DNR Capital Australian Equities Income Fund

Performance Report – September 2021

Performance

The S&P/ASX 200 Industrials Accumulation Index was down 0.76% during the period.

Utilities (+2.1%) was the best performing sector, as a bidding war between APA (APA) and a private equity consortium erupted over Ausnet Services (AST +30.2%). Financials (+1.5%) also outperformed as bond yields spiked higher and the market rotated towards value names and higher interest rate beneficiaries. Health Care (-5.5%) was the worst performing sector, as the sector leader CSL (CSL -5.9%), experienced continued issues in sourcing plasma. Consumer Staples (-4.4%) also underperformed, following a selloff in the more expensive defensive exposures such as Woolworths Group (WOW -5.8%) and Coles Group (COL -6.0%).

The DNR Capital Australian Equities Income Fund outperformed the Index for the month. Key stock contributors were Woodside Petroleum (WPL), Macquarie Group (MQG) and Qube Holdings (QUB).
Key stock detractors were Commonwealth Bank of Australia (CBA, No Holding), Lendlease (LLC) and BHP Group (BHP).

The Portfolio's dividend yield expectation for 2021 is currently 4.2% (5.5% grossed up for franking credits).

Top 10 active holdings

Security details	Active weight %	Actual weight %
National Australia Bank	4.46	9.82
Tabcorp Holdings	4.24	4.87
Telstra Corporation	3.81	6.56
Lendlease	3.69	4.13
Aurizon Holdings	3.39	3.80
Qube Holdings	3.39	3.76
SKYCITY Entertainment	3.37	3.44
IPH	3.35	3.46
Suncorp Group	3.35	4.29
Macquarie Group	3.17	6.85

Source: Mainstream Fund Services and DNR Capital

Fund overview

APIR Code	PIM8302AU
Investment bias	Style neutral with a quality focus
Designed for	Investors who are seeking a greater level of income and who can make use of franking credits.
Investment objective	To invest in a concentrated portfolio of Australian equities that aims to outperform the Benchmark (net fees) and deliver higher levels of income relative to the benchmark over a rolling three-year period. The investment objective is not a forecast of the Fund's performance.
Benchmark	S&P/ASX 200 Industrials 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
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	Quarterly
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 2021

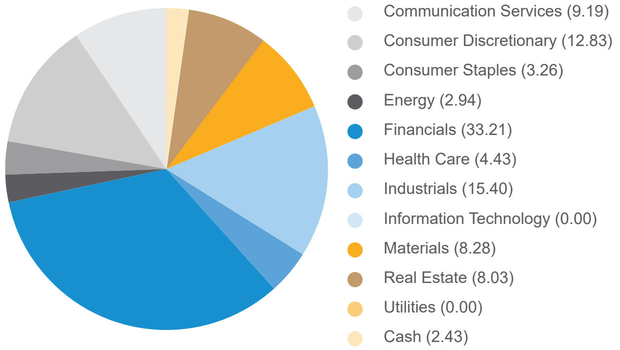
	1mth %	3mth %	6mth %	1year %	Incep.* %
Income Fund	0.90	6.11	11.26	40.38	29.97
S&P/ASX 200 Industrials Accumulation Index	-0.76	4.48	13.44	33.71	20.03
Excess return	**1.66**	**1.63**	**-2.18**	**6.67**	**9.94**

** Inception Date—11 March 2020*

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 Income 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:

- **Woodside Petroleum (WPL):** bounced as global demand for energy increased as economies opened up and supplies remain limited.
- **Macquarie Group (MQG):** guided to a strong 1h profit result thanks to commodity volatility and active markets for asset sales.
- **Qube Holdings (QUB):** QUB outperformed following ongoing strength in port container volumes. QUB also acquired Newcastle Agri Terminal for A$90m, providing additional geographic and commodity diversification beyond the earnings accretion.

The top stock detractors for the month were:

- **Commonwealth Bank of Australia (CBA, No Holding):** rallied into an off-market buyback where those tendering their shares have limited ability to sell.
- **Lendlease (LLC):** continued to underperform after reporting softer than expected guidance for FY22 at the August result. The softer outlook has been driven by rolling global lockdowns which have slowed the delivery of development projects. The company remains confident of development production reaching $8bn by FY24.
- **BHP Group (BHP):** underperformed over the month as spot iron ore prices continued to trade lower on concerns that Chinese steel production curbs would lead to lower demand. The proposal to collapse the dual listing saw continued selling in the Australian market with the premium of the Australian listing finishing the month at 6%.

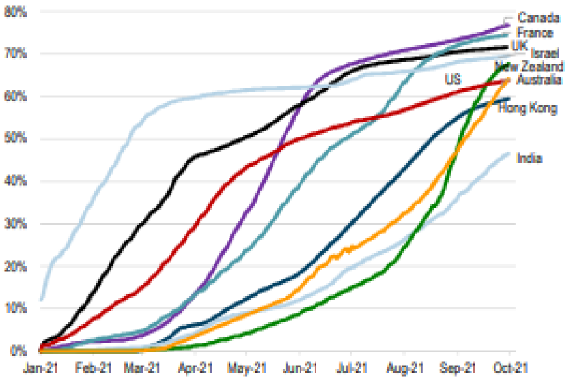
Market review

After 11 consecutive months of gains, the market suffered its first down month in a year with concerns over China and higher energy prices weighing on market sentiment and increasing probability of a stagflation scenario. Bond yields moved higher, following the Federal Reserve's hawkish tone. Meanwhile, after a slow start, Australia's vaccination roll-out has accelerated with NSW and Victoria now on the cusp of emerging from lockdowns. The Fund outperformed its benchmark over the month, given its exposure to re-openers (eg. Scentre (SCG)), defensives (eg. Telstra Corporation (TLS)) and financials (eg. Suncorp Group (SUN)).

Australia's reopening in sight

Australia's vaccination roll-out has accelerated, with first doses administered now ahead of the US. A key factor in this take-up has been the promise of re-opening when certain thresholds are reached. With ~60% of the country still in lockdown, hitting vaccination thresholds is crucial to lifting economic activity levels. The two most populous states (NSW and Victoria) are expected to be above 80% during November.

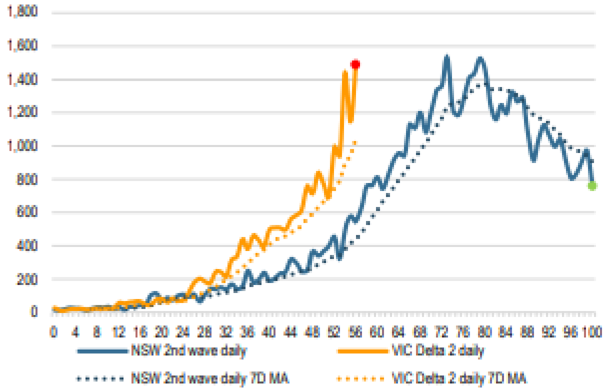
Share of populaton received at least one dose



Source: Our World in Data

Reaching a high proportion of the population vaccinated is also crucial to slowing the outbreaks in Sydney and Melbourne. There are already promising signs from NSW that this is coming into effect, with daily cases well below the mid-September peak.

VIC vs NSW outbreaks



Source: covid19data.com

China contagion concerns

Uncertainty regarding the solvency of large Chinese property developer, Evergrande raised a number of questions for investors, including potential risk to China's property and banking sectors and global contagion.

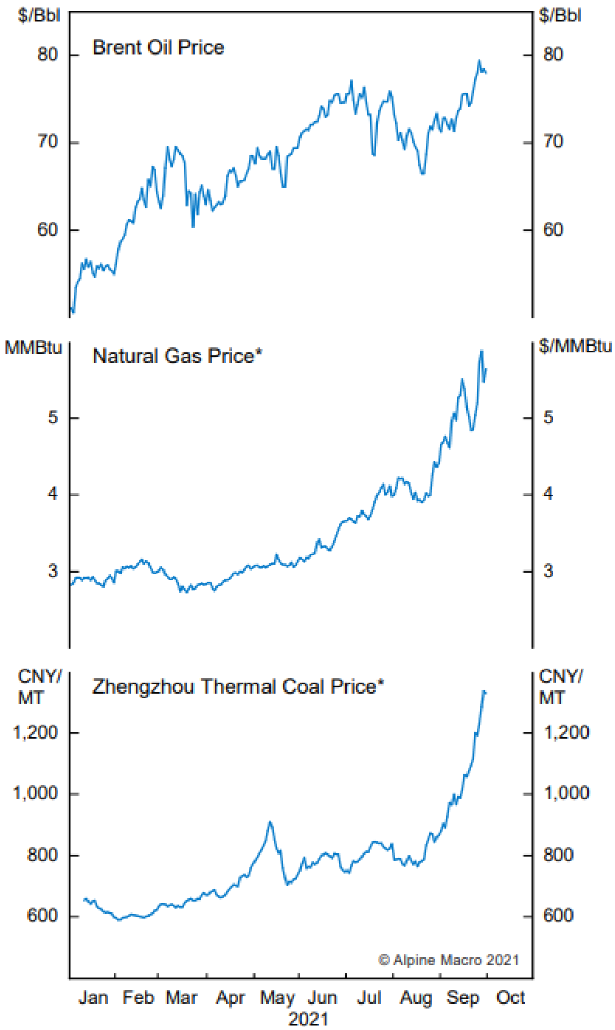
Evergrande has a substantial amount of debt (as do other property players). Evidence that Evergrande has been in trouble since early this year has made these creditors reluctant to extend financing to Evergrande, exacerbating the company's liquidity stress. Making matters worse, regulators have instructed banks to tighten mortgage lending standards, which significantly prolongs mortgage processing time reducing developers' turnover. Home sales have slowed, and new mortgage loan volume has contracted sharply, intensifying Evergrande's liquidity woes.

Markets have been concerned as to the possibility of a systemic failure across the Chinese financial system. We view this risk as low. The failure is unlikely to have surprised authorities in China, as they appear to have 'allowed Evergrande to fail'. We are more concerned as to whether the Chinese have made a policy mistake. For some time, the Communist Party has harboured a desire to reduce speculation in the property market. Having suffered from growing inequality, China is concerned about housing affordability, and the Communist Party is seeking to rebalance the economy. An apparent willingness to sacrifice growth in order to regain control of the economy, is highlighted by recent edicts on the tech and education sectors. This intervention may undermine investor sentiment and confidence, catalysing further knock-on impacts to the economy.

Nonetheless, there is an old adage that investors stop panicking when the regulators start panicking. Historically, when problems have emerged within the Chinese economy, they have stimulated aggressively. Increasingly, authorities appear reluctant to do so, as it fuels speculation and drives up commodity prices. Instead, they have modestly loosened credit restrictions over the past three months, but the market will be watching for further action. Property remains ~20% of the Chinese economy, so the key question is whether China would really allow other property companies to fail. Gathering economic headwinds could force the Chinese authorities to further relax policies to support growth, setting the stage for the reflation trade to return. Until there is credible evidence of this shift in policy settings, the risks for Chinese growth remain elevated.

Energy crisis looming?

Panic buying of energy – from gas to coal to oil has accelerated as the Northern hemisphere fears being short of energy over winter.



Source: Alpine

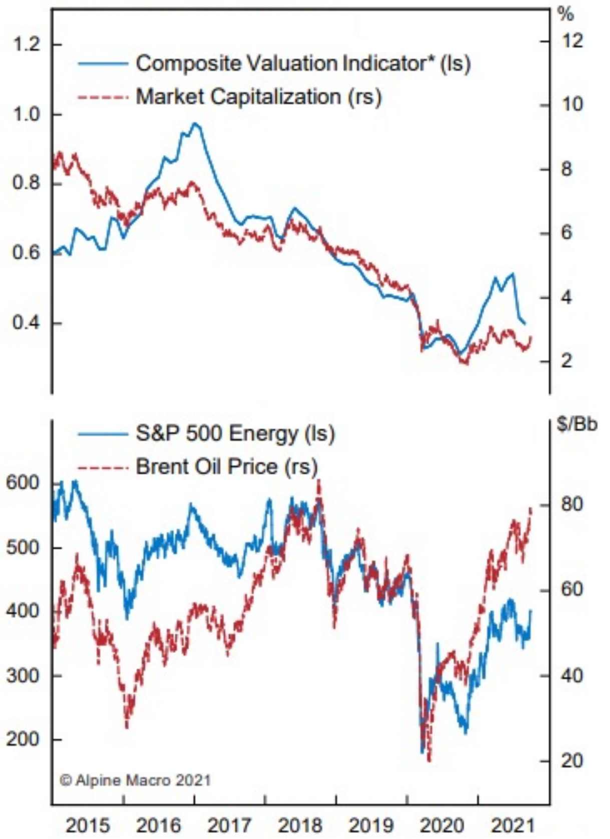
The drivers of this include:

1. Strong demand on reopening of the economies.
2. A lack of investment in fossil fuels and related infrastructure as ESG concerns and concerns regarding investing in stranded assets limit investment.
3. Realisation that there are no quick fixes. Once renewables reach a certain threshold then there is a need to accompany it with LNG or nuclear to provide support at peak times when sun is not shining or wind blowing. Alternatives such as hydrogen appear to be some way off practical application and battery storage offers limited application at present.

The consequence is panic buying pushing oil price up to US$75 a barrel and LNG in Asia at US$30/BTU (compared to long term expectations of $8). These moves have supported energy companies but they have still sharply underperformed over the past year which suggests they can continue to re-rate. We are favourably disposed to Woodside Petroleum (WPL) given we think the BHP Group (BHP) transaction substantially improves the quality of the WPL portfolio of assets and reduces the risks on project outcomes.

Energy relative to S&P 500

*Equally-weighted average of relative P/B, P/S and P/C ratios



Source: Alpine

Stagflation scenario?

Energy raises memories of a 1970's style energy crisis. The issue with tightness in energy markets is that the problems are not quickly resolved. It is difficult to envisage a strong pick up in fossil fuel projects and nuclear remains politically difficult. This increases risks regarding slower growth at the same time as inflation pressure builds. We would not forecast this as a base case but given the strong moves in markets to date we remain wary.

Bond yields sharply higher

Long bond yields rose sharply over the month, due to a flattening of the global Delta wave, a hawkish September Federal Open Market Committee (FOMC) meeting (given the prospect of a faster taper timeline), more signals of monetary policy withdrawal from other central banks (including the BoE and RBNZ), and a renewed rally in commodity prices (with Brent breaking US$80/bbl).

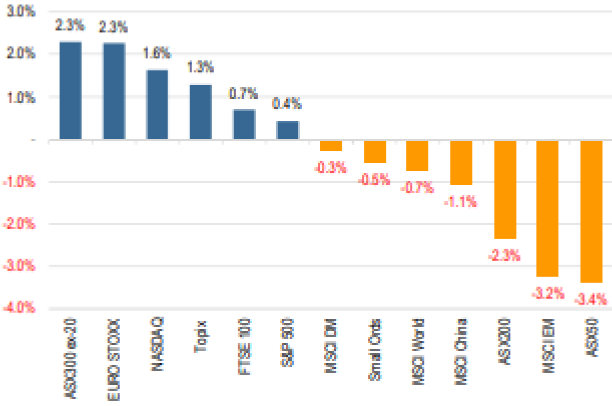
US 10-year yield

Source: J.P. Morgan calculations, Bloomberg Finance LP.

Downward dividend revisions

The ASX 200 saw negative dividend revisions during the month of -2.3%, driven mostly by the large miners given plummeting iron ore prices.

Figure 32: DPS revisions | 1-month Δ



Source: J.P. Morgan calculations, Bloomberg Finance LP.

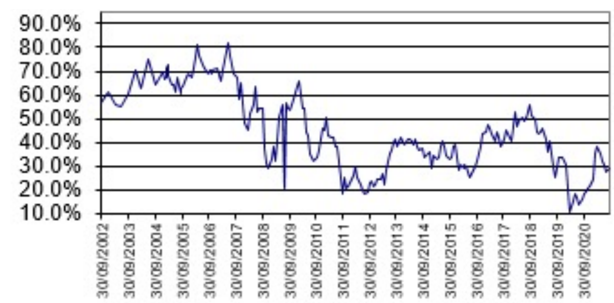
Current market valuations

Market valuations remain elevated from a price earnings (PE) perspective but reasonable relative to low interest rates.

Rolling forward per trend

Source: DNR Capital

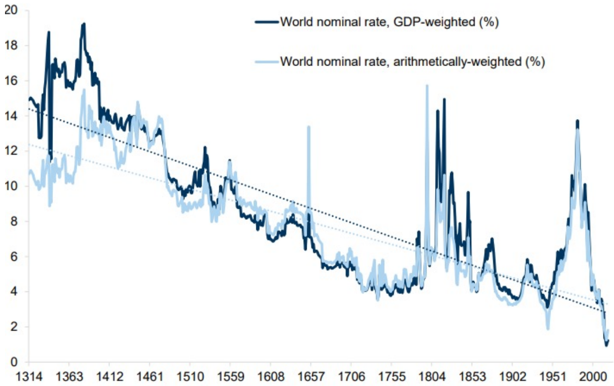
Bond yield on earnings yield



Source: DNR Capital

However interest rates are at 600 year lows and unlikely to become too much lower.

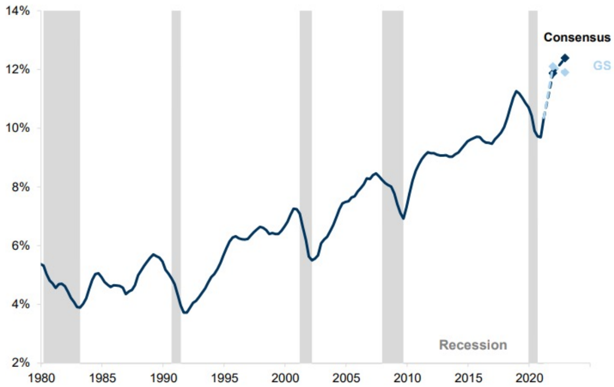
Nominal interest rates are at record low levels
Nominal bond yields, GDP- and arithmetically-weighted, 1314-2018



Source: Goldman Sachs, Bank of England

Profit margins are high which can be pressured by higher inflation.

Margins are high
S&P 500 net profit margin



Source: Goldman Sachs

And these low interest rates (as well as digital disruption driving earnings growth for tech stocks) has supported growth stocks.

Growth has outperformed since the GFC
MSCI Indices. Relative price performance in local currency*

Source: Goldman Sachs

Fund characteristics

We continue to position the Fund in high-quality businesses that offer a combination of attractive dividend yields, growth, franking benefits and importantly, valuation support.

Our Fund of quality names with attractive risk-return characteristics should deliver a growing dollar income outcome through the cycle.

The Income Fund is expected to generate a gross yield of 5.5% (including franking) for calendar year 2021, very attractive relative to alternatives.

- The quality characteristics of the Fund are attractive relative to the Fund's benchmark:
  - 2-year forward return on equity is above the market at 11.2% compared to 11.0% for the benchmark.
  - 2-year forward dividend yield is 4.5% compared to the benchmark at 3.5%.
  - 2-year forward earnings growth and dividend growth expectations are in line with market growth rates at 9% and 9% respectively.
- Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:
  - 2-year forward PE is at 16.0x compared to 19.7x for the benchmark.
- In addition, despite the superior growth outlook, the defensive attributes of the Fund have been maintained:

2-year forward free cash flow yield is 5.6% compared to the benchmark at 4.2%.

Fund categories

At DNR Capital, we categorise income-generating companies as:

Growers – High-conviction stocks that may be paying a below-market dividend yield, however we see a clear path towards delivering a sustainable and growing income profile in the medium term (ALX).

Compounders – Quality stocks operating within a robust industry structure that have a strong competitive position, underpinning attractive and sustainable income growth (IPH)

Cows – Stocks with a solid balance sheet and capital management potential that are being undervalued on traditional earnings-based metrics (AZJ)

Yielders – Quality companies at attractive valuations that are delivering sustainable and cash-backed dividends, however with little growth (TLS)

Fund positioning

The DNR Capital Australian Equities Income strategy stands to benefit from four clear performance drivers over the next 3–5 years. These include:

1. **A favourable factor exposure.** We are positioned in a clear set of quality leaders/defensives, including COVID-19 recovery beneficiaries with notable value.
2. **Recovery in dividends** as the global economy reopens.
3. **Increasing payout ratios** as boards regain confidence and utilise franking credits, rewarding shareholders in a low yield environment.
4. **Strong demand**, given the continued search for income in a record low-interest-rate world.

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.

Stock moves

No stock moves to report for September 2021

Investment strategy

The DNR Capital Australian Equities Income Fund has an investment style best described as ‘style neutral’ with above-average income and associated franking credits. The stock selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices.

The Fund seeks to identify quality medium to long-term investments delivering sustainable, growing income. The Fund seeks to invest in a selection of securities that have high and sustainable dividend capability, strong profit-to-cash conversion, and relatively assured earnings growth.

We define quality companies as being those companies with the following attributes:

- Superior industry position
- Earnings strength
- Dividend sustainability and growth potential
- 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 portfolio. 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 considers stock weightings based on the risk versus the expected return. It is also influenced by a top-down economic appraisal, sector exposures and liquidity considerations.

Investment philosophy

DNR Capital believes a focus on quality companies will enhance returns when it is combined with a thorough valuation overlay. DNR Capital seeks to identify quality companies that are mispriced by overlaying our quality filter, referred to as the 'quality web', with a strong valuation discipline. The investment strategy of the Fund is intended to result in a concentrated portfolio that is high conviction, after-tax focused and invests for the medium-to-long term.

Platform access

- Ausmaq
- BT Panorama
- HUB24
- Macquarie Wrap
- Mason Stevens
- Netwealth
- Praemium
- Wealth02

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