

DNR Capital Australian Equities Income Fund

Performance Report – December 2020

Performance

The DNR Capital Australian Equities Income Fund underperformed its benchmark for the month. Key stock contributors were CSL (CSL, no holding), BHP Group (BHP) and Super Retail Group (SUL). Key stock detractors were Commonwealth Bank of Australia (CBA, no holding), Afterpay (APT, no holding) and Lendlease (LLC).

The S&P/ASX 200 Industrials Accumulation Index was down 0.56% during the period. Information Technology (+9.4%) was the best performing sector during the period. Large-caps Afterpay (APT, +24.4%) and Xero (XRO, +13.8%) drove the gains, following a strong lead from U.S technology peers. Consumer Staples also outperformed as the grocery names led the sector higher. Both Woolworths (WOW, +6.3%) and Coles (COL, +1.6%) contributed, with the smaller Metcash (MTS, +14.6%) also stronger. Utilities (-6.8%) was the worst performing sector, as defensive sectors continue to underperform in the re-opening trade. AGL Ltd (AGL, -11.5%) and APA Group (APA, -6.8%) led declines. Health Care (-4.9%) also underperformed as their defensive nature counted against them in a month that largely rewarded cyclical names. CSL (CSL, -4.8%) was the largest contributor to the sector's performance, however many of the large cap names were down strongly.

The portfolio's dividend yield for Calendar year 2020 was 3.56% (4.67% grossed up for franking credits).

Top 10 active holdings

Security details	Active weight %	Actual weight %
Cash	6.33	6.33
Tabcorp Holdings	4.44	5.04
Telstra Corporation	4.00	6.43
Atlas Arteria	3.99	4.41
SKYCITY Entertainment Group	3.91	3.98
Lendlease	3.89	4.51
IPH	3.44	3.54
Aurizon Holdings	3.23	3.73
BHP Group	3.22	3.22
National Australia Bank	3.19	8.32

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 December 2020

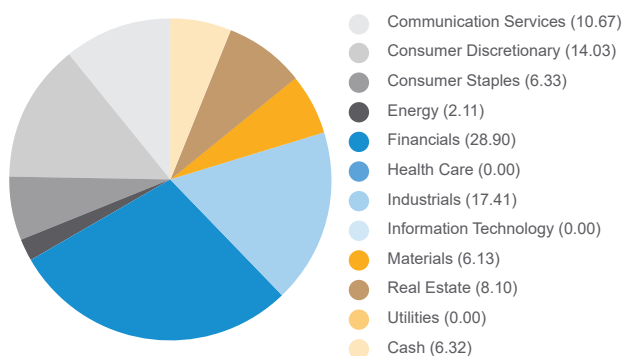
	1mth %	3mth %	6mth %	Incep.* %
Income Fund	-0.75	15.58	14.64	23.81
S&P/ASX 200 Industrial Accumulation Index	-0.56	12.58	12.05	11.86
Excess return	-0.19	3.00	2.59	11.95

* 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:

- CSL (CSL, no holding):** Underperformed in line with the broader health sector and after announcing its COVID-19 vaccine candidate, under development with The University of Queensland, would not be progressing to Phase 2/3 clinical trials.
- BHP Group (BHP):** Outperformed as the strong iron ore price continues to hold up. Supply disruptions remain present following Vale's restrictions and demand is being driven by global fiscal stimulus, particularly from China. The strength should see bumper revenues at the half-year result.
- Super Retail Group (SUL):** Continues to benefit from multiple themes stemming from increased automotive DIY activity, home exercise, and demand for camping and outdoor equipment. We believe the group's vertical market means it is well positioned to capitalise on changing consumer habits, offering a dominant market position and capturing online sales.

The top stock detractors for the month were:

- Commonwealth Bank of Australia (CBA, no holding):** Was an outlier in the sector, outperforming in the month. During December, APRA removed dividend restrictions for 2021 while expecting banks to continue to moderate dividend payout ratios. The announcement paves the way for banks to return excess capital. CBA has a strong CET1 ratio of ~12.7% and is well placed to return capital to

shareholders in the form of a share buyback. Despite this, the bank remains the most expensive of the majors and we therefore see better value elsewhere.

- Afterpay (APT, no holding):** Outperformed during December, following strong online sales events in North America. While we continue to monitor the story and recognise the potential of the platform, we find the stock unpalatable, given regulatory risks and a model relatively untested under bad debt scenarios.
- Lendlease (LLC):** Was weaker during the period on limited news flow. The departure of the CFO during the month was not entirely unexpected and of minimal impact to the investment thesis. The company also confirmed the limits of its exposure to the Melbourne Metro overruns, which have been guided to previously.

Market review

This month we focus on the investment dynamics likely to define 2021. We believe three key themes will drive the year ahead:

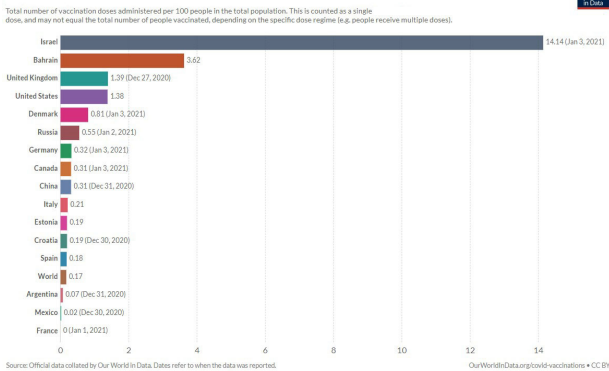
- 1) The rollout, uptake and efficacy of COVID-19 vaccines
- 2) The quantum and pace of global fiscal stimulus
- 3) Global inflation and central bank appetite for asset purchases, influencing the outlook for interest rates.

As key inputs to an ongoing and overarching debate around growth versus value, these will frame how best to position portfolios for a year potentially defined by the reopening, recovery and reflation of the global economy.

Vaccine rollout

Alongside infections, testing and mortality rates, tracking efforts now shift to include global vaccinations as a barometer of potential normalisation. The Pfizer-BioNTech and Moderna vaccine candidates are now approved in many countries, and early-stage inoculations have begun. In addition, the high efficacy of these two vaccine candidates at >95% is positive in terms of encouraging uptake.

COVID-19 Vaccination doses administered per 100 people, Jan 4, 2021



Source: Official data collected by Our World in Data. Dates refer to when the data was reported.

Undoubtedly, this provides a clearer road to defeating the virus, but the task of distributing and administering the doses is a substantial logistical undertaking. Even in the developed world, coordinating hundreds of millions of recipients for multiple doses and transporting the vaccine and requisite equipment will be one of the biggest peace time logistical feats in history. Undertaking this in the developing world, lacking crucial supplies and infrastructure, is significantly more difficult.

Any significant delay in the distribution of the vaccine, or major health issues arising from it, has the potential to slow the uptake from the population. This will have a material impact on the global recovery and represents a key risk to our market outlook for 2021.

Stimulus

Unprecedented levels of government support and fiscal stimulus have buffeted economies around the world from the crippling impacts of economic lockdown and shelter-in-place orders. These measures have been of greater magnitude than that seen during the global financial crisis (GFC).

COVID-19 stimulus and spend

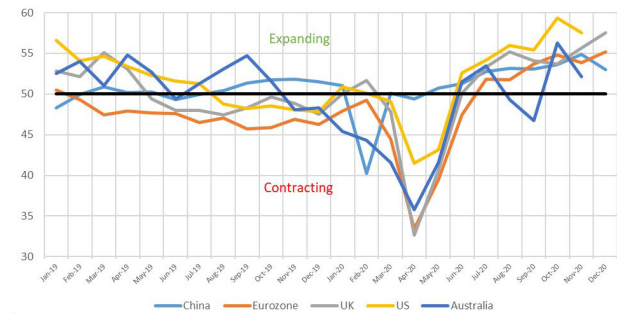
Country	Stimulus % GDP	GDP 2019 \$	Spend \$ (US Billion approx)
Japan	20	5,080	1,000
Canada	15	1,736	260
US	14	21,433	3,100
Australia	13	1,387	185
UK	10	2,830	290
Germany	9	3,862	340
China	7	14,731	1,065

Source: DNR Capital

As second and third waves of the virus impact parts of the world, further extensions of welfare and business support are likely, on top of planned fiscal stimulus. The next phase of recovery needs to shift from stabilising financial systems and providing emergency support to households, to restarting economic growth and facilitating reopening and a return to normality.

Heavy focus will be placed on the purchasing manager indices (PMI) around the world, as an early indicator of economic health. Following the rolling global shutdowns that started in February 2020, the indices rebounded strongly in the second half of the year but must be sustained in any global recovery. This indicator will continue to be volatile while varying levels of lockdown impact economic activity around the world, but provides us cautious optimism as we assess the success of fiscal stimulus plans.

Global PMI



Source: FactSet, DNR Capital

Inflation outlook

Central to the outlook for global equities is inflation, and more importantly, the market's expectations for it. An unexpected inflationary surge would be negative for equities, as concomitant interest rate increases provide more attractive alternatives in the form of bonds and deposits. However, the relative impact on different sectors of the market may be stark, as cheaper pro-cyclical industries like energy, resources and financials benefit from the increased economic activity coincident with inflation, while growth and defensive sectors like technology and healthcare are likely to underperform.

The inflation narrative was widely expected to have taken hold following the GFC, however this ultimately failed to materialise as subdued demand and excess capacity extinguished any inflationary spark.

Perhaps this time it will be different. With unprecedented levels of stimulus and ongoing government support payments, it can be argued that a spike in consumer spending will see increased demand for a shrinking supply of resources, driving prices up. With receding globalisation and travel restrictions rendering migration for skilled labour difficult, the potential for further upward pressure on wages is possible. Under this scenario, elevated inflation is plausible, in the near term at least.

Dividend outlook

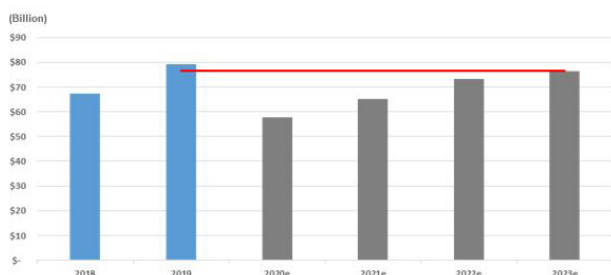
Anthony Albanese has formally dumped Labor's policy to abolish franking credit refunds and will not take any changes to franking credits to the next election. This allows investors to invest with confidence in Australian equities and take advantage of franking credits available.

Australian equity gross dividend yields of 5–7% are on offer over 2021 to 2023, which is very attractive with interest rates expected to stay low and alternatives not appealing.

We expect dividends to be materially higher in 2021–23, compared to 2020, due to the following key reasons:

- COVID-19, macroeconomic and geopolitical risks are less uncertain, and a recovery is underway
- dividends have rebased – company earnings will recover, and payout ratios will normalise
- dividends continue to be a large component of market returns and remain reliable.

ASX 200 Dividends paid excluding special dividends



Annual rebasing of ASX 200 dividends

Source: IRESS, Factset

Portfolio positioning

Entering 2021, we observe valuation risk in some areas of the market (in particular in the Information Technology and Health Care sectors). While maintaining our core focus on quality, we are positioned in a balanced portfolio of stocks characterised as follows:

Out of favour stocks, despite substantial free cash flow generation

We believe free cash flow generation will become a greater focus by the market, particularly given the back drop of low interest rates.

- Aurizon Holdings (AZJ) substantially underperformed during 2020 due to the probable shift away from thermal coal, China's unofficial ban on Australian coal imports and perceived ESG risks. We think these risks are overstated in Aurizon's current share price. The stock is trading cheaply and has a sustainable gross yield of ~9% pa. In addition, the company has ~\$1.2b of balance sheet capacity, so capital management in the form of on-market buybacks will be ongoing.
- Telstra Corporation (TLS) has not been immune from COVID-19 disruption with some negative one-off impacts from lower international roaming charges, customer incentives and delayed synergies hitting both FY20 and FY21 earnings. The market appears to have focused on the risk to the 16cps dividend from a lowering of near-term ROIC targets. We believe that ~\$7.5b EBITDA is achievable by FY23 and as such, the 16cps dividend remains sustainable and represents an ~8% gross yield at current prices. The competitive environment in mobiles remains rational and is likely to see improving earnings over the next few years and we also expect Telstra will recover lost earnings from disruption caused by the pandemic.

Defensive exposures with valuation support

There is still much uncertainty and it is prudent to retain a cautious outlook. Importantly, our preferred defensive exposures retain valuation support.

- Coles (COL) and Woolworths (WOW). The supermarket sector holds appeal going into CY2021 from both a sales and margin perspective. Sales, while likely weaker than 2020, will remain robust as household inventories are elevated and consumers favour entertaining at home over dining out. Margins are expected to benefit from reduced levels of discounting alongside underlying food inflation, with fresh and dry grocery prices firming during the year. COL and WOW also stand to benefit from a reversal of the "shop near home" phenomenon observed in regional areas, having benefited independent grocers. Finally, progress in online capabilities supports market share gains for the major chained supermarkets, with a technological and logistical advantage over competitors.
- Transurban (TCL) network of toll roads is typically defensive, albeit will benefit from a reopening in the short term. In addition, earnings are largely protected through inflation-linked pricing. The balance sheet has been repaired through the sell down of a 50% stake in its US road portfolio at an attractive price, justifying current valuations. The share price has been under recent pressure given the potential for an equity raise to fund growth opportunities, which has provided the opportunity to add the stock.

Reopening beneficiaries with substantial valuation support and attractive free cash flow generation on a two to three-year timeframe

The portfolio retains a reasonable allocation toward stocks that will benefit from the reopening, recovery and reflation of the global economy.

- Atlas Arteria (ALX) is once again being impacted by France lockdown restrictions, however we expect it will be short term and that traffic will recover quickly, as it did in 2020. Normalised traffic volumes and a simplified corporate debt structure imply a sustainable dividend of up to ~40cps, which represents a yield of >6% pa at current prices. There is further upside as management look to restructure debt on the Dulles Greenway and Warnow tunnel to unlock cash at these assets.
- Scentre (SCG) maintains a portfolio of world-class shopping centres in prime locations. These destinations will be prime beneficiaries of reopening, with progress on domestic vaccinations to provide consumers further comfort to resume shopping in physical stores. This will relieve much of the pressure faced by retailers throughout the pandemic, facilitating more productive lease negotiations and rent collection for landlords.
- SKYCITY Entertainment Group (SKC) holds a number of casino licences across New Zealand (including Auckland, Queenstown, Hamilton) and Australia (Adelaide). The Auckland casino licence generates the majority of earnings and was significantly impacted by lockdown restrictions over 2020. SKC's mid-November

trading update highlighted a strong rebound on the back of pent-up demand and stimulus and more broadly, the resilience of revenues under a normal trading environment.

Resource and energy

While the resource and energy sectors are outside of benchmark for this portfolio, we believe both sectors are attractive in a recovery scenario.

- BHP Group (BHP) offers ongoing earnings growth potential from its iron ore and copper exposure, with leverage to an eventual global economic recovery through coal and energy resources. In particular, iron ore prices continue to be robust given i) ongoing strong China demand, ii) Brazil supply constraints and iii) contracting economic output in world ex-China. Dividend yields of mid-single digits are supported by free cash flow yields in the high single and double digits over the next two to three years.
- Woodside Petroleum (WPL) is the most leveraged name to spot LNG vs peers and is also the most leveraged to long-term LNG fundamentals given growth prospects. LNG prices have more than doubled over the last couple of months due to China's stronger-than-usual winter demand as manufacturers operate at levels near 100% as demand soars. Coal import restrictions into China, along with China's household power supply guarantee, also lead to increased demand for LNG. WPL guided to 25–30% LNG spot exposure in 2020.

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 below summarises our current Fund positioning:

- A basket of stocks with defensive characteristics at attractive valuations - Atlas Arteria (ALX), Aurizon (AZJ), Coles (COL), IPH (IPH) and Telstra (TLS).
- Selective exposure to COVID-19 impacted stocks with quality characteristics - Scentre Group (SCG), SKYCITY Entertainment Group (SKC), Sydney Airport (SYD)

- Underweight Australian banks - Negatively correlated to low interest rates and bad debts. National Australia Bank (NAB) preferred. No Commonwealth Bank of Australia (CBA) holding. Prefer other financials - Macquarie Group (MQG), Suncorp (SUN), Virgin Money UK (VUK).
- Overweight consumer stocks that should benefit from stimulus in recovery phase - Tabcorp (TAH), Wesfarmers (WES), Super Retail Group (SUL).
- Select exposure to quality growth stocks - REA Group (REA), SEEK (SEK).
- Overweight global cyclicals, resources and energy - James Hardie Industries (JHX), Lendlease (LLC), BHP Group (BHP), Woodside Petroleum (WPL).

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 Transurban (TCL)

TCL manages and develops urban toll road networks in Australia and the US.

TCL meets DNR Capital's six-point quality web:

1. **Industry strength:** TCL has 25-100% ownership of 21 toll road concessions with a weighted average expiry of 2043.
2. **Earnings strength:** TCL's road networks in Australia and the US are leveraged to inflation-linked toll increases, economic growth and employment, providing predictable and sustainable ongoing cash flows.
3. **Dividend sustainability and growth:** TCL FY21 distribution is expected to be in line with free cash, excluding capital releases. This reflects a dividend yield of ~4% pa, with growth of ~10% over the next 3 years, driven by a traffic recovery and growth projects.
4. **Balance sheet:** TCL's balance sheet is robust, with group net debt of ~\$22b and gearing of ~36% - its defensive earnings allow higher gearing levels.
5. **Management:** Under the leadership of Scott Charlton, TCL management are successfully leveraging the existing asset base to expand and extend the network at attractive returns.

6. Environment, social and governance (ESG): TCL has a low risk ESG exposure, as it works with partners to ensure the future of transport is efficient, safe and sustainable.

Key catalysts

COVID-19 restrictions: Faster / slower removal of COVID-19 restrictions will impact traffic volumes positively / negatively.

New projects: TCL has a material pipeline of opportunities emerging in core markets to drive growth over the medium term.

Equity raising: An equity raising is possible during 2021 as TCL investigates its potential involvement in Stage 2 of the WestConnex project.

Key risks

Traffic: The use of toll roads for passenger vehicles is linked to discretionary consumer spending, however risk is reduced given lack of alternatives and proximity to key residential catchment areas feeding into primary business districts in Australia's east coast capital cities.

Capex projects: Efficiencies / delays to construction projects, lower / higher capex than budgeted (including environmental costs with the Westgate tunnel).

Interest rates: TCL's high level of gearing exposes it to rising funding costs (a 1% move in interest rates would impact FCF/share by >10% of current DPS), however TCL is still benefitting from a cost of debt tailwind.

Valuation

We derive a sum-of-the-parts valuation of ~\$15 / share. This implies a FY22e EV/EBITDA multiple of ~20x and a ~5% dividend yield, in-line with long-term averages. We expect TCL's dividend to grow at ~10% pa over the next three years in-line with free cash flow.

Conclusion

The recent pull-back in share price resulting from higher bond yields, provides an attractive entry point. We purchased TCL due to its combination of resilient earnings, underpinning a ~4% dividend yield, which is expected to grow at ~10% pa over the next three years and backed by free cash flow.

Purchase of QBE Insurance Group (QBE)

QBE is a diversified, global property and casualty insurance group. Its main operations are in Australia, North America and Europe. QBE operates predominantly in the commercial lines/intermediated insurance markets. Individually significant operations include Lloyd's market operations, Australian lenders mortgage insurance (LMI) and US Crop insurance.

QBE Insurance Group QBE meets DNR Capital's six-point quality web:

1. Industry structure: QBE Insurance Group is one of the top 20 insurers and reinsurers worldwide by Gross Written Premium (GWP).

2. Earnings strength: With global premium rate momentum continuing to be strong and potentially improving further, we see earnings growth of double-digits over the next three years.

3. Dividend sustainability and growth: FY20 is expected to be the trough for dividends. We forecast dividend yields of 4-6% (~30% franked) over FY21-23, based on a payout ratio of ~60%.

4. Balance sheet: QBE balance sheet is robust with CET1 ratio of ~1.2x.

5. Management: Richard Pryce has assumed the role of interim group Chief Executive Officer while the search process for a permanent replacement is underway. Having joined QBE in 2012, Richard became Chief Executive Officer, European Operations in 2013, and in 2019 he became Chief Executive Officer, International Operations.

6. Environment, social and governance (ESG): We rate QBE's ESG risk exposure as medium. Specifically, QBE faces increased risk from natural disasters due to climate change.

Key catalysts

Margin improvement: We see upside risk to margin expectations from pricing momentum, improving volume growth, delivery of cost initiatives, and higher yields.

Interest rates: QBE profitability and investment yields will benefit from higher interest rates / global bond yields.

Key risks

Efficiency program execution: Execution on efficiency programs may be more difficult in the current environment.

COVID-19 headwinds: Scope for recent rate increases to continue may reduce given COVID-19 economic headwinds.

Catastrophes: An above-average catastrophe season is expected in the Northern Hemisphere.

Australian housing: To the extent that the Australian housing market deteriorates significantly, QBE is a major player in the Lenders Mortgage Insurance sector.

Valuation

We value QBE at ~\$11 / share. Our valuation uses a WACC of ~11%, terminal growth rate of 3%, and beta of ~1.3x. QBE trades at ~12x FY21E and a dividend yield of >5%. We believe there is further upside from (1) improving underwriting discipline, (2) capital management, and (3) planned cost initiatives.

Conclusion

QBE is trading at an attractive valuation, has improving top-line growth momentum, improving underlying underwriting profits and a robust balance sheet. After years of repair the balance sheet and underwriting book looks much improved and the global market is enjoying an improved cycle. Margins should improve from here so the stock looks attractively priced on modest earnings expectations.

Sale of Ramsay Health Care (RHC)

The position in RHC was exited after a relatively short holding period. The stock was initially acquired during the period of heightened concerns around the impact of COVID-19 on hospital volumes and we participated in the successful capital raising. While we are still optimistic on the return of elective surgery volumes, the stock had rallied to a level where the risk / return trade off was more balanced and we decided to exit the position.

Sale of Mirvac Group (MGR)

Following its strong performance in November on the back of positive vaccine news, we have exited our not out position in Mirvac. The COVID-19 pandemic has heavily impacted physical asset use, particularly the office and retail assets which Mirvac specialise in. The case for reduced office usage going forward due to the relative success of 'working from home' during the lockdown periods has cast a shadow over office asset prices. The same can be said for retail assets, which have been the victim of an acceleration in digital retail during the period, likely bringing forward years-worth of penetration. While we still view the business and its assets as high quality, our valuation no longer supports the investment thesis.

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.

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.

Disclaimer

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