

DNR Capital Australian Equities Income Portfolio

Performance Report June 2023

Performance

The DNR Capital Australian Equities Income Portfolio underperformed the S&P/ASX 200 Industrials Total Return Index by -1.60% in June. The Portfolio's dividend yield expectation for 2023 is currently 0.06% (0.00% grossed up for franking credits).

Gross active return as at 30 June 2023

	1mth %	3mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	10yr p.a. %	Incep.* p.a. %
Income Portfolio	-0.87	1.61	9.15	14.39	9.02	9.55	10.71	8.02
S&P/ASX 200 Industrials Total Return Index	0.73	2.16	11.83	8.96	5.67	6.94	7.95	5.50
Excess return	-1.60	-0.55	-2.68	5.43	3.35	2.61	2.76	2.52
Income Portfolio dividend yield incl. franking credits¹	0.06	1.75	7.37	7.41	6.84	7.36	8.58	7.38
Franking %	0.00	86.41	79.79	77.95	76.53	75.05	73.86	72.33

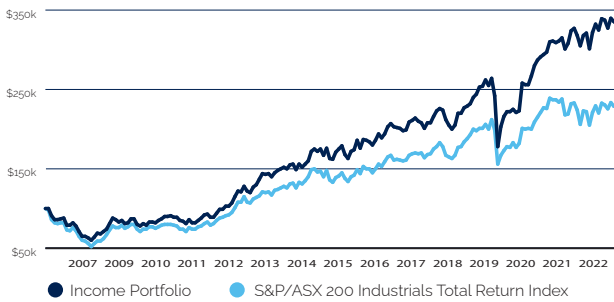
*Inception date—December 2007.

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).

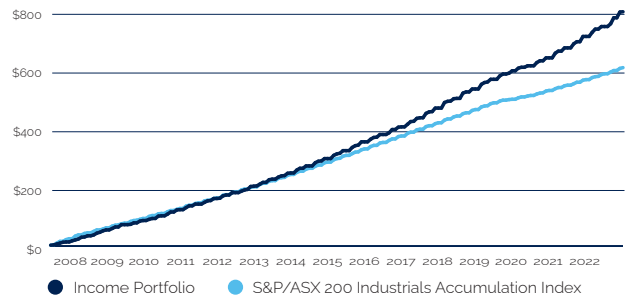
Performance data relates to the DNR Capital model Portfolio Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators.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



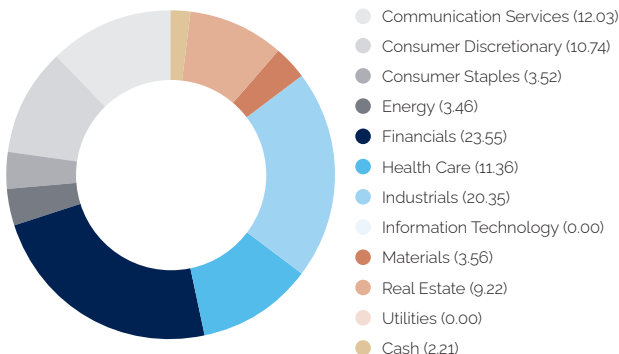
Source: DNR Capital

Accumulated income from \$1,000 since inception



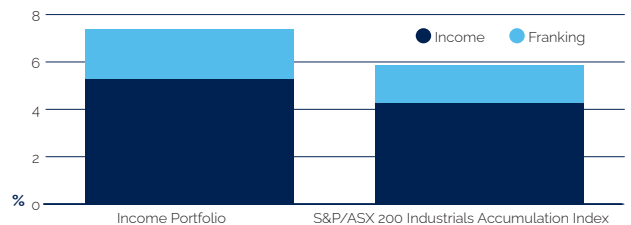
Source: DNR Capital

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

Monthly top contributors and detractors

Top 3 contributors		Alpha*
Aurizon Holdings	Overweight	0.32%
QBE Insurance Group	Overweight	0.22%
Computershare	Overweight	0.11%
Top 3 detractors		
TPG Telecom	Overweight	-0.49%
Commonwealth Bank of Australia	No Holding	-0.30%
CSL	Overweight	-0.30%

* 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

- **Aurizon Holdings (AZJ):** higher interest rates in June will result in a higher WACC over the next regulatory period for the Network asset and an additional ~\$25 million p.a in revenue/EBITDA, which will be collected from FY25.
- **QBE Insurance Group (QBE):** outperformed this month as general insurance margin outlooks should benefit from higher investment yields.
- **Computershare (CPU):** outperformed this month following an increase in short term interest rate expectations, with future rate curves indicating possible EPS upgrades across FY24-26.

Detractors

- **TPG Telecom (TPG):** underperformed as the Australian Competition Tribunal (ACT) upheld the ACCC's decision to reject the proposed network sharing agreement between TPG and Telstra.
- **Commonwealth Bank of Australia (CBA, no holding):** Financials outperformed this month as short-term interest rate expectations rose, and soft-landing expectations increased. APRA data for May also highlighted that recent mortgage competition has been abating.
- **CSL (CSL):** provided first-time earnings guidance for growth in FY24, which was below expectations, primarily driven by a lower margin expectation. The company reiterated that Behring margins are tracking positively and should return to pre-COVID19 levels in the "medium term", while collection volumes continue to track well.

Portfolio and market review

The S&P/ASX 200 Industrials Total Return Index was up 0.73% during the period. Information Technology (+3.5%) was the best performing sector, following the lead of US peers who continued the AI-optimism-led run (Wisetech Global (WTC) +6.7%, Xero (XRO) +8.2%). Financials (+3.1%) also outperformed, with insurers and market-beta exposed companies leading the sector (QBE Insurance (QBE) +7.2%, Macquarie Group (MQG) +4.0%). Health Care was the worst performing sector (-6.6%), primarily due to a slower-than-expected recovery in FY24 margins for sector heavyweight CSL -9.5%. A-REITs also underperformed (-1.6%), with their bond-proxy nature seeing them trade lower as a more hawkish US Federal Reserve (Fed) pushed rates higher (Scentre (SCG) -2.2%, Stockland (SGP) -2.0%).

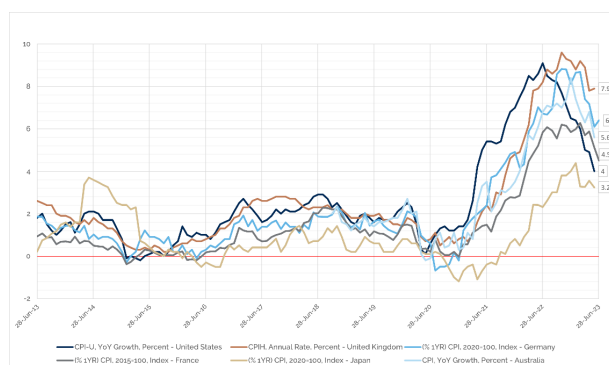
A soft landing or a longer lag?

Equities continue to defy pessimism and are up (ASX 200 Industrials Total Return Index +x% / S&P500 +x%) from October lows, due to:

- Developed market inflation peaking and hopes that central bankers are nearing the end of tightening.
- Economic data generally being better than feared largely due to savings buffers and pent-up demand.
- A warmer European winter eased the energy crisis; and
- A consensus underweight in equities.

The time lag of the aggressive tightening policy makes it difficult to predict whether there has been too much, too little, or just enough to bring inflation under control (and without damaging the economy). Whilst at various stages of slowing, inflation has peaked in key economies, but still eludes the 2-3% band targeted by most central bankers.

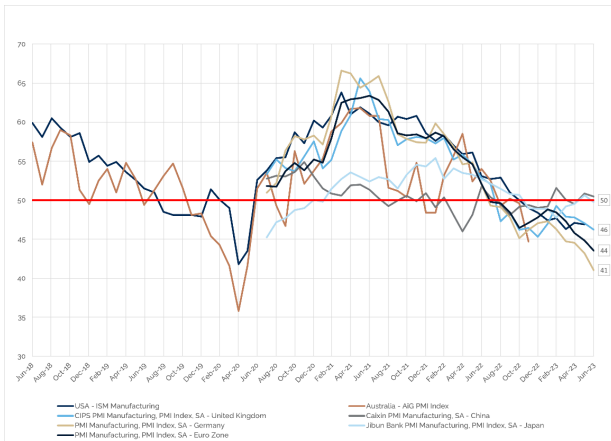
Key global inflation measures



Source: DNR Capital, FactSet

A range of important forward measures of economic activity are exhibiting weakness. The Purchasing Manager Indices (PMI), measuring the prevailing direction of economic trends in manufacturing, sits in contractionary territory, following strong rebounds post COVID-19 lockdowns.

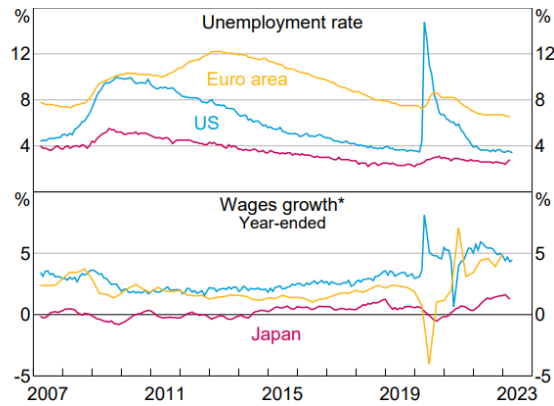
Key purchasing Manager Indices (PMI)



Source: DNR Capital, FactSet

While stubbornly low record unemployment continues to be a feature of most developed world economies.

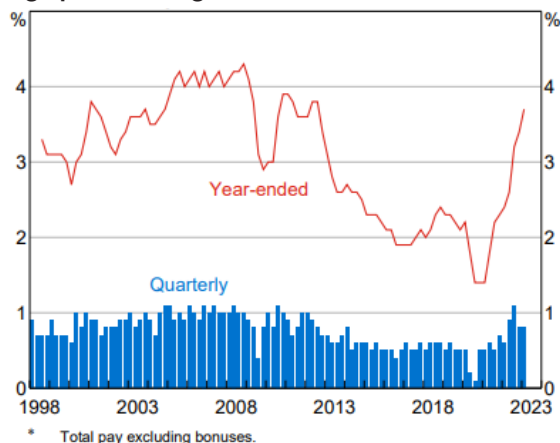
Labour markets – advanced economies



* Average hourly earnings for the US; compensation per employee for the euro area; smoothed full-time base wages for Japan.

Source: CEIC Data, RBA, Refinitiv

Wage price index growth

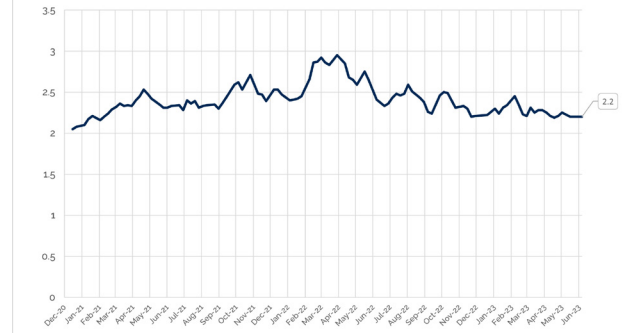


* Total pay excluding bonuses.

Source: ABS

Whilst bond yields have begun rising again, the closely watched US "breakeven rate", which infers market expectations for inflation, peaked in early CY22 and continues to decline.

US 10-year breakeven rate



Source: DNR Capital, FactSet

As such, the outlook for inflation, central bank policy and the economy continues to produce substantial debate:

Bulls point to:

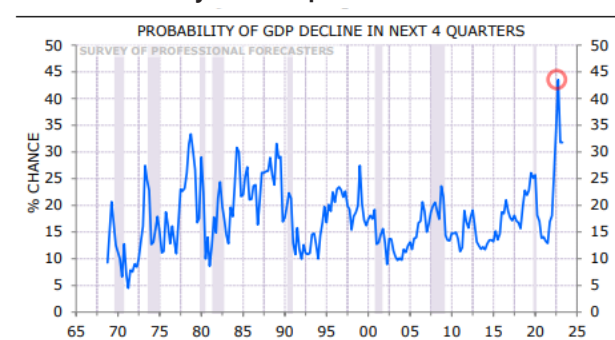
- There will be no severe recession.
- Inflation will continue to surprise to the downside.
- Real interest rates are lower.
- China stimulus is imminent.

Bears point to:

- This is the first synchronised developed market economy tightening cycle in 15 years.
- Unemployment is stubbornly low and is typically at cycle lows as a recession starts.
- Corporate earnings always fall in a recession, and operating and financial leverage has been increasing over time.
- The average interest rate required to keep inflation within target is likely to be higher this cycle (due to the end of secular stagnation).

Whilst no one knows for sure, we know from experience that recessions lower inflation and equities fall in a recession. We also know that recession expectations have lowered over the last few months.

Consensus rarely never expects a recession

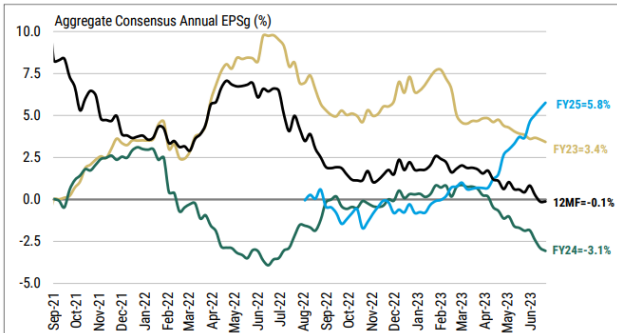


Source: Philadelphia Fed, NBER, Minack Advisors

In our view, the expected recession has not been avoided, it has just been kicked down the road. It is clear that central bank policy prefers to tighten too much rather than too little, increasing the risk of a recession. The key uncertainty relates to its possible timing (i.e. 4th quarter of 2023 or 2024).

On this basis, we continue to believe that earnings per share (EPS) estimates for the market will prove too high as the economy contracts. Consensus earnings continue to be revised lower, however, the risk is still to the downside.

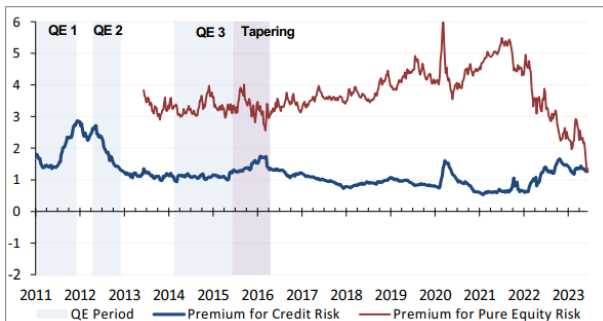
FY23-25 annual aggregate consensus EPS growth trends



Source: RIMES, IBES, Morgan Stanley Research

Another way of thinking about risk and return is looking at the equity risk premium that the market applies when investing in equities. The following chart highlights that the equity risk premia have contracted significantly over recent months to ~1% (a decade low), which is at odds with the risk factors currently at play.

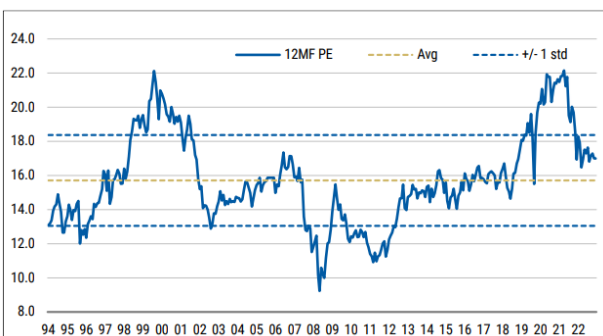
Equity risk premia saw some pullback in June, while credit risk premia has stayed subdued



Source: Datastream, Morgan Stanley Research

The S&P ASX 200 Industrials Total Return Index continues to trade at ~17x 12-month forward PE, which still looks elevated relative to history and given the potential earnings risks.

ASX 200 Industrials 12mf price-to-earnings



Source: RIMES, IBES, Morgan Stanley Research

Portfolio positioning

Given the uncertainty, we continue to position the portfolio in high-quality businesses that offer a combination of growing \$ income, franking benefits and attractive valuations.

Given our views on recession risks, the portfolio is positioned more defensively. Nonetheless, we have also sought strong quality franchises that we are comfortable to own through the cycle that have seen de-rates and downgrades (eg. Lendlease (LLC), Reliance Worldwide (RWC), SEEK (SEK)).

- **Quality defensives:** Franchise leading stocks that should be able to win market share regardless of the economic cycle and pass inflation onto customers (eg. IPH, Telstra (TLS)).
- **Quality cyclicals:** A downturn often allows stronger companies to become stronger as they acquire the weak or invest through the cycle (eg. MQG, SEK).
- **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, TPG Telecom (TPG)).
- **Inflation beneficiaries:** Stocks that should benefit from higher inflation and higher interest rates and where valuations are attractive (eg. Beach Energy (BPT), Woodside Energy (WDS)).

The portfolio remains underweight the banking sector, a position we have held for some time. This view has been predicated on increasing competition for mortgages and deposits affecting margins, higher wholesale funding costs and normalising bad and doubtful debt charges.

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 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.

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