

DNR Capital Australian Equities Income Portfolio

Performance Report September 2023

Performance

The DNR Capital Australian Equities Income Portfolio outperformed the S&P/ASX 200 Industrials Total Return Index by 0.79% in September. The Portfolio's dividend yield expectation for 2023 is currently 5.10% (6.60% grossed up for franking credits).

Gross active return as at 30 September 2023

	1mth %	3mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	10yr p.a. %	15yr p.a. %	Incep.* p.a. %
Income Portfolio	-2.84	-0.04	10.36	14.58	8.20	8.79	9.31	10.16	7.88
S&P/ASX 200 Industrials Total Return Index	-3.63	-0.97	11.27	8.78	5.11	6.22	6.97	7.98	5.35
Excess return	0.79	0.93	-0.91	5.80	3.09	2.57	2.34	2.18	2.53
Income Portfolio dividend yield incl. franking credits¹	0.54	1.61	7.10	7.77	6.63	7.20	7.89	9.30	7.44
Franking %	56.53	50.10	72.27	74.68	74.53	74.23	73.03	71.77	71.56

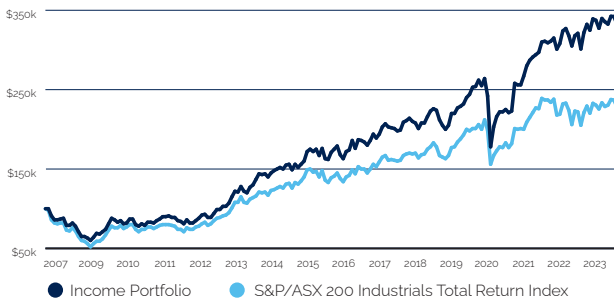
*Inception date—December 2007.

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).

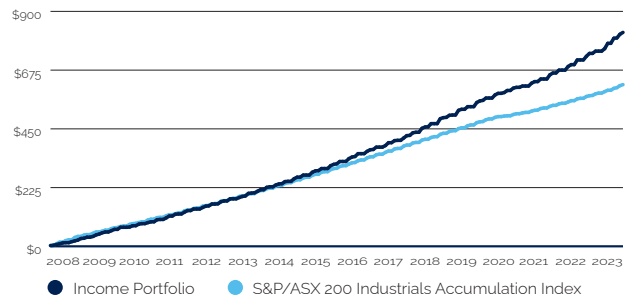
Performance data relates to the DNR Capital model Portfolio Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators.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



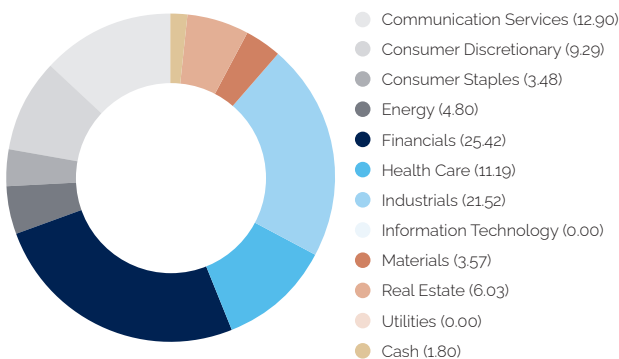
Source: DNR Capital

Accumulated income from \$1,000 since inception



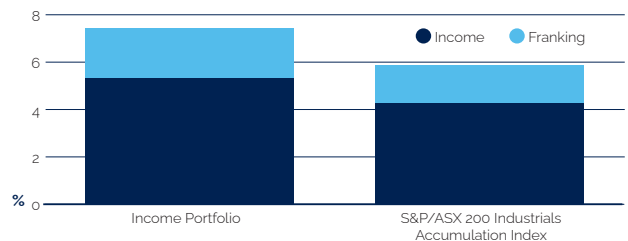
Source: DNR Capital

Sector weightings %



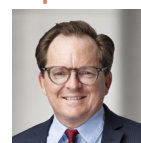
Source: DNR Capital

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

CSL (CSL)
National Australia Bank (NAB)
ANZ Group Holdings (ANZ)
Telstra Group (TLS)
IPH (IPH)

Monthly top contributors and detractors

Top 3 contributors		Alpha*
QBE Insurance Group	Overweight	0.26
Beach Energy	Overweight	0.25
Computershare	Overweight	0.20
Top 3 detractors		
Tabcorp Holdings	Overweight	-0.29
Scentre	Overweight	-0.18
Commonwealth Bank of Australia	No holding	-0.16

* 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

- **QBE Insurance Group (QBE):** outperformed as rising bond yields supported expectations for return on shareholder funds, and broader insurance industry dynamics.
- **Beach Energy (BPT):** outperformed during the period, with oil and gas prices rallying on tight markets. OPEC+ continue their restricted output settings through voluntary quota cuts, and Russian supply appear to be tapering off, at a time when Chinese demand proving stronger than feared.
- **Computershare (CPU):** outperformed as rising bond yields supported margin income expectations on the group's rate sensitive cash balances.

Detractors

- **Tabcorp Holdings (TAH):** underperformed over the month despite delivering continued progress post demerger. Competitors' trading results did highlight moderation in waging demand.
- **Scentre (SCG):** underperformed during the period, following a strong move higher in bond rates. As a result of REITs' high correlation with bonds due to their duration and pricing, the entire sector finished lower.
- **Commonwealth Bank of Australia (CBA, no holding):** outperformed in line with global banking exposures as steeping yield curves supported the outlook for financial stocks.

Portfolio review

The S&P/ASX 200 Total Industrial Return Index was down 3.63% during the period. Financials (-1.7%) was the best performing sector, as a shifting outlook towards higher rates could see benefits to margins in the near term (ANZ

Group Holdings (ANZ +1.3%), QBE Insurance Group (QBE +4.9%). Consumer Staples (-2.2%) also outperformed, as investors sought safety in defensive earnings streams (Woolworths Group (WOW -2.1%), Coles Group (COL -2.5%)). A-REITs (-8.7%) were the worst performing sector, with a strong move higher in bond yields leading to a broad-based sell off in duration assets (Goodman (GMG -8.2%), Scentre (SCG -10.6%)). Information Technology (-8.0%) also underperformed, similarly impacted by the moves in the bond market which impacts the present value of their growing, future cash flows (Wisetech Global (WTC -6.3%), Xero (XRO -10.1%)).

The DNR Capital Australian Equities Income Portfolio outperformed its benchmark for the period. Key stock contributors were QBE, Beach Energy (BPT) and Computershare (CPU). Key stock detractors were Tabcorp Holdings (TAH), Scentre (SCG) and Commonwealth Bank of Australia (CBA, no holding). The Portfolio's dividend yield expectation for CY2023 is currently 5.10% (6.60% grossed up for franking credits).

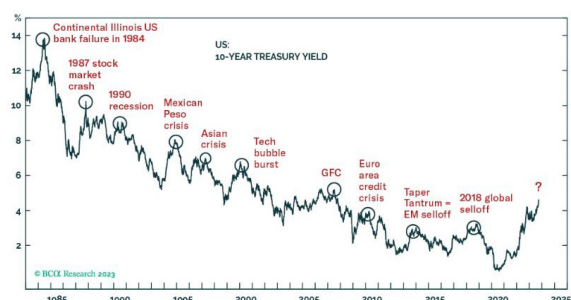
Market review

The 'higher for longer' narrative dominated market action this month. Long-term bond yields in the US (4.6%) and Australia (4.5%) reached the highest levels since October 2011, as expectations regarding 'higher for longer' interest rates to combat persistent inflation and a strong economy overwhelmed the market. The price of oil also surged by 10% in September, further fuelling fears of renewed inflationary pressure and that central banks will have to maintain tight monetary policy for longer.

Interest rates are probably close to the peak, although it is more likely than not that we will see further rate rises, given inflation is too high and sticky. However, the more important focus for the market should be on how long rates are likely to remain at these levels. Factors such as high oil prices and excess savings have persisted longer than expected, impacting economic growth dynamics. With upside risks remaining for inflation and wages, central bankers (in the US and Australia) are likely to maintain the hiking bias for some time, with expectations of easing in mid-2024 likely to be premature.

The market has recently seen a sharp move up in interest rates (especially for 10 year and 30 year debt). When long term interest rates rise faster than short term interest rates it is known as a bear steepening rally. A big sell off in bonds typically does not end that well as a consequence.

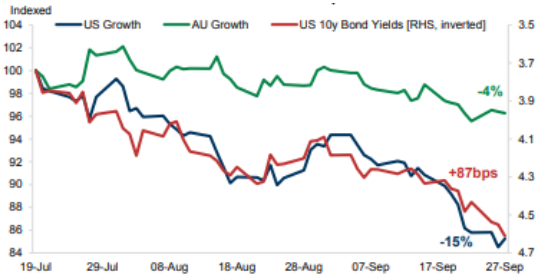
A rise in bond yields typically ends with a financial accident



Source: BCA Research

While US growth stocks (-15% since mid-July) have de-rated as bond yields have increased, their Australian peers (-4%) have seen only modest losses, performing broadly in-line with the Australian market.

Australia vs US Growth stocks performance



Source: Goldman Sachs Global Investment research, FactSet

We have noted previously that the valuation multiples of Australia's growth stocks (~35x 1yr forward price earnings ratio (fwd P/E)) were already trading at extremes relative to bond yields, but this recent move has stretched beyond historical bounds - current bond yields imply growth stocks are overvalued by 30-40% (depending on the time-frame).

Australia growth stocks performance vs bond yields

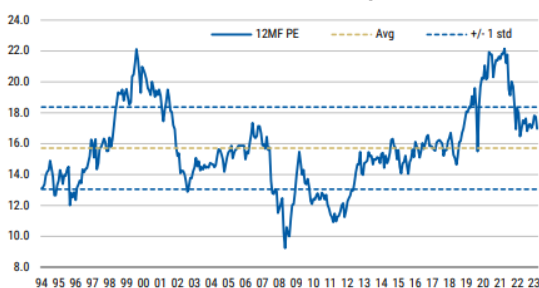


Source: Goldman Sachs Global Investment Research, FactSet

Being defensively positioned has been somewhat painful year to date, however we believe that markets are optimistically pricing the Goldilocks scenario whilst being complacent about key challenges, which include: 1) That the full impact of interest rate hikes is yet to be seen; 2) Persistent inflation; 3) China's economic recovery has been underwhelming; 4) Artificial Intelligence (AI) mania has prompted a significant rally in the "Magnificent 7" that has distorted valuations; and 5) Ongoing geopolitical risk (most recently further complicated by the escalation in the Israel-Palestine conflict).

The S&P ASX200 Industrials Total Return Index is currently trading at 12-month forward PE of ~17x, which remains elevated relative to history.

ASX 200 Industrials 12m forward price-to-earnings



Source: RIMES, IBES, Morgan Stanley Research

Overall, we continue to add to existing portfolio
DNR Capital Australian Equities Income Portfolio

positions in resilient quality companies that have recently underperformed the market despite delivering operationally good results and presenting good value on risk-reward metrics. These include CSL (CSL), IPH (IPH), Telstra Group (TLS) and The Lottery Corporation (TLC).

Potential changes to bank hybrids may limit capital management

The Australian Prudential Regulation Authority (APRA) recently released a discussion paper outlining options to improve the effectiveness of Additional Tier 1 (AT1) capital (also known as hybrids).

APRA's principal concern is that hybrids may not work as designed in a crisis and the authority wants to ensure AT1 capital can be used to absorb losses if needed, to build confidence in the system in times of stress. Current holders of these instruments are largely retail investors.

In the end, it is possible that APRA will change the design of AT1 instruments such that they are riskier from an AT1 investor perspective and result in a higher cost for issuers. If there is insufficient investor demand for the redesigned instruments, then the banks may need to hold more CET1 capital.

APRA has requested feedback on the discussion paper by 15 November 2023 and will formally consult on any proposed changes during 2024. Ultimately, we would expect there would be a transition period for the banks to comply.

The prospect of capital management is one of the potential positive catalysts for banks. Further to the risk of asset quality deterioration, this potentially provides another reason for bank boards to be conservative with regard to capital management.

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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