DNR Capital Australian Equities Income Fund

Performance Report – October 2021

Performance

The S&P/ASX 200 Industrials Accumulation Index was up 0.14% during the period.

Information Technology (+2.1%) was the best performing sector, following global peers higher after underperforming last month. Health Care (1.0%) also outperformed with companies exhibiting pricing power outperforming in an inflationary environment. Industrials (-3.3%) was the worst performing sector, as infrastructure-style assets were sold down with higher interest rates. Consumer Staples (-2.3%) also underperformed with sector heavyweight Woolworths Group (WOW -3.2%) disappointing shareholders at their quarterly update.

The DNR Capital Australian Equities Income Fund underperformed the Index for the month. Key stock contributors were Macquarie Group (MQG), National Australia Bank (NAB) and Transurban Group (TCL, No Holding). Key stock detractors were Aurizon Holdings (AZJ), IPH (IPH) and Suncorp Group (SUN).

The Fund's dividend yield expectation for 2021 is currently 4.19% (5.53% grossed up for franking credits).

Top 10 active holdings

Security details	Active weight %	Actual weight %
Tabcorp Holdings	4.29	4.94
National Australia Bank	4.02	9.61
Telstra Corporation	3.72	6.39
Lendlease	3.57	3.99
SKYCITY Entertainment Group	3.34	3.40
Macquarie Group	3.24	7.23
Qube Holdings	3.16	3.51
IPH	3.12	3.22
QBE Insurance Group	3.11	4.13
Scentre	3.02	3.95
Suncorp Group	2.90	3.78

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 31 October 2021

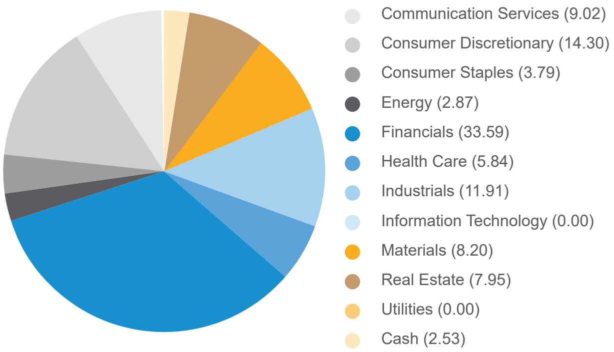
	1mth %	3mth %	6mth %	1year % p.a.	Incep.* % p.a.
Income Fund	-0.48	4.05	7.18	37.78	27.22
S&P/ASX 200 Industrials Accumulation Index	0.14	4.92	10.31	30.30	19.00
Excess return	**-0.62**	**-0.87**	**-3.13**	**7.48**	**8.22**

** 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:

- **Macquarie Group (MQG):** performed strongly delivering a strong 1H22 profit result which was substantially above expectations with energy volatility, strong M&A activity, and the Green Investment Group (GIG) contributing.
- **National Australia Bank (NAB):** rallied ahead of its result in November. Australia and New Zealand Banking Group (ANZ) and Westpac Banking Corporation (WBC) have been struggling operationally which has meant NAB has been a preferred bank ahead of its dividend.
- **Transurban Group (TCL , No Holding):** underperformed following a ~$4bn entitlement offer in September to fund the ~$11bn acquisition of a 50% stake in WestConnex. In addition, the company was hit by a first strike by investors against its FY21 remuneration report.

The top stock detractors for the month were:

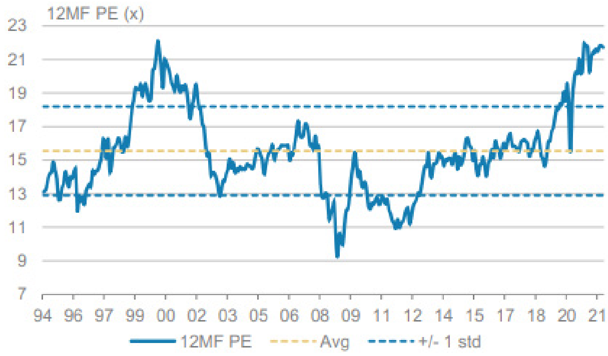
- **Aurizon Holdings (AZJ):** announced it had signed an agreement to acquire One Rail Australia for A$2.35bn, however due to ACCC clearance requirements, it is prerequisite to divest East Coast Rail through a demerger or trade sale. The perceived execution risk and uncertainty of valuation impact saw the stock underperform.
- **IPH (IPH):** was an underperformer during the period on the back of unfavourable currency moves. IPH bills the majority of its clients in USD, while its costs are primarily in AUD. This exposes the company to weakness in the USD, which occurred during the month.
- **Suncorp Group (SUN):** a large amount of catastrophe activity including a range of hail storms means the 1H will be soft. SUN has strong reinsurance cover which will support the full year.

Market review

Monthly

Australian stocks were roughly flat in October, lagging a 5% rally in global equities and the S&P 500 up 7%. The rise in bond yields was the key event in October, as Australia's 10- year yield rose 59bps to 2.08% (after a 33bps rise in September). This is a much larger rise than we saw in the US-10 year, which ended the month at 1.55%, just 2bps higher than where it started. Despite this, Growth (+0.8%) outperformed Value (-1.0%), with Quality flat over the month and the portfolio's benchmark (the S&P ASX200 Industrials Index) continues to trade at, or near, record valuations.

ASX 200 Industrials – latest: 21.7x

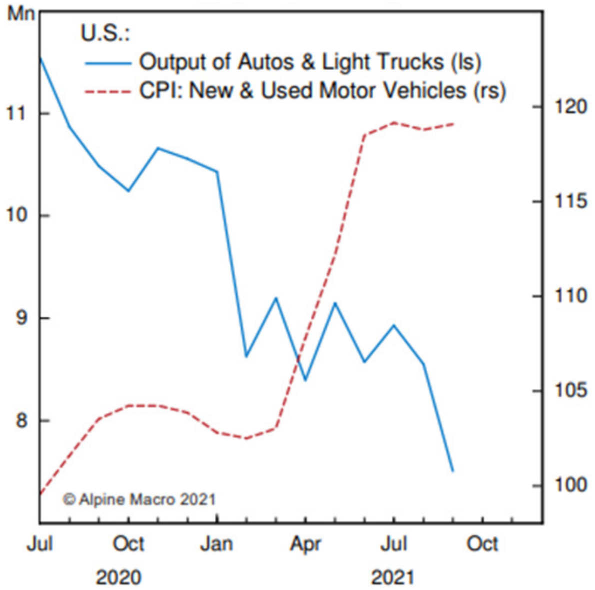


Source: RIMES, IBES, Morgan Stanley Research

Supply disruption and inflation

A synchronised economic recovery post pandemic and strong fiscal stimulus have boosted demand across the globe. Supply chains are challenged across many markets – oil, gas, wheat etc. Access to labour is also causing constraints. A lack of mobility is causing tightness in labour markets which appears to be further exacerbating the supply response. Below is an example of the motor vehicle market in the US which has seen strong price pressure but a lack of a supply response due to a lack of goods such as computer chips and labour constraints.

U.S. Auto sector: supply-inspired stagflation



Source: Alpine Macro 2021

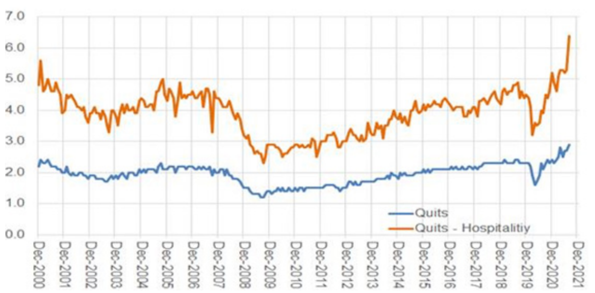
Ultimately we would expect to see these supply constraints resolved but wage pressure is building which might prove less transitory. The beginnings of wage pressure is evident in the chart below.

Atlanta Fed wage tracker: 20 year + highs

Source: Atlanta Federal Reserve

In addition the quit ratio is high and job openings remain at a record high which again suggests inflation pressure is building.

Quit ratio at record highs

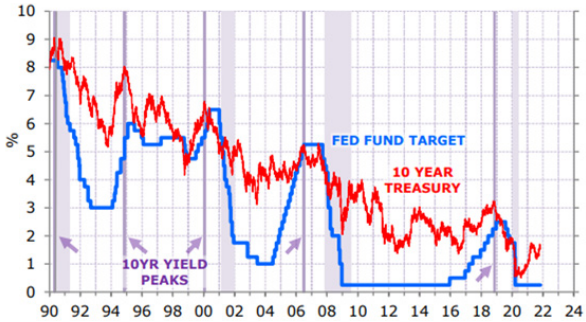


Source: Atlanta Federal Reserve

Bond market response

The sharp rise in labour costs in the US does bring the likely start date for US Federal Reserve (Fed) tightening closer. The surprising market development has been that 10 year bond yields have not pushed up very aggressively. Rate markets are now pricing several rate increases next year. That may prove to be too aggressive, but that is typical: short-rate futures often price policy tightening that ends up not occurring.

US 10 year bond and Fed funds target



Source: Bloomberg, NBER; Minack Advisors

It's also notable that the 10 year bond rates fell as short rates rose. This is consistent with what seems to be a deeply held view that the neutral rate of interest remains exceptionally low (and that the Fed will make a policy mistake by lifting interest rates too aggressively). Rate markets continue to expect that the Fed fund rate will be negative in real terms over the medium term.

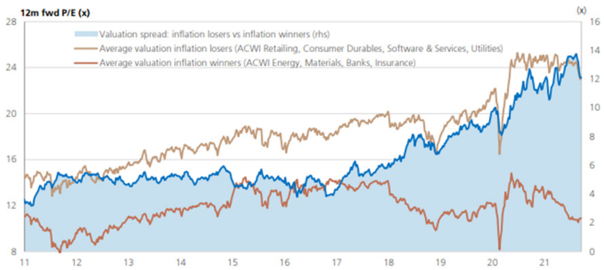
In short, markets don't see that the pandemic has changed the structural framework for rates. However there have been two big framework changes. Firstly, governments now embrace fiscal policy across the globe. Secondly, central banks are no longer setting policy on a pre-emptive basis, rather waiting until they see inflation especially wage inflation. This increases the risk of inflation taking hold, in our view.

Fed fund target and wage growth

Source: BLS, Federal Reserve, NBER; Minack Advisors

Of most interest, the equity market seems to be dismissing the likelihood of inflation with the spread of inflation winners versus inflation losers at extremes.

Inflation expectations – IV: Valuations of inflation losers relative to inflation winners

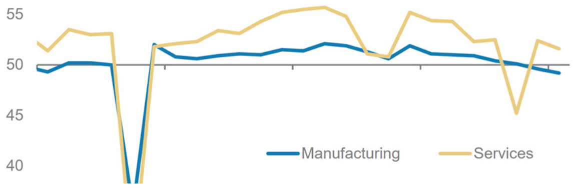


Source: IBS, MSCI, Datastream, UBS

China uncertainty

China remains in transition seeking to reduce its reliance on the property market, increase domestic consumption, deliver common prosperity and reduce inequality. President Xi is powerful, a populist and lacks challengers which increases the dangers of a policy mistake. China has been reluctant to support the economy despite it slowing. Is this a sign of overconfidence? Does cracking down on prominent businessmen and movie stars reduce risk appetite in the broader economy? If the economy continues to stagnate, income levels for most people will not grow. Increasing risk of social discontent will be the needed trigger for the government to back off from monetary austerity.

China PMI



Source: Morgan Stanley

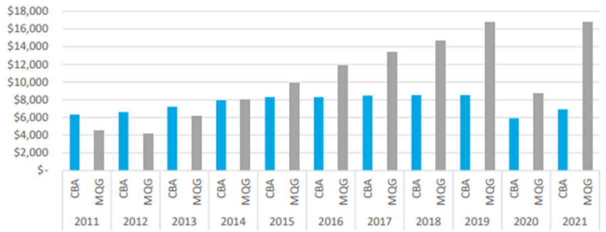
China's goal of common prosperity aims to increase labour's share of national income relative to capital's share by increasing the marginal productivity of labour and having laws and regulations that ensure that workers get paid in accordance with their higher productivities. In certain sectors, they would rather eliminate certain business models they deem detrimental to social equality rather than nationalize them despite their profitability. Authorities want to encourage more investment in higher-risk projects that, if successful, can increase labour productivity and enhance technological self-reliance. However this is a difficult task to undertake without reducing risk appetites.

Growing dollar income case study: Macquarie Group (MQG) v Commonwealth Bank (CBA)

Capital growth and dividends each play an important role in delivering growth in dollar income over time. Capital is what income grows off, along with providing duration to the retirement funding pool well into the future, countering longevity risk. DNR Capital strongly believes that a growing dollar income over time delivers the best outcome for retirees as they seek to offset inflation and look to maintain lifestyles in retirement.

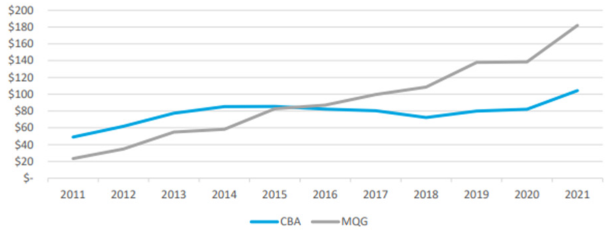
In the following analysis, we have compared an initial investment in Commonwealth Bank (CBA) versus Macquarie Group (MQG) over the last ~10 years. The following charts show the dividend profile (including our projections for FY21e) and share price over this period. CBA's 2021 dividend is broadly in-line with 2011, whilst its share price has doubled. On the other hand, MQG's 2021 dividend has almost quadrupled since 2011 and its share price has increased by a factor of almost ~9x. As such, the implied dividend yield on investment for MQG is currently ~16%, compared to CBA at around ~6%.

Dollar income from $100,00 investment in MQG v CBA



Source: Iress, Visible Alpha

MQG vs CBA share price



Source: Iress

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 5.53% (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 11.5% compared to 11.0% for the benchmark.
  - 2-year forward dividend yield is 4.3% compared to the benchmark at 3.4%.
  - 2-year forward earnings growth and dividend growth expectations are in line with market growth rates at 9% and 8% respectively
- Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:
  - 2-year forward PE is at 16.4x compared to 20.5x 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 3.8%.

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 (MQG)

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

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

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.
- **Global growth.** Higher energy costs and supply chain disruptions could drag on global growth rates.

Stock moves

Sale of Sydney Airport Holdings (SYD)

We have exited our position in Sydney Airport Holdings (SYD). We acquired the stock during the COVID-19 lows of March 2020. The stock is now trading at a small discount to the $8.75 bid from Sydney Aviation Alliance, which is still subject to risk of finalisation and not expected to complete until 2022. We have deployed the proceeds across existing portfolio holdings where the risk / return balance is favourable.

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

- Asgard
- BT Panorama
- HUB24
- Mason Stevens
- Netwealth
- Wealth O2

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