

Australian Equities Income Portfolio

Performance Report – January 2022

Market overview and portfolio performance



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The S&P/ASX 200 Industrials Accumulation Index was down 8.59% during the period.

Utilities (+2.6%) was the best performing sector again, as Origin Energy (ORG +7.2%) benefitted from record gas prices in the quarter. Financials (-6.5%) also outperformed with the major banks partially sheltered from the market sell off due to their positive exposure to rising interest rates. Information Technology (-18.4%) was the worst performing sector, continuing the bond-yield-induced rout of high valuation names across global markets. Healthcare (-12.1%) also underperformed, with the more speculative healthcare stocks facing the worst of the sell off.

The DNR Capital Australian Equities Income Portfolio outperformed the Index for the month. Key stock contributors were Woodside Petroleum (WPL), BHP Group (BHP) and Virgin Money UK (VUK). Key stock detractors were Westpac Banking Corporation (WBC, No Holding), Commonwealth Bank of Australia (CBA, No Holding) and Sydney Airport Holdings (SYD, No Holding).

The Portfolio's dividend yield expectation for 2022 is currently 3.8% (5.0% grossed up for franking credits).

Portfolio overview

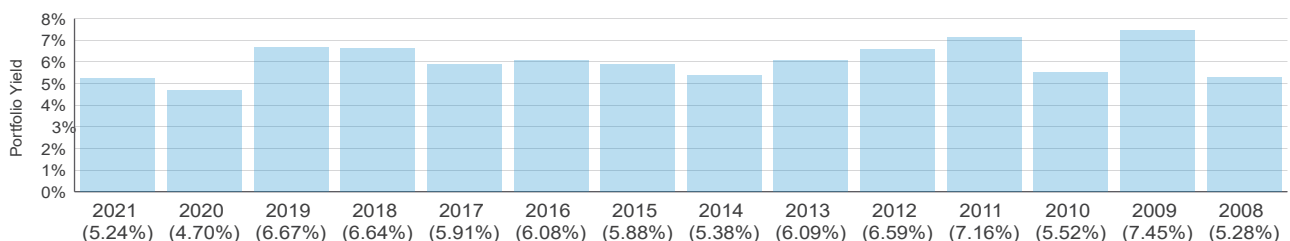
Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before 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	-4.62	-2.76	1.36	17.63	13.62	9.79	9.42	13.47	8.08
S&P/ASX 200 Industrials Accumulation Index	-8.59	-8.31	-3.79	8.45	9.15	7.26	6.49	11.02	5.64
Excess Return	3.97	5.55	5.15	9.18	4.47	2.53	2.93	2.45	2.44

* 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

Market Update

Australian equities have started the year with a –6% correction and a signification rotation out of growth and duration stocks, with growth underperforming value by -10% over the month of January.

The impact from the pandemic is expected to lessen as economies reopen, however supply chain disruption, labour supply shortages, high commodity prices and the withdrawal of monetary stimulus are all expected to have a meaningful impact on inflation and the prospect for higher interest rates.

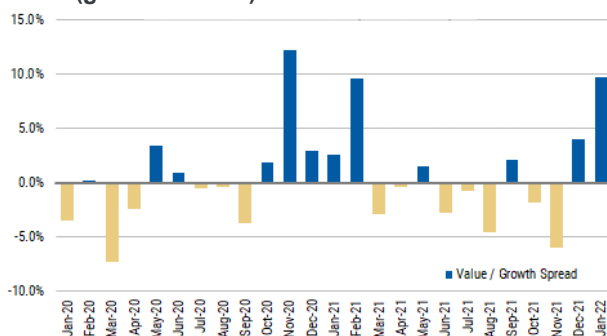
A change in language from the US Federal Reserve (Fed) indicating “it will soon be appropriate to raise the target range for the federal funds rate” has been the key catalyst for the shift in market sentiment.

A market correction was perhaps overdue given the strong run over the course of last year (ASX200 +13%) and growing macro and geopolitical risks, however the ongoing valuation dispersion within markets continues to represent an interesting opportunity, in our view.

Given the nature of long-duration cash flows, the valuation premium of high growth stocks (relative to value) has demonstrated a strong correlation between 10-year bond yields over time.

Over the last two years, there have been three notable value rotations in November 2020, February 2021 and January 2022, coinciding with significant changes in bond market expectations, highlighting the importance of inflation and interest rate expectations relative to outcomes for equities.

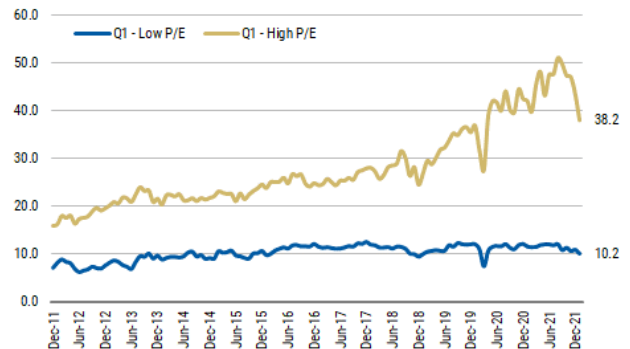
Value relative to growth. Based on MSCI Australia index (growth returns)



Source: Morgan Stanley

Despite the latest market moves, the valuation dispersion between high PE and low PE stocks remains at extremes, relative to history.

Top quartile (low P/E) vs bottom quartile (high P/E) median 12mf P/E



Source: Morgan Stanley

To the extent that inflation and interest rate expectations trend higher, the market rotation toward cyclicals and value is likely to continue.

However, higher interest rates kill cycles and the market has started to worry that future higher interest rates will hurt the economy.

Sentiment regarding interest rates has deteriorated just as the economy becomes incrementally softer following a very strong period.

US business confidence (PMI)



Source: Factset

We think it is unusual to start worrying about the Fed making a policy mistake and ending the cycle before they have even undertaken the first rate rise.

So a buying opportunity is presenting itself in selective companies.

Portfolio positioning

Despite the outperformance of growth (relative to value) over the last decade, the DNR Capital Australian Equity Income Strategy, upon which the Portfolio is based, 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.

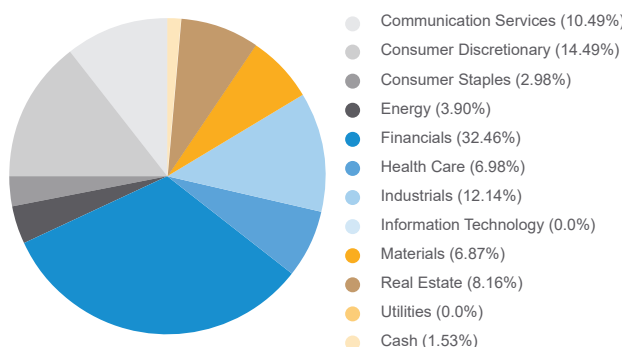
Quality defensives: Industry leading stocks that should be able to win market share regardless of the economic cycle and pass inflation onto customers (eg. IPH (IPH), Wesfarmers (WES)).

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 (CSL), SKYCITY Entertainment Group (SKC)).

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

Portfolio attribution

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors		Alpha*
Woodside Petroleum	Overweight	0.81%
BHP Group	Overweight	0.55%
Virgin Money UK	Overweight	0.31%

Top 3 detractors		Alpha*
Westpac Banking Corporation	No Holding	-0.17%
Commonwealth Bank of Australia	No Holding	-0.13%
Sydney Airport Holdings	No Holding	-0.12%

12 month - top contributors and detractors

Top 3 contributors		Alpha*
Afterpay	No Holding	1.28%
Macquarie Group	Overweight	0.98%
Virgin Money UK	Overweight	0.93%

Top 3 detractors		Alpha*
Lendlease	Overweight	-0.93%
Commonwealth Bank of Australia	No Holding	-0.84%
SKYCITY Entertainment Group	Overweight	-0.48%

* 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, following a strong rally in the oil price and a solid quarterly update. Energy prices continue to rise as pandemic-impacted supply has failed to recover due to geopolitical impacts and environmental pressures. WPL reported sales above expectations in the quarter, largely due to their spot price exposure to LNG, which reached record highs in the month.
- BHP Group (BHP):** rallied over the month as the iron ore price bounced strongly after significant falls in the second half of calendar 2021. Quarterly supply updates have highlighted the difficulties in ramping up production given supply chain and COVID-19 related issues.
- Virgin Money UK (VUK):** expectations regarding interest rate rises in the UK resulted in increased interest in value financials.

The top stock detractors for the month were:

- Westpac Banking Corporation (WBC, No Holding):** expectations regarding inflation and interest rates saw interest re-emerge for financials.
- Commonwealth Bank of Australia (CBA, No Holding):** expectations regarding inflation and interest rates saw interest re-emerge for financials.
- Sydney Airport Holdings (SYD, No Holding):** FIRB approved the proposed acquisition of SYD (by Sydney Aviation Alliance at \$8.75) on 22 December 2021 and the stock was delisted on 9 February 2022. As such, SYD stock has acted as a cash proxy during the month of January and outperformed the market given the sell off.

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 Income Portfolio is expected to generate a gross dividend yield of 5.0% (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 11% compared to 10.9% for the benchmark.
 - 2-year forward dividend yield is 4.6% 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% 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 17.7x 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 6.0% compared to the benchmark at 4.6%.

Portfolio categories

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 (eg. ALX, QUB).

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

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

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

Key risks

Key risks to the Portfolio 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.

Portfolio moves

No changes to report for the month.

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)
- Colonial First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium
- Wealthtrac

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