

# DNR Capital Australian Equities High Conviction Fund

## Performance Report – August 2021

### Performance

The S&P/ASX 200 Accumulation Index was up 2.50% over the month.

Information Technology (+16.8%) was the best performing sector, following Afterpay's (APT +39.2%) takeover offer from Square and Wisetech's (WTC +57.0%) strong profit result. Health Care (+6.8%) also outperformed as the majority of the sector met expectations during reporting season. Materials (-7.9%) was the worst performing sector, as fears of an economic slowdown stemming from the COVID-19 Delta variant affected commodity prices, with iron ore in particular impacting the majors. Energy (-5.1%) also underperformed as oil prices fell, similarly affected by economic sentiment.

DNR Capital Australian Equities High Conviction Fund outperformed the Index for the month. Key stock contributors were Domino's Pizza Enterprises (DMP), Fortescue Metals Group (FMG, no holding) and James Hardie Industries (JHX). Key stock detractors were BHP Group (BHP), Afterpay (APT, no holding) and Woodside Petroleum (WPL).

### 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	4.15	4.65
Macquarie Group	4.04	6.72
Lendlease	4.00	4.39
National Australia Bank	3.72	8.05
Aristocrat Leisure	3.31	4.69
SEEK	3.22	3.76
Computershare	2.99	3.43
Telstra Corporation	2.92	5.08
Qube Holdings	2.88	3.16
Suncorp Group	2.88	3.64

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 August 2021

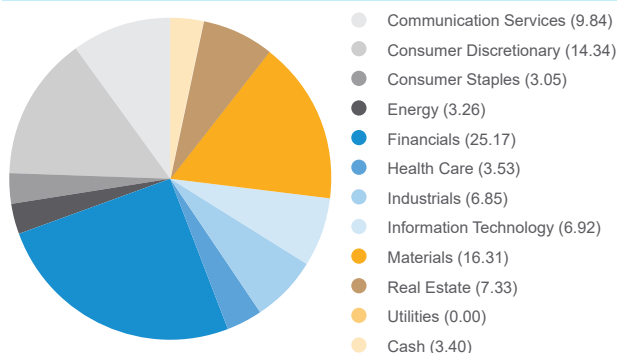
	1mth	3mth	6mth	1yr	3yr	5yr	Incep.*
High Conviction Fund	3.71	5.95	16.40	36.89	11.08	11.79	11.00
S&P/ASX 200 Accumulation Index	2.50	5.97	14.96	28.15	9.87	10.94	9.31
<b>Excess return</b>	<b>1.21</b>	<b>-0.02</b>	<b>1.44</b>	<b>8.74</b>	<b>1.21</b>	<b>0.85</b>	<b>1.69</b>

\* 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

- Afterpay (APT, No Holding):** outperformed during the month following a bid by Square, Inc. to acquire the group in an all-stock deal, valuing the business at nearly AU\$40b. We view the deal as likely to proceed with little regulatory risk or alternative bidders emerging.
- Woodside Petroleum (WPL):** underperformed during the period on a weaker oil price and stock overhang concerns. The company announced a proposed merger of equals with BHP's petroleum business, which would create a top 10 global oil and gas company by size. Despite the benefits that would accompany such a transaction, such as improved cash flow metrics and growth profile, the likely overhang from such a large scrip deal has weighed on the stock.

### Attribution

The top stock contributors for the month were:

- Domino's Pizza Enterprises (DMP):** outperformed following the release of FY21 earnings results. A strong second half combined with positive confidence and increased store rollout target was positively received. The group is well positioned for growth in FY22 by leveraging an expanded customer base and ongoing network expansion in Europe and Japan.
- Fortescue Metals Group Limited (FMG, no holding):** fell over the month as spot iron ore prices traded lower on concerns that Chinese steel production curbs would lead to lower demand. FMG was also impacted by increased spreads between high and low grade ore, given its lower grade output.
- James Hardie Industries (JHX):** delivered a strong 1Q result with sales up 35% and EBIT up 45% with guidance upgraded. The company outlined the opportunity to increase capacity and grow high margin product.

The top stock detractors for the month were:

- BHP Group (BHP):** underperformed over the month as spot iron ore prices traded lower on concerns that Chinese steel production curbs would lead to lower demand. During the month, the company announced they would merge their petroleum business with Woodside Petroleum (WPL) and proposed to collapse the dual listed structure back into a single Australian listing. The proposal to collapse the dual listing saw significant selling in the Australian market which has traditionally traded at a premium.

### Market review

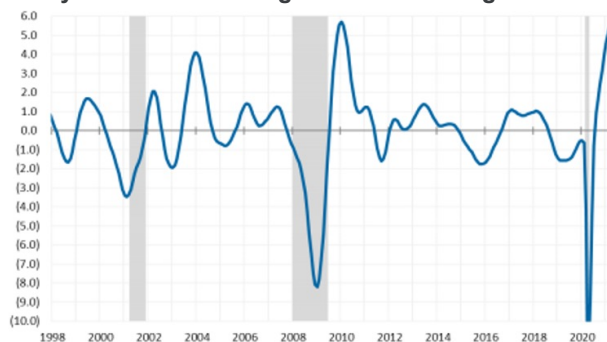
This month we review the current economic growth in China and the US, discuss the impact of the Delta strain, and implications of the recent US Federal Reserve (Fed) meeting. Finally, we assess the implications of the recent reporting season.

#### Growth

Over the past three months a tightening of the Chinese economy and concerns over the impact of the Delta variant, have overhung the outlook for the global economy.

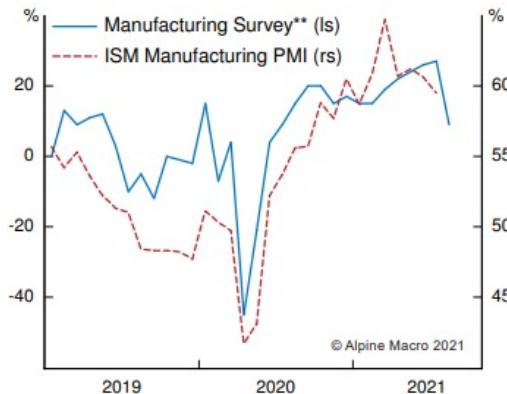
The US economic growth rate has peaked as evidenced by OECD leading indicator.

#### US cycle based on change in OECD leading indicator



Source: Jeffries

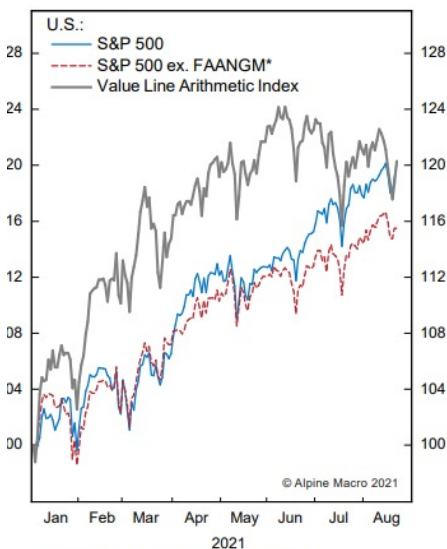
Manufacturing still exhibits solid expansion albeit off its highs however.



\*Source: Federal Reserve Bank of St. Louis  
\*\*Source: Federal Reserve Bank of Richmond

The US market has steadily moved higher. Notably, the S&P500 excluding leading technology stocks has corrected, highlighting market concerns around the growth outlook.

**S&P 500 vs. S&P S&P500 ex FAANGM**

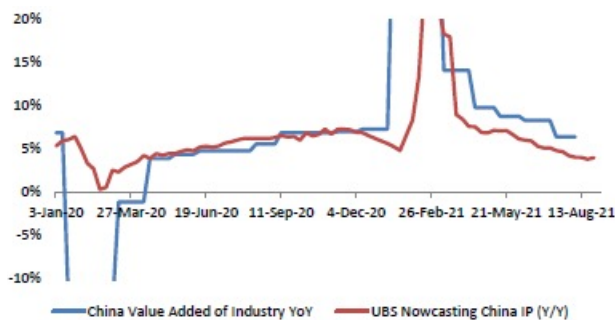


Note: All series are rebased to Jan 2021 = 100  
\*Market cap weighted average of Facebook, Apple, Amazon, Netflix, Alphabet's Google and Microsoft

Source: Alpine Research

Chinese economic growth has also rolled in response to tightened economic conditions.

**Industrial production**



Source: UBS Evidence Lab, Bloomberg, UBS Research

The lagged impact of Chinese policy tightening combined with catastrophic flooding in Central China and domestic outbreaks of COVID-19 have increased the downside risks to the economy. Escalating property restrictions have resulted in two straight months of declining home sales, while construction starts accounted for nearly half the forecasted GDP slowdown. We have seen some signs of a political response in relation to this softening. The People's Bank of China (PBOC) Governor Yi Gang promised to boost credit support and improve efforts to moderate real lending rates for businesses.

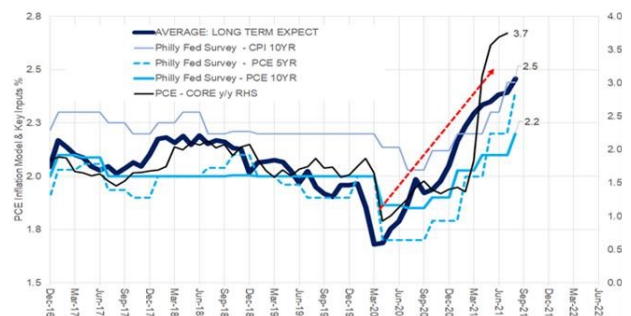
The PBOC vowed financial support for the rural sector with the monetary policy tools at its disposal. When in doubt, central banks are conditioned to go deep and to go fast, hence, it is not unthinkable that both the Reserve Requirement Ratio (RRR) and Loan Prime Rate (LPR) are cut.

**US Federal Reserve response**

From the July meeting statement and minutes, we have become all too familiar with the idea that the Fed is looking for “substantial progress” on both inflation and job creation fronts. With this in mind, Chair Powell has conceded that “substantial progress” has been made on the inflation front. He has resisted suggestions that “substantial progress” has been made on the job creation front however. The Chair describes the Fed as seeing “clear progress” on the pace of job market recovery, but also suggests the recent coronavirus surge has clouded the outlook.

In response to Powell’s dovish comments, real bond yields, equity market volatility (VIX) and the US dollar (USD) dropped. Inflation expectations moved slightly higher however, mitigating the decline in nominal yields.

The US will continue to leave rates low and run the economy hot until there is overwhelming evidence of sustainable inflation. The market is focused on the fact that sequentially growth rates and inflation are slowing down and that fiscal policy is turning from a tailwind to a headwind. As the 2nd derivative of COVID-19 cases growth turns we should see cases peaking. As we get better data, interest rates have room to sell off which would support a rotation in the market (subject to Chinese growth slowdown not impacting the broader market).

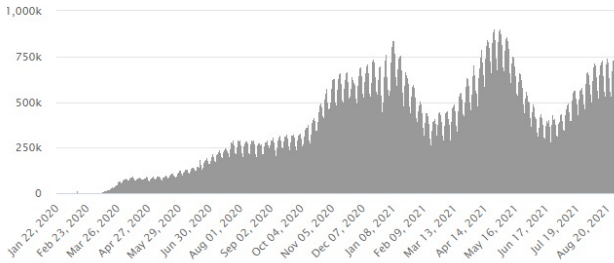


Source: Endeavour Research

### COVID-19

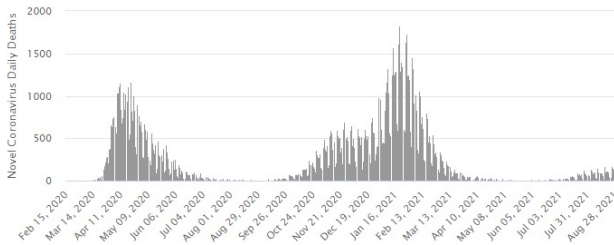
Case numbers across the globe are experiencing a third wave as the Delta variant spreads. For regions with a high number of prior cases and/or a high number of vaccinations, deaths have fortunately remained modest.

#### Daily new cases



Source: Worldometers.info

#### Daily new deaths in the United Kingdom



Source: Worldometers.info

Consequently, in major economies such as UK and US, populations and governments appear to have little appetite for further lockdowns and economies are returning to a level of normality. Australia is clearly lagging this trend, but under Delta, zero COVID-19 targets appear increasingly unachievable. We believe accelerating vaccination rates are helping shift the conversation around opening up but clearly a level of uncertainty remains.

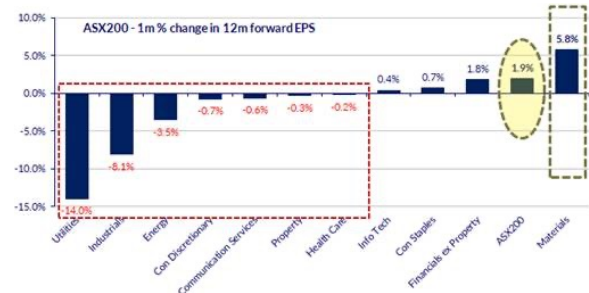
### Conclusion

Global growth is slowing following a strong bounce back from the depths of COVID-19. The Fed remains supportive and evidence of sustainable inflation will take time to emerge. The fly in the ointment is China and the new COVID-19 variants. China is slowing and authorities have pivoted to a more domestic focused economy, and further redistribution of wealth. A slowing of recent economic data however, has seen authorities appear to begin to loosen monetary policy again. Further stimulus would be supportive of cyclical, particularly in a normalising post COVID-19 world. We retain a balanced portfolio with a range of strong franchise companies, offering defensive resilience combined with quality businesses trading cheap due to the pandemic impacts.

### Reporting season

Key observations from reporting season

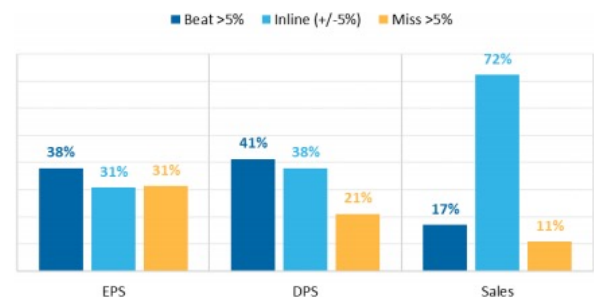
1. FY22 outlook is clouded by lockdown. The short term outlook was impacted by the duration of the lockdown, but markets are generally willing to look through this given the vaccine roll out.
2. Earnings per share (EPS) growth of 26% was delivered for the year, off a COVID-19 impacted base. Earnings were revised up 2% driven by materials and financials.



Source: CSLA

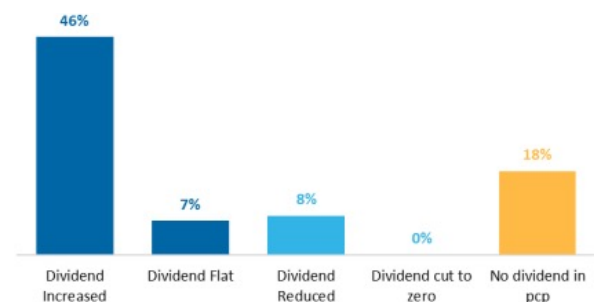
3. 38% of companies beat expectations and 31% disappointed. Dividend performance was stronger as financials and resources lifted dividends.

#### Half year EPS beat or miss vs MRE – percent of companies



Source: FactSet, Macquarie Research

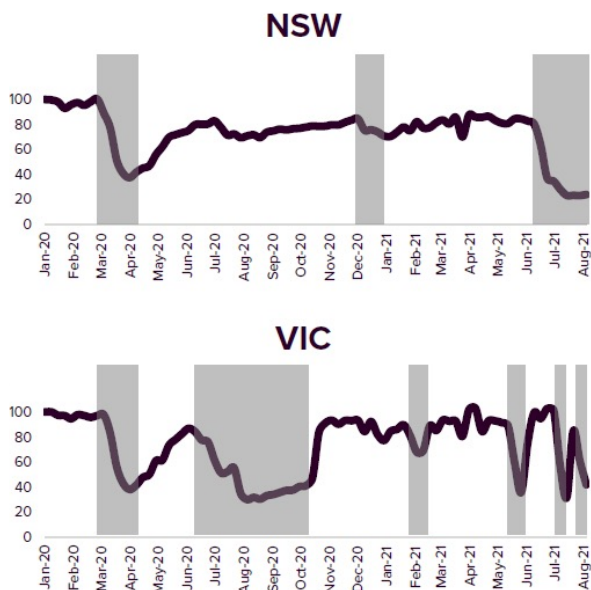
#### Reported half year dividends (% of companies)



Source: FactSet, Macquarie Research

4. Reviewing the COVID-19 winners vs losers, we noted a rotation from COVID-19 beneficiaries' to laggards. Winners are trading on high multiples and potentially inflated earnings. As these stocks begin to cycle strong growth, it is increasingly difficult to accurately forecast the earnings outlook. This was well illustrated by Wesfarmers (WES), which delivered a solid result ahead of expectations, but was subsequently sold off. Conversely, a company like Scentre (SCG), whose shopping centres remain closed in some regions, performed well despite only meeting expectations. We believe this reflects the willingness of consumers to return to centres when able, and the strength of the cash flows when that occurs.

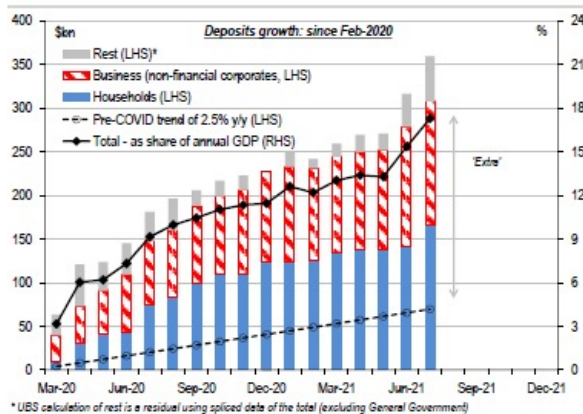
**Scentre customer visits by region**



Source: Scentre Group

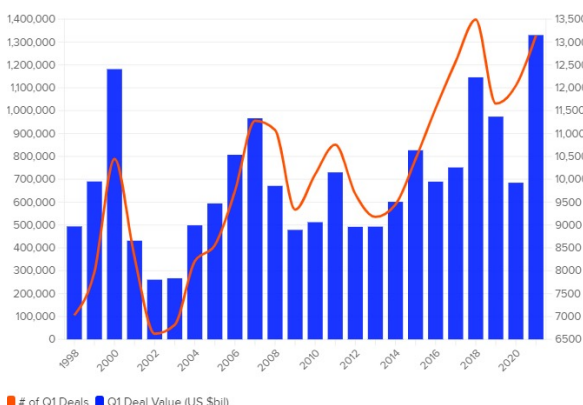
5. Banks. Results were soft. Lower bad debts and capital returns provided positive news but softer margins, and higher expenses suggests underlying growth is moderating. Competition is intensifying with the four majors focused on the domestic market. Westpac Banking Corporation (WBC) and ANZ Banking Group (ANZ) are struggling operationally, with WBC cutting prices as a result. Fintech companies also continue to raise capital and invest in acquiring new customers, taking market share from the four majors.
6. Improving quality. A highlight for us was the performance of the general insurance and telecommunication sectors. After many years of poor performance, and an internal focus on repair, we are beginning to see the benefits of price rises and cost-cutting across these sectors. QBE Insurance (QBE) saw double digit EPS upgrades and a strong share price reaction. Suncorp Group (SUN) also experienced earnings upgrades and a positive market response. Similarly, Telstra Corporation (TLS) saw large upgrades and a good bounce.
7. Strong growth stories. A number of companies reasserted the strengths of their business models and were rewarded accordingly. Examples:
  - James Hardie Industries (JHX). Strong market share gains with continued yield enhancement through selling higher value product. The US housing and renovation cycle remains strong and contributes to solid upgrades and positive share price reaction.
  - Domino's Pizza Enterprises (DMP). Whilst DMP remains a COVID-19 beneficiary, it has also capitalised on COVID-19 to cement its position in Japan, Germany and France. This promises a long run way of growth as it accelerates store rollout.
8. Reset. The biggest disappointment for our portfolio was Lendlease, where the new CEO reset expectations for FY22 despite reconfirming expectations for long term growth. A change in accounting policy and delayed timing expectations for developments pushed out expectations for profit recovery. Nonetheless, the medium term outlook remains positive while the stock is priced for disappointment.

9. M&A. Strong balance sheets and excess liquidity is fuelling an M&A cycle. Stocks such as Computershare (CPU) and Macquarie Group (MQG) should do well in terms of fees from this cycle. The impact on the portfolio is mixed with benefits from EQT Holding's bid for Iress (IRE), offset by Square, Inc's proposed acquisition of Afterpay (APT).



Source: RBA, APRA, UBS

**Global announced M&A**



Source: Refinity Deals Data

10. BHP Group (BHP)/Woodside Petroleum (WPL). The WPL/BHP deal was also a significant announcement during reporting season. The combined group will have a strong portfolio of assets, positioned low on the cost curve, with minimal debt and reasonable growth options. We believe this will look attractive in the medium term. As illustrated in the table below the combined entity has less risk and more growth at a cheaper valuation relative to Santos (STO)/Oil Search (OSH). The downside is that WPL will issue a significant number of shares to BHP shareholders, many of whom will not be long term shareholders of WPL. We acknowledge an overhang that needs to be worked through in the near term.

	WPL/BHP	STO / OSH
EV/EBITDA	4.5	4.6
EV/ 2P and 2C	3.2	3.9
Cost / BOE	11-14	11-14.7
Sovereign risk	Low	High
Gearing	12%	30%
Management reputation	Poor	Strong

Source: DNR Capital

## Fund positioning

Our current positioning is:

- **Reopening beneficiaries:** SKYCITY Entertainment Group (SKC).
- **Beneficiaries of infrastructure/green new-deal spending:** ALS (ALQ), Qube Holdings (QUB).
- **Improving quality:** Computershare (CPU).
- **Strong franchise companies:** James Hardie Industries (JHX), SEEK (SEK), Aristocrat Leisure (ALL).
- **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.

## Portfolio moves

No changes to portfolio.

## Disclaimer

*This document has been prepared by DNR Capital Pty Ltd, AFS Representative - 294844 of DNR AFSL Pty Ltd ABN 39 118 946 400, AFSL 301658. It is general information only and is not intended to be a recommendation to invest in any product or financial service mentioned above. Whilst DNR Capital has used its best endeavours to ensure the information within this document is accurate it cannot be relied upon in any way and you must make your own enquiries concerning the accuracy of the information within. The information in this document has been prepared for general purposes and does not take into account the investment objectives, financial situation or needs of any particular person nor does the information constitute investment advice. Before making any financial investment decisions you should obtain legal and taxation advice appropriate to your particular needs. Investment in the DNR Capital Australian Equities Income Fund can only be made on completion of all the required documentation. The Trust Company (RE Services) Limited ABN 45 003 278 831 AFSL No 235150 (as part of the Perpetual Limited group of companies) is the issuer of the PDS for the Fund. An investor should obtain and read the PDS and consider their circumstances before making any investment decision. The PDS is available at the Fund website at [www.dnrcapital.com.au/invest](http://www.dnrcapital.com.au/invest), or a paper copy can be obtained, free of charge, upon request by calling DNR Capital Pty Ltd ('Manager'), the investment manager of the Fund. This material is general information only and not an investment recommendation. The Manager or The Trust Company (RE Services) Limited does not guarantee the repayment of capital from the Fund or the investment performance of the Fund. An investment in this fund is subject to investment risk including loss of some or all of an investor's principal investment and lower than expected returns.*

**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](mailto:info@dnrcapital.com.au)

**Website**  
[www.dnrcapital.com.au](http://www.dnrcapital.com.au)

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