

DNR Capital Australian Equities Income Portfolio

Performance Report March 2023

Performance

The DNR Capital Australian Equities Income Portfolio underperformed the S&P/ASX 200 Industrials Total Return Index by 0.86% in March. The Portfolio's dividend yield expectation for 2023 is currently 4.2% (5.5% grossed up for franking credits).

Gross active return as at 31 March 2023

	1mth %	3mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	10yr p.a. %	Incep.* p.a. %
Income Portfolio	-2.99	0.75	1.12	22.48	10.20	9.63	10.45	8.04
S&P/ASX 200 Industrials Total Return Index	-2.13	2.39	-2.75	13.00	6.59	7.03	7.69	5.45
Excess return	-0.86	-1.64	3.87	9.48	3.61	2.60	2.76	2.59
Income Portfolio dividend yield incl. franking credits¹	1.62	2.42	6.66	8.56	7.05	7.29	8.34	7.30
Franking %	80.3	73.7	80.6	75.2	75.6	74.3	73.3	71.8

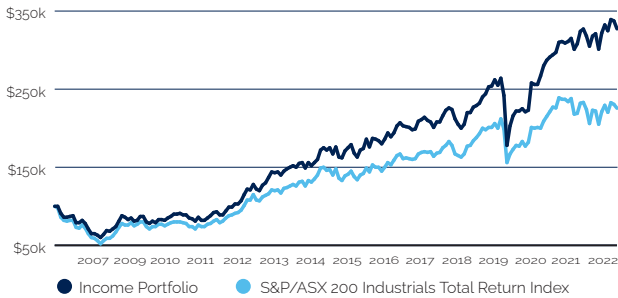
*Inception date—December 2007.

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).

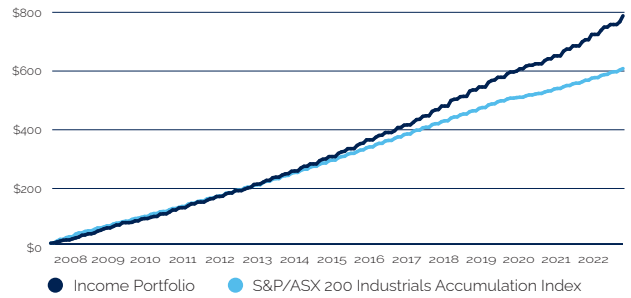
Performance data relates to the DNR Capital model Portfolio. Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators. 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



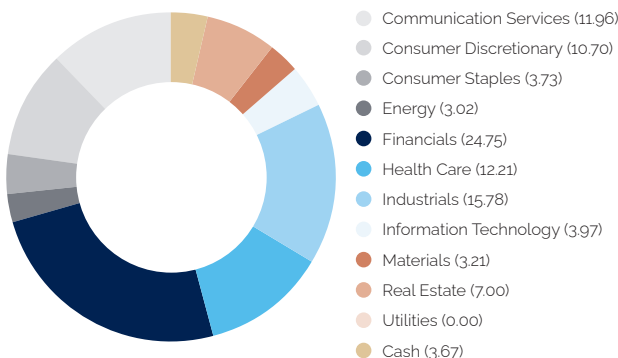
Source: DNR Capital

Accumulated income from \$1,000 since inception



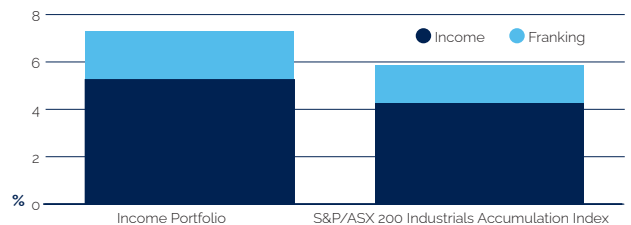
Source: DNR Capital

Sector weightings %



Source: DNR Capital

Income yield incl. franking credits since inception



Source: DNR Capital

Experienced portfolio managers



Top 5 active holdings

Security details

IPH (IPH)
QBE Insurance Group (QBE)
The Lottery Corporation (TLC)
TPG Telecom (TPG)
Aurizon Holdings (AZJ)

Monthly top contributors and detractors

Top 3 contributors		Alpha*
Reliance Worldwide Corp	Overweight	0.15%
Telstra Group	Overweight	0.14%
ANZ Group Holdings	Underweight	0.13%
Top 3 detractors		
Computershare	Overweight	-0.33%
IPH	Overweight	-0.24%
Qube Holdings	Overweight	-0.23%

* 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

- **Reliance Worldwide Corporation (RWC):** after a period of underperformance RWC bounced as the market started to look towards a potential recovery in US housing activity.
- **Telstra Group (TLS):** defensives outperformed during the month. The mobile market remains rational with TPG the latest mobile operator to put up prices across its customer base.
- **ANZ Group Holdings (ANZ, underweight):** banks sold off following the run on US banks and failure of Silicon Valley Bank.

Detractors

- **Computershare (CPU):** following the failure of Silicon Valley Bank expectations around interest rates declined.
- **IPH (IPH):** detected a cyber security incident with unauthorised access to a portion of its IT environment. IPH enacted its business continuity plan (BCP) which will result in more manual processing and higher costs in the near term, whilst longer term impacts could relate to potential client losses.
- **Qube Holdings (QUB):** February container volumes declined 18% across Australia's four major ports. Monthly movements are volatile and the trend is in-line with company expectations. In addition, QUB has historically been able to generate revenue growth well ahead of industry volumes.

Portfolio and market review

The S&P/ASX 200 Industrials Total Return Index was down 2.13% during the period. Communication Services (+1.6%) was the best performing sector. A flight to defensives saw Telstra Group (TLS +3.5%) trade higher, while REA Group (REA +13.0%) saw some support as domestic house pricing appeared to stabilise. Utilities also outperformed, with the gentailers seen as a defensive option that can grow earnings in a higher wholesale electricity price environment (AGL Energy, AGL +16.7%, Origin Energy, ORG +3.5%). A-REITs (-6.9%) were the worst performers as commercial real estate funding concerns surfaced following regional bank stress in the US (Goodman, GMG -5.4%, Dexus, DXS -10.9%). Financials (-5.1%) also underperformed, with banks sold off globally. Increasing bad debts, falling asset prices and a more expensive, less sticky deposit base paint a poor outlook for the sector (Commonwealth Bank of Australia, CBA -2.4%, National Australia Bank, NAB -7.6%).

Despite moderating inflation, strengthening the case for a pause in interest rate hikes, Australian equities lagged global peers. US equities were up 3.6% despite the failure of multiple US banks and concerns this could lead to weaker credit growth and bring forward the timing of a possible US recession. Offsetting these concerns was an expansion of the Federal Reserve (Fed) balance sheet as it provided liquidity support for banks. The DNR Capital Australian Equities Income strategy underperformed its benchmark over the month.

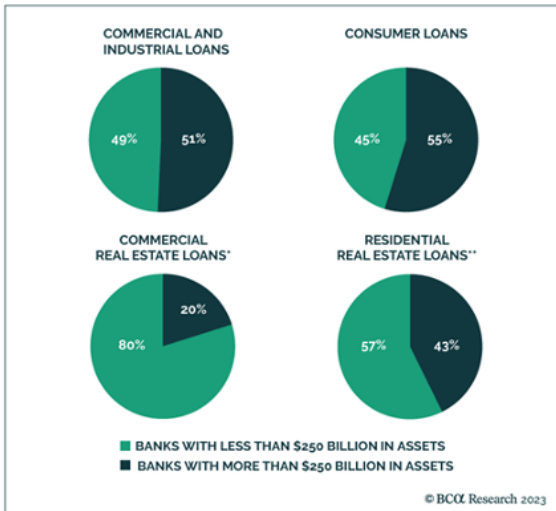
Bank crisis: when interest rates are lifted sharply, things begin to break

The failure of Silicon Valley Bank (SVB) was a catalyst for the most impactful month for financial institutions since the Global Financial Crisis (GFC), however, it is unlikely to be similar to the systemic problems experienced during the GFC.

The GFC was a liquidity issue from undercapitalised financial institutions and problem loans. In this instance, banks had invested in portfolios of bonds, which were deeply underwater as interest rates rose. SVB compounded this issue with deposits tied to the tech sector, drawing down cash balances to fund operating losses. The subsequent balance sheet crunch catalysed a broader bank run on smaller and less capitalised lenders. Capital fled to the safety of larger institutions, requiring the government to step in and guarantee all SVB bank deposits to stabilise the banking system.

We retain a watching brief on the asset side of bank balance sheets, specifically on commercial property loans. Regional banks in the US grew these loans aggressively over the past decade and now command an estimated 80% market share. With higher bond yields and occupancy lower, there will be further casualties in this market segment. The magnitude of losses is unclear but note lending standards have generally been tighter than pre-GFC. Unfortunately, many assets were priced off low interest rates, and banks have likely lent against inflated values.

Large vs. small US bank share of loans by category



* INCLUDES COMMERCIAL, MULTI-FAMILY RESIDENTIAL, CONSTRUCTION & LAND DEVELOPMENT, AND FARMLAND REAL ESTATE LOANS.
 ** INCLUDES SINGLE-FAMILY REAL ESTATE LOANS.
 NOTE: DATA AS OF Q4 2022. INCLUDES ALL FDIC-INSURED INSTITUTIONS (COMMERCIAL BANKS AND SAVINGS INSTITUTIONS).

Source: BCA Research

Banks are tightening lending standards in response to the crisis, further restricting economic growth and potentially aiding a slowdown in inflation.

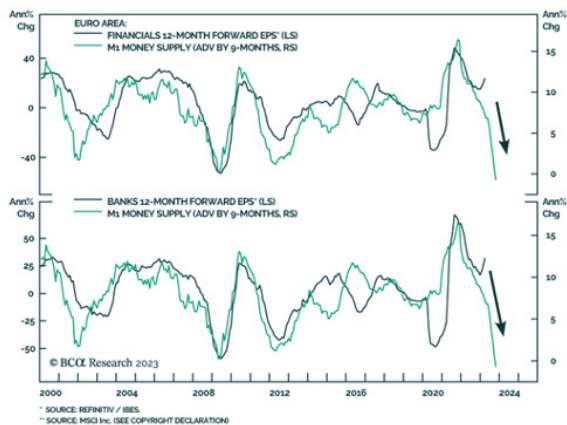
Commercial lending and lending standards



Source: Federal Reserve, NBER; Minack Advisors

We have already seen money supply fall in recent months, further tightening the economy.

Money supply

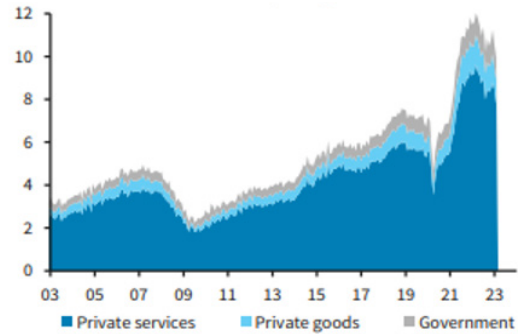


Source: BCA Research

US economy

This month we also saw tangible signs of the US economy slowing, with job openings coming off their peak. This is important, as rising unemployment is crucial in freeing up capacity in the economy and enabling the Federal Reserve (Fed) to cease lifting interest rates.

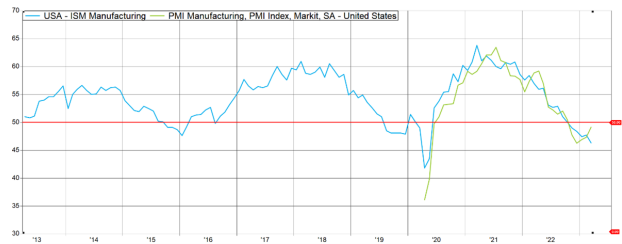
US job openings



Source: Bureau of Labor Statistics, Haver Analytics

Additionally, the US Manufacturing PMI survey currently sits below 50, consistent with a contraction in economic activity and often accompanied by a recession.

US ISM

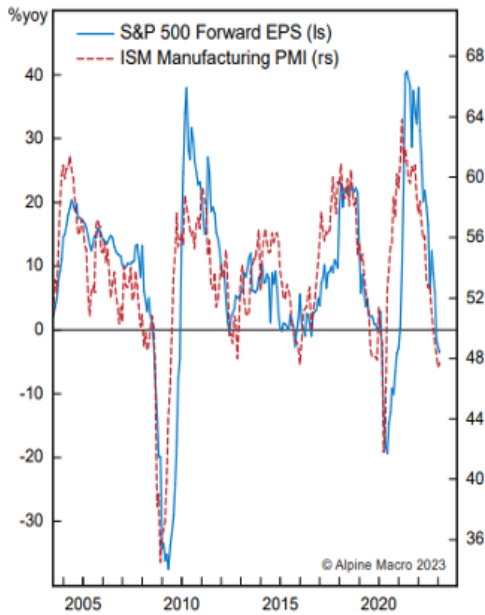


Source: FactSet, DNR Capital

Earning downgrades still to come

Credit tightening and slowing lead indicators suggest company profits are set to moderate, however markets have been worried about this for several months. Companies with obvious economic sensitivity have therefore already experienced substantial earnings adjustments. As illustrated below, the US market has already lowered earnings estimates, albeit more modestly than before the GFC or COVID-19 downs. We are cautious in expecting further downgrades as the economic cycle plays out but selectively seizing opportunities where valuations already discounted a downturn.

S&P 500 EPS vs ISM manufacturing PMI

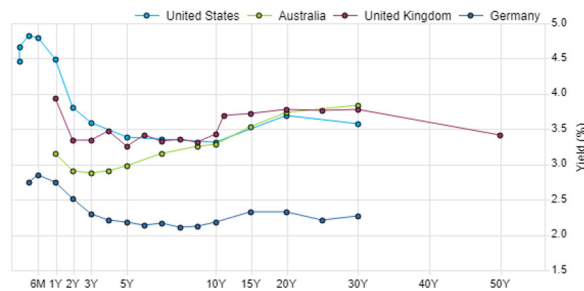


Source: Alpine Macro

Interest rate expectations being lowered

Interest rates reacted to the news through the month. The market started to price in expectations that interest rates will peak and subsequently fall over the next few years. Longer term interest rate markets are consistent with inflation easing. The yield curve in the US, Germany and the UK suggests interest rates are close to peaking and will subsequently fall consistent with a recession. In Australia, we may well withstand another recession thanks to a resilient China and higher population growth.

Comparable treasuries

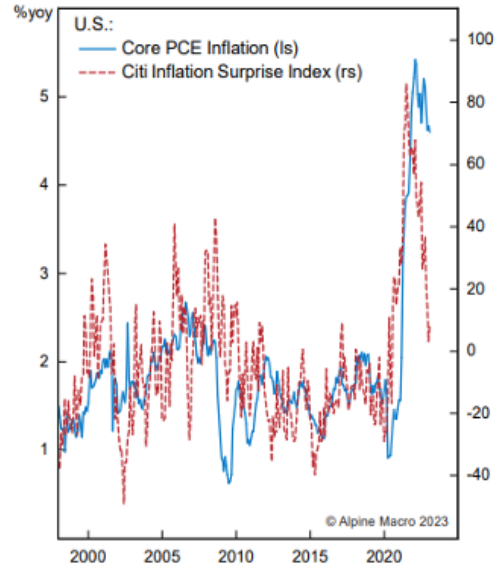


Source: FactSet, DNR Capital

Inflation

Inflation remains a crucial piece of the investment puzzle. Capacity within the economy remains tight albeit we expect pressure to ease as the economy slows. The Citi inflation surprise index is consistent with inflation easing.

US Core PCE Inflation vs. Inflation Surprise Index

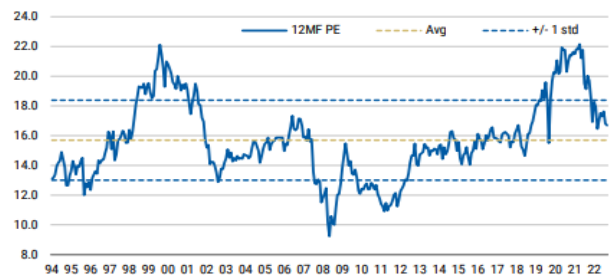


Source: Alpine Macro

Valuation

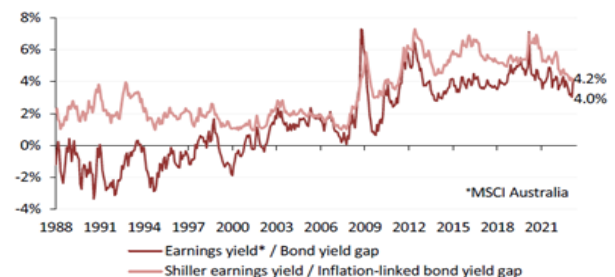
Whilst equities appear to be resilient, the bond markets signal another story. Whilst the earnings yield to bond yield gap has compressed to ~4%, it remains elevated to history. Despite the risks, the ASX200 Industrials 12-month forward PE is trading slightly above its long-term average at ~17x.

ASX 200 Industrials 12mf Price-to-Earnings (latest = 16.7x)



Source: RIMES, IBES, Morgan Stanley Research. As at 31 March 2023

Equity yields vs bond yields



Source: Datastream, Morgan Stanley Research

Portfolio positioning

There are a range of factors that can influence portfolio positioning at present:

- There is likely to be more failure and further cracks appearing in credit markets as the impact of higher rates plays out.
- Earnings and dividend downgrade risk.
- Inflation should begin to slow, which should provide some interest rate relief.
- Expectations are already low, with this recession widely predicted. Cash weightings have increased, and the market has pulled back.
- Market valuations are not cheap. Valuation relativities will depend on the extent inflation can ease.

- **Cows:** A company with a solid balance sheet and capital management potential that is being undervalued 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.

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.

Disclaimer

This document has been prepared by DNR Capital Pty Ltd, AFS Representative - 294844 of DNR AFSL Pty Ltd ABN 39 118 946 400, AFSL 301658. Whilst DNR Capital has used its best endeavours to ensure the information within this document is accurate it cannot be relied upon in any way and you must make your own enquiries concerning the accuracy of the information within. The information in this document has been prepared for general purposes and does not take into account the investment objectives, financial situation or needs of any particular person nor does the information constitute investment advice. Before making any financial investment decisions you should obtain legal and taxation advice appropriate to your particular needs. Investment in a DNR Capital managed account can only be made on completion of all the required documentation. An investor should obtain and read the target market determination and consider their circumstances before making any investment decision. The target market determination is available at www.dnrcapital.com.au, or a paper copy can be obtained, free of charge, upon request by calling 07 3229 5531. This material is general information only and not an investment recommendation. An investment in this portfolio is subject to investment risk including loss of some or all of an investor's principal investment and lower than expected returns. DNR Capital does not guarantee the repayment of capital from the portfolio or the investment performance of the portfolio. If you have invested in the Australian Equities Income Portfolio via a service such as investor directed portfolio service, managed account service or separately managed account ('Portfolio Service'), you can obtain information from the Portfolio Service operator. If you invest via a Portfolio Service, different terms may apply to your investment. You should read the disclosure document for that Portfolio Service and consider your circumstances prior to investing.

Office address

Level 23
307 Queen Street
Brisbane QLD 4000

Postal address

GPO Box 3263
Brisbane QLD 4001

Telephone

07 3229 5531

Email

info@dnrcapital.com.au

Website

dnrcapital.com.au