

DNR Capital Australian Equities High Conviction Fund

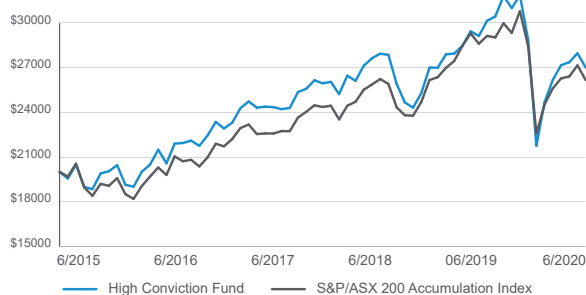
Performance Report – September 2020

Performance

The DNR Capital Australian Equities High Conviction Fund outperformed its benchmark for the period. Key stock contributors were James Hardie Industries (JHX), Aristocrat Leisure (ALL) and ALS (ALQ). Key stock detractors were CSL (CSL, no holding), Virgin Money UK (VUK) and Cleanaway Waste Management (CWY).

The S&P/ASX 200 Accumulation Index was down 3.66% during the period. Health Care (+0.4%) was the best performing sector during the month as both Sonic Healthcare (SHL) +3.7% and Cochlear (COH) +3.1% outperformed. Industrials (-0.7%) also fared better than the market, with Sydney Airport Holdings (SYD) +8.1% rallying ahead of peers. Energy (-11.6%) was the worst performing sector on the back of weaker oil prices, with all oil and gas majors heavily down. Consumer Staples (-8.2%) also performed poorly, with Woolworths Group (WOW) -8.6% and Coles Group (COL) -4.1% both struggling after outperforming during the COVID-19 lockdown period.

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	4.62	5.08
REA Group	3.88	4.21
Lendlease Group	3.81	4.28
James Hardie Industries	3.79	4.70
Cash	3.76	3.76
National Australia Bank	3.57	7.18
Aristocrat Leisure	3.45	4.64
ALS	3.21	3.49
Seek	3.10	3.56
Macquarie Group	3.03	5.55

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 September 2020

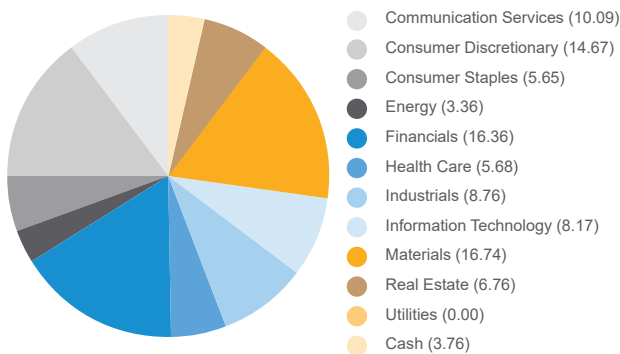
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	Incep.* %
High Conviction Fund	-3.46	-0.60	24.16	-10.45	3.59	7.47	5.82
S&P/ASX 200 Accumulation Index	-3.66	-0.44	15.97	-10.21	4.80	7.31	5.19
Excess return	0.20	-0.16	8.19	-0.24	-1.21	0.16	0.63

* 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:

- **James Hardie Industries (JHX):** Outperformed thanks to the ongoing recovery of the US housing market. The recovery is supporting the market's expectations over the company's annual earnings.
- **Aristocrat Leisure (ALL):** Outperformed as the company appears to be winning share in land-based participation; 85% of US casinos are open and digital gaming performed, and continues to perform, well during lockdown.
- **ALS (ALQ):** Outperformed as junior capital raisings in gold companies have surged globally, which strongly supports minerals testing. The company's life science testing continues to grow steadily.

The top stock detractors for the month were:

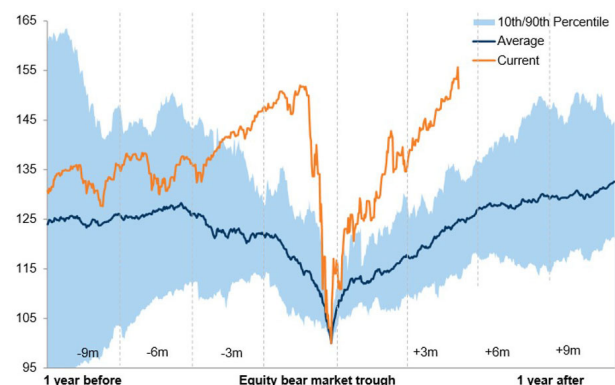
- **CSL (CSL, no holding):** Outperformed after a period of relative weakness as collection centre volumes showed signs of gradual improvement. The market is expecting a further update on guidance at the AGM in October and expectations are that the guidance range could be narrowed towards the upper end of the current range of 0–8% growth.
- **Virgin Money UK (VUK):** Underperformed as, like the Australian banks, VUK is struggling in today's low interest rate environment. Underperformance has been compounded by both the resurgence of COVID-19 cases in the UK and the impact of Brexit.
- **Cleanaway Waste Management (CWY):**

Underperformed following media reporting of the CEO's allegedly overly assertive behaviour towards his management team. The board had previously initiated an independent investigation into the accusations and has implemented a range of measures including leadership mentoring, enhanced reporting and monitoring of the CEO's conduct. The CEO has acknowledged his behaviour, expressed contrition and volunteered to forgo his performance rights grants.

Market review

Equities across the globe have rebounded sharply since the markets bottomed in March. This is despite COVID-19 disruption remaining in most countries. Markets appear to be anticipating a recovery in expectation of the development of a vaccine and assisted by stimulus. However, the segments of the market that have been strongest tend to be those areas least impacted by the COVID-19 pandemic, so it would appear that low interest rates and a lack of alternative investments are prime market drivers. This month we discuss the key factors impacting the outlook for the market – fiscal stimulus, the US election, vaccine development, and emerging growth areas.

MSCI World around bear markets since 1970



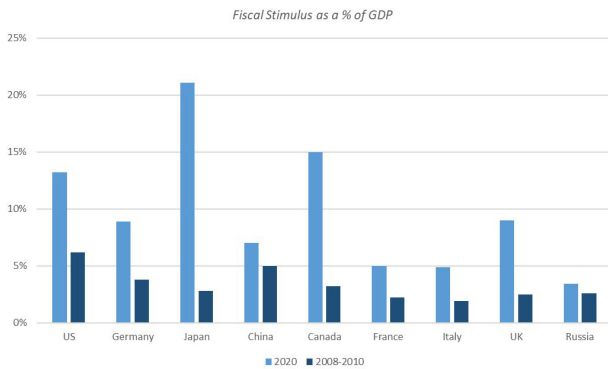
Source: Goldman Sachs

Stimulus

Make no mistake, the size of the fiscal stimulus across the globe is extraordinary. At around 9% of GDP it dwarfs the stimulus during the GFC, and dwarfs that of most economic periods over the past 100 years. The US is spending trillions and we expect further trillions to be

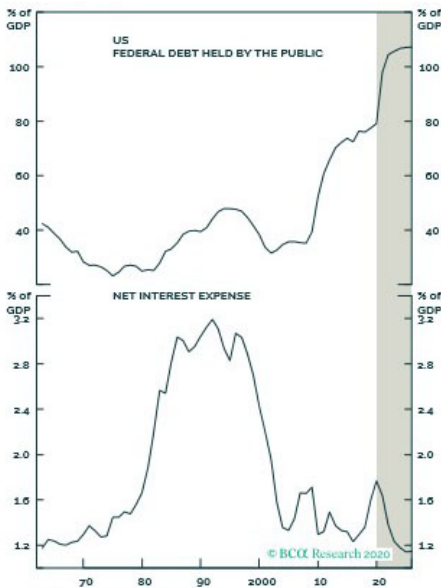
spent following the election. This will have important consequences for the performance of various market segments and have longer term consequences for growth rates, given the debt burden that will emerge (but this remains tomorrow's issue).

Fiscal stimulus is greater than it was during the GFC



Source: DNR Capital, the IMF 2020

Low interest payments amid skyrocketing debt in the US



Source: Congressional Budget Office (CBO), BCA Research

Note: Shading denotes forecast.

In Australia we are seeing the introduction of further stimulus. The Federal Budget introduces \$98b in new spending and \$50b in tax cuts. Treasurer Frydenberg's second budget is structured to cushion the economy as the government begins winding back its COVID-19-related economic support and to incentivise business to lead the recovery through investment and jobs.

While the JobKeeper initiative has been extended a further six months and the JobSeeker supplement to the end of the calendar year, several direct tax reductions are underscored by lifting the upper limits of the 19% and 32.5% tax brackets to support households.

Youth unemployment is addressed through covering half the wages of new apprentices and trainees, combined with a proposal to pay up to \$200 per week for employing workers aged 16–29 and \$100 per week for workers aged 30–35. The university research sector will receive \$1b, alongside funding for additional undergraduate positions and online short courses for unemployed Australians.

The centrepiece for business is the instant asset write-off program, enabling the immediate deduction of capital asset purchases for companies with turnovers less than \$5b. SMEs earning between \$50–\$500m are able to apply this to second hand purchases of less than \$150k.

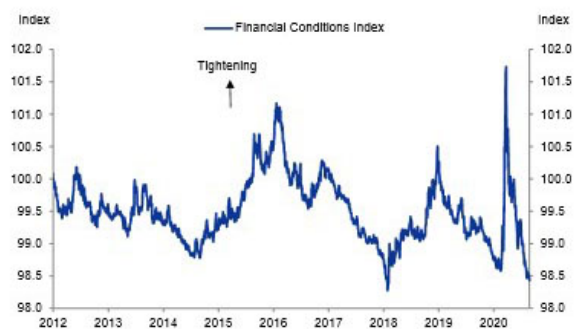
Infrastructure is flagged to receive \$14b in new and accelerated funding and \$4.5b has been allocated to the upgraded NBN rollout. An additional 10,000 places have been created in the first home loan deposit scheme for the purchase of new homes.

Older Australians wanting to receive at-home care will receive \$1.6b in funding for 23,000 new packages. New drugs on the PBS and investment in COVID-19 treatments and vaccine development will receive \$2.3b. Further funding is earmarked for COVID-19 testing and establishing dedicated respiratory clinics to assist with diagnosing and managing cases.

On top of the pre-announced spend for its technology roadmap, the budget includes a range of environmental commitments, including pilot projects for carbon capture and storage, gas infrastructure, and initiatives to reduce the timeframe for major project approvals. Of note was the \$250m investment for waste and recycling policies, with funding for modernisation in recycling.

In addition to the fiscal stimulus, financial conditions remain easy. This is supporting housing in most markets and the liquidity is supporting asset prices.

Financial conditions remain relatively easy



Source: Goldman Sachs Global Investment Research

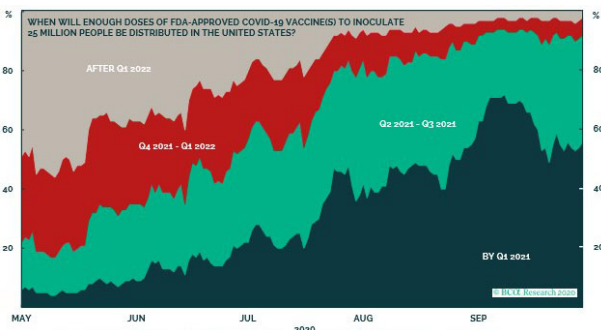
The benefits of this stimulus and easy financial conditions have supported economic growth and markets this year but will become more important as markets reopen. If economies remain closed, or continue to have to operate in restricted capacities, even the best support measures for economic growth may not be effective. In this scenario, the development of a COVID-19 vaccine becomes critical.

COVID-19

COVID-19 remains a challenge. Second waves in many nations and further movement restrictions highlight the uncertain trajectory for reopening the economy. Governments (and markets) appear to be betting on a vaccine. For instance, the Federal Budget is predicated on rolling out a vaccine in 2021.

We find that the consensus expects a vaccine announcement in the near term, with distribution and implementation in Q1 of next year. The news flow of vaccine approval will likely lead to a knee-jerk market bounce, but that might not be sustainable, in our view. The news could have a feel of 'travel and arrive' as the market will then refocus on logistics, efficacy, and other risks.

When will a vaccine become available?

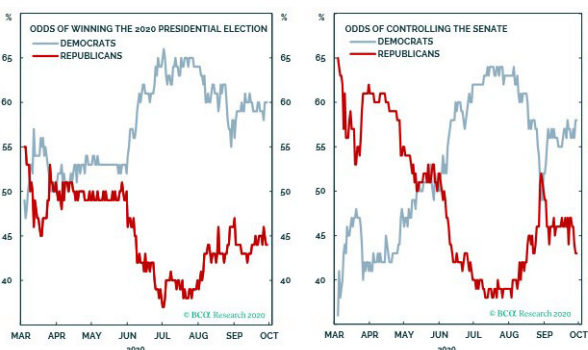


Source: Good Judgement Inc. Forecasts from Good Judgement's professional Superforecasters. Data access Sept 21, 2020

US election

Markets are worried about the possibility of a contested US election result, something along the lines of the Bush vs Gore Florida recount in 2000. This could lead to legislative paralysis for some time, exactly when the rollout of fiscal support packages is crucial for the economy. However, as Trump's polls have waned, the market has rallied as the risk of the contested results eases. The election outcome continues to be a source of uncertainty.

Betting markets putting their money on the Democrats



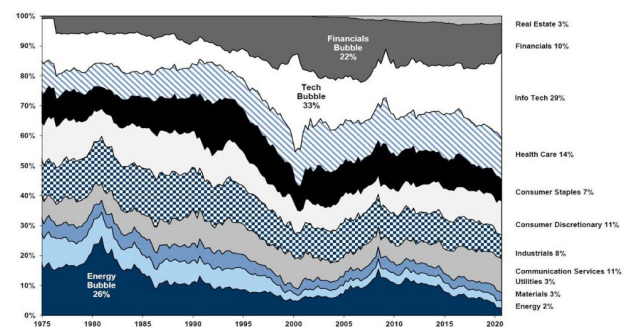
Source: PredictIt; BCA Research

Given the increasing likelihood of a Biden victory, here we outline some of the potential consequences of that outcome:

- Higher taxes over time, which would be a negative for markets
- More aggressive fiscal stimulus, which would support cyclical parts of the market
- Acceleration of environmental spending, which likely supports renewables but would be negative for the oil sector
- Regulatory oversight of Wall Street, which would be negative for investment banks
- Regulation of 'big pharma'
- Potential regulation of large tech.

Technology has been a major structural winner of the increased IT spend and digitisation of the economy. The technology sector represents a much larger part of the economy reflecting this structural change. Increased regulation has the potential to negatively impact some of the successful business models like Amazon and Facebook, however we expect intense political lobbying and at this point the outcome remains uncertain. Exposure to the technology sector offers structural growth in a world where growth is scarce. Earnings momentum remains strong for this sector and has been accelerated by the COVID-19 pandemic. However, valuations are pricing in a substantial level of future growth, and alternatives could become more interesting should a vaccine be successfully developed. A Biden victory will likely accelerate stimulus and possibly usher in a stricter regulatory environment for big tech.

S&P 500 equity capitalisation by sector since 1975



Source: Goldman Sachs

Major growth opportunities emerging

Renewable investment and infrastructure spending

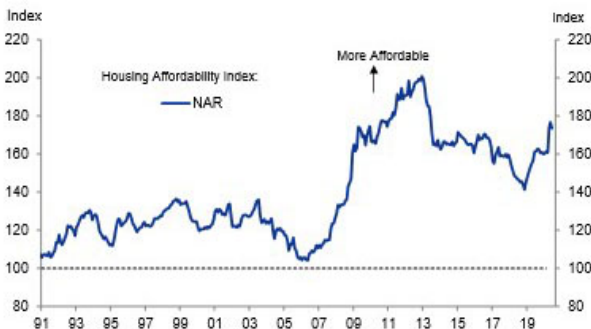
The level of stimulus across the globe is accelerating infrastructure spending. We understand the rationale to accelerate environmental infrastructure investment (it may not be near-term economically rational in all cases, but if we were prepared to kill the economy to save lives during the COVID-19 pandemic then it becomes harder to argue against impacting the economy to save the world). We see momentum building. The UK Government has a target to achieve new offshore wind 1GW capacity by 2030 (15x present global volumes) to power every UK home by 2030 (10% now); the International

Monetary Fund World Economic Outlook October 2020 advocates for a global public/private investment push in renewable energy; and US election polls indicate a likely Democrat victory and the party is more supportive of climate change initiatives than the incumbents. The money needed to support renewables, and the change in infrastructure to support their use, is substantial (trillions of dollars). Macquarie Group is well placed, through its ownership of the Green Investment Bank, to support this investment and participate in advisory, financing and potentially asset management fees. We see this as a multi-year opportunity.

US housing

Low interest rates are supporting housing affordability and this, combined with supportive demographics and an historic underbuild, is supporting a rebound in housing starts.

Low mortgage rates have boosted housing affordability



Source: NAR, Goldman Sachs Global Investment Research

Housing sales and starts growth show a V-shaped rebound through July



Source: Goldman Sachs Global Investment Research

Digitisation of the economy

The COVID-19 pandemic has accelerated the use of cloud software as businesses and consumers recognise the need to work from home. In addition, staying at home has introduced many people to stay-at-home services like internet shopping or home delivery food services. These were strong trends anyway, but have no doubt been

beneficiaries of the current environment.

Increased regulation around recycling and environment and health testing

Typically, we would expect an event like the COVID-19 pandemic to accelerate regulation around health and safety and consequently, we would expect opportunities to arise for testing companies.

Sheds and beds

The COVID-19 pandemic has highlighted structural concerns for office property and regional retail property (work from home trends and online shopping). Institutional property investors are looking at industrial property (which supports the online trend) and momentum is building towards build-to-rent housing (to provide affordable housing).

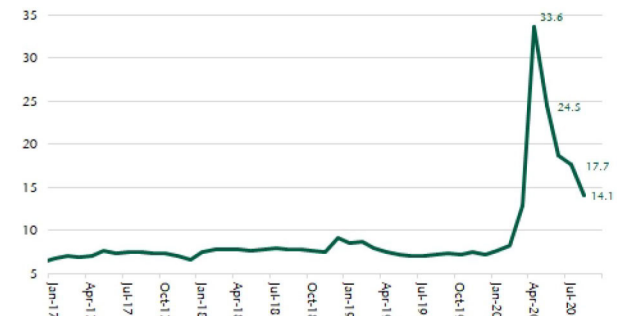
Stimulus

The stimulus spend should support infrastructure projects and this spend should support commodities like iron ore, copper and companies providing engineering services.

Reopening of the economy

One of the surprise packets of the past six months has been the US personal savings rate. The US consumer (and to a lesser extent the Australian consumer) has saved money by not travelling, eating out and spending on services. As the economy reopens, we expect a range of companies to benefit as the consumer starts spending again on services like casinos, travel and shopping.

Personal saving rate (%)



Source: Haver, JEF Economics

Fund positioning

Our current positioning is as follows:

- **Strong global franchise stocks:** James Hardie Industries (JHX), Macquarie Group (MQG), Cochlear (COH).
- **Strong domestic franchise stocks:** REA Group (REA), Ramsay Health Care (RHC), and Wesfarmers (WES).
- **Quality mid-caps:** Cleanaway Waste Management (CWY), ALS (ALQ), Xero (XRO), and Qube Holdings (QUB).
- **Reopen beneficiaries:** Scentre (SCG), SKYCITY Entertainment Group (SKC)
- **Resources:** Overweight Rio Tinto (RIO) and BHP Group (BHP).
- **Underweight banks.**

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.
- **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:** It is an election year in the US, which adds to potential uncertainty. Further geopolitical uncertainty could create negative implications for stocks and portfolios.

Stock moves

Purchase of Scentre Group (ASX:SCG)

SCG has underperformed the market and listed-REIT peers since the market downturn. This has provided an opportunity to add SCG to the portfolio.

SCG meets DNR Capital's five-point quality web:

1. **Industry structure:** SCG remains the premier shopping centre operator in Australia and New Zealand (Westfield), holding the best assets among peers. Despite ongoing headwinds from the transition to online retail, we believe that the quality of the assets, combined with the increased diversification of centres, will maintain the company's growth profile going forward.
2. **Earnings strength:** Underlying earnings will remain relatively stable out to 2023 as the business releases its tenancies at lower rents, before returning to low single-digit growth going forward.
3. **Balance sheet:** SCG's balance sheet reflects a higher gearing level than its domestic peers, however internationally it compares favourably. Gearing is

expected to be around 40%, well within its debt covenants. This is evidenced by the recent favourable terms on its bond issue.

4. **Management:** The executive team is considered by us to be best in class, with management having handled the COVID-19 shutdown with maximum efficiency.
5. **Environmental, social and governance (ESG):** The ESG risks are considered low, although it is noted that management has identified opportunities to increase the environmental efficiency of the assets.

Key risks

There are a number of key risks:

1. Unfavourable outcomes from the renegotiation of leases because of the COVID-19 lockdown.
2. A substantial acceleration in the uptake of digital retail (faster than SCG can reposition its business).
3. Extreme economic stress and a resultant lack of consumer spending.

Valuation

The business currently trades on a price/NTA of ~0.60 and a dividend yield in excess of 7%. Current prices insinuate a greater than 25% decrease in the value of its shopping centre assets, in an environment of decreasing interest rates.

Conclusion

SCG represents an undervalued, quality group of assets that should deliver a yield in excess of 7%, growing at mid-single digits. The threat of digital retail to traditional retail is not unfounded, however its impact will not be uniform. Arguably, SCG owns the best assets in the best locations, in an environment where new shopping centres are not being built and lower-quality centres are struggling. Physical retail will shrink, with the premium assets remaining as the primary physical connection between brand and consumer. We expect the valuation of SCG's assets to maintain or increase their premium to peers and remain consistent through the cycle.

Purchase of SKYCITY Entertainment Group (SKC)

SKC operates in the gaming, entertainment, hotel, convention, hospitality, and tourism sectors in New Zealand and Australia.

SKC meets DNR Capital's five-point quality web:

1. **Industry structure:** The primary assets of SKC are the Auckland and Adelaide casinos, both of which are long-dated exclusive licenses in stable regulatory environments.
2. **Earnings strength:** Returns are improving as both major properties reopen post COVID-19. Additionally, the \$330m Adelaide expansion is set to open in the next quarter, which should provide incremental earnings.
3. **Balance sheet:** Post the recent capital raising the company has a very manageable level of long-duration debt.
4. **Management:** Management has run the business well through the challenge of COVID-19 shutdowns through tight cost management and prudent capital control.

5. Environmental, social and governance (ESG):
Given the nature of the business, the board and management of SKC are very conscious of its need not only to meet the regulatory guidelines, but also to focus on maintaining a 'social licence' to operate.

Valuation and thesis

SKC is trading at under 7x EV/EBITDA multiple assuming no international VIP business returns, which is well below historical averages. Additionally, the strong balance sheet and cash flow position should enable the business to start paying dividends in FY21 assuming no further shutdowns.

We see SKC as a high-quality asset that has been impacted by COVID-19 shutdowns but is well positioned to benefit from a gradual reopening of the economy. The business is entering a phase when capital expenditure is likely to be lower given recent projects are completing, and this should drive very strong, free cash flow.

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.

Disclaimer

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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.

Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when 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.

Platform access

- Asgard & BT Wrap
- BT Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- My North & North
- Netwealth