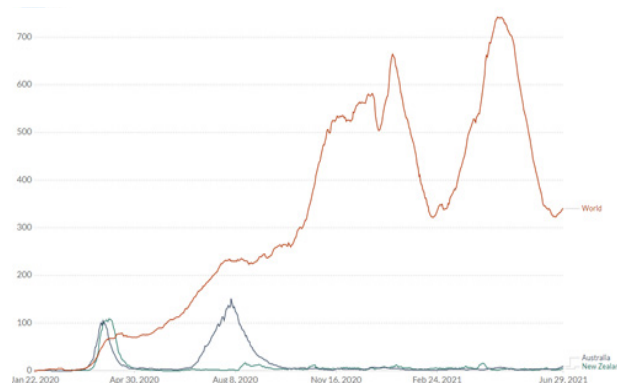
Market review

The June quarter caps off an historically unpredictable and unique financial year for investors. Markets at all-time highs seemed implausible a year ago, but investors appear to have shrugged off pandemic risks and are looking through to a rapid but evolving economic recovery. With vaccinations key to Australia's ability to rejoin the global community, we assess the current vaccination rollout, review what did and didn't work in FY21, and discuss portfolio positioning in the context of current market dynamics.

Australian vaccination analysis

Australia has fared better than most countries regarding COVID-19 fatalities and economic disruption, but on most metrics, progress on inoculating the population lags. Hard border closures and a willingness to execute statewide lockdowns for low-level community transmission have demonstrated Australia's commitment to containing the pandemic.

Weekly confirmed COVID-19 cases per million people



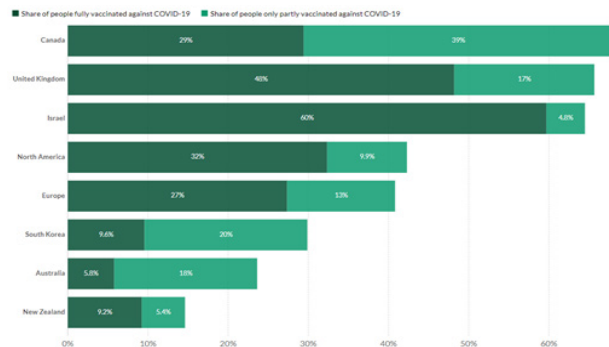
Source: Our World in Data

Our success may have engendered a lack of urgency around vaccination, but several issues have exacerbated rollout delays. The Therapeutic Goods Administration (TGA) gave approval in mid-February for Australia's preferred AstraZeneca vaccine, several weeks after it was approved in Britain and broader Europe. Targets of delivering four million doses by April were then delayed by the European Commission blocking exports of doses manufactured on the continent. While CSL has been locally manufacturing AstraZeneca since March, a link established between the vaccine and a rare but potentially lethal side effect of blood clotting led the Australian Technical Advisory Group on Immunisation (ATAGI) to raise the recommended age to 60 and over.

The government has also purchased 40 million doses of the Pfizer/BioNTech mRNA vaccine, which received approval for use in late January. Dosing began in mid-February, but half of the doses will not arrive until the fourth quarter of 2021. Finally, 51 million doses of the Novavax protein-based vaccine and 25 million doses of Moderna's mRNA product have been contracted for supply in late 2021, but both are pending TGA approval.

National daily vaccination numbers continue to improve but Australia, along with New Zealand, lags many developed countries.

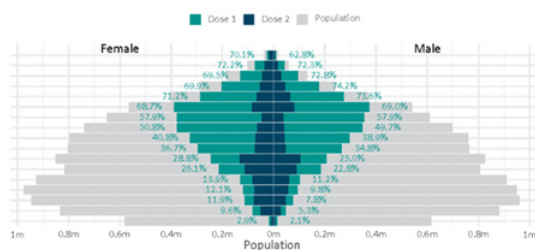
Share of people vaccinated against COVID-19



Source: Our World in Data

Despite the low absolute percentage of the population vaccinated, the eligibility system has seen a larger proportion of older and more vulnerable cohorts receive at least one dose.

Australia – Vaccinations rates by demographic



Source: www.health.gov.au

State-by-state comparisons are difficult given that national vaccination numbers are reported separately, but recent lockdowns appear to have accelerated vaccinations in affected regions.

Doses per 100 residents



Source: www.health.gov.au

The most recent outbreaks, subsequent lockdowns and confusion over eligibility have increased pressure on the Federal Government to accelerate vaccination rates. Combined with lowering the AstraZeneca-eligible age to 18 under GP supervision, the Morrison Government has now outlined a four-phase “return to normal” plan:

Phase 1: Ongoing vaccination rollout, reduce inbound passenger arrivals cap by 50%, trialling shorter and possibly home quarantine for vaccinated residents.

Phase 2: Post-vaccination, an easing of lockdown and border restrictions, caps to student and economic visa holders.

Phase 3: Lifting restrictions on vaccinated residents, increasing limits on students/visa holders, extending travel bubbles, and ultimately treating COVID-19 like any other infectious disease.

Phase 4: A return to normal with pre- and post-flight COVID-19 testing for all arrivals.

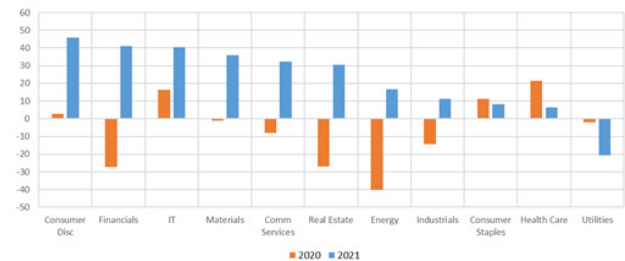
From an investor perspective, markets appear to be shrugging off outbreaks and looking through the short-term impacts of lockdowns. The ultimate goal of reopening international borders will be the most impactful on domestic industries (for better or worse). Australia's ability to attract tourists, students, and workers to our shores, balanced by our propensity to travel and consume offshore, will likely shape investment themes in the coming years.

FY21 – What worked and what didn't

Sectors

With the exception of Utilities, all sectors of the ASX 200 had positive returns in FY21. Consumer Discretionary and Financials both returned in excess of 40%. Several sectors enjoyed a bounce from the previous year's drawdown, but retail, Health Care and Information Technology delivered sequential, positive, annual returns.

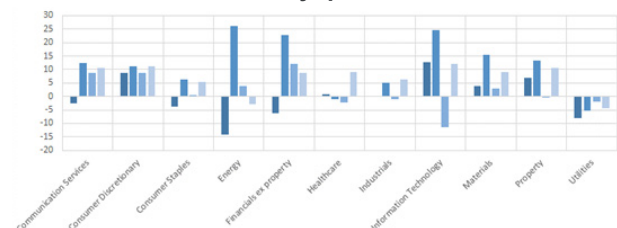
% return by GICS Sector



Source: FactSet, DNR Capital

Returns were broadly consistent over the year, but Energy, Information Technology and Financials displayed more volatility.

FY21 Sector total return by quarter



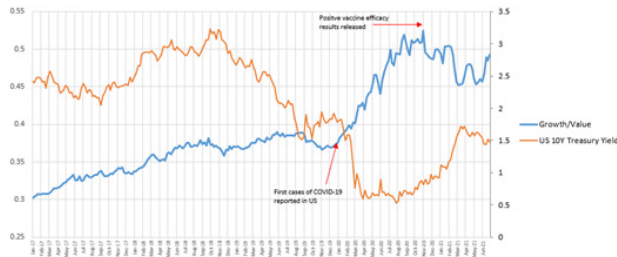
Source: FactSet, DNR Capital

Value versus growth

The performance of growth stocks peaked in the first quarter of FY21, when initial trials from a clutch of COVID-19 vaccines showed impressive results. The subsequent cyclical rally led a sharp rotation into value stocks, unwinding some of growth's historic outperformance. Having bottomed in August last year, bond yields rose through March as inflation expectations peaked. Much of this rotation unwound in the fourth

quarter however, driven by the Federal Reserve’s confidence in transitory inflation and ongoing dovish commentary.

iShares S&P 500 Growth (IVE)/iShares S&P 500 Value versus S&P 500

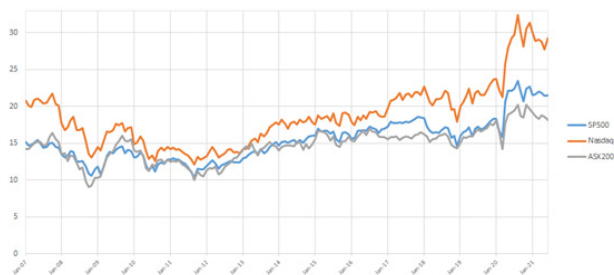


Source: Iress, DNR Capital

Market valuations

Globally, market valuations are hovering near all-time highs.

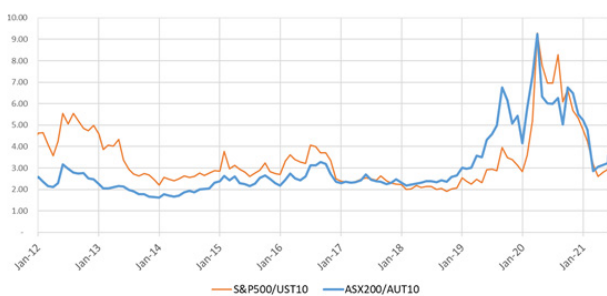
S&P 500, NASDAQ 100 and ASX 200 PE (next 12 months)



Source: DNR Capital

From a relative perspective however, when comparing the earnings yield of the market against that of bond yields, equities still appear reasonably cheap, and in line with levels observed prior to the coronavirus pandemic.

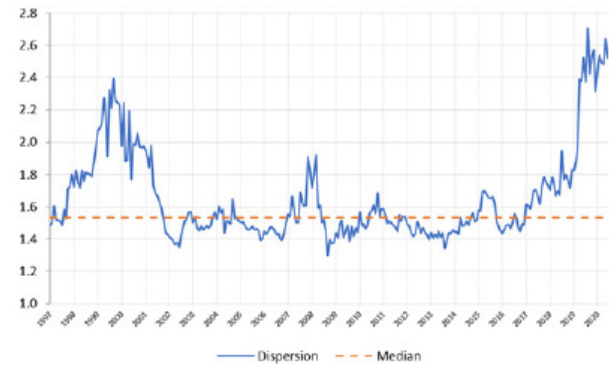
Bond equity earnings yield ratio (10-year Government Bond Yield)



Source: FactSet, DNR Capital

Despite narratives of value’s return, the gap between high-growth and low-growth stocks remains extreme. Gauging the ASX 200’s price to earnings (PE) multiple dispersion, measuring the difference between the two, we note that a modest retracement has reverted to near all-time highs.

PE multiple dispersion



Source: UBS Quant & Strategy

Outlook for interest

Significant attention has been placed on June’s Federal Open Market Committee (FOMC) commentary. Chairman Jerome Powell acknowledged that the committee had begun “talking about talking about” raising interest rates, contrasting last June’s insistence that they were not even “thinking about thinking about” raising rates. Notably, the median expectation for rates to increase moved forward from 2024 to 2023. The market’s response saw a sharp rise in the US dollar and a general flattening of the yield curve. The implied level of future inflation, which had been steadily rising since the beginning of the year, also declined.

US Treasury 5-year breakeven inflation rate



Source: FactSet, DNR Capital

The reaction surprised many investors, given the implied negative impact on equity valuations from rising interest rates. Support among investors for the Federal Reserve’s transitory inflation view has grown however, and the pull forward of rate hikes suggests a willingness to contain any breakout. Subsequent economic data has further galvanised the case for a not too hot nor too cold ‘Goldilocks’ economic recovery. While still broadly debated, as the US begins to cycle soft data from last year, questions around pace of growth and permanence of inflation will begin to be answered.

Fund positioning

Our current positioning is:

1. **Reopening beneficiaries:** SKYCITY Entertainment Group (SKC).
2. **Beneficiaries of infrastructure/green new-deal spending:** ALS (ALQ), QUBE Holdings (QUB).
3. **Improving quality:** Computershare (CPU).
4. **Strong franchise companies:** James Hardie Industries (JHX), SEEK (SEK), Aristocrat Leisure (ALL).
5. **Resilient/defensive companies:** 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 development 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 including civic destabilisation in the US and regional tensions with China could create negative implications for stocks and portfolios.

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.

Disclaimer

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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 Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- My North & North
- Netwealth
- Wealth O2