DNR Capital Australian Equities Income Portfolio

Performance Report January 2023

Performance

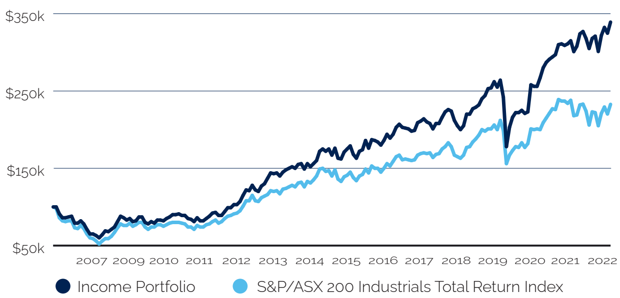
The DNR Capital Australian Equities Income Portfolio underperformed the S&P/ASX 200 Industrials Total Return Index by 1.23% in January. The Portfolio's dividend yield expectation for 2023 is currently 3.90% (5.00% grossed up for franking credits).

Gross active return as at 31 January 2023

	1mth %	3mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	10yr p.a. %	Incep.* p.a. %
Income Portfolio	4.41	5.39	12.74	8.66	10.04	10.59	11.44	8.39
S&P/ASX 200 Industrials Total Return Index	5.64	5.31	6.94	3.11	6.59	7.73	8.72	5.73
Excess return	**-1.23**	**0.08**	**5.80**	**5.55**	**3.45**	**2.86**	**2.72**	**2.66**
Income Portfolio dividend yield incl. franking credits[1]	**0.00**	**0.77**	**6.32**	**5.44**	**6.46**	**7.14**	**8.35**	**7.10**
Franking %	0.00	89.2	81.8	76.1	75.5	74.0	73.2	71.7

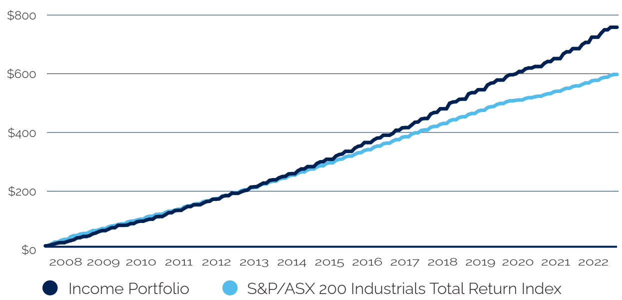
*Inception date—December 2007.
Source: DNR Capital
[1] Portfolio income yield calculated as the sum of all income received over the period divided by the capital base at the start of the period and uses income sources ex-date (including franking credits).
Performance data relates to the DNR Capital model 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.

Growth of $100,000 since inception



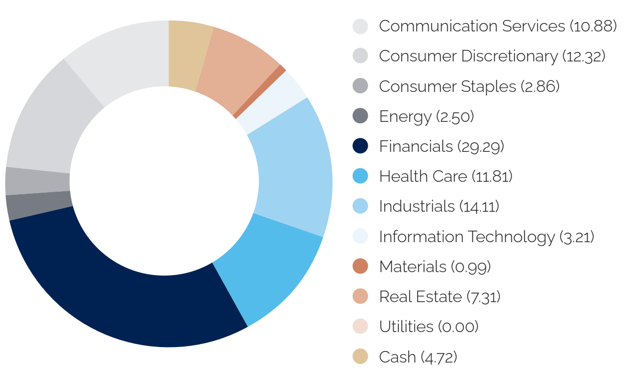
Source: DNR Capital

Accumulated income from $1,000 since inception



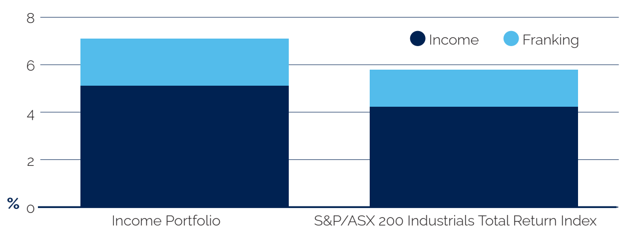
Source: DNR Capital

Sector weightings %



Source: DNR Capital

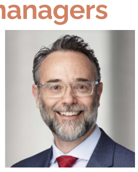
Income yield incl. franking credits since inception



Source: DNR Capital

Experienced portfolio managers

Jamie Nicol
Chief Investment Officer



Scott Kelly
Portfolio Manager

Top 5 active holdings

Security details
The Lottery Corporation (TLC)
QBE Insurance Group (QBE)
Scentre (SCG)
Suncorp Group (SCG)
Qube Holdings (QUB)

Monthly top contributors and detractors

Top 3 contributors		Alpha*
Domino's Pizza Enterprises	Overweight	0.24%
Super Retail Group	Overweight	0.20%
SEEK	Overweight	0.20%

Top 3 detractors		Alpha*
Computershare	Overweight	-0.37%
Commonwealth Bank of Australia	No Holding	-0.21%
TPG Telecom	Overweight	-0.21%

* 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.

Contributors

- **Domino's Pizza Enterprises (DMP):** outperformed during the month following on from a successful capital raise to fund the buyout of its German joint venture from its UK counterpart in December. Key commodity inputs continue to decline, providing more comfort on European earnings.
- **Super Retail Group (SUL):** outperformed following a strong trading update, highlighting continued sales growth in each segment, along with sustained gross margin improvement.
- **SEEK (SEK):** duration and cyclical stocks outperformed this month as recession expectations faded, increasing the potential for a soft landing.

Detractors

- **Computershare (CPU):** underperformed on no company specific news but in line with other interest rate sensitive stocks, as bond yields fell across the curve in January.
- **Commonwealth Bank of Australia (CBA, no holding):** outperformed the market and banking peers in anticipation of its February results, with investors preferencing CBA's superior competitive position.
- **TPG Telecom (TPG):** defensives underperformed during the month as recession expectations faded, increasing the potential for a soft landing. TPG also commenced the formal sale process for Vision Network, which could raise up to $1bn.

Portfolio and maket review

The S&P/ASX 200 Industrials Total Return Index was up 5.64% during the period. Consumer Discretionary (+9.8%) was the best performing sector, as strong consumer data and more dovish commentary out of the Federal Reserve (the Fed) encouraged a "soft landing" (WES +8.2%, ALL +11.3%). AREITs (+8.1%) also outperformed, as bond rates declined sharply in expectation of fewer necessary rate rises from the RBA (GMG +15.0%, SCG +5.9%). Utilities (-3.0%) was the worst performing sector, as declining gas and coal prices following a mild Northern Hemisphere winter saw producers under pressure (AGL -5.2%, ORG -3.2%). Health Care (+3.9%) also underperformed, with its defensive nature overlooked in the cyclically-driven, risk-on rally (CSL +3.6%, RHC +3.0%).

Portfolio update

Australian equities started 2023 strongly, with a higher probability placed on a soft landing scenario as recession expectations fade (following a slowing in inflation and stable unemployment). The rapid re-opening of China and lower gas prices in Europe were also positives for global growth. Investors aggressively bought cyclicals, growth and duration stocks with defensives underperforming during the month. The ASX 200 Industrials Total Return Index (the DNR Capital Australian Equities Income Portfolio benchmark) was up +5.6% in January. The Portfolio is currently more defensively positioned and underperformed during the month.

The most expected recession is no longer expected

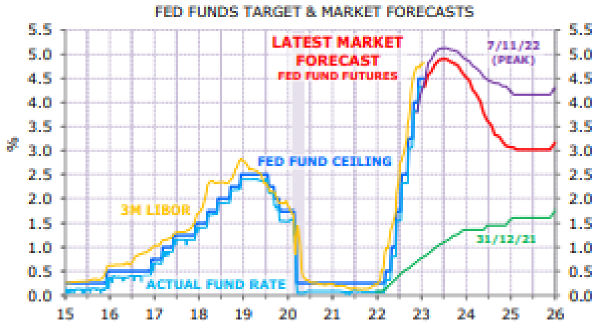
Financial markets expect the inflation/interest rate headwinds of 2022 to reverse in 2023, with inflation swaps forecasting a quick return to a sustained 2-2.5% headline CPI.

A quick return to target inflation

Source: BLS, Bloomberg, NBER; Minack Advisors

Financial markets also think the Fed fund rate peak is near and that the Fed will begin an easing cycle in the second half of 2023.

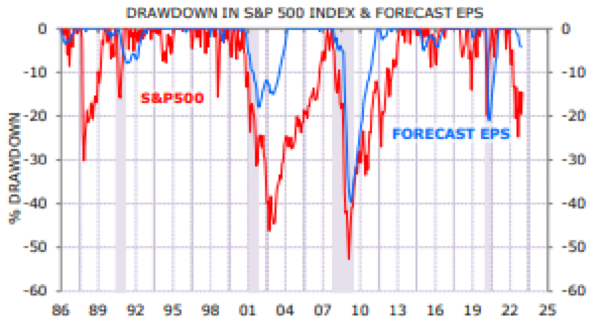
A quick turn to lower rates



Source: Federal Reserve, Bloomberg, NBER; Minack Advisors

This thinking would be logical if markets also expected a recession. However, the recent equity rally implies there will be only a moderate (and already forecast) decline in earnings.

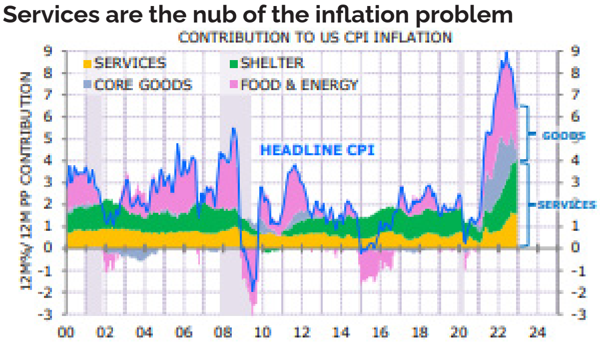
Equities look through a small expected EPS fall



Source: Standard & Poor's, IBES/DataStream, NBER; Minack Advisors

Prices of goods will normalise in time, yet wages are notoriously sticky. Inflation in the US has begun to fall however, as noted in the chart below this is largely driven by falling goods inflation as the supply chain normalises and demand for vehicles and other goods eases. Importantly, service inflation which reflects wages and rents, remains elevated.

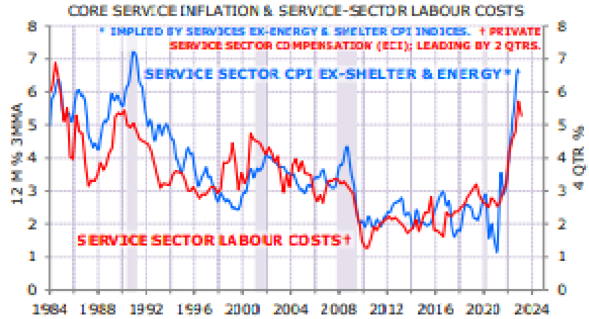
Services are the nub of the inflation problem



Source: BLS, NBER; Minack Advisors

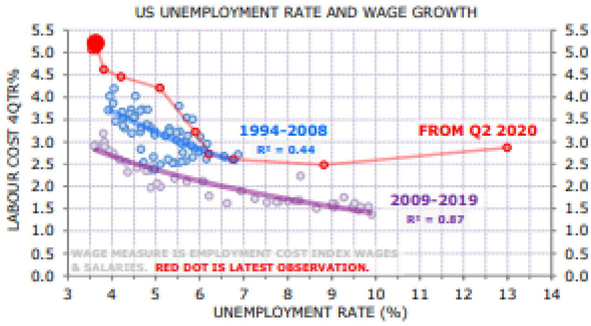
The employment market remains tight with unemployment low. Unemployment tends to be a lagging indicator but with unemployment tight pressure will remain on wages.

Wage growth is the key to service inflation



Source: BLS, NBER; Minack Advisors

Lower wages require higher unemployment



Source: BLS; Minack Advisors

We believe that equity markets are placing the highest probability on the least likely outcome (i.e. soft landing scenario). A recession still seems the most likely outcome, in our view. The potential for higher and stickier inflation is another scenario that also can't be ignored.

The DNR Capital Australian Equities Income Portfolio retains a defensive tilt with a focus on quality companies with earnings resilience.

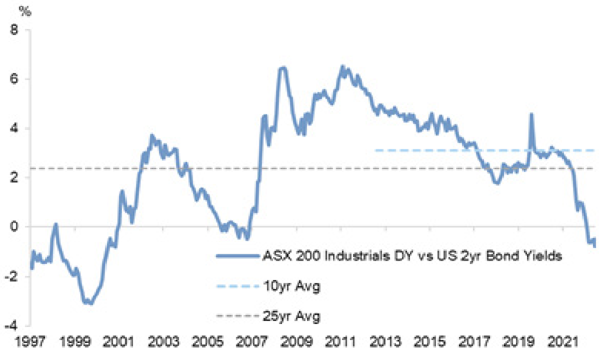
"Dividend Compounders" are in the sweet spot

Continued hawkishness from central bankers has caused 2 year bond yields to rise sharply, to the highest level since 2007. This has seen the gap between the dividend yield on stocks (~4%) for the ASX 200 Industrials Index and Bonds close. As bonds have become a legitimate alternative to stocks as a source of income, bond proxy sectors have been under pressure.

Historical yields - ASX200 Industrials Total Return Index dividend yield

Source: Goldman Sachs

Historical yields - US 2-year bond yield



Source: Goldman Sachs

Interestingly, dividend payout ratios are also well below pre-pandemic levels. We had expected dividend payout ratios to recover more quickly, particularly given strong corporate balance sheets. However, heightened uncertainty over the economic outlook has kept management conservative.

ASX median forward payout ratio

Source: Goldman Sachs

Despite our cautious view on the economic outlook and the likelihood of earnings recessions, we think dividends are likely to be more resilient and income streams from dependable dividend payers can help buffer returns.

About DNR Capital and the Portfolio

Concentrated: Investing in 15-30 highest conviction, Australian listed equities. Concentrated portfolios of quality companies maximise the opportunity for outperformance.

Style neutral and quality focussed: A disciplined approach to quality and valuation.

Dual investment objective: Acknowledging the value of both income and capital, this strategy focuses on delivering a high level of tax effective income, that grows over time, in addition to growing the investors capital.

A diversified set of opportunities: At DNR Capital, we categorise income generating companies as:

- **Growers:** A company that is delivering below market income in the short term, however is expected to deliver above market income growth over the long term.
- **Compounders:** A company that is delivering a market level of income, with the potential to deliver above market income growth on a sustainable basis.
- **Cows:** A company with a solid balance sheet and capital management potential that is being under-valued on traditional earnings-based metrics.
- **Yielders:** A company that is delivering sustainable and cash-backed dividends, however with minimal (or no) income growth.

Experienced and aligned team: The portfolio managers have more than 45 years of combined investment experience and are invested alongside our clients.

Proven process: DNR Capital was established in 2001 and a consistent firm-wide investment process has delivered more than 19 years of investment outperformance.

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