

# DNR Capital Australian Equities Income Portfolio

## Performance Report July 2023

### Performance

The DNR Capital Australian Equities Income Portfolio underperformed the S&P/ASX 200 Industrials Total Return Index by 0.12% in July. The Portfolio's dividend yield expectation for 2023 is currently 4.98% (6.60% grossed up for franking credits).

### Gross active return as at 31 July 2023

	1mth %	3mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	10yr p.a. %	Incep.* p.a. %
Income Portfolio	2.97	0.81	7.51	15.61	8.99	9.03	10.44	8.17
S&P/ASX 200 Industrials Total Return Index	3.09	1.76	6.59	10.25	5.96	6.48	7.85	5.68
<b>Excess return</b>	<b>-0.12</b>	<b>-0.95</b>	<b>0.92</b>	<b>5.36</b>	<b>3.03</b>	<b>2.55</b>	<b>2.59</b>	<b>2.49</b>
<b>Income Portfolio dividend yield incl. franking credits<sup>1</sup></b>	<b>0.00</b>	<b>1.68</b>	<b>7.05</b>	<b>7.42</b>	<b>6.65</b>	<b>6.96</b>	<b>8.21</b>	<b>7.34</b>
Franking %	0.00	86.41	79.79	77.95	76.53	75.05	73.84	72.33

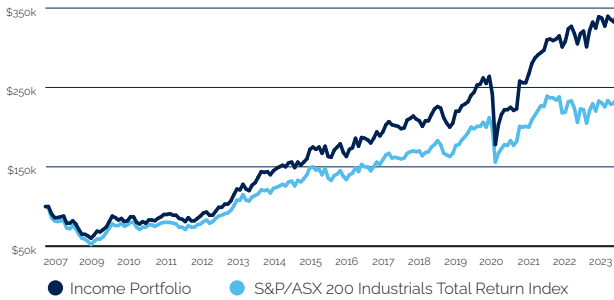
\*Inception date—December 2007.

Source: DNR Capital

<sup>1</sup> 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).

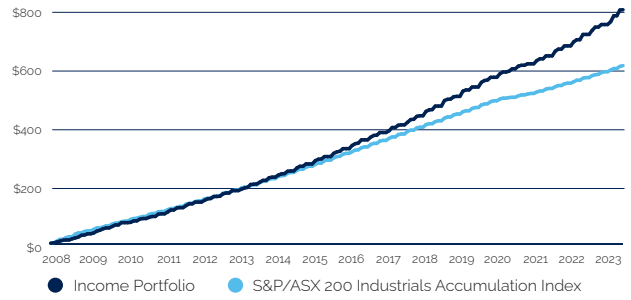
Performance data relates to the DNR Capital model Portfolio Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators.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



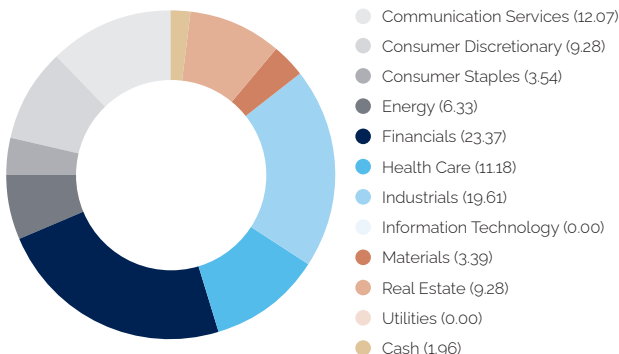
Source: DNR Capital

### Accumulated income from \$1,000 since inception



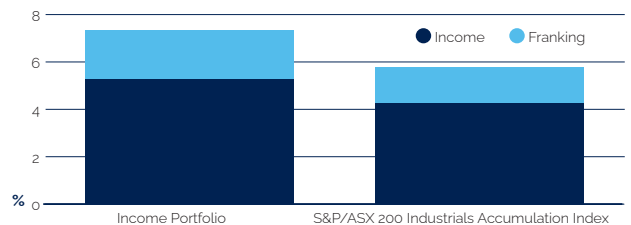
Source: DNR Capital

### Sector weightings %



Source: DNR Capital

### Income yield incl. franking credits since inception



Source: DNR Capital

### Experienced portfolio managers



## Top 5 active holdings

### Security details

CSL	
National Australia Bank	
ANZ Group Holdings	
Telstra Group	
QBE Insurance Group	

## Monthly top contributors and detractors

Top 3 contributors		Alpha*
Beach Energy	Overweight	0.27
SEEK	Overweight	0.25
Lendlease	Overweight	0.22

Top 3 detractors		
Commonwealth Bank of Australia	No Holding	-0.25
Aurizon Holdings	Overweight	-0.21
Tabcorp Holdings	Overweight	-0.20

\* 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

- **Beach Energy (BPT):** outperformed during the period as global energy prices rose and the company reported a strong quarter of price realisation, beating estimates. Energy prices have recovered from recent lows as recent OPEC+ cuts begin to bite and Russian over-production slows from historic levels.
- **SEEK (SEK):** with softer-than-expected inflation prints in the USA and Australia, investors are more hopeful of a soft landing and this supported the outperformance of cyclicals.
- **Lendlease (LLC):** outperformed on no stock specific news. Management continues to make incremental progress towards its stated 2024 return targets with a sharpened focus on executing the existing development backlog of over \$100bn.

### Detractors

- **Commonwealth Bank of Australia (CBA, no holding):** banks bounced in July as the outlook for bad debts improved and some signs of easing competition.
- **Aurizon Holdings (AZJ):** released a new strategy of pursuing a land-bridge operation at Darwin Port to capture a portion of the container freight market (currently primarily delivered to the east coast ports), which will result in upfront capex, however with limited visibility on earnings profile.
- **Tabcorp Holdings (TAH):** underperformed over the month despite delivering continued progress post The Lottery Corporation demerger. Competitors' trading results did highlight a normalisation in digital wagering turnover post the easing of lock downs.

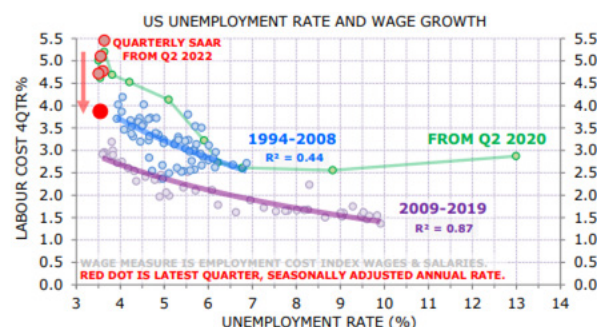
## Portfolio and market review

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 their AI-optimism-led run (WTC +6.7%, XRO +8.2%). Financials (+3.1%) also outperformed, with insurers and market-beta exposed companies leading the sector (QBE +7.2%, MQG +4.0%). Health Care (-6.6%) was the worst performing sector, in the most part due to a slower-than-expected recovery in FY24 margins for sector heavyweight CSL (-9.5%). A-REITs (-1.6%) also underperformed, with their bond-proxy nature seeing them trade lower as a more hawkish Federal Reserve pushed rates higher (SCG -2.2%, SGP -2.0%).

### Market review

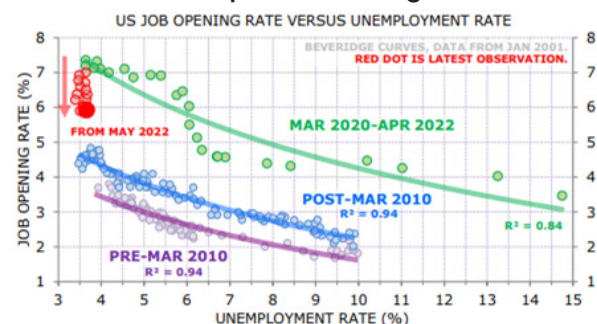
Australian stocks rose in July, with the ASX Industrials Index (the strategy's benchmark) up 3.09%. The gains followed softer-than-expected inflation prints in both the USA and Australia, which has reduced the risk of further interest rate hikes. With inflation slowing without any rise in unemployment (at least so far), investors are more hopeful of a soft landing (e.g., the US Federal Reserve (Fed) gets inflation back to target without a recession) and this supported the outperformance of cyclical stocks, over defensive stocks.

### An immaculate disinflation?



Source: BLS, Minack Advisors

### Labour market disruptions are fading



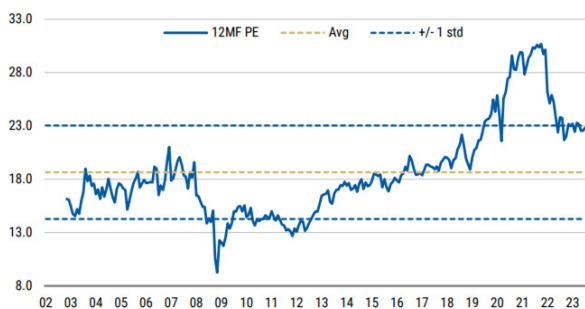
Source: BLS, Minack Advisors

However, hurdles remain. Wage growth remains above the Fed's 3½% comfort zone, tailwinds for consumer spending (i.e., stimulus checks and the sharp fall in goods sector inflation) will fade in the second half and the Fed may keep policy too tight for too long.

Australian equities look stretched too, in particular, the ASX200 Industrials ex-Financials Index at ~23x 12-month-forward price to earnings (PE) ratio, with stocks running up in sympathy with US markets and with some relief as

the Reserve Bank of Australia (RBA) tone pivots dovishly.

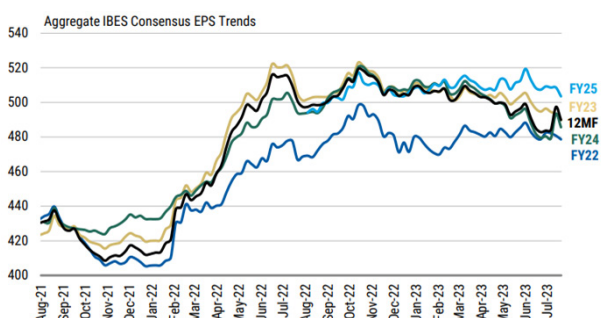
### ASX 200 Industrials ex Financials 12mf Price-to-Earnings



Source: RIMES, IBES, Morgan Stanley Research

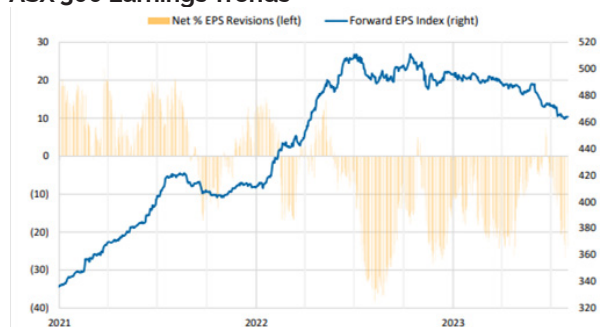
However, earnings forecasts continue to be revised down with consensus earnings estimates for FY24 down -5% on FY23 estimates.

### FY22-25 Annual Aggregate Consensus EPS Trends



Source: RIMES, IBES, Morgan Stanley Research

### ASX 300 Earnings Trends



Source: FactSet, Macquarie Research

Risks still lie ahead in Australia in our view. Australian household leverage is among the highest globally, and household disposable incomes are just starting to bear the brunt of the RBA tightening cycle, whilst China's stimulus does not, at this stage, look particularly large or commodity intensive.

### Reporting season

While economic activity has slowed, recent data has typically surprised to the upside. Pre reporting season profit warnings have been largely concentrated in discretionary retail sector, where spending is still normalising post COVID-19, while other cyclical sectors show few signs of a significant downturn. Key themes of interest over reporting season are likely to focus on the following:

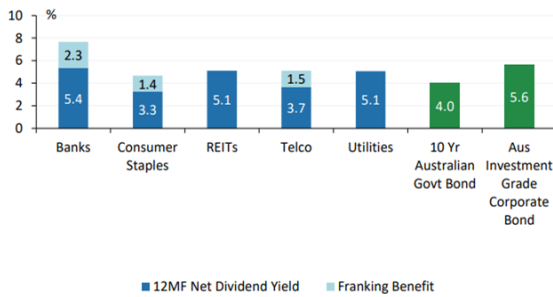
- **Trading updates:** Australian households' intentions on discretionary spending have turned negative over recent months. Earnings results may not reflect this slowdown, however, trading updates on activity levels for the opening weeks of FY24 could be weak.
- **Labour cost trends:** Raw input prices have largely retraced off prior year peaks, but wages are now putting more pressure on companies. The return of migration will provide some relief, however, with unemployment still at historical lows, corporate wage pressure on profit margins still lies ahead.
- **Self-help initiatives:** Next year's margin forecasts appear optimistic, however cost-out programs could provide some positive surprises given falling labour productivity.
- **Interest costs:** Companies may report higher interest expenses than expected, given that short-end rates have increased considerably.
- **Guidance / outlook:** We expect conservative initial guidance from companies, given ongoing macro uncertainties.
- **Dividends:** Corporate balance sheets remain in good shape, however payout ratios are likely to align with prior periods at ~65% (ASX200 Industrials Index), below pre-COVID-19 level highs of ~80%.

### Big 4 Banks update

Commonwealth Bank of Australia (CBA) is the only big bank reporting over August. The 2H23 margin outcome and margin outlook commentary will be the key issues to watch in its FY23 result. With cashback offers being removed, there is a lot of market anticipation that the margin outlook is significantly improving. There is still downside risk to FY24 margins, albeit a cost-out program could potentially positively surprise.

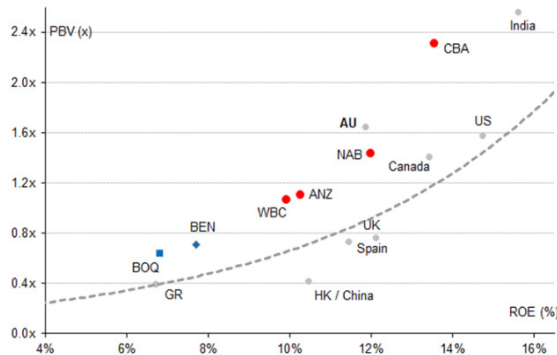
Australian bank gross yields of ~7.7% appear attractive relative to the equity market and fixed income alternatives, however they are broadly in line with historical averages. Our sector underweight position largely reflects our non-holding of CBA (which accounts for ~11% of the ASX 200 Industrials Index). CBA remains one of the most expensive banks globally trading on ~2.4x Price / Book, despite return on equity (ROE)'s declining from >18% to ~13% over the last decade.

### Banks grossed up dividend yield yet again standing out



Source: Bloomberg, Datastream, Morgan Stanley Research

### CBA vs offshore peers (consensus P/BV vs ROE)



Source: FactSet consensus

We continue to target quality companies that deliver sustainable and growing dividends over time and see better opportunities on a risk/return basis.

### 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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