Australian Equities Income Portfolio

Performance Report – February 2022

Market overview and portfolio performance

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The S&P/ASX 200 Industrials Accumulation Index was up 0.71% during the period.

Consumer Staples (+5.6%) was the best performing sector as a flight to safety drove the sector higher. Utilities (+3.0%) also outperformed, following a bid for AGL (AGL +5.9%) from a Brookfield consortium. Information Technology (-6.9%) was the worst performing sector, with the rotation from growth to value continuing and a new-found focus on profitability in reporting season. Consumer Discretionary (-5.8%) also underperformed, with key constituents Wesfarmers (WES -8.6%), Aristocrat Leisure (ALL -7.6%) and Domino's Pizza Enterprises (DMP -23.7%) all reporting against strong comparative periods.

The DNR Capital Australian Equities Income Portfolio outperformed the benchmark for the month. Key stock contributors were Woodside Petroleum (WPL), Lendlease (LLC) and Scentre (SCG). Key stock detractors were Westpac Banking Corporation (WBC, No Holding), SEEK (SEK) and TPG Telecom (TPG).

The Portfolio's dividend yield expectation for 2022 is currently 4.8% (grossed up for franking credits).

Portfolio overview

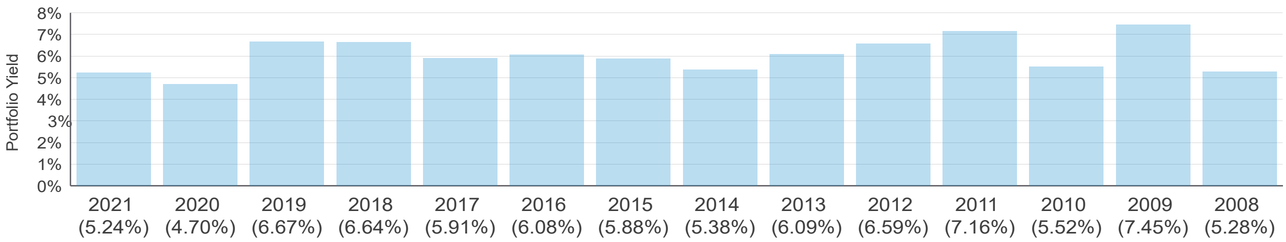
Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before fees) over a rolling three year period
Investable universe	ASX listed securities with a focus on S&P/ASX 200 and ASX listed convertible securities
Number of stocks	15–30
Asset allocation	Australian equities 80–100% Cash 0–20%
Stock limit	15% maximum weighting
Minimum suggested investment timeframe	5 years

Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	2.27	-0.93	-0.83	15.19	11.85	9.61	8.64	13.35	8.21
S&P/ASX 200 Industrials Accumulation Index	0.71	-6.24	-8.23	9.35	7.39	6.69	5.70	10.84	5.66
Excess Return	**1.56**	**5.31**	**7.40**	**5.84**	**4.46**	**2.92**	**2.94**	**2.51**	**2.55**

** Inception date—December 2007*

Grossed-up yield (calendar year)*



**Gross yield calculation uses income (including franking credits) ex-date and applies a monthly capital rebasing over the 12 month period (January to December).*

Source: DNR Capital

Performance data relates to the DNR Capital model portfolio. Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators. Past performance is not an indication of future performance. No allowance has been made for taxation and fees are not taken into account.

Market review

As global equity markets corrected for a second month, Australian equities outperformed. The ASX 200 Industrials Index (the strategy's benchmark) rose +0.7%, significantly better than the -3.1% decline in the S&P 500. Escalating geopolitical tensions triggered the decline for global benchmarks, as the fallout from the Russian invasion of Ukraine deepens.

The key reason for the outperformance of Australian equities relative to global equities is higher exposure to late cycle sectors like banks, along with low exposure to technology stocks. The continued trend in value stocks outperformance relative to growth was sustained.

Russian invasion of Ukraine

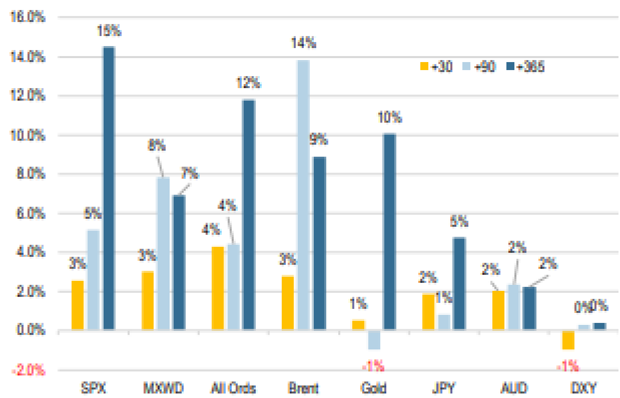
The Russia-Ukraine war is moving very quickly with significant uncertainty and inevitable fall-out. A global coalition is implementing a raft of economic restrictions on Russia. In turn, oil and gas supply will be disrupted, increasing the cost of energy. The impact of higher energy prices on demand is likely to have negative consequences for economic growth.

Germany has announced it will increase spending on defence by ~1% of GDP. We expect other nations to follow suit, further cementing a willingness of governments to increase spending, a change that has been observed since the onset of COVID-19. This may well provide a growth offset, while potentially adding to inflationary pressures and resulting in higher commodity prices.

While investors are rightly wary about the escalating Ukraine-Russia war, at times the shock of war can cause markets to overreact, leaving opportunities for level-headed and forward-looking investors. In this regard some opportunities appear to be emerging and we are selectively topping these up in our portfolios.

Historical evidence also points to equity markets remaining resilient in the aftermath of geopolitical upheavals. History shows that most wars are followed by periods of rising asset prices. Looking at the performance of markets in the wake of a series of wars since 1982, shows a strong tendency for equities to trade higher.

Cross-asset performance | Post-war performance



Source: J.P. Morgan calculations, Bloomberg Finance L.P.
**Falklands ('82), Kuwait invasion ('91), Afghanistan ('01), Iraq ('03)*

Other implications

Despite elevated European risks, we remain cognisant of political risks closer to home with ongoing tensions between Canberra and Beijing. Beijing's designs on Taiwan are well documented, and a lack of forceful retaliation from the West may embolden China's strategy to bring the island further under their influence.

Should geopolitical risks stabilise, the relief that initially comes from any moderating of geopolitical risks is likely met with the reality of more persistent inflationary signals and sustained resolve in central bank intent to normalize monetary policy settings. This would take investors back to a future heavily influenced by rising yields and rising rates.

Geopolitics and increasingly hawkish central banks are pushing market volatility, evidenced by large wild intraday moves. While using volatility to selectively increase exposure to our high conviction positions, we view balance across the portfolios as warranted.

During the month we reduced the number of stocks held in the portfolio to 22 (from 25) and increased our portfolio active weight from 62.5% to 65%. This primarily represents increased confidence around high conviction ideas with attractive risk-return metrics, whilst maintaining a balanced portfolio across quality, defensive, COVID-19 recovery and inflation-beneficiary exposures.

Reporting season takeaways

A strong results season has been supportive for the Australian equity market. Our key takeaways are as follows:

1. **Benefits of scale are back.** Inflationary pressures means good businesses with buying power have competitive advantages. We saw this with larger resource companies controlling costs better than smaller players, and larger insurance companies managing claims inflation relative to smaller competitors. Will larger companies (which have been under pressure from competitors in a digital world) will be better placed to compete by leveraging scale as costs rise?
2. **Banks were mixed.** Soft underlying results for ANZ Banking Group (ANZ) and Commonwealth Bank of Australia (CBA), better than feared for Westpac Banking Corporation (WBC) and a strong result for National Australia Bank (NAB), reflecting a strong turnaround. The margin outlook continues to be challenged in the near term, albeit the change to the yield curve promises some relief further out.
3. **COVID-19 winners struggled.** Despite solid results, companies like Wesfarmers (WES) gave up relative performance as the sustainability of margins and earnings was questioned by the market, as we cycle COVID-19 benefits. Conversely, COVID-19 losers performed well.
4. **Just in Case trend.** A transition from "Just in Time" to "Just in Case" inventory management is leading to surge in working capital, impacting cash flows. As an emerging "de-globalisation" thematic takes hold, many retailers will need to carefully manage working capital as they further build inventory buffers.
5. **Commodities strength.** The Resources sector was strong reflecting surging commodity prices and better than expected cost control for the majors.

Significant ASX200 Index changes do not materially impact Income strategy benchmark

The S&P ASX 200 Accumulation Index (ASX200) is predominantly used as the benchmark for Australian equity funds. DNR Capital's Australian Equities Income Strategy however, benchmarks its performance against the S&P ASX 200 Industrials Accumulation Index (ASX200 Industrials).

In our view, the ASX 200 Industrials is better suited as a benchmark for income seeking investors, primarily because the index has historically delivered higher dividends, with less volatility in both dividends and share prices.

The composition of the ASX 200 has changed significantly recently, with BHP Group's (BHP) unification having the largest impact. In addition, the index weights of Industrials and Utilities have dropped following the removal of Sydney Airport Holdings (SYD) and AusNet. Materials now accounts for 26.5% of the index up from 23.0%. BHP's weight in the index has climbed from 6.9% to 11.4%. The removal of SYD sees the weight of Industrials drop to 5.6% from 7.0%.

These changes have not had a material impact on the ASX200 Industrials Index given the exclusion of the Resource and Energy sectors.

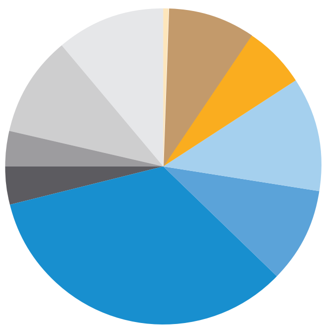
Whilst the ASX200 Industrials is DNR Capital's preferred choice of benchmark for the Income Strategy, this does not mean that we cannot and will not invest in resource and energy companies when opportunities present themselves. We do, but importantly are not obliged to. We currently have preferred positions in BHP Group (BHP) and Woodside Petroleum (WPL).

BHP Group (BHP): Shares have experienced significant volatility recently, given the collapse of its dual-listing structure in the UK and the proposed merger of its Petroleum assets with Woodside Petroleum (WPL). However, BHP offers ongoing appeal through its iron ore and copper exposures, with leverage to global economic recovery. In addition, dividend yields remain attractive and are supported by free cash flow over the next two to three years.

Woodside Petroleum (WPL): provides exposure to high quality energy projects that are underappreciated by the market. The proposed merger with BHP represents a significant opportunity given its cash flow benefits, operational synergies and Scarborough project progression. The Scarborough project is set to provide low-cost, low-carbon LNG for decades to come, helping to satisfy the strong future demand for and undersupply of natural gas in the transition to a net-zero carbon economy.

Portfolio attribution

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors		Alpha*
Woodside Petroleum	Overweight	0.72%
Lendlease	Overweight	0.27%
Scentre	Overweight	0.21%
Top 3 detractors		
Westpac Banking Corporation	No Holding	-0.56%
SEEK	Overweight	-0.18%
TPG Telecom	Overweight	-0.14%

12 month - top contributors and detractors

Top 3 contributors		Alpha*
Afterpay	No Holding	1.17%
Woodside Petroleum	Overweight	1.07%
IPH	Overweight	1.06%
Top 3 detractors		
Lendlease	Overweight	-1.28%
Commonwealth Bank of Australia	No Holding	-0.98%
Goodman	No Holding	-0.51%

** Alpha is the portfolio return less benchmark return. These tables represent the stocks contribution of alpha to overall portfolio alpha and is determined by the stocks active weight relative to the benchmark and share price return relative to the benchmark.*

Attribution

The top stock contributors for the month were:

- **Woodside Petroleum (WPL):** outperformed during the period, with energy prices surging beyond $100 per barrel. The Russian invasion of Ukraine has caused severe disruptions to energy markets. Russia represents ~10% of global oil and gas supply and while sanctions have not yet been placed on Russia's energy exports directly, the risk of an extreme supply shock has elevated considerably.
- **Lendlease (LLC):** bounced after a period of weakness leading into the result. The result itself was towards the lower end of expectations, however the company showed solid progress towards the 2024 earnings targets.
- **Scentre (SCG):** outperformed following a strong annual report. The update showed improvements in foot traffic, retail sales, re-leasing spreads and cash collections, indicating further progress from COVID-19 lows. SCG also outlined its considerable inflation protection through its rent escalation mechanisms, separating it from its peers who favour fixed-rate agreements.

The top stock detractors for the month were:

- **Westpac Banking Corporation (WBC, No Holding):** bounced following its quarterly update which highlighted progress on cost out, meaning the underlying result was not as bad as feared.
- **SEEK (SEK):** underperformed the market in line with technology and classified peers, and despite a strong above market earnings result and positive outlook.
- **TPG (TPG):** FY21 result disappointed the market, albeit the longer term investment thesis remains intact. The anticipated pace of Fixed Wireless Access (FWA) uptake in FY22 (+80k) was lower than expectations, with TPG hamstrung by supply issues. The regional access deal with Telstra (TLS) negatively impacts short-term financials albeit is a good long-term outcome (with break-even estimated at only ~100-200k additional subscribers). Capex is now also likely higher in both FY23/24 at ~$1b (vs. previous c$0.8b expectations).

Portfolio positioning

Despite the outperformance of growth (relative to value) over the last decade, the DNR Capital Australian Equity Income Strategy has achieved its objectives and exceeded its benchmark and the broader market.

We are a quality investment manager with a neutral investment style (neither growth nor value), albeit with a robust valuation discipline.

This focus on valuation has resulted in the Portfolio's current value tilt.

We continue to position the Portfolio in high-quality businesses that offer a combination of growing dollar income, franking benefits and attractive valuations.

Quality defensives: Industry leading stocks that should be able to win market share regardless of the economic cycle and pass inflation onto customers (eg IPH, COL).

COVID-19 recovery plays: Quality stocks that have been oversold following the negative impact of lockdowns and are early in the recovery phase (eg CSL, SKC).

Inflation beneficiaries: Stocks that should benefit from higher inflation and higher interest rates and where valuations are attractive (eg. SUN, WPL).

Portfolio characteristics

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

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

The Portfolio is expected to generate a gross yield of 4.8% (including franking) for calendar year 2022, very attractive relative to alternatives.

- The quality characteristics of the Portfolio are attractive relative to the Portfolio's benchmark:
  - 2-year forward return on equity is above the market at 10.5% compared to 10% for the benchmark.
  - 2-year forward dividend yield is 4.4% compared to the benchmark at 3.9%.
  - 2-year forward earnings growth and dividend growth expectations are in line with market growth rates at ~9.5% 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 14.9x compared to 17.4x for the benchmark.
- In addition, despite the superior growth outlook, the defensive attributes of the Portfolio have been maintained:
  - 2-year forward free cash flow yield is 5.4% compared to the benchmark at 4.5%.

Portfolio 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).

Key risks

Key risks to the Portfolio include:

- **Political environment.** The crisis in Ukraine and sanctions against Russia are severely impacting commodities markets, with the potential to destabilise the region and cause global inflationary shocks. Regional tensions with China also continue to pose risks to trade.
- **COVID-19 disruption.** The development of vaccine-resistant COVID-19 variants or sustained supply chain impacts still poses risks, especially with government support mostly withdrawn.
- **Interest rates.** Low interest rates have been a primary driver of markets over the past few years. With markets now pricing monetary tightening, changes to this trajectory or further inflationary shocks would have a significant impact on valuations.
- **Global growth.** Sanctions against Russia are driving up energy prices and creating global energy security concerns. Historically, sustained price shocks in oil have impacted global growth and catalysed recessions.

Portfolio moves

Sale of Deterra Royalties (DRR)

We have exited our position in DRR. With iron ore prices back at ~US$140 / tonne and Australian 10-year bond yields now over 2%, the stock is trading at a full valuation.

Sale of Atlas Arteria (ALX)

We have exited our position in ALX. France 10-year bond yields have risen to ~0.75% from flat to negative over just two months. Whilst the toll regime has inflation protection and underlying traffic has been robust despite the Omicron outbreak, the stock has performed well and is trading at a full valuation.

Sale of Wesfarmers (WES)

We have exited our position in WES. The business, in particular Bunnings, continues to perform well and the balance sheet remains robust for future investment opportunities. However, it has been a beneficiary of COVID-19 and a strong property market, and going forward we expect it will experience volatile trading which will represent a challenge. The stock is now trading at a full valuation.

Purchases

We have deployed proceeds across existing portfolio holdings and increased our active weights where we see better risk / return opportunities. These include Amcor (AMC); BHP Group (BHP); Coles Group (COL); CSL (CSL); IPH (IPH); Lendlease (LLC); Qube Holdings (QUB); SKYCITY Entertainment (SKC); Super Retail Group (SUL) and TPG Telecom (TPG).

Investment strategy

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

The Australian Equities Income Portfolio also has a preference for securities that have high and sustainable dividend capability, strong profit-to-cash conversion, and relatively assured earnings growth. Securities that generate franking credits predominate.

We define quality businesses as being those with the following six attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low environmental, social and governance (ESG) risk
- Income sustainability / growth

The focus of the Portfolio is on yield. We are focused on a growing, sustainable dividend yield above the market.

Where we are satisfied that a security 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 business being assessed to identify mispriced opportunities.

The Portfolio construction process is influenced by a top-down economic appraisal and also considers the risk characteristics of the Portfolio, such as security and sector correlations.

Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when it is combined with a thorough valuation overlay. We seek to identify quality businesses that are mispriced by overlaying a quality filter, referred to as the 'quality web', with a strong valuation discipline. The Portfolio is high conviction and invests for the medium term.

Platform access

- AMP PPS
- BT Panorama (Direct, Compact and Full)
- Coloinal First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium
- Wealthtrac

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